

**AUSCRIPT AUSTRALASIA PTY LTD**

ABN 72 110 028 825

Level 6, 114-120 Castlereagh St SYDNEY NSW 2000

PO Box A2405 SYDNEY SOUTH NSW 1235

Tel:(02) 9238-6500 Fax:(02) 9238-6533

**TRANSCRIPT OF PROCEEDINGS**

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**COMMONWEALTH GRANTS COMMISSION**

**MR ALAN MORRIS, Chairman**  
**MR ROSS WILLIAMS, Commissioner**  
**MR GLENN APLEYARD, Commissioner**  
**MRS HELEN OWENS, Commissioner (Apology)**

**COMMONWEALTH GRANTS COMMISSION/  
HEADS OF TREASURIES CONFERENCE  
2010 REVIEW**

**SYDNEY**

**9.11 AM, THURSDAY, 24 NOVEMBER 2005**

### **Australian Treasury**

Mr David Tune (Apology)  
Mr Michael Willcock  
Ms Michelle Dowdell  
Mr Brendan McKenna

### **NSW Treasury**

Mr John Pierce  
Mr Robert Carling  
Mr Bruce Freeland  
Mr Tim North  
Ms Medha Gupta

### **VIC Treasury**

Mr Ian Little (apology)  
Mr Peter Dawkins  
Mr Jeff Byrne  
Mr David King

### **QLD Treasury**

Mr Gerard Bradley  
Mr Gary Ward

### **WA Treasury**

Mr Tim Marney (apology)  
Mr David Smith  
Mr Mark Altus  
Mr Alex Scherini

### **SA Treasury**

Mr Jim Wright  
Mr Robert Schwarz  
Mr John Henderson

### **TAS Treasury**

Mr Don Challen  
Mr Rob Nicholl  
Ms Wendy Sawford  
Mr Alex Tay

**ACT Treasury**

Mr Paul Grimes  
Mr Roger Broughton  
Mr John Purcell  
Mr Andrew Phillip

**NT Treasury**

Ms Jennifer Prince  
Mr Tony Stubbin  
Mr Bruce Michael

**Commonwealth Grants Commission**

Mr John Spasojevic  
Mr Malcolm Nicholas  
Ms Catherine Hull  
Mr Marc Boisseau  
Mr Lintong Feng  
Ms Priscilla Kan

**2010 REVIEW  
COMMONWEALTH GRANTS COMMISSION / HEADS OF TREASURIES  
CONFERENCE**

**Premier's Conference Room, Level 41, 1 Farrer Place, Sydney**

**24 November 2005**

**AGENDA**

**OPEN: 9.00 AM**

**A. MAIN MEETING**

- (1) OPENING STATEMENTS**
- (2) MATERIALITY**
- (3) RELIABILITY**
- (4) EARLY IMPLEMENTATION**
- (5) STATE TAXES**
- (6) OTHER BUSINESS (if any)**

**B. LUNCH DISCUSSION**

- (1) THE PRINCIPLES THAT SHOULD GOVERN HFE POST 2010**

**CLOSE: 2.30 PM.**

THE CHAIRMAN: Good morning, everyone. I think we should get underway. I understand that the ACT Treasury representatives will be here in just a matter of minutes. The Commonwealth Treasury people will not be here for perhaps a half an hour. So there is some incentive for us to move quickly through the events of the morning I think. But I don't think we should be penalised by rewarding those who are tardy. So if it's acceptable you we will get underway.

First of all, can I welcome you to this conference and I do want to thank you very much for agreeing to participate. We have tried to make this as easy as possible by back-to-backing it with your Heads of Treasury meeting tomorrow, but even so I do appreciate that it is something of a strain to take another day for this kind of process. We think it's important enough to warrant that and I am grateful to you that you are able to participate.

I do have a couple of apologies from the Commission. I have an apology from Helen Owen. I think most of you are aware of Helen's situation. I also have an apology for Ian Little. Ian is not able to be here for reasons that I consider to be entirely justifiable. I also have an apology from David Tune. I'm not sure whether that's as justifiable but he won't be with us.

And I would like to welcome a few people who are having their first taste of this kind of process. For the Commission, if this is not Glenn Appleyard's first such meeting but it is his first sitting on this side of the table, and all of the values and principles which he held so dear for all those years are about to be shattered in the space of the morning. So welcome to Glenn.

I can't welcome Paul Grimes or Michael Willcock because they're not here, but I can welcome Peter Dawkins from Victoria who's representing Ian Little. Peter, welcome indeed and we look forward to your participation.

I understand the meeting will need to conclude no later than 2.30 as you move into other things. This conference is an important part of the work program that the Commission has set in consultation with all of the states. It particularly follows the release of our Issues Paper on Materiality and Reliability, the State submissions in response to that paper, and of course the work of the Data Working Party. We are very grateful for State input to date through submissions that we've received and for your participation in the Data Working Party.

My letter of 28 October, together with its attachment, sets out the Commission's broad thinking on most of the key issues. So it really isn't necessary for me to lay all of these out again in an opening statement.

The structure of the day. For the morning I hope we can deal with the issues of Materiality, Reliability, Early Implementation, and State Taxes. I also think we should briefly discuss some data issues which are not on the agenda that I

circulated and I propose to do this as the last item on the morning's agenda. At lunch we have the opportunity for a broader discussion about the principles that should govern our recommendations implementing fiscal equalisation post-2010. You will recall that I did indicate in my meetings with you earlier this year that I thought an opportunity for a first general discussion on the wider issues would be appropriate and I confirmed this in my October letter.

We propose that all of the discussions today will be on the record. That includes the discussions at lunchtime. A transcript is to be kept and will be circulated to all of the States and the Australian Government. While the lunch discussions are preliminary, we think there is value in having a clear record of reviews, even at this early stage.

The focus of course for today is responding to the terms of reference and particularly to their requirement that the Commission move to simplify its procedures. The Commission first indicated in its 2004 report that it believed that changes needed to be made. And this thought was confirmed through the Heads of Treasury process last year and in the way in which the 2010 Review terms of reference have been structured. Simplification is required by the terms of reference and the Commission both accepts and agrees that this is appropriate.

The question though is why simplify? We haven't seen simplification as the end but rather the means to an end. We regard the end as strengthening the robustness of our work, giving greater confidence in the results, and strengthening the acceptance of horizontal fiscal equalisation in Australia. We're not approaching this work on the basis that there is a trade-off between simplification and equalisation. Our objective is to deliver equalisation but in a simpler and more robust way.

So our approach for the first two years is to focus on data quality, the overall structure, and the guidelines that we should adopt for our review. In subsequent years leading to 2010, we would work on the more specific issues associated with particular assessments and assessment issues.

While the terms of reference require us to report separately in February 2006 and 2007, the issues we are asked to address in each of these years don't stand alone. There is an obvious inter-relationship between materiality and data issues on the one hand and aggregation on the other. We aim to report on materiality and reliability in 2006, as required by the terms of reference, including setting out some proposed assessment guidelines to use in disaggregation. In 2007 we will report on the outcome of our work on disaggregation and on any modifications to the guidelines that become evident as we do that work in consultation with the States.

In my letter of 28 October I set out the Commission's views on issues such as starting with a clean slate, taking a top-down approach to disaggregation, our

thinking on early implementation, and on data quality. This morning's agenda provides an opportunity for these key issues to be considered. But I need to make the point that, taken together, these have potentially large implications for the way the Commission goes about its work. We don't think this review will be just more of the same. We think it will require quite different ways of proceeding and in looking and assessing the issues that are required to deliver equalisation.

Before I ask my colleagues if they want to add anything to those remarks, can I just say how much we appreciate, John, that you've made these facilities available to us and I understand the cooperation that the staff have received in doing those extraordinarily challenging administrative things has been first class. So thank you very much for all of that.

I've been warned that the acoustics in this room are very bad. That of course may be a very good thing, but when you do feel moved to intervene, would you please do so loudly and clearly and lean, albeit in an ungainly fashion, towards the microphone. That will help. We're proposing morning tea around 10.30 or whenever things are getting particularly difficult and I think a time out would be appropriate. So it could be any time from about half past 9 onwards. And lunch at 12.30.

Would my colleagues like to add to those remarks? Leaning into the microphone of course as you do.

MR ROSS WILLIAMS: Just a brief comment. I think that the tops-down approach does actually influence all the other topics on today's agenda and it's useful to sort of think in terms of the tops-down. That's all.

MR GLENN APPLEYARD: Alan, thank you for your welcome. It's nice to see so many familiar and at this stage friendly faces around the table and I look forward to that continuing.

THE CHAIRMAN: It won't last. Thank you. Well now, opportunity for states who may want to make something by way of introductory remarks before we get to the first substantive item of materiality. In keeping with convention and protocol, John, New South Wales.

MR JOHN PIERCE: Thank you. Alan's comments about the acoustics of this room - I was the one that brought that fact to his attention. Some of my colleagues who have had to struggle to listen to me in the past may find that somewhat ironic that I should note that sort of thing.

Obviously today is really the beginning of this 2010 review process in earnest. The fact that we are sitting around talking about a review for 2010 for - I don't know how some of my colleagues feel but perhaps for some of us it's an indication that we've been doing this for too long. But the exciting part of it is

that there's a real opportunity to do a complete rebuild job, and I appreciate that's not just in terms of the processes but in terms of the way in which the Commission and its staff operates and that is also going to be a significant challenge.

The way in which the Commission has started with its papers we feel quite positive about and gives us I think a good set of opening principles, if you like, to try and approach this rebuild job because it will be I think probably the most major change to the way in which this process operates we've seen for some decades.

The terms of reference obviously recognise that the current system's overly complex and being asked to do too much and hence the outcomes that we're looking for, that certainly something is simpler, makes less demands on the data, more reliable, more efficient - everyone accepts that. The other point that I would add though is that this system that we come up with needs to retain or perhaps in some cases re-establish the confidence of the key stakeholders, not just the people in this room but the people who have to live with the outcomes.

As you've said, Alan, the Commission started this by stating it's going to approach it from a clean slate and we certainly think that's an appropriate strategy. I think there's also been an improvement, by the way, in the way in which the papers have been presented. Certainly found them to clearly define the issues and make the choices clear. One of the outcomes that we would expect to see is significantly fewer assessment categories than the current system. The materiality thresholds that are being proposed are heading in the right direction. Given that the Heads of Treasury review found that there was 172 assessments and involved the redistribution of 5 million or less, and I think there was about 30 assessments that involved a distribution of 50 million or more, you would think that there's plenty of scope to reduce the number of assessments quite - number of categories quite significantly.

