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Submission to the Productivity Commission Inquiry into Horizontal Fiscal Equalisation

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Introduction

This submission is about how transport infrastructure grants from the Commonwealth to the states are treated under the system of horizontal fiscal equalisation (HFE).

The submission focuses first on how the current HFE system creates perverse incentives and unintended consequences, which are consequential for the Australian community and economy.

The submission then addresses the question of options to treat transport infrastructure within a framework of HFE.

The focus of the submission is not the general merits of HFE in principle, but rather the processes by which it currently operates and their impacts.

1. Does the current HFE system create perverse incentives or unintended consequences for reform at the state level?

Transport infrastructure entails a degree of shared funding responsibility between the Commonwealth and the states. This is due not only to vertical fiscal imbalance but also to the importance of a strong transport network for the nation as a whole in addition to the state in which a particular piece of infrastructure lies.

But having two (or three) levels of government involved makes for complexity and the potential for perverse incentives.

This section focuses on two perverse incentives of the current system: the incentive for the Commonwealth to skew project selection, and the incentive for states to lobby for favourable classification of their projects. The following sections explain each of these incentives.

1.1 The incentive for the Commonwealth to skew project selection

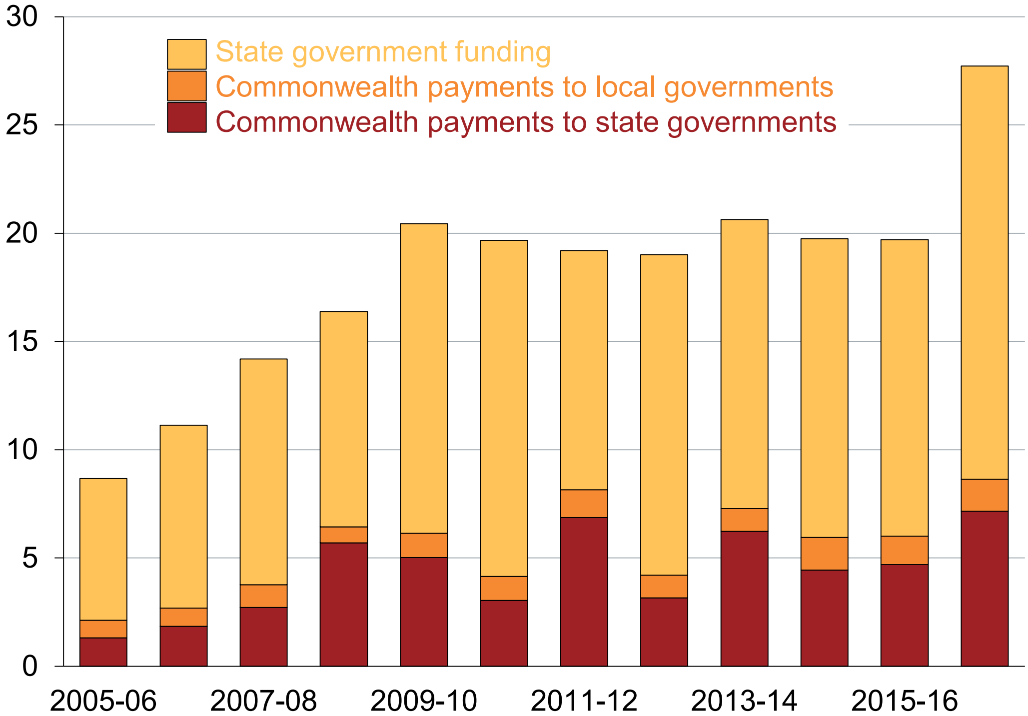
The Commonwealth does not itself build roads, railway lines, bridges, busways or tram routes. It contributes to such infrastructure primarily by granting funds to state governments.

Most of these grants are National Partnership payments. They are governed by rules established by the Council of Australian Governments. National Partnership payments for transport infrastructure specify a dollar contribution for a specific project, and are reported each year in the Commonwealth's budget papers.

The Commonwealth's contribution to the states for transport infrastructure under National Partnership grants constitutes one quarter to one third of states' spending on transport infrastructure (see Figure 1 below). In 2016-17, the Commonwealth is forecast to contribute \$8.6 billion, with the states collectively spending \$19.1 billion. At present, NSW and Victoria are spending heavily on transport infrastructure, while some of the smaller states are spending below their long-term average.

