THE REVIEW OF HORIZONTAL FISCAL EQUALISATION

By Way of Introduction

For at least the last three decades the more prosperous States have been

The Same Capacities or Comparable Capacities (Chapter One)

^ d Z W v o t] v š t g e whether providing comparable capacities for States would be an approach more suitable to current challenges than ‰ Œ } À]] v P u š Œ] o o Ç š Z • u ‰] š] • _ X

In other words the Panel wishes to hear argument about whether an inferior form of equalisation is to be preferred to a superior form of equalisation. This can only make sense if you believe that equalisation is inconsistent with some other (unspecified) higher order objective. Without knowing what that objective might be it is difficult to mount an argument.

In the course of its investigations the Panel needs to bear in mind that equalisation has never been anything more than a noble aspiration. It is not as if the methods employed by the Commonwealth Grants Commission have ever actually produced outcomes which match the aspiration.

For almost 40 years the Commission used the modified budget approach which concentrated effort on the main State expenditure areas of education, health and public order, making use of whatever inadequate data was available. Significant areas of State activity were left unexamined. And it was stated explicitly by one of the first Commissioners, Professor Giblin, that the claimant States were expected to make a greater effort than the standard States to raise revenue and to achieve greater efficiency in the delivery of services before they could expect equalisation payments.

With better data and the change to the direct assessment method in the early 1970s equalisation became more rigorous and more contested, obviating the v (} Œ '] o] v [• (( ]] v Ç] became apparent that the o • } concept could be taken only so far and in more recent times the Commission has abandoned attempts to extend its methodology to functions which do not lend themselves to assessments of need and has reverted to a simpler and more broad brush approach.

What has remained throughout, although sometimes stated in slightly different language, has been the aspiration that the Australian States should be able to provide to their citizens broadly the same level of public services.

What is now in contemplation is that we should abandon equalisation even as an objective. So fragile are the bonds of Federation (the Interim Report suggests) that they may burst asunder unless we treat some States better than others.

No longer can a young Aboriginal person in the Northern Territory expect the same educational opportunities as another young person living across the border in Western Australia or Queensland. No longer can elderly South Australians in need of hospital treatment expect access to the same standard of care as elderly people living in Victoria or New South Wales. And in the name of what principle? In pursuit of what objective?

Some clues are given at the bottom of page 22 of the Interim Report where the ‰ Œ • v š Œ Œ v P u v š • Œ • Œ] therefore } u ‰ o Æ U } % v } š P Œ } Œ v } š Á o o µ v Œ • š } } X _ / š] • š Œ µ š Z š are complex and not well understood. So is the modern internal combustion engine but that is not a reason to change it. If people bother to make the effort they can master the equalisation methodology just as they can master the internal combustion engine. Most of them are too sensible to try because they are content with the outcome.

d Z µ • } (š Z Á } Œ ^ } ‰ ‹ µ _] • µ v (} Œ š µ v š X / š] u ‰ o methodology is not clearly expressed which is not true. A better word might be ^ • } š Œ] _ Á Z] Z] u ‰ o] • š Z š] (Ç } µ Á] • Z š } µ v Œ • š some effort. As I have suggested in the previous paragraph, this is not a reason to abandon or undermine an important process.

d Z } • Œ À š] } v š Z š š Z ‰ Œ • v š Œ Œ v P u v š • Œ obvious rejoinder. Exactly what arrangements do you think might be agreed? It is a zero sum game. There will never be agreement.

At the foot of page 22 appears also the following statement:

^ & µ Œ š Z Œ u } Œ U } š Z] v š Œ v š] } v o Æ ‰ Œ] v v show that something considerably less than pursuit of absolute equality between jurisdictions can result in a fair outcome and produce confidence in & Œ o ( ] v v] v P Œ Œ v P u v š • X _

Let us examine international experience. The report touches on the equalisation arrangements in Canada and Germany. Admittedly, neither Federation seems on the verge of collapse but whether this means their equalisation arrangements result in a fair outcome and produce confidence in Federal financing arrangements is not readily apparent. The United States of America is also a Federation which appears remarkably cohesive but I sincerely hope we are not invited to conclude from this that its Federal financing arrangements are a suitable model for imitation.