Reliability is the other major topic and as such we take the view that only those assessments that can be reliably modelled and measured should be included in the framework. And on judgment, you won't eliminate it completely but if we do everything else right, then the need for the use of judgment through the process we'd expect to be very much reduced.

I must say though that - this is really a flag for the lunchtime discussion I suppose - we cannot, as we work through this process - ultimately I think we won't be able to take a position on the materiality and reliability types of issues unless we have an understanding of the objective function that we're trying to satisfy. The position that we take on those materiality and reliability and simplicity types of issues if the objective function is complete equalisation. It may be quite different if we had an objective function that was, say, perhaps the - for example, the more older fashioned type of objective of providing people with the capacity to provide services at a standard not appreciably below that of

the other States or something of that sort of nature. So I'm quite pleased to see the Commission is open to discussion on that front on the nature of HFE because I think how we define that will drive a lot of - at the end - the positions on the materiality and reliability and simplicity types of issues. Thank you.

THE CHAIRMAN: Thanks very much, John. Victoria, Peter?

MR PETER DAWKINS: Thank you, Alan. Well, Victoria is also very encouraged by the preliminary views that you put forward in your letter and the draft agenda for the meeting. The top-down approach is something that we think represents the best way to achieve the kind of reform that we think is needed, and your outline of the need to adopt sort of a clean slate approach and new ways of doing this is something that we certainly support.

The preferences that you've indicated about materiality thresholds is something that we think is definitely heading in the right direction in terms of simplifying the methodology, and also the view that the thresholds should be applied rigorously. And we also think that reducing the importance of judgment in the application of thresholds will also help in preventing complexity in the system and in the processes involved.

I think - and also obviously reliability, we think that that's a very important discussion to be had as well. And we also are pleased that you're scheduling discussion today on the objective of how HFE should be defined and the associated principles, and very pleased that you're keen to have a broad discussion about that and we look forward to that discussion and ways in which the principles can be developed. And would also think that discussing the objective in terms of whether perhaps appreciably different services might be - not appreciably different services might be the objective rather than having the same because we think that fits very well with the aim of reducing complexity, increasing simplicity and improving the sort of transparency and the credibility of the system. So that's our opening comments.

THE CHAIRMAN: Thanks very much, Peter. Queensland, Gerard?

MR GERARD BRADLEY: Thank you, Alan, and thanks to the Commission for the opportunity to participate today. I think it is encouraging, both from the way in which the Commission is viewing its work and I think the way the States and Territories are also approaching it. I think we do have a general agreement or consensus on the need to try and improve the process, make it more simple and transparent and I think that is a constructive approach which we're certainly wanting to play in making that occur with the Commission. And obviously we'll be seeking to engage actively and constructively throughout the whole process to see that that occurs.

Queensland has consistently supported the principles of HFE as they applied in the 2004 Review and I guess we see that obviously as principles not in

themselves not being a matter of review but the way in which they're applied in a practical sense is something we all need to constructively approach. We'd agree that the observation from the Commission that equalisation in a broad sense should take precedence over simplification, but nevertheless we need to pursue that to try and improve the way in which the equalisation process is perceived to be working.

With that in mind, we support the broad thrust of some of the positions put in the Commission's papers. We think the materiality threshold is certainly worth considering as a way of achieving some simplification. We do think however that we need to keep our eye on the ball in the sense of allowing some flexibility where we can establish that other criteria - reliability, materiality, etcetera, can be satisfied with reasonable confidence.

We also support the Commission's view that proposed method changes need to be brought in as a package in 2010. Other than that I think we'd be happy to contribute on the particular topics the Commission's nominated through the morning and hopefully lead to a good consensus for the way forward. Thank you, Alan.

THE CHAIRMAN: Thanks very much, Gerard. Western Australia, the microphone is closer to you, David, than Mark I think so does that mike you?

MR DAVID SMITH: That's a rule we'll use. Thanks, Alan, and thanks to the Commission for this opportunity to participate in the discussion which we are certainly looking forward to. Thanks also to the work that's been done by the Commission. I think the papers certainly spell out some interesting issues for us to discuss today. We certainly see simplicity as being the focus of attention at this point at least. It's a clear task that's been given to the Commission in the terms of reference that came out of the work of the Heads of Treasuries. And simplicity is something that we certainly support.

But like, as you expressed, Alan, simplicity in our mind is a means not an end and I think that's very important to keep that in mind. Simplicity - there's lots of reasons for why we should be seeking simplicity. To my mind, the most important is about confidence, another aspect that you raised and I think John Pierce mentioned as well. It's about being able to present the results, the outcomes if you like of the Grants Commission work to stakeholders in a transparent, understandable way.

Having said all that, simplicity is not easy. I think we've made that comment previously and I don't under-estimate the task that the Commission will have to achieve that goal. The Commission has, in the papers that it's presented, and we'll talk more about this under the agenda items I think, but it has taken an approach of fundamental change, the tops-down approach. I think there is good reason for doing that but there are other alternatives. But if you do take the tops-down approach to fundamental change, then I think you've got method

change and simplicity inexorably linked. And that may mean that simple rules like early decisions on thresholds and so on are not the answer, a more holistic approach to simplicity will need to be considered.

A final comment. It's not formally on our agenda today, and I say this in the spirit of make sure we have as constructive discussion around these issues as we go forward as we possibly can, and that's the issue of if there is fundamental change that emerges out of these processes, the implementation of that fundamental change for the parties involved, for the States and Territories is something that I think we need to have an early discussion around. It might be something we have an opportunity to touch on in our lunchtime discussions, because I feel without that you're certainly asking a lot of bureaucrats and perhaps too much of politicians to be able to have fullsome discussion around some of the fundamental changes that the Commission might be contemplating.

THE CHAIRMAN: Thank you, David. I think the clouds are starting to build now. Still we - and we got through about 20 minutes with all the sweetness and light but we'll see how we go. I'm looking to Jim to restore the sunshine on the morning. Jim?

MR JIM WRIGHT: You can rely on us, Alan.

THE CHAIRMAN: Indeed it's terribly, terribly fortunate that you were next.

MR WRIGHT: It is. We have got a few things we'd like to say. I kind of hesitate about these phrases that are thrown around, tops-down and clean slate. I'm not entirely sure what they mean in an operational sense. Presumably they don't mean throwing the baby out with the bath water.

So we look at the issues of materiality and reliability as a package in a way and we think it would be a false or unwise thing to do if you've got some area where the reliability's very high, the data's good, the methodology's good, the fact that it only moves a small amount of money around doesn't necessarily mean it should be eliminated from the process. Whereas at the other end of the scheme, if you've got less reliability but it's a massively important issue, then again you might be prepared to tolerate less reliability in order to pick up what is clearly an important factor that impacts upon the process. And that is an area where of course - that second category is an area where the judgment of the Commission is going to be important. I mean we need to face the reality that what we're working here with is a constrained set of data, it's not as ideal as we'd like, it's a very difficult question that people are asked to answer, and the idea that somehow we can develop a black box that's going to give us the answer is just I don't think a sensible one. So we need to accept that there's got to be scope for judgment going forward.

The other little point that I guess crossed my mind listening to some of the earlier comments was this phrase "not appreciably different" pops into the

conversation. Now, not appreciably different is only an operational viable thing to do if you know not appreciably different to what? And if you measure the what, I'm not sure that you're going to be saving anything at all in then going away to somewhere that's not appreciably different to the what. I suspect that's a phrase that has very little useful meaning.

The only other thing I'd record just for the record is that of course in terms of HFE principles, we agree with Queensland about where we ought to be. Thank you.

THE CHAIRMAN: Thanks very much, Jim. Tasmania, Don?

MR DON CHALLEN: Thank you, Alan. I don't want to say much. I do want to thank the Commission and the Commission staff for making this opportunity available and for the organisation that's gone into it. I'd also like to commend you on the clarity and particularly the brevity of the papers that you provided for this meeting.

The only point of substance I want to make is that there are a couple of points at which we find it difficult to understand the interpretation that the Commission has put on some elements of the terms of reference, and I'll speak on those under the particular agenda items. But I find the basis on which the discussion that we're going to have over lunch to be flawed. And while I'm happy to indulge in that debate, as Tasmania always is, we don't find the basis on which you have decided to have that discussion over lunch at all appealing. But I'll have some more to say on that when we get to it. And in the interests of simplicity and materiality, that's all I say at this stage.

THE CHAIRMAN: Thank you, Don. The ACT, Paul is on his way. Are you taking it upon yourself, Roger, to speak in his place at this time?

MR ROGER BROUGHTON: Well, I suspect the opening comments brief is in his folder, not mine.

THE CHAIRMAN: Okay. Well, in that case I might shut you up.

MR BROUGHTON: I might add a couple of things.

THE CHAIRMAN: I still might shut you up.

MR BROUGHTON: Yes. Just in support of some of the people around the table, the ACT believes in the primacy of fiscal equalisation as part of this exercise. We believe that judgment is always going to be an important part of that, that's why we have a Commission. If it was just down to a formulae approach then we wouldn't need anywhere near the amount of people involved in the process that we have now. Some people might see that as an advantage but I doubt if the results would be terribly appealing.

We think it's appropriate to revisit all of the assumptions and I think that's been the standard practice in reviews for at least the last couple and we support that, and even if it ends up reinforcing the assumptions that have been made in the past. And finally, we also believe that in the interests of equitable outcomes that changes should be delivered as a package and not as a piecemeal approach. Now you can feel free to shut me up.

THE CHAIRMAN: Okay. Shut up, Roger. Thanks very much, Roger. Northern Territory, Jennifer.

MS JENNIFER PRINCE: Thanks, Alan, and thanks to the Commission and staff for putting together the papers in the way that they have and the approach to this 2010 Review. We agree that it's very important for the stakeholders, the very broad range of stakeholders to be supportive of and committed to equalisation and one clear way that we can all contribute to that is by supporting the Commission in its task for simplification through this review.

There are two things that I wanted to say. I agree that equalisation and simplification are not issues to be traded off. We are achieving both equalisation and simplification in this process. And Ross made the point about thinking of the issues outlined in these papers with the top-down approach in mind. We certainly agree with that. It is difficult I think to see how we can achieve the level of simplification that we're looking for without placing great reliance on the top-down approach. And if we start from that basis, many of the other considerations can be made simpler and easier.