The Commonwealth's agreed role is to focus on transport infrastructure that supports the national economy, or is important beyond a single state's borders. It is also concerned with infrastructure spending because it is responsible for macro-economic management.[1]

Figure 1: The Commonwealth is a minority funder of transport infrastructure
Transport infrastructure spending, $billions, 2005-06 to 2016-17



Notes: Actual amounts used where available in following year's budget. Otherwise, budgeted amounts used.
Source: Grattan analysis of Commonwealth, State and Territory budget papers 2005-06 to 2016-17; Department of Infrastructure and Regional Development (unpublished).

But in practice, the Commonwealth's deep pockets have led it beyond infrastructure projects that are important to more than one state or are particularly important to the national economy. Because of its funding contribution, the Commonwealth has a substantial say in what is funded.

What actually happens is a skewing of spending to favour particular states, locations and projects, rather than a focus on pursuing national economic growth and productivity. The rest of this section outlines three ways in which the Commonwealth has sought to skew project selection away from its agreed focus on nationally important or multi-state transport infrastructure.

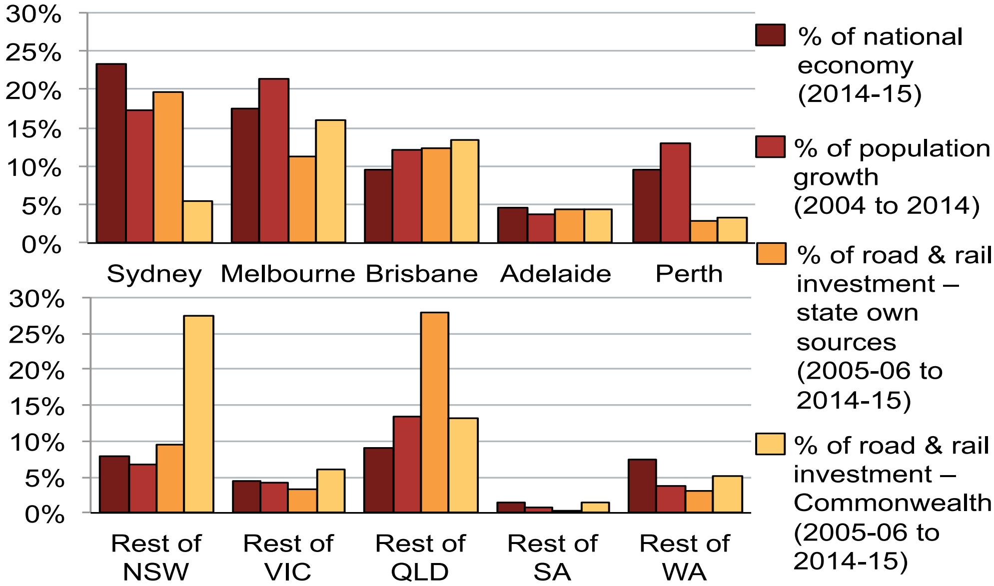
[1] Council on Federal Financial Relations (2011), schedule E, p.E-4

1.1.1 Too little of the Commonwealth's investment has been in cities

First, the Commonwealth has under-emphasised transport infrastructure in the large cities, despite the fact that they are the engines of national economic growth. Even in the mining boom, most economic activity and economic growth occurred in cities. Our largest cities face increasing congestion and competition between passengers and freight.

But instead of concentrating its investment on new infrastructure in large and fast-growing Sydney, Melbourne, Brisbane and Perth, the Commonwealth has instead spent disproportionately outside the capital cities in New South Wales and Queensland (Figure 2).

Figure 2: More was spent in the country than in capital cities



Notes: Road and rail investment is over the 10 years from 2005-06 to 2014-15. Road and rail investment excludes private sector contributions to public-private partnerships. If included, the urban share of spending would be slightly higher.
Source: Grattan analysis of Commonwealth and State budget papers 2005-06 to 2014-15; ABS (2015j); SGS Economics & Planning (2015); Department of Infrastructure and Regional Development (unpublished)

1.1.2 The Commonwealth has sought to overrule state government decisions

Second, the Commonwealth has attempted to skew project selection by seeking to overrule decisions by incoming state governments. There has been $3 billion in the contingency reserve for East West Link since the 2015-16 Budget, for "the first Victorian government willing to build the East West Link". This is an attempt to skew project selection and override the Victorian government's decision to abide by its election commitment to cancel the project. [2]

Similarly, the 2016-17 Budget included in the contingency reserve $1.2 billion for "the first Western Australian government willing to build the Perth Freight Link".[3] This, too, is an