The proper conclusion is that different Federations have widely different histories and widely different approaches to reconciling State autonomy, regional equity and national cohesion. It would be reckless in the extreme to imagine that what works elsewhere will work in Australia where mateship and the fair go still resonate and where the national Government has immense power relative to the States.

Returning to Australia, you assert that our own past practice shows that ‰ µ Œ • µ] š } (• } u š Z] v P ^ } v •] Œ o Ç _ o • • š Z v • } o µ fair outcome. I make two observations. Firstly, I do not accept that we have ever pursued something considerably less than equality. Even if the outcomes have been something considerably less than equality the aspiration has always v u µ Z o } • Œ š } ‹ µ o] š Ç š Z v u Œ ( ] v Œ v • • M X ^ } v The notion has as many possible interpretations as there are commentators. Judging by the frequently bitter reaction by the claimant States to past recommendations of the Commonwealth Grants Commission, they certainly did not regard the outcomes as fair.

I do not understand why the Panel would fear equality. In this context we are talking only of equality of opportunity. How can this be a bad thing? We are not discussing equalisation of wealth or incomes. Wealthy Western Australians can still buy their yachts and jewellery and have expensive holidays as can wealthy Australians in other States. They can send their children to private schools and be admitted to private hospitals. None of these things are being equalised. All HFE does is give those who are not wealthy a fair chance in life.

Predictability and Stability (Chapter Two)

Predictability and stability in State general purpose funding requires two things. It requires the size of the pool available for distribution to move predictably and in a stable fashion and it requires State shares to do the same. The former seems unattainable since it would require State entitlements to be decoupled from GST revenues and determined by some variant of the old Financial Assistance Grant formula. I do not hear any State Premier clamouring for a return to the old days. In truth they prefer a bit of unpredictability if it is the price to be paid for a pool which grows reasonably quickly.

This leaves us with trying to find a way to stabilise State shares. One approach would be to set Z ^ š š [• • Z Œ } (š Z ‰ } } o] v À v (} Œ based on projections by the Commonwealth Treasury of likely movements in their needs over that period. In the meantime the Commonwealth Grants Commission could hear submissions from the States about its methodology and crank the numbers in preparation for the next three year period. The new relativities so produced would form the basis for the next set of Commonwealth Treasury projections. For the sake of simplicity, there would be no retrospective adjustments for winners and losers over each three year period.

Such an approach would be less equitable but more predictable. Which is the preferred objective?

Simplicity (Chapter Three)

If it were possible to equalise just as effectively and more simply that would be a good thing but given the intellectual resources poured into the topic of equalisation over the last 80 years do you consider it likely that such an improvement is possible? Do you not find it instructive that the only parties arguing for simplification are the same parties arguing for less equalisation?

If, as seems certain, the price to be paid for simplification is less effective equalisation one might reasonably expect those advocating simplification to advance some estimate of the benefits to be derived from simplification. Based on the arguments in your nineteen page chapter on this subject these benefits are all but invisible to the naked eye. True it is that commentators would not

have to work so hard to understand the Grants Commission methodology but compared with the advantages of equalisation for needy people this seems a trivial benefit.

It is argued that a simpler process would be less resource intensive. Well, it is not compulsory for the States to devote resources to equalisation. If they think it is unimportant, by all means direct their efforts elsewhere. The plain fact is that equalisation is a critical issue involving huge sums of money and requires adequate resources to be properly delivered. Unsurprisingly no State takes the topic lightly. At the national level the resources devoted to the task are insignificant.

A more valid argument is that excessive complexity may occasionally imply a spurious sense of accuracy but that is a matter of methodology which should properly be argued before the Grants Commission as it has been in recent times with considerable success. The sensible course for the review would be to point out this fact and to leave it to the Grants Commission to decide in consultation with the interested parties. To seek to substitute your judgement (} Œ š Z } u u] • •] } v [• } v u š š Œ • } (u š Z } } o } P Ç Á } µ o of inappropriate detail.