THE CHAIRMAN: Thanks very much, Jennifer. I think before we move into the substantive discussion on materiality there are probably only three very quick points that I would like to make. The first is that we have already discovered in the Commission that simplification is not simple. Indeed, while the Commission's administrative and budget issues are of no concern to you, we found ourselves in the position of having to argue that we actually might need some additional resources because of the complexity of progressing a simplification agenda. Needless to say that has been a very difficult argument to sustain.

Secondly, the issue of what I think John called the objective standard, the not appreciably different or however you want to formulate that, is a lunchtime issue rather than a morning issue because it goes to issues of principle. It of course offers nothing in terms of simplification. Nothing at all. So it's strictly a matter of principle. Indeed, my sense is that it's actually a little trickier to work out what not appreciably different means than it is to work out what equalisation means. But it's an issue that people want to put on the table and, notwithstanding Don's stern warnings, we think as a Commission that we need to provide an opportunity for these issues to be discussed. Whether we can do anything about them is another matter.

And the third point is judgment. We would hope that simpler, more reliable assessments, fewer assessments with fewer moving parts would of itself eliminate many of the areas of judgment that the Commission has had to make in the past, many of which are contentious in themselves. But it is certainly not the Commission's view that we should be seeking to put in place a process in which there is no call for the Commission's judgment. That is just simply not an issue that is on our agenda. We do not see any circumstance in which you would say there will not be a call for substantial judgment to be exercised by the Commission.

Is there anything that my colleagues would like to add at this stage? No. John, nothing to start? Okay. I neglected to welcome John Spasojevic to his first meeting. I think he is known to all of you. He's done his rounds and tipped his lid to all of you in the early months of his appointment but this is his first opportunity to see the full majesty of the process at work.

Well then, can we turn - John, did you - are you flagging me?

MR PIERCE: If I could just sort of put one other issue on the table if I may. You - I'm not quite sure how we handle this. I'd certainly welcome discussion about it. In your paper you make the point that making comparisons between a 2010 method and a 2004 method is going to be logically flawed so people please don't do it. Whilst that is certainly the case in relation to method, of course the final fiscal outcomes will be compared and have an impact on people. And as I think David said, in taking this approach of reconstruction there's some potentially significant risks for all of us in terms of those outcomes. At some point I think we need to have a discussion about how we could manage that and the earlier on in this process and the more often we talk about that, then the more confidence we can have that those risks will be managed when the final review comes out.

THE CHAIRMAN: Thanks, John. Those comments in our papers of course relate to the making of comparisons about methods and - - -

MR PIERCE: Yes, I appreciate that.

THE CHAIRMAN: - - - they were deliberately not written about comparison about outcomes. I don't think you need - any of you need the Commission to encourage you to think about comparisons about outcomes.

MR PIERCE: We can't just ignore them.

THE CHAIRMAN: There is always the potential for discussion about all of these issues. Once people begin to develop their own sense of where the outcomes might be going. And that's just a natural part of the process that we readily acknowledge. We can't avoid and shouldn't avoid. I note that the

terms of reference that we have for the 2010 Review do have a clause 7 which says that the Ministerial Council will give further instruction to the Commission on transitional arrangements if and as necessary. And I think that probably prospectively anticipates those sorts of issues might need to be discussed. But I think it's far too early in the process. I think it's good to flag that but I think it's far too early to start anticipating them in the positioning and the jockeying.

MR PIERCE: I appreciate that.

MR CHALLEN: Well, at the risk of positioning, I mean my response to your last remark about paragraph 7 of the terms of reference is not necessarily. In fact that element of the terms of reference was put in there to send a very strong signal to the Commission that the authors of your terms of reference and the Minister that has conveyed them to you does not want you dealing with transitional issues. I mean what it says is that when we want to we'll ask you. Until then please leave it alone. That's what it says.

THE CHAIRMAN: We will not be addressing transitional issues until such time as we are instructed to do so.

MR PIERCE: Good, we agree on that paragraph of the terms of reference then, Chairman.

MR CHALLEN: We agree on the interpretation of that paragraph of the terms of reference.

THE CHAIRMAN: But what I think the point that John is flagging is that the stakeholders at some point may decide to activate that paragraph and give instruction.

MR CHALLEN: Indeed they may and he's right about that, but in the meantime we can all forget about it and get on with the rest of review.

THE CHAIRMAN: I half agree. We'll get on with the rest of the review. Whether you all forget about it, I'm not so sure.

MR CHALLEN: Well, we might not but you can and indeed should, and I might go further, must.

THE CHAIRMAN: It's not on our agenda today and it's not in the work plan that we have agreed with you.

MR CHALLEN: I am greatly reassured.

THE CHAIRMAN: Can we move to materiality? The Commission's experience through the 2004 Review on the issue of the simplification

generally and materiality specifically leads us to the conclusion that we would need to be very clear and very firm on a strengthened approach to materiality if there is to be progress in achieving fiscal equalisation in a simpler and more robust way. Most of you will recall the brave approach that we initiated at the start of the 2004 Review to tackle the issue of simplification and materiality in which we were soundly rolled by the States and that approach that we had advocated slipped from the agenda as the review progressed.

It can't slip this time. It is a specific requirement of the terms of reference and we are obliged to consider the issue of materiality thresholds because that is what the terms of reference have instructed us to do. Annexure 1 to my letter of 28 October summarises where we think this issue currently stands. While acknowledging that differences of view remain across the States, the Commission is looking at two issues in particular: a top-down approach to disaggregation and the use of thresholds to guide decisions about materiality.

Our understanding is that States generally support the use of thresholds but differ on the specifics. The use of materiality thresholds was one of the options recommended for further consideration by the Heads of Treasury Review last year although specific thresholds were not identified in that work.

Much of the debate about current methods reflects the fact that there are a large number of assessments and adjustments, many of which are contentious in themselves, which do not have a significant impact on redistribution. Avoiding these would be consistent with the direction indicated by the terms of reference and with the underlying objective of strengthening the acceptance of equalisation outcomes.

What we think is required is that we capture the important influences on the financial capacities of the States. If the application of materiality thresholds isn't done consistently and rigorously, we think these objectives will be compromised. So we think, quite firmly, that materiality thresholds should be established and should be implemented rigorously. We think that the most appropriated basis on which to do this is on a per person per State basis, and I note that most States support that approach.

So we have proposed a framework for categories, factors and disabilities. As indicated in the papers, we have proposed a category size of \$50 per person based on the all State average, a category redistribution threshold of \$30 per capita for any State, and a disability threshold of \$10 per capita for any State and the disabilities would be assessed on an aggregated basis and then as an implementation method would probably be distributed across categories.

Initially the first two points, that is the category size and the category redistribution threshold, would guide the disaggregation of revenues and expenditures through the review, and the last three would be used to determine if a differential assessment is to remain in our final methodology. Assessments

which don't meet these thresholds could be aggregated with other categories or factors where there were similar characteristics or treated on an equal per capita basis. Just what should be done we think can only really be determined on a case-by-case basis.

With respect to a top-down approach, although we're not required to report on aggregation until February 2007, our thinking about materiality has led us to the view that a top-down approach rather than a bottom-up approach offers the best way forward. With a top-down approach the case needs to be made for greater disaggregation rather than the other way around. The onus of proof would be on demonstrating that differences across States require greater disaggregation rather than arguing that similarities between States permit greater aggregation.

What drives disaggregation would be a combination of the assessment guidelines that we would develop and what States actually do. What we will be looking for is to identify and capture what we need to deliver equalisation but in a simpler way. We've indicated in the papers that this approach requires a strengthening of the assessment guidelines and we will be proposing much stronger assessment guidelines for the 2006 report to the Ministerial Council.

This approach will obviously result in larger categories and this will require a rethink of the approach to what the drivers of differences between the States are and the way disability should be assessed. We haven't yet progressed our thinking on the details but I think we all need to be clear that there will need to be substantial changes in thinking about these issues and that would be a major part of our work commencing in 2007.

In the annexure to my letter I raised two questions. They seem to me to be a sensible way on which to progress the discussion of this issue. How could consistency in decision-making be ensured if thresholds are not strictly applied? And why should the Commission not use the proposed thresholds?

Open to the States. I don't think there's necessarily a need to maintain strict protocol order any further, but rather than sit through a painful and embarrassing pause, John, can I ask you to start.

MR PIERCE: First of all, can I just ask you to clarify your assumption in relation to the - before we just deal with those issues - the assessment guidelines. They will be - some people might think I should already know this but they'll be produced at what point? There'll be draft for comment just in terms of the process in relation to these assessment guidelines of what you're envisaging.

THE CHAIRMAN: What we are intending to do is to consider some draft assessment guidelines for the second or third time - I'm just not sure which - at our Commission meeting next week. We would then, subject to the decisions

and the degree of confidence that we have in them, we would write to each of the States immediately thereafter. Our intention is to have draft assessment guidelines included - proposed assessment guidelines included in our report to the Ministerial Council in February next year.

MR PIERCE: Okay. So not final, we still get to - it says for discussion - - -

THE CHAIRMAN: There will be two opportunities. The least attractive would be that the Ministerial Council has a discussion and debate about them.

MR PIERCE: I wasn't suggesting that happen.

THE CHAIRMAN: But between mid-December and early February there will be an opportunity for you to indicate your views.

MR PIERCE: Thanks.

THE CHAIRMAN: I am not anticipating that - provided we have a satisfactory discussion of materiality and reliability and early implementation today, I am not anticipating that the draft guidelines themselves would cause large problems for anybody.

MR PIERCE: Okay. I think we were the standout on the definition of the materiality threshold which we were effectively suggesting percentages just simply because the percentage approach we expect to produce similar effects on States regardless of the size of their population and their budget. But you'd be heartened I suppose to hear that my notes tell me that the Commissions proposals appear to be a reasonable compromise. And in terms of whether they're strictly applied or not, we would certainly favour doing that, just because of it allowing us to really concentrate our resources on analysing what seems to be one of the significant fiscal issues and we hopefully also discourage submissions that lacked good data. So if you're taking that approach we're quite keen on it.

The issue about the - - -

MR GLENN APPLEYARD: I'm sorry, John, just before you go on. Could I ask in relation to your proposal - I note your remarks about you find the Commission's suggestion an appropriate compromise but your proposal was I think an eighth of one per cent of the budget. Can I ask if there was any particular science to the eighth of one per cent because we are picking numbers, as it were, out of the sky.