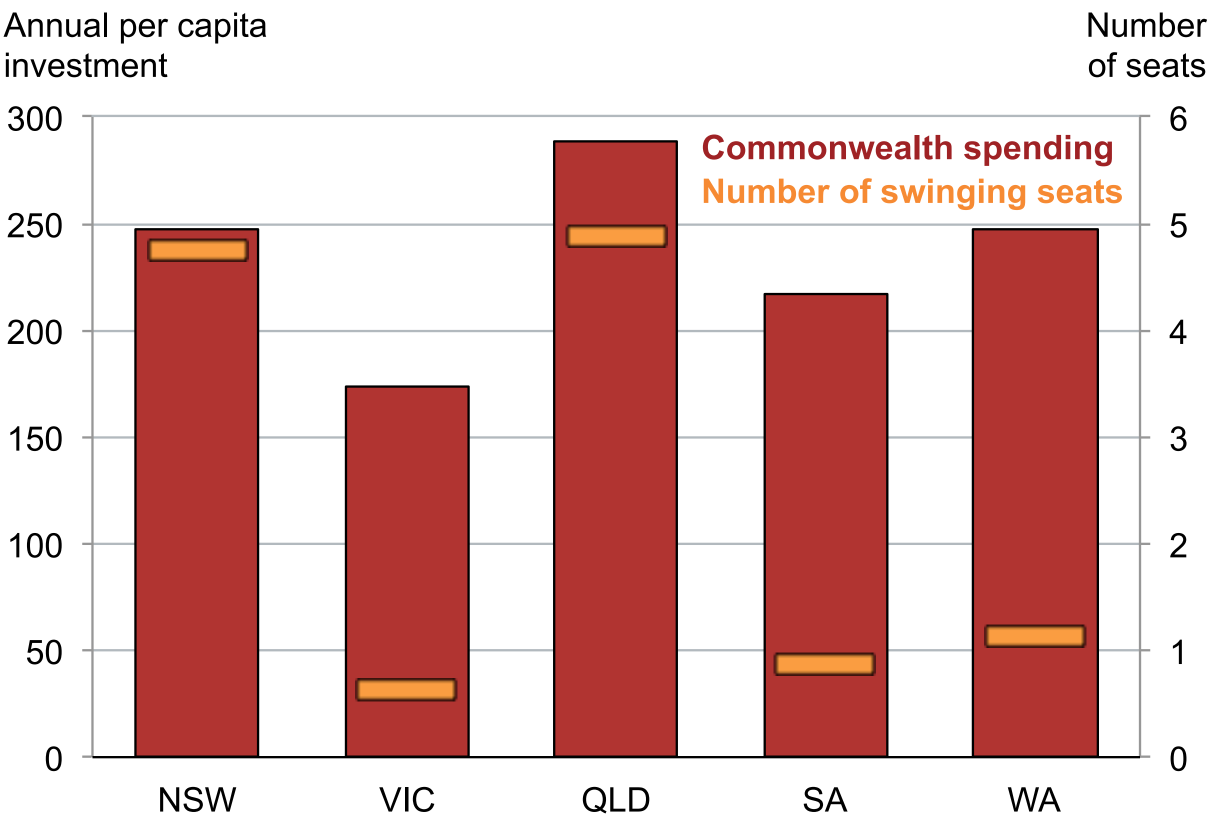
[2] http://www.budget.gov.au/2017-18/content/bp1/download/bp1.pdf, page 9-33.
[3] http://www.budget.gov.au/2017-18/content/bp1/download/bp1.pdf, page 9-33.

attempt to skew project selection in the face of the incoming Western Australian government seeking to abide by its election commitment to cancel the project.

1.1.3 The Commonwealth has consistently spent more in Queensland and New South Wales

Third, the Commonwealth has consistently spent more of its transport infrastructure dollar in New South Wales and Queensland. The significance of these states is that recent federal elections have been won and lost because a sizeable number of New South Wales and Queensland seats changed hands (see Figure 3).

Figure 3: The Commonwealth spends more on transport infrastructure per capita in swing states
Average annual per capita Commonwealth spending on transport infrastructure, 2005-06 to 2016-17, dollars
Average number of seats contributed to swing over the past seven federal elections (1996 to 2016)



Notes: Spending includes amounts paid directly to local government. The seats measure is the number of extra seats won in each state, by the party that made an overall gain at the election (i.e. Coalition 1996, 2001, 2004, 2010, 2013. Labor 1998, 2007, 2016).
Source: Grattan analysis of Commonwealth budget papers 2005-06 to 2016-17; AEC ; Department of Infrastructure and Regional Development (unpublished).