The Interim Report says the Panel's Z] P Z o Ç š š Œ š _ š } š Z µ • } (indicators. I have no informed comment to make on the expenditure side but on the revenue side I think you are overlooking one fundamentally important structural issue. That is the level of vertical fiscal imbalance in the Australian Federation.

If we were discussing a Federation in which the States had access to a wide range of taxation powers there would be some force in the argument that rather than focus on actual tax bases (what States do) it would be better to focus on potential (broader) tax bases. But as we all well know, and particularly Messrs. Greiner and Brumby, the Australian States have fewer tax powers than any of their counterparts in comparable Federations. They do not have access to broad tax bases and that is why they impose the taxes they do including inefficient taxes. To compare their taxable capacities by reference to broad tax bases would be grossly unfair.

The point can be illustrated by reference to one of the examples given in the Interim Report, insurance taxes. If I correctly understand the proposition, it is that the capacities of the States to raise revenue from this source would be measured by reference to personal incomes, the justification being that ultimately such taxes become a burden on individuals. This would be an appalling injustice. Many large corporates pay their insurance in Sydney and Melbourne so that the relevant stamp duty is collected by the NSW and Victorian Governments. It is then passed on to customers throughout the nation so that the burden is more or less equally distributed at the individual level. The other States have much less access to this revenue stream and so would be required to make up for their lower revenue raising capacities in this area by imposing other taxes on their citizens (if such taxes could be found) or by imposing other taxes at higher rates. This would be profoundly unfair and at odds with the whole principle of HFE.

Broad indicators such as personal income may not be unreasonable for some revenue raising measures which fall directly on resident individuals although even there they have limitations, but they are almost never appropriate for taxes which fall initially on businesses and only indirectly on individuals.

Returning to my main point, it should be glaringly apparent that simplicity is being used as a stalking horse by those with a vested interest in less equalisation or a philosophical objection to the principle of HFE. A useful principle for the review to adopt might be to confine its attention to simplification proposals supported equally by those who support equalisation and those who do not. Then you can be reasonably certain that simplicity is the real objective.

Efficiency (Chapter Four)

I think your chapter on the possible efficiency effects of equalisation is very good. The only disappointing part is where you express the view that notwithstanding the lack of any evidence of the disincentive effects of ‹ µ o] • š] } v ^ Y š Z } v ideas to spread that all practical options to reduce or eliminate them must be explored X Z Speaking for myself, I have never in my 67 years had a business executive or a professional engage me in conversation about the disincentive effects of equalisation. And even if I

had, since they would be unlikely to be able to produce evidence in support of their argument, why should I take a blind bit of notice of them? The only people confecting outrage are those with a vested interest. They should be ignored.

I note that you intend to explore the practicalities of equalising to an external standard. If you really must, I urge you to focus first and foremost on revenues from mining where our Governments have been failing miserably to secure for the Australian people an appropriate share of the mining boom.

Other Commonwealth Payments to the States (Chapter Five)

I think this chapter also is very good and in particular the conclusion that the default position should be for other Commonwealth payments to be equalised. I agree with my great friend and former colleague Mr. Emery and with the Panel that there are exceptions to be made for nationally significant projects but have no useful guidance to offer on how to distinguish such projects from others (although expenditure on roads generally seems an unlikely candidate).

The Mining Boom (Chapter Six)

My knowledge of the situation in Canada is not contemporary, but as it happens, I was working on secondment to the Alberta Treasury in 1981 at the š] u } (s quinquennial review of fiscal equalisation. Under the Canadian system of equalisation at that time there was no predetermined pool of revenue to be shared between the provinces. Rather, the Federal ' } À Œ v u v š š } ‰ ‰ µ ‰ š Z } š Z Œ ‰ Œ } À] v • š } š Z o provinces in a way closely analogous to the claimant State phase of Australian equalisation. Because of its fabulous oil and gas resources Alberta was one of the standard provinces. These resources were raising the standard to such heights that the Federal budget was coming under stress as a result so it was decided to discount the mining revenue base for equalisation purposes. But even this did not solve the problem so in 1981 the decision was taken to make Ontario o } v š Z • š v Œ • } š Z š o Œ š [• }] o v . P • Œ • } µ Œ