MR BRUCE FREELAND: That was based on the analysis that was done for the HoTS HFE Review which used those sort of guidelines, Glenn. So I was just trying to get something which gave some sort of an approximate feel for likely impacts.

MR APPLEYARD: Thanks, Bruce.

MR PIERCE: I want to talk about how to deal with assessments that fail the materiality thresholds. I suppose I would have thought if an assessment fails the materiality threshold, then what you're looking for is for those assessments should not affect the outcome, otherwise why have the materiality threshold and hence can't see why they wouldn't be eliminated from consideration.

MR CHALLEN: What does that mean in practice though, John? Do you ignore them or do you allow them to fall into the budget result and why wouldn't you treat them equal per capita or actual per capita as the tidiest way of dealing with them?

MR PIERCE: Look, you might, but I would have thought if it fails the materiality threshold then it would be by definition unlikely to have a material impact regardless of their - regardless of the way you treat them.

THE CHAIRMAN: I don't want to make this even more complicated, but it's possible that you and Don are actually talking about two different things. You are probably talking about assessments of disabilities where these are not material, and I think Don was talking about assessments of categories and there's - a different approach presents itself in each case.

MR PIERCE: Yes. .... each case, yes.

THE CHAIRMAN: Jim?

MR WRIGHT: I wanted to address your first question, Alan, about consistency. I mean I think the danger we've got here is if you have materiality threshold of, you know, whatever dollar amount you choose, you've got consistency at some level in the sense that you've got a consistent dollar amount but you haven't necessarily got consistency in terms of impact on equalisation. It's a point I've already made that in some cases you can have an assessment which is soundly based, good data, everything going for it, and it's good information. And so you can be confident that what it does is contribute to equalisation and you chuck it out of the door because it's below some number. Equally well you can - I won't go through the whole thing here, you understand my strain of logic, but this argument of somehow using a fixed dollar number gives you consistency I think is a false one and we ought to be careful about it. It's very convenient but it's not necessarily consistency.

THE CHAIRMAN: Your point is technically correct - I always worry about that word technically. But if we are to progress the simplification agenda that the terms of reference have required, and specifically respond to the terms of reference requirement for us to consider materiality thresholds, then it seems to us that you've got to have - you've either got to have a materiality threshold or

you don't have one. And if you take the view - if you put the proposition that you have a materiality threshold but if the data's good you don't have one, then you get into an argument about whether the data's good or not. And it becomes terribly - in that context it becomes terribly difficult to maintain consistency because people will argue about whether the data's good.

MR CHALLEN: Alan, if I may interrupt.

THE CHAIRMAN: Of course you may.

MR CHALLEN: Or good enough.

THE CHAIRMAN: Or good enough, good enough. Thank you, Don. So it does seem to us as we're doing our thinking about how we're going to progress this work, that if you establish materiality thresholds for category size, for category redistribution or for disabilities, and if applying those leads to the clear conclusion that there is no material impact on the redistribution, then the simplest thing to us - remember this is about simplification - the simplest thing to us is to treat them in whatever way is appropriate to ensure that they don't affect the outcome.

MR WRIGHT: I mean I'm quite sympathetic to your problem, I understand what the issue is, but I don't think we should kid ourselves that if we do this we may be ignoring the problem rather than solving it, and if you ignore it, it won't go away. There will - I mean if you apply a fixed dollar materiality argument you're going to find exceptions where it's clear that this has given you a bad outcome. And, I mean, okay, we can just pretend that doesn't matter but it will in some cases.

THE CHAIRMAN: Yes. Ross?

MR WILLIAMS: Can I make a comment again about my theme about tops-down. With the tops-down approach the issue is how far you should keep on going down rather than the other way around, but it means that if you end up with a reasonably large category that you don't want to split up because the components are too small - I mean, if the drivers of the individual components are pretty much in the same direction then those drivers will show up in the larger category. I think that's a useful point to realise. I mean you shouldn't associate small things with EPC necessarily because when you aggregate them up as they're all moving in the same direction you will get disabilities coming through.

MR ROBERT SCHWARZ: Could I give an example of what we're talking about and it might make it more concrete. The first homeowners scheme. Here's a scheme that's absolutely uniform around the States, \$7000 for first homeowner. So the policy is absolutely uniform so the differences in the level of spend in each State per capita is a very reliable measure of need. Now, this

is a small line of expenditure, it doesn't necessarily aggregate terribly well with anything else. Wouldn't something be lost if you had no regard to the actual reliability of that assessment and just tossed it out because it was below the threshold?

THE CHAIRMAN: Well, you wouldn't be tossing it out on the grounds of reliability, you'd be tossing it out on the grounds of materiality that it didn't make any difference. It didn't make a sufficient difference. I can't remember - I don't know whether the encyclopaedic memory of the staff can remember what this is worth.

MS CATHERINE HULL: It's a \$40 per capita category.

THE CHAIRMAN: Well, \$40 per capita category.

MS HULL: And the redistribution - I haven't found that. Another part of the report.

MR SCHWARZ: That's one example, but there are numbers - you know, the assessments on the revenue side for example are generally considered quite reliable and they might be relatively small lines but could the reliability issue perhaps be balanced with judging whether to eliminate something because of materiality.

THE CHAIRMAN: Well, I can repeat again what I said to Jim that we are putting to you our thinking that if you have a test of category size, redistribution and disability, then if an assessment or a category fails that test and does not have a material impact on the outcome, then in order to progress a simplified approach, the most obvious thing to do is to ensure that it doesn't continue to impact on the overall outcomes.

MR CHALLEN: Picking up Ross' point and I'll come back to Robert's point in a moment. If a category fails the materiality test and can be aggregated into something else in a useful way, you don't have an issue. So the issue that Robert and Jim are raising is where you've got a category that is unique enough that it doesn't easily aggregate into anything else. I suspect there aren't many categories that look like that. They have raised a rather good example that we had thought of too, and I think it's an interesting example because by definition there are no policy differences between the jurisdictions and consequently you could get a good equalisation outcome for the first homeowners grant by treating it actual per capita. But I think the presumption would be generally you would go equal per capita, and if you're confident that there are no policy differences between jurisdictions you could go APC.

THE CHAIRMAN: That's absolutely right. Some states have insisted that we set our face completely against actual per capita. We haven't accepted that at this stage. We have not accepted that. That where it is clear - and this does

appear to be a good example - where it is clear that there are no policy differences at all, then bringing that in on the basis of actual per capita would be, we think, appropriate. Have we got the numbers yet?

MS HULL: Sorry, yes. It would fail the \$30 per capita test.

THE CHAIRMAN: Right, okay. Glenn?

MR SCHWARZ: Alan, that was my point, and to have it fail that test when it's a perfectly reliable assessment and not, you know, and then go to equal per capita rather than using the actual per capita as an indicator of need would be a mistake.

THE CHAIRMAN: But, Rob, if you take - if you accept the view - and I'm not saying that South Australia does - if you accept the view that a \$30 redistribution is an appropriate materiality threshold, then I mean that's really the end of it.

MR SCHWARZ: Well, you say actual of \$50 - sorry, there is another example. Heavy vehicle registration fees are uniform across the States. That would fail the \$50 per capita threshold and yet once again is a totally reliable assessment.

MR APLEYARD: But, Rob, in a sense you're not starting from the top-down. You're starting with the disaggregated existing components rather than saying okay, first home owners may be in general public services. You'd look firstly at general public services to determine where you would go in relation to the disabilities and how you would make those particular assessments.

MR WRIGHT: Yes. I mean, what we're doing is we're putting it forward as an illustration of the fact that the fixed dollar amount doesn't give you a consistent result in terms of equalisation. That's the point we're making. So if you're talking about consistency, it's a question of how you define it and we're saying you should define it by equalisation and impacts, which I know is very, very difficult. .... argue the point but - - -

THE CHAIRMAN: Yes. I take that point. Glenn's observation though is absolutely essential in thinking this through. We see this - we see the top-down approach to disaggregation as being inextricably linked to this. If you think through the materiality threshold from a bottom-up approach then you will keep raising, you will keep stumbling across all of these issues. Heavy vehicle licence fees - well, in an aggregated - in a top-down approach it is highly unlikely that you would get to heavy vehicle licence fees as a separate standalone category. It would sit with other things and in so doing would pass the materiality threshold and would be considered.

MR WRIGHT: Yes, but how is the question then of course.

MR SCHWARZ: That's entirely true and if you add it together with light vehicle registration fees, in fact you've got two different assessment methods used. At the moment because there are uniform heavy vehicle registration fees, you can rely on APC for that bit of it and then go and look at other statistics for the light vehicles. Now you bring them together, how are you going to do your assessment?

THE CHAIRMAN: Well, that is a very good question. But the prior question is are these two revenue categories sufficiently similar that they can be assessed without further disaggregation? And you would only contemplate disaggregation if you concluded that the drivers of disabilities across the States, the differences between the States, and the inherent differences between these two components themselves was such that they obliged you to look at them separately. But it is - if we go through a top-down approach and end up with a category that says heavy vehicle licence fees, then I think you could probably declare the top-down approach a failure.

MR SCHWARZ: Well, if that's your thinking I think we'd ask you to rethink that because here's an example of a very reliable assessment and to lose that from the system because it's another principle of tops-down where you're going to add it into something and end up with a more unreliable assessment, I think you probably need to work that through a bit more.

MR APPLEYARD: But, Rob, when you say it will be lost, it won't be lost. It will be in a broader category where the onus is on the Commission and the States if they want to present arguments to determine what drivers or factors we ought to be examining for that particular category.

MR WRIGHT: Well, Glenn, that's exactly right. And we don't want to solve this problem right here and now, but I think all we're pointing out is that you will get - this is an issue that will arise. You'll have an aggregation and when you look at how you're going to assess it, form an assessment for that aggregation the data will lead you to saying okay, we should look at this bit in this way and this bit in that way, and before you know it you've got a disaggregation for bloody good reason. And it might then be below the materiality threshold and you chuck it out the door. We just think that's a bit of a dangerous process and it's something that has to be thought about. I'm not saying that one way's right or one way's wrong, but it's going to have its difficulties.

MR APPLEYARD: If they are for good reason so be it, but I guess the conclusion you'd say at the moment if you looked at the degree of disaggregation, say, within national parks - - -

THE CHAIRMAN: Don't, don't.