In the past seven federal elections, one of the major parties gained an average of five seats from the other in each of New South Wales and Queensland. By comparison, Victoria has very little influence on federal election results, despite containing a similar number of seats to New South Wales and Queensland. Victoria has, on average, contributed only one seat to the swing in the past seven elections, and never more than three swing seats.

These arguments are laid out in further detail in *Roads to Riches,*[4] which focussed on the size of, and outcomes from, government investments in transport infrastructure. It found that the large increases in spending on transport infrastructure over the past decade have not been spent wisely. While state governments are the dominant funders of transport infrastructure, Australia's horizontal fiscal equalisation processes gives the Commonwealth a prominent role in infrastructure project selection. This is undesirable given the evidence that this role has been used to further political goals at the expense of economic growth and productivity.

1.2 The incentive for states to lobby for favourable project classification

Although the Commonwealth selects a suite of projects to fund each year, the GST redistribution methodology partially unravels the effects of Commonwealth decisions to fund more transport infrastructure in one state rather than another. The methodology reduces subsequent GST payments to a state that has received a disproportionate share of transport funding in previous years. In effect, the CGC recommends an end result as if the transport project funding were just added to the GST pool.

If this methodology were applied across the board, individual states would not benefit financially from particular infrastructure decisions by the Commonwealth – although there is obviously a political advantage to the profile given to an individual project.

However, there are two sources of variation from this treatment. The first is for a project to be classified as part of the National Land Transport Network, and the second is for a project to be carved out entirely from consideration in the distribution of the GST.

1.2.1 A 50 per cent exemption for projects on the National Land Transport Network

A new system has come into effect in recent years, with the effect that there are now two different treatments of Commonwealth transport infrastructure payments to the states.

If the infrastructure is outside of the National Land Transport Network, any Commonwealth payments for infrastructure reduce that state's GST share, as has been the arrangement historically. Off-network infrastructure includes urban passenger rail, urban arterial roads, urban local roads, and rural roads other than the major highway links. The effect is that if one state receives more than its share of off-network funding, it gets a smaller GST share over the third, fourth and fifth year after the payment – that is, the GST distribution unravels the Commonwealth's funding decisions.

On the other hand, if the infrastructure forms part of the National Land Transport Network, half of the Commonwealth payment is quarantined from GST calculations. The other half is counted, and reduces the state's share of GST over years three, four and five following the

[4] Terrill, M., Emslie, O. and Coates, B. 2016, *Roads to riches: better transport investment*, Grattan Institute, https://grattan.edu.au/report/roads-to-riches/.

grant. The Network consists of the most important roads and railway lines linking capital cities, major centres of commercial activity and/or intermodal transfer facilities. The Network, including additions and deletions, is determined under Commonwealth law by the relevant minister.

This 50 per cent quarantining arrangement came into effect for roads in 2010 and for rail in 2015. [5]

It provides a state with an outcome that is more favourable for National Network than non-National Network infrastructure. Payments by the Commonwealth to local government are fully exempted, and do not affect the GST shares. This complexity makes a system where few – including politicians – can appreciate the real impact of decisions.

Typically around three quarters of Commonwealth grants to states relate to projects on the National Land Transport Network.[6] For example, Victoria received $1.9 billion between 2012-13 and 2014-15 for the Regional Rail Link, which is not on the National Network. As a result, its GST payments for 2015-16 and the following two years would have totalled $1.5 billion less, and the GST payments for other states and territories would have correspondingly been $1.5 billion more.[7] If the project had have been part of the National Network, only $0.95 billion[8] would have been redistributed from Victoria to the GST grants of other states.[9]

States only really receive a long-term advantage from Commonwealth funds for projects that are designated as part of the National Network. Over the past decade, these projects were even more skewed in favour of New South Wales and Queensland than total Commonwealth funding for transport infrastructure (shown in Figure 4 on the following page).

The special treatment of spending on the National Network is only justifiable if it is limited to nationally important roads and railway lines. The National Network legislation prescribes that it applies to roads and railway lines that connect capital cities, major centres of commercial activity, and/or inter-modal transfer facilities.[10]

But in reality, while there are roads and rail lines on the National Network are certainly important, others in fact carry very little freight or passenger traffic.[11] For instance, the National Network includes the 89-kilometre Princes Highway West, a spur from Geelong to

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[5] The 50 per cent discount has come into effect in stages. Since 2010, the Commonwealth Grants Commission has quarantined 50 per cent of payments for National Network roads projects from affecting GST shares. In the supplementary terms of reference for the 2015 review, the then Treasurer directed the Commission to quarantine 50 per cent of Commonwealth payments for seven specified roads from affecting GST shares. The Commission decided in that review to apply the same treatment to National Network rail as well.