More to the point, the circumstances were entirely different from the current situation in Australia and have no relevance. In the first place there was the ethnic divide . The province of Quebec was openly hostile to the Federal

Government in a way and to an extent not conceivable to an Australian. The people of Alberta had an active distrust of the Federal Government derived partly perhaps from their history of near bankruptcy in the 1930s (before the discovery of oil and gas) and stoked into flame by periodic attempts by Ottawa to secure a greater share of tax [illegible] resources. In the second place the level of VFI was much less than in Australia, leading to a mindset amongst Canadians even in the poorer Maritime provinces that the solution to their problems should be sought first within their own province rather than nationally. In the third place the equalisation process was confined to differences in revenue raising capacity and excluded entirely any assessment of expenditure needs. While equalisation was important to the poorer provinces it fell far short of the strong commitment to national unity and regional equity which exists in Australia.

You suggest that discounting the mining revenue assessment or excluding some mining revenue might be a means of addressing some of the concerns about unmeasured needs in relation to mining related infrastructure or expenditure. Well, yes it might, but probably an unsatisfactory one. If there are deficiencies in the way these expenditures are dealt with in the equalisation process I urge you to tackle them directly and not try to offset one unsatisfactory process with another.

I agree that the current two-rate structure needs to be reviewed. There may be a case for an external standard to be applied to all mining revenue given the generally unsatisfactory nature of State royalty regimes.

Indigeneity (Chapter Seven)

I have strong views about this issue.

Where people of Aboriginal and Torres Strait Islander heritage live in towns and cities and have access to the mainstream economy and the full range of State public services I think the equalisation process works satisfactorily and the only issue is to arrive at the appropriate disability factor (if any) for indigeneity.

Where Aboriginal and Torres Strait Islander people live in remote communities the needs are so enormous and the problems so intractable that fiscal

equalisation is not an adequate mechanism for dealing with them. Providing States with the capacity to deliver to these people the same level of services as to the rest of us is not sufficient. If common humanity is not argument enough, š Z u P š } µ • š Œ E o] [• • š v] v P] v š Z] v š Œ v š] } v (the abject circumstances in which so many of these people live demands action by the national Government.

My suggestion is that the Commonwealth Government assume more direct responsibility for all such communities and that funding for them be removed from the untied grants process. The Commonwealth Grants Commission could continue to assess needs for the delivery of services to these remote communities but the funding of such needs would be by way of special purpose grants tied to expenditures which meet these needs and not available for other purposes. Furthermore the additional funding required to bridge the gap between their standard of living and ours should be quarantined from the equalisation process. This is not the same thing as saying a parallel system of service delivery is necessary. There is no obvious reason why States should not continue to deliver the required services but the funding of those services would be by direct, acquitted and supervised specific purpose funding from the Commonwealth budget.

Should this approach to service delivery not work a parallel system of service delivery may become necessary but the immediate and pressing task is to improve the standard of living of these people and over time to bring them into the mainstream economy. The untied grants process is not designed for this task.

We cannot afford to be too concerned about State sensitivities or transitional problems. This is a critical national problem which is adversely affecting the reputation of all of us and must be addressed as a priority.

Governance (Chapter Eight)

It is incongruous that HFE is not defined in the Commonwealth Grants Commission Act. I point out however that to define it as anything less than full equalisation (for example, to specify comparable standards) is not to define it

at all. A requirement for the Commission to achieve comparable standards allows fora very wide range of possible outcomes including full equalisation.

Even a requirement for full equalisation will allow the Commission to achieve a diverse range of outcomes depending on its preferred methodology.

It is hard to find an objection in principle to periodical reviews of the } u u] • •]s } v [effectiveness in achieving its legislated goals. However I point out that the recommendations of the Commission and its methodology are probably the most scrutinised in the country. Furthermore those undertaking the scrutiny are in a position to make changes to the legislation governing the Commission if changes are considered necessary. I find it difficult to identify the value which reviews by another body would contribute and fear we may be contemplating process for its own sake.