MR APPLEYARD: Has the pendulum swung too far?

MR SCHWARZ: We don't allow horses in national parks.

THE CHAIRMAN: But you do allow courses I presume. Jeff?

MR JEFF BYRNE: The issue here at the end of the day is what gets the best - - -

THE CHAIRMAN: Can you speak to the microphone, Jeff, I think we might be - - -

MR BYRNE: The issue at the end of the day is what gets the best equalisation outcome. Now, when you look at aggregation, two things can happen. One is when you assess in a more aggregated way that may incorporate some of the things that were previously assessed at a disaggregated level, so they could get picked up in that way. But the other thing is there will be swings and roundabouts even if something is not assessed, that some things will have favoured some States, other things would have favoured other States. You're looking at the combined effect of all of those, so when you look at things from an aggregated new package, you have to really say is that equalisation outcome better or worse than the one you had before. So it really stands on how well the total package works rather than saying a particular assessment has been eliminated, because it could have been eliminated but there's swings and roundabouts there. It could have been aggregated up, there are swings and roundabouts there as well. So I don't think you can say just because something was eliminated that in some way the equalisation outcome is worse. It's not as clear as that.

MR WRIGHT: Mr Chairman, maybe I misunderstood Jeff, but he seems to be saying you choose an outcome and if it looks all right you just go from there, you don't worry about all the detail behind it. Have I misunderstood you?

THE CHAIRMAN: I didn't quite hear that, Jim. I think what Jeff was saying is that you need to take a broad view of how this works rather - a broad view of how it works in terms of delivering equalisation rather than picking on highly disaggregated specific elements and saying well, if we lose that we'll get a worse outcome.

MR WRIGHT: Well, I'm not sure how you form a broad view. I mean, I'm not sure what process you go through to get a broad view of how equalisation is being met unless you look at the - you know, exactly what you've done to get there and what the methodology is. You can't form an a priori broad view of whether you've got equalisation or not.

THE CHAIRMAN: We're not - for the Commission we're not taking a broad a priori view. We acknowledge that in order to implement this in a sensible,

coherent and consistent fashion, we will actually have to do a lot of work at high levels of disaggregation to establish whether categories can remain highly aggregated or how far they need to be disaggregated to determine the extent to which disabilities apply. So we'll actually have to work from the top and bottom within the Commission, but in terms of bringing forward progressively our thinking to you.

What we're looking for at this stage is a satisfactory consensus about the way in which we will formulate and present the results of our work to you. We can't take an a priori view about whether an existing assessment or an existing disability assessment is material or not. I mean, we need to do that work and we are not pretending at the moment that we've done that work, and we're certainly not pretending that we see perfectly how all of this is going to play out for every single category and disability assessment. But what we do have is a very clear sense of the way in which we have to approach the task and the way in which we have to present our thinking to you progressively if we are to comply with the requirements of the term of reference.

And we're proposing to do all of that, having made it I hope clear that we don't see equalisation and simplification as a trade-off. That the purpose of this approach is not to, if you like, somehow reduce equalisation. Whether that's to happen, that's for another discussion on another day. That's not why we are proposing to do this. But if we - from the Commission's experience and from our own thinking, if we don't indicate clearly how we intend to go about the task and what criteria we intend to use in doing it, then you can kiss that part of the terms of reference goodbye I think. Yes, John.

MR PIERCE: Perhaps I can ask your indulgence perhaps to explain the rationale for your preference for the dollar per capita materiality thresholds rather than percentages? If I can just sort of reverse an earlier question.

THE CHAIRMAN: Rather than the percentage of budget or something?

MR PIERCE: Yes.

THE CHAIRMAN: Well, the first answer that occurs to me is a purely practical one. Practical and relevant. Given what equalisation is trying to deliver, a per capita impact on a State appears to us to be the relevant intellectual criteria, the relevant base on which to work. That way we give what we think is appropriate opportunity for the real cost differences or revenue differences between States to be captured, but of course on the other side, for those that are not material not to influence the outcomes, particularly many of these are amongst the most contentious. I hesitate to mention this again because I don't want to upset Jeff just before morning tea, but cultural and linguistic diversity. I mean it clearly wasn't material. Clearly wasn't material but we probably had as much debate about that as we had about mining revenue.

So it just seems to us that in terms of thinking practically about how we'd look for capturing the relevant impacts on States and the differential impacts, that the per person approach just seems to make sense. It's also helpful that everybody else supports it.

MR PIERCE: Yes, I know that, I'm just thinking in terms of being able to - getting back to how do you explain and rationalise it outside the room. In a sense are you saying - well, is it correct to say that you're seeking a threshold that is designed around equalisation between people as distinct from State budgets.

MR APLEYARD: But I think, John, if you only have the focus on budgets you may well have categories which aren't significant dollar wise in terms of size of budgets but because of the diverse disability influences, indigeneity perhaps is an example, you may well have large redistribution effects. So we want to capture the redistribution effects not necessarily the impact on a particular budget.

MR WILLIAMS: Of course the only difference between the two methods is one of indexation.

MR PIERCE: Well, that's - I'm sure that one can be .....

THE CHAIRMAN: Gerard?

MR BRADLEY: Chairman, just one point of clarification. I guess from our point of view we're supporting the approach to materiality threshold. I think we do see however practical issues in how you apply that and then how you actually determine it. How you actually treat categories once they've been caught in that cipher, I suppose, which is we're we've raised issues about APC, EPC or how we actually go about dealing with that particular category and I guess SPPs were another example we gave which we think we can achieve sensible outcomes which are simple and which still largely and substantially apply the materiality threshold. It's the practical way in which you then proceed and actually apply any methodology. It's something we think we need to allow yourself some level of flexibility or judgment as you then work through what the implications of that are basically.

THE CHAIRMAN: Yes, I think that's right, Gerard. That's essentially the only response that I think we can give to Jim at this point. What we're looking for is a degree of consensus about the approach that we should take, recognising that in actually developing the detail of this approach that there will be issues that we'll have to come back to and reflect very seriously on how we deal with them. And we haven't done that yet. Yes, David.

MR SMITH: Thanks, Alan. I'm not sure I'm going to help you find the consensus that you're after because we've got a slightly different view, although my notes here when I read them coming over I thought we had a completely view from everyone else around the table. I'm hearing a more common theme this morning to our views than I thought was evident before and I think that's important for the Commission to hear. And that is when we were sort of thinking about this issue and thinking about it from a broad perspective and taking all the comments you said a moment ago, Alan, about the Commission's objectives in this and the fairly clear message that we've got through the papers and this morning about wanting to see simplification being achieved through a tops-down approach rather than continuing the approach of the past of trying to make it more simple.

But if you take that approach - I mean, in our logic, if you take that sort of tops-down simplification to be achieved by starting at the top rather than building up from the bottom, we actually think that the early agreement which you're seeking from us or views on to the early imposition of an arbitrary - in the Commission's words - an arbitrary threshold is not going to help that process and is not necessary to do so, especially one that's rigorously applied.

Those sorts of statements from the Commission at this stage I think do reasonably arouse some concerns around the States that we've heard this morning on that. We think it's not necessary, especially if you're taking a top-down approach to this, for you to ask or to impose a rigorous rule on thresholds in the way in which you've proposed in this paper. I mean, it's a very conceptual approach but we sort of think that essentially cost-benefit sort of study or approach should be taken by the Commission in deciding in that tops-down approach how far you go down in disaggregating categories for instance.

And I think that approach is consistent with what Queensland have pointed out about SPPs, South Australia were talking about in relation to some of the categories where the equalisation - the achievement of equalisation objectives is clear in those categories even though they mightn't meet these arbitrary thresholds that you're imposing or seeking to impose. You know, in fact these sorts of thresholds are more the sorts of things you'd need if you were doing a bottoms-up in a repeat of the micro-analysis of past assessments. You don't need them and you don't need them at this point to impose them in a rigorous way if you're taking a tops-down approach.

And that's not to say that these sorts of guidelines - the sorts of things that you've got in mind there mightn't be I guess a less rigorously imposed decision-making tool for the Commission as it progressed through its top-down approach to decide when it is that you wanted to go further. But I think that's a different - to me that's a different nature of tool than the rigorous application of the thresholds as proposed by the Commission in their paper.

I think if despite all that thresholds along the lines that you're proposing are to be applied by the Commission, there are a raft of other issues that apply. It's not clear to us for instance from the papers and so on whether or not the Commission is intending that these thresholds, particularly the redistribution thresholds apply sort of both to positive and negative needs, or do they just apply to positive needs? There seems to be an implication in the paper at one stage that that was the case. I think there's issues around the application of those thresholds to the components within categories. You know, do categories that continue to have components, will they have the same thresholds apply to the components within those categories?

And lastly, and this is by no means an exhaustive list I don't think, but the issue about whether to disaggregate further the application of a \$1 per capita threshold is not really the right question in that circumstance. The question should be is what's the threshold of impact between keeping it at an aggregated level or going to a disaggregated level? That's the threshold. If you are going to apply the threshold, that's the sort of threshold that should be applied in the decision-making. But that to our mind comes back to the cost benefit. What's the benefit in terms of the proven and equalisation outcomes that's achieved by going to that final level of detail?

THE CHAIRMAN: I must say that how you would consistently apply cost benefit type thinking in working through these questions is something that's sort of a bit beyond me at the moment. Maybe when we've had morning team it will all come clear, but I am concerned that we need to move forward. Although John started by making the point that 2010 is a long way away, we do need to move forward.

MR PIERCE: I'm sorry, it was scaring me that it's so close and I'm still here.

THE CHAIRMAN: Oh. I need to take you back to the Heads of Treasury work last year and to the terms of reference. We have terms of reference that tell us that we should simplify our assessments by applying a materiality threshold to current and future assessments. So it does seem to us that it is not an option for the Commission to consider whether or not it will have materiality assessments. We understand the terms of reference to be quite clear in telling us that there should be materiality assessments and we are required to report our conclusions in that respect in February of 2006.