[6] For more details, see *Roads to Riches* Appendix B.

[7] The amount transferred is effectively 1 minus 22 per cent, Victoria's normal share of GST payments.

[8] That is, half of $1.9 billion.

[9] Commonwealth Grants Commission (2015a), Volume 1, page 3

[10] *National Land Transport Act 2015*, Part 2, Division 5

[11] *National Land Transport Network Determination 2014*

Colac. [12] While Geelong is an important centre of commercial activity, it is hard to see how Colac, with a population of 11,939 and no heavy industry, could qualify as a transport hub or commercial centre. While some traffic from beyond Colac uses this section of road in transporting freight to Melbourne, its total use, measured as vehicle kilometres, is much lower than most other National Land Transport Network roads.

Figure 4: A significant portion of Commonwealth transport spending is washed out by GST payments

Average annual amount of Commonwealth transport infrastructure payments to state and local governments, by state, per capita, 2011-12 to 2014-15

Notes: The 'exempt from distribution' amount is calculated as 50 per cent of National Network payments plus all payments to local governments. This analysis examines the way the 2015 method would have affected GST shares if the new treatment had been established in 2013.
Source: Grattan analysis of Commonwealth budget papers 2005-06 to 2014-15, Department of Infrastructure and Regional Development (unpublished).

The incentive that this arrangement creates is for states to lobby for roads and rail lines in their state to be included in the *National Land Transport Network Determination 2014*, so that they keep a larger share of the payment.

[12] National Land Transport Act (2014a), Part 2, Division 5.

1.2.2 A full exemption for other projects

Even more special treatment applies to the $490 million given to Western Australian in the 2015-16 budget. Unusually, this money was given without specifying at the time which projects it was for, other than “roads”. This infrastructure funding has no effect at all on GST distributions – the full amount sticks where it hits.[13]

2. What preferable alternatives are there to the current HFE system of equalising states’ fiscal capacities?

Transport infrastructure operates as a network, and it makes sense to have some national involvement in the network. National elements include those that cross state boundaries, are important not just to the state that they are in, or that are particularly critical to the national economy, even if located in a single state.

But the current approach is opaque, even to some decision-makers. This allows room for grants to states to be treated more or less favourably on grounds that are not consistently applied, giving rise to perverse incentives for both states and the Commonwealth.

There are two options to reduce the opacity and perverse incentives, and both entail a consistent treatment.

One approach would be fully include all Commonwealth transport infrastructure payments to the states in the calculation of GST shares. This would mean reverting to an older approach. This makes sense if the Commonwealth’s decisions are liable to be biased by electoral rather than economic or social criteria. This treatment would mean that no state ultimately got more than its fair share, in terms of being able to provide better levels of amenity than another.

A second approach would be to fully exempt all Commonwealth transport infrastructure payments to the states from the calculation of GST shares. In other words, these payments would “stick where they hit”. This approach would make sense if the Commonwealth restricted its funding to those projects that were nationally important or important beyond a single state’s borders. A more contestable process for infrastructure to gain National Network status could assist with such an approach.

These arguments are covered in more detail in *What price value capture?*[14] This report examined the Commonwealth government’s ability to create incentives for state governments to implement effective value capture charges as a source of transport infrastructure project funding. While they are not the only barrier to implementing efficient and fair value capture charges, the report noted that existing horizontal fiscal equalisation processes effectively limit the Commonwealth’s ability to pursue its policy goals to the extent that these apply to infrastructure outside the National Network.

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13 https://www.cgc.gov.au/index.php?option=com_docman&view=document&Itemid=509&layout=default&alias=864-u2016-terms-of-reference-pdf&category_slug=u2016-terms-of-reference.

14 Terrill, M. and Emslie, O. (2017). *What price value capture?*. Grattan Institute, https://grattan.edu.au/report/what-price-value-capture/

Conclusion

This submission has argued that there is clear evidence of biased Commonwealth decisions. Until there is a more disciplined and fair approach to the allocation of Commonwealth transport infrastructure funding, the case is strongest for all relevant payments to be fully included in the assessment of GST shares.