As to whether the thresholds that we've chosen are arbitrary, they're arbitrary in the sense that you could have chosen any other set - you could have. But they're not arbitrary in the sense that we just plucked numbers out of the air without having regard to the likely implications for equalisation. And that, Jeff, is not - and Jim, that's not trying to guess outcomes in advance but it is reflecting the known fact that a large number of assessments and adjustments that we have made for reasons that some people thought robust and some didn't do not have a significant effect on the outcome. And if you cannot progress an

agenda that removes those from the moving parts bit of the assessment, then there's not much left to demonstrate that you've achieved simplification. If you can't get rid of those - and by getting rid of them I don't mean throwing them away, I mean aggregating them, treating them EPC, APC if that's appropriate, but if you can't eliminate the moving parts of them and the arguments about whether there's a conceptual case, whether there's data, is it good enough, then it really is going to be impossible for us to do what we understand the Ministerial Council expects and requires.

So if there is now coming around the table a suggestion, if you are telling the Commission that we should move away from materiality thresholds, then that is I think a substantial step backwards. I think it's inconsistent with what we've quite expressly been asked to do, and I think the more constructive approach is to encourage us to develop further an assessment process based around that kind of framework and to report to you progressively as we go forward on how we are finding this approach works or what difficulties we are finding and how we propose to deal with those difficulties. And that's what we'd be looking for. We need to continue - February 2006 is not very far away and Don's going to New Zealand for two weeks. So, you know, we're really running out of time here.

MR CHALLEN: It's only two weeks.

THE CHAIRMAN: Unfortunately only two weeks. We need to move forward. We really have to move forward with an acceptable level of consensus that the approach we are taking is supported. Nobody's asking you to sign off on all of the detail, but if we are going to continue working to meet the deadlines that are put on us, we've got to keep going.

MR SMITH: Sorry, Alan, just if I - because I fear my comments may have been misunderstood in that. We're not resiling from the materiality, the application of materiality as a means of bringing simplification to the Commission's work. Our comments this morning are about the particular application of materiality that the Commission's proposed. So the comments I made are not around to reality per se, it's what's been proposed in the papers that have been put to us. We don't think are going to achieve - especially in the environment that you've described in relation to wanting to take a tops-down approach to achieve simplification, that the proposals that you put in place are going to achieve that in a consistent way. Those objectives - you know, I think in fact, as I said, those materiality thresholds that you've imposed are the sorts of things that you would impose to achieve simplification with the approach that was taken, the micro approach that's been taken in 2004 and preceding years.

MR CHALLEN: I haven't actually stated our position on this and David's comments give me an opportunity to do so and I do so by way of reassuring you that if there is some kind of consensus along the lines that your anxiety

revealed a moment ago in learning we're not part of it, we are actually quite comfortable with the position the Commission's articulated. And I say that against the background of the entire context that you've wrapped around it. I won't go over all that but I've taken a lot of comfort from the way in which you've explored the context.

Philosophically we think we will get the best outcomes, best achievement of equalisation in an environment in which we're trying to achieve simplification by using a tops-down approach. But I disagree with David. I think you still need materiality thresholds to operationalise a tops-down context because it's a question of when you are looking at disaggregating from the top down, you have to have some concept of where you'll stop and that's what the materiality threshold will do for you. And I heard you say a few moments ago that in being able to operationalise those concepts, the Commission is actually going to have to do some thinking and maybe some work below the level of the materiality thresholds to actually test the propositions that are inherent in your approach.

And I must say I am, on behalf of Tasmania, very comfortable with that and if I'd had an opportunity to say this without interrupting others earlier and running the risk of not being able to get to New Zealand on time, I would have said so earlier.

THE CHAIRMAN: Thanks very much, Don. Yes, Peter.

MR DAWKINS: Alan, Victoria would also like to give you the encouragement you're looking for in saying that we think that in meeting the terms of reference you're approaching this issue of materiality in an appropriate way, both in terms of the levels that you're choosing and the rigorous application. So there's no doubt in our mind that the simplification thrust of the terms of reference are there and need to be approached with a certain degree of urgency and that you're proceeding in an appropriate way.

THE CHAIRMAN: Thanks very much, Peter. Jennifer?

MS PRINCE: Alan, could I also reinforce our support for the approach and particularly the top-down approach. There was just one thing that was said earlier and I guess that's where some of the discussion's been confusing, the top-down approach and the bottom-up approach, that the suggestion was many of the smaller assessments would have to be eliminated if we are seeking simplification. Certainly our view of the top-down approach is that that wouldn't be the case. What we're trying to achieve both through simplification and the top-down approach is that for people outside of this room would have some understanding of the process. And I think that - - -

THE CHAIRMAN: Well, inside this room would be good too.

MS PRINCE: For that I think we need larger functional categories because one of the ways of eliminating categories that are now small would be including them in the budget result term. That would mean that we would have a very large budget result term and that of itself would be not understandable. So I think the simple approach of looking at large functional categories that make sense and have similar disabilities is the approach that we'd support and I think that your proposals in the paper will get us there.

THE CHAIRMAN: Thanks very much, Jennifer. I think there is firstly a recognition by all States that the terms of reference that we have for the review *inter alia* require us to progress a simplification agenda through the application of materiality thresholds. There is also a general acceptance that materiality thresholds are appropriate and can be helpful in progressing this agenda. There is not complete agreement as to how rigorously materiality thresholds should be applied, but you have heard the Commission's view that we think that they need to be rigorously applied but that rigorous application has to be seen in the wider context, that if you focus just on materiality thresholds without understanding that this is taking place within a top-down approach to disaggregation, then you don't really get the full picture of what we're proposing to do.

We understand that there are differences of view about what materiality thresholds should actually be set. I think there is now a general acceptance of per person per State, a category size, a redistributive effect and a disability threshold. I think there's general acceptance of that, but not - but people remain either opposed to or very apprehensive about the precise thresholds that the Commission is proposing to develop.

I would ask you to park that apprehension until you see how this will all fit together, and of course that's not going to happen until 2007 because it has to be fitted in to the context of the work on disaggregation. So I would ask you to just put on hold your final responses to how this might be developed. I did indicate in my own opening remarks that in 2007 when we report on the outcome of our work on disaggregation, that will also include the further work that we've done when we've thought about the top-down disaggregation and how that impacts on materiality and what we do as a consequence of all of that.

I think there is sufficient agreement around the room for me to conclude that by indicating that we will continue to progress our work, including the report to the Ministerial Council in 2006, on the basis of the proposals that we have put forward in the papers we circulated for this meeting.

And if there are no further rejoinders, we might adjourn for morning. Adjourn for morning tea. Thank you.

## SHORT ADJOURNMENT

[10.58am]

## RESUMED

[11.17am]

THE CHAIRMAN: Can I welcome to today's conference Paul Grimes, who is I think attending for the first time as ACT Under Treasurer. Welcome, Paul. Roger has held the fort admirably in your absence. And can I also welcome Michael Willcock, who is representing the Australian Treasury and representing David Tune specifically. So welcome, Michael.

We move to reliability. If I had the right page it would be helpful. In the issues paper that we circulated some time ago in June, we suggested that a reliable assessment method should have a number of features. The first was that it should be conceptually rigorous, that is it should identify the links between State expenses and revenues and the non-policy influences that cause them to vary. It should relate to what the States actually do, be based on sound theory, and be as simple as possible.

Secondly, it should be implementable. That the measures used in the quantification process should accurately reflect the influences that do actually drive State revenues and expenses. And although it's possibly a statement of the obvious, it's got to be an assessment that actually works, that does what it's supposed - what it represents that it is doing.

Thirdly, that it should track reality. It must be capable of reflecting what is happening in the real world in the assessment period and over the period that the assessment is likely to be used. And the results should be consistent with the conclusions that could be drawn from examining other information that reflects the real world.

And fourthly, that it should be robust. That the method should not be unduly affected by small variations to the data employed or to the judgments that are made about the method.

Reliability is also of course very much a data issue and the Data Working Party has been particularly helpful in assisting the Commission to think about what data might be unreliable and how we should progress issues of concern with data reliability.

Our objective then is to have a reliable assessment method, reliable covering those areas, that is as simple as possible. We're not proposing to review the reliability of methods used in the last review. I mean, we think we need to move away from thinking about reflecting back and judging everything against what was done in the last review. We don't think that's the sensible way forward to do what we think is expected of us. It would also be a waste of

resources, given that we are focusing on developing a different methodological framework for the 2010 Review.

In evaluating reliability, we do propose that there should be much more use of sensitivity testing. The sensitivity of inputs to change we agree is an important issue. But we also agree with the comments that a couple of you have made that interpreting the results of sensitivity testing is also important. We don't think that reliability requires or is actually achieved by some slavish adherence to statistical methodology. There will be a call for judgment and it doesn't seem to us that putting excessive focus on statistical techniques for all of the assessments that we make is actually consistent with simplification.

We do agree with all of you that there is scope for the involvement of external experts in the process. We don't necessarily agree with all of you on the extent to which that is required or the particular format that that should take. We have in the past exposed some of the more contentious assessment areas to external review and it is ironic that some of the assessments that continue to cause the greatest anguish with some people are actually the ones that we've had peer tested by external experts.

So we remain quite unconvinced that mandating that independent experts should examine everything that we do is actually a step forward, if such experts actually assist. But we do acknowledge that there is a role, an important and valuable role from involving independent experts to validate the work that we have done, or in some cases to actually contribute to doing the work with us. So we are very open to that. Not only should that help reliability but we would hope that it will also encourage a greater level of confidence in what's being done.

The question of how the Commission should evaluate situations where the inherent reliability of assessments is low but the equalisation consequences are significant is something that clearly needs to be thrashed out over the review process, and I hope we can make a start on that this morning.

It's not possible to actually think about reliability on its own, as Jim has reminded us this morning. You have to look at reliability, you have to look at materiality, you have to look at aggregation and disaggregation - you need to look at the whole context in coming to a view. But again, the terms of reference which we hold are very clear that we are to eliminate unreliable assessments. We haven't - the Commission in the past has not wittingly progressed unreliable assessments but we accept that there are differences of view about the extent to which some of those assessments have been reliable. And if you look at top-down, materiality, reliability taken together, then we think you can begin to see a clear picture in which some of the concerns about the reliability of some of the work that's done in the past should be dealt with in a constructive and sensible way.

So that's really all I think that I wanted to say about reliability. Reliability will also be covered off in the assessment guidelines that we propose and properly covered off when the assessment guidelines have been finalised. I acknowledge with thanks the contribution from Victoria of some suggestions for assessment guidelines. We agree with much of what has been said, and in the draft assessment guidelines that we're thinking about ourselves, there are some strong similarities. We differ on some specific points but certainly our thinking has been usefully informed by those. So we appreciate that and I acknowledge that contribution.

Glenn or Ross, John? Well, I don't - I'm not going to call on John to go first this time unless he particularly wants to. Let's just throw it open. You see, this is what happens when you don't call on somebody. All right, John, thank you.

MR PIERCE: I should be used to it by now, shouldn't I? Look, on the criteria that's been proposed, we're happy to support that criteria. You make a point in the issues paper that you don't favour using predictability and stability as a method for evaluating reliability on the basis that fluctuations in the relativities can emerge, I suppose over time a State's circumstances change, and fair enough. Though we would expect that assessments that are predictable and stable are more likely to be robust over time sort of anyway.

The issue about things where you've got question marks about the reliability but they are material, you're getting - there's been a theme here about where should the onus of proof lie. Now, from our viewpoint I suppose that I think the onus of proof should be - in that circumstance why they should be included. It's hard I think to be general because it's a matter of degree. You know, what's the degree of unreliability, what's the degree of redistribution. And again I suppose it's a bit of a case-by-case basis but if there was an onus of proof as to why it should be included, because I suppose by definition if it is reliable you don't really know whether the impact is moving outcome closer to or further away from equalisation.

You made the point about not wanting to slavishly follow statistical tests but I thought the - I suppose at least as a guide the sort of tests that Victoria were suggesting was an interesting one - - -

THE CHAIRMAN: This is the margin of error?

MR PIERCE: Yes. That would be helpful.

THE CHAIRMAN: Thanks, John. If I just comment on one point, your first point about predictability and stability. I actually think of that the other way round, that reliable assessments that meet these other criteria will themselves then be more predictable and more stable. Stable and predictable in the sense of course that they are delivering the objective. It doesn't actually mean that

the amounts of money don't change or change less. So I actually think of it the other way - cause and effect the other way round I think.

MR PIERCE: Yes, okay. Well, there's robustness over time as well I was referring to rather than necessarily don't change over time.

THE CHAIRMAN: Yes. And robustness is one of the criteria that we had proposed. Yes, Don.

MR CHALLEN: Alan, I think the only interesting question that's even a little bit controversial in this area is this question about what you do when you're faced with an assessment that is material but unreliable. I think the answer, and I think you've already hinted at this actually, lies in the top-down philosophy. So it's a bit that you don't go there so you're not going to find yourself in this neck of the woods. And if you look like you're heading in that direction, I think the answer is use the best data, the best methodology, and you get to the right answer with the application of judgment. And what you end up with is something that will pass the reliability test. So it's a bit of semantic problem that if your methodology is a good methodology you will never find yourself in this camp.

THE CHAIRMAN: Nice thought. But indeed, that is the construct. I don't want to throw back to the discussion before morning tea but - - -

MR CHALLEN: Wouldn't be a good idea.

THE CHAIRMAN: - - - we'll have to see how - we'll have to work our way through this because it's not always going to fall out absolutely neatly and that word that strikes terror into the hearts of some - Commission judgment - will inescapably come into play.

MR CHALLEN: I mean it strikes no terror into my heart at all. In fact it - - -

THE CHAIRMAN: Well, I wasn't actually aware that you had one. It's the - - -

MR CHALLEN: You should hear what my friends say about me. God, it's hard to keep a line of thought going when you're under this kind of attack.

THE CHAIRMAN: Sorry, mate.

MR CHALLEN: Where was I.

THE CHAIRMAN: It was a good point though.

MR CHALLEN: No, you've destroyed it completely, I'll come back to it.

THE CHAIRMAN: Oh dear, oh dear.

MR CHALLEN: Yes, judgment. I mean judgment is the whole reason for the Commission's existence. If it wasn't necessary for judgments to be made we wouldn't need a Commission. And, you know, that's why the Heads of Treasury spend so much of the time they do at their more private meetings agonising about who we might suggest to the Australian Government minister should be appointed to vacancies on the Commission because it's really important because that's what the Commission is all about. And at the end of the day, nobody should be fearful of the Commission's judgments because at the end of the day somebody has to make the call and that's what you're there for.

MR .....: Don't try that tactic again, please.

THE CHAIRMAN: We won't but we won't go there because there are other reasons that you like to prolong these informal private gatherings in the evening at Heads of Treasury.

MR CHALLEN: Something to do with the rate of consumption of red wine.

THE CHAIRMAN: Are there other comments? I don't want to oblige people to speak. If you're generally happy with what we've put forward we can move on. Gerard?

MR BRADLEY: We're generally happy with the approach you're taking in broad terms. We think the Commission's the best place to make judgments about when it needs independent input and where it might get that independent input from. I guess the only point we'd make is that there needs to be a commitment from jurisdictions where you have problems with the data source from jurisdictions to actually call upon jurisdictions to improve the quality of that data in the first instance rather than simply throw it down because we can't rely upon it. So I guess that's a key issue I'd throw in to think about.

THE CHAIRMAN: Agree. Agree strongly, Gerard, and we'll come back briefly and touch on data just before lunch and that would be one of the points that we would want to make. Yes, David.

MR SMITH: Sorry, Alan. I don't have a lot to say on this item and I don't know that there's necessarily a lot of constructive discussion that can be met around - I mean I think there's largely some hinting of the issue of what the - you know, how you decide what's reliable needs to be measured against what it is that you're trying to achieve. And really - and again at sort of a conceptual level I think the best test and really what the process that the Commission's gone through over a number of years is actually not a bad one of testing reliability and that's been the process it's gone through, the challenge and the scrutiny that your assessments go through and the arguments that we each put

up to you go. I think that's an important element of ensuring sort of reliable results.

From that perspective then I do have - I mean I can understand the view that you're not - in assessing reliability you're not going to be backward looking, you're going to be encouraging us to be forward looking. But in a sense for us and for the outside world as well, until such point as we've got a new set of assessments, the 2004 results are, you know, the best judgment - were taken as the best judgment of the most reliable assessments at the time. Okay, things will move on and things will change and so on, but I think you can't throw out that benchmark entirely would be just my comment.

THE CHAIRMAN: Yes. I understand the point. We're not going to be constantly going back and trialling our thinking going forward against what was. We're not going to be constantly doing that. But is it possible to cast that from your mind completely? I doubt it and I'm sure that the States will be looking back - flipping back from time to time to see how things compare. Yes, Bruce.

MR FREELAND: Alan, can I just make a comment just on the use of the independent panel of experts or some sort of review panel. The assessments the Commission does are very extensive, both in their form, the data requirements, all the rest of it. We all look at them and we all assess them as they come around but in a way it's a fairly insular little group of us that looks at those assessments and has done over time. I think that's where the benefit of having the independent panel of experts or review panel or whatever you want to refer to it as really does come into its own.

And I think that we'd like to see that review panel used as comprehensively as possible as much as anything else just to try and break that insular circle that we tend to get into of constantly looking inwards. Having some experts or having some others just come in, try and throw a bit more light on some of the things which we've been seeing as just being part of the background is a pretty useful way of shedding some light on some of the difficulties, some of the problems that may be inherent to some of the assessments that we've all just seen so many times, we don't see any problems with them any more.

THE CHAIRMAN: Bruce, we would welcome suggestions from States of experts who could contribute in areas of the Commission's activities. We actually find it difficult to identify people who have the level of expertise which is a combination of both academic expertise and an understanding of what this is all about, of what it is you're actually trying to referee or review. So any suggestions that States have of people that they think could contribute to that process we would welcome that. We don't find the notion of a standing panel of experts to review everything that the Commission has done at all appealing. Now, I'm sure you'll be flabbergasted at that.

MR CHALLEN: You didn't get all our orders, did you?

THE CHAIRMAN: We take the view and I think this is what Don was getting at before, we take the view that in a sense that's why the Commission itself is appointed. So we welcome the opportunity to involve experts who can be helpful in parts of the process. We just don't think a standing panel of experts which endeavours to understand, interpret, comment on what we've done and why we've done it, we just don't think that's going to add to the process and we're not attracted to that specific idea. Jim?

MR WRIGHT: Just in support of that point, Alan, we would be - I mean I think what we need to recognise is that in the Commission, in the Commission staff and around this table and in the Treasuries that we come from there is a massive degree of expertise. And the point you made I think about the difficulty of getting an expert who one, is expert in one particular area but also understands the broader context of it, I think that's a real limitation on what experts can contribute. So we have no problem whatsoever if there's a specific thing where we need extra expertise getting people, but the idea of a standing panel or some higher authority called expert that can rule on these things - not rule, that's the wrong word, but we don't think there's much of a contribution that can be made in the generic use of an expert panel.

THE CHAIRMAN: Thanks, Jim. Peter.

MR DAWKINS: I'd just like to say three things. One is that we agree with the general approach. Secondly, we're pleased that our suggestions are being looked upon favourably. Thirdly, we would like to support the concept of independent review being useful. I think we've made one or two suggestions of the type of auditors you might call them that could be called upon in our submission. We just think that that would help the credibility and the transparency and the confidence in the process so we'd encourage you to keep looking at that idea and we'd be happy to continue to offer suggestions in that area.

THE CHAIRMAN: Thanks, Peter. Let me be absolutely clear. We would welcome suggestions from you as to people who you feel can contribute. In areas of the work that we do the two criteria would be sort of an intellectual understanding of the issues and a practical understanding of how these are actually relevant to what it is that the States do. But we won't be taking any initiative on our own to progress the standing panel concept.

I might also - while we're in sort of the negative part of the market, I might just say that one specific proposal in the suggested Victorian draft assessment guidelines that we're not attracted to is the margin of error concept. And I've heard that, you know, New South Wales is attracted to it. I'm not attracted to it at this stage. I might be able to think of more reasons later on, but I'm not attracted to it at this stage because I don't actually understand what it is and I

don't actually understand how you would do it. I mean, if you know that the right answer is 10 and you get an answer of 8 or 12, well, you can work out what the margin of error is. But if you don't know what the right answer is to start with, it's not - I haven't yet grasped how you would actually do this in a meaningful way.

We are committed to sensitivity analysis type to establish the robustness of the assessments that we are making, but if you would like us to - well, if you'd like me - probably the staff understand this absolutely perfectly, but if you would like me to think more favourably about margin of error I would have to actually understand what it meant and how you would apply it.

MR DAWKINS: Look, we might come back to you with more detail on that but two things I think I'd say. One is that we basically took the concept from the current assessment guidelines which refers to the margin of error. And the Commission will make an assessment when the margin of error associated with the assessment is acceptably small. I think what we see that dovetailing with your concept of sensitivity analysis really.

THE CHAIRMAN: Yes, okay.

MR DAWKINS: So the sensitivity analysis will give you a view about whether the margin of error is acceptably small. But maybe we need to continue a dialogue all the way - - -

THE CHAIRMAN: I think we just need to talk through that a bit more because there's a different nuance in the old assessment guidelines. Margin of error came right at the end of a process where things fell in or out and you got down to margin of error. So I just think we need to talk that through a bit more. We may not - in terms of what we're trying to establish, I don't think we're very far apart at all. Any further comments?

If not, then I think the general conclusion is that the proposals we've made in respect of reliability have broad support and that we should continue to progress our thinking along those lines, including greater use of both external review and sensitivity analysis, and I repeat an invitation bordering on an appeal that if you can assist us by suggesting names of people who could contribute to this external review either in an ex post sense by reviewing what we've done or by actually participating with us in thinking through the issues, we would certainly welcome that. Glenn, Ross? All right, I don't see any pens waving.

Thanks very much for that. The next item on the agenda is early implementation. Our thinking on early implementation was set out in annexure 2 of my letter of 28 October. Our general view is that method changes except data driven ones should be introduced as a package in the review and we are not proposing the introduction of method changes except where they're driven

by data issues. We're not proposing the introduction of method changes before the 2010 Review.

We think there is a strong case for the earlier introduction of data driven changes where no change in method is involved. This was recommended unanimously I think by the Data Working Party and we think it's consistent with the 2004 Review principle and so we would propose where data driven changes that don't require a change of method are seen to be appropriate we propose to introduce them in the update.

But the big question I think is about data driven method changes. We think that where data issues indicate that an assessment is unreliable but the new data requires a new method in order for it to be introduced, then provided that this is consistent with the 2004 HFE principle, these changes should be made in the next update as we become aware of them or are made aware of them.

So data tells us that it's unreliable; can be fixed but requires a method change; probably new and better data coupled with a method change; and thirdly, that it's got to be consistent with the 2004 equalisation principle, then we think those changes should be made and not wait for 2010. Put quite simply, it seems to us that this makes more sense and is more defensible than continuing with an unreliable assessment and is consistent with the terms of reference call for continuous improvement.

There is an issue though - well, the first issue is whether States agree with that. The second issue is one of timing and protocol. If we proceed in this direction, should the Commission make the change as soon as it has reached a judgment that it should be made? That is, in the next update, or is there a need to report to Ministerial Council first? In annexure 2 of my letter we set out an approach for dealing with unsatisfactory data in an update and you will have looked at that.

In thinking about this, two practical examples. These are not the largest examples under the sun but the two specific examples have emerged to date. The first is data, purely data driven. The ABS has said that the establishments count for primary industry data is not fit for purpose but there is new data - I think it's - I can't remember what it is. It's not establishment count, what is it? Whatever it is, it's a different - that it is fit for purpose. So the question arises what should we do and when should we do it? In thinking this through, what we are actually proposing is that in the 2006 update we will replace the business register counts with ABS establishment counts for the primary industry category, because not to do so means that we continue to implement an assessment where the data has been indicated as being not fit for purpose.

So the first question for us is do we do it all in 2006? Do we do this in 2006 because we're also aware that in the non-primary industry components of that assessment there are also problems with the business register data for water

sanitation, protection of the environment manufacturing. And the issue there is that our conclusion is that these are assessments that are simply not material. And do we replace the business register counts in those areas with factor income data for mining fuel and energy, and GSP data for general public services because these are reliable and fit for purpose, but of course that gets you into the debate about whether these are method changes or not.

So we really don't think there's an issue with primary industry because we're replacing data that's not fit for purpose with data that is fit for purpose, so we propose to actually do it in the 2006 update. And at this stage we're proposing to indicate in our 2006 report to MinCo that we'll make the other two changes in 2007. So we'd be glad to hear your views about that. And this is a practical way of trying to run through this question about what you implement early and what you don't.

And then there's a second set of issues that relate to alcohol subsidies. Very appropriate given the Heads of Treasury dinner tonight. We have observed that in relation to low alcohol subsidies, State policies have changed and it's no longer standard policy to provide these subsidies. So we propose in the 2006 update to assess those EPC. And to report to MinCo in 2006 that for 2007 we will assess the whole alcohol products EPC because it simply doesn't have a material impact on State shares.

So they're sort of two practical areas in which thinking through this question of what if anything we implement early, and what we do when we find that data is unsatisfactory. What do we do, when do we do it, how do we do it? So to summarise, broad issue, package implementation of new methods in 2010. Data unreliability that can be dealt without a method change, bring it into the next update. Data problems that can be fixed but require a method change or where things are simply not material or State policies have changed, report that we intend to bring those in in the following update. Now, that of course can only apply in 2006 and 2007 unless we're asked to report again after those years to Ministerial Council. But that's the broad approach. Don't

MR CHALLEN: I'll give John a rest. On the protocol question first of all. I do not read the terms of reference as requiring you to report to Ministerial Council before you make such a change. And since I wrote these terms of reference I ought to know what they meant. All they require you to do is to highlight the fact that you have done it, that's all they were ever intended to do. And in fact I think it's highly undesirable that you report it in a way that makes it look as if you're asking for endorsement of Ministerial Council when you're going to do it. So I don't think there is an issue and in fact I find it hard to understand how you could read the terms of reference in a different way.

On the way in which the Commission is proposing to handle the issues on early adoption, I am broadly comfortable and I accept that the terms of reference have been constructed in such a way that you have been given the option to do

all the things that you've described to us that you plan to do. The one thing that leaves me with a bit of anxiety is the early implementation of a data driven method change. Now, the way you've wrapped it up, the way you've described it gives me a fair bit of comfort but it just leaves me with a little of anxiety because the principle of the annual updates is that we want relatively stable changes through time. So data driven changes we're all comfortable with because those things tend to evolve nice and gradually. Method changes tend to create shocks in the relativities - and I'm telling you something that's very consistent with your own thinking, but we and you have always been more comfortable with doing all the method changes at once because there are swings and roundabouts and things wash out.

So I'm a bit anxious about what you've said about data driven method changes. And I wouldn't say don't do it, I'd just say be especially careful about it case by case because you will I think undermine the acceptability of the annual updates process if you introduce something that creates a relativity shock. So I don't think there are any general principles that you can apply, you're simply going to have to look at the consequences of what you are contemplating doing in a particular case, but I just urge you to be careful not to undermine the acceptance of the annual updates process in doing that.

THE CHAIRMAN: Thanks, Don. Jim?

MR WRIGHT: A couple of things. Firstly, we kind of agree that - well, we strongly agree with your first position, Alan, about the implementation of methodology changes before the - you know, it should be a package. On the question about MinCo, I mean we disagree with Don there. I mean I don't think this argument that somehow it suggests that the Commission is asking for the Ministerial Council's blessing has much weight at all. I mean every - that's what the Ministerial Council is there for. There was never any presumption that when you - you know, kind of every recommendation you make, every update you make it comes to Ministerial Council and they tick it off. But the fact that you recommend a certain thing has weight with the Ministerial Council, that's the idea that somehow if you suggest that it needs to be ticked, it's not going to change whether it's discussed at the Council or not. I mean, if people are upset about it, it will be discussed. If they're not upset it won't be discussed. And as we all know, at the end of the day, the Commonwealth Treasurer decides what happens. So I think there is probably merit in it going to the Ministerial Council on that basis.

On the data driven method changes, we agree with you once again. Clearly if there is a good case and the data's moved or we've found something's wrong, the sensible thing would be to try and adjust it in this case. I mean, kind of given there's a strong data argument for it. The only thing that we do object to in this particular set of stuff that you've mentioned here is the - it seems to us that the second category, the change to EPC for the subsidy alcohol products is purely immaterial that will be changed. It's not a data problem that you've

discovered and it seems to us it's a selective use of the materiality threshold and while I should note that in terms of our self interest - I mean the other ones that we're supporting are going to hurt us by about 10 million, this one which we're opposing will hurt us by about 6 or 7 million. So in South Australia's level it's material, I can promise you.

THE CHAIRMAN: Jim, it is a materiality issue but the low alcohol subsidy is more than that, it's actually a change in standard policy.

MR WRIGHT: But there's a different - I'll let John - - -

THE CHAIRMAN: John.

MR JOHN HENDERSON: There's actually two components to the category though, Alan. It's our point that we have no problem with changing the low alcohol subsidy policy element which we understand is only about 10 per cent of the category, that's fine to make that EPC but we don't see why you should change the assessment of the other 90 per cent of the category which still remains and .....

THE CHAIRMAN: Okay, I note the point. The first we were proposing to do in the 2006 update.

MR WRIGHT: Yes, we have no problem with that. We're happy.

THE CHAIRMAN: John?

MR PIERCE: The pure data changes which you're proposing to do we're comfortable with. I just raise one question about the - in terms of taking the logic of while you're comfortable with it, the gross state product data is presumably more reliable than the ATO business register counts at this point in time - - -

THE CHAIRMAN: So I am advised.

MR PIERCE: Well, that's - - -

MR .....: The other must be pretty hopeless then.

MR .....: The gross product data is .....

MR .....: The GSP data is a load of rubbish.

MR PIERCE: You see why I raised it.

MR .....: It's certainly not stable over time.

MR PIERCE: No, that's right. I speak from the jurisdiction that had the highest annual growth in GSP in the latest release.

THE CHAIRMAN: Is that a percentage - highest percentage in your growth?

MR PIERCE: It's percentage.

THE CHAIRMAN: Yes, we understand how the mathematics works.

MR PIERCE: I raised it because I was surprised to see it there, as indeed some of my colleagues are. You might - you're not proposing to do anything with that, as I understand, until 2007. I don't know whether there's an alternative but you might like to ask the ABS whether they think that's fit for purpose in that case.

I was hoping Don would be out of the room when I admitted that I was largely in agreement with what Don had to say.

MR CHALLEN: Come on, John. I expect this from the chair, not from you.

MR PIERCE: I suppose I need to think a bit more about - I mean I certainly don't think you need to come to MinCo and, as Don said, invite people to ask permission for these purely data driven changes. I we are changing method then I think that's a slightly different case.

THE CHAIRMAN: Which is why we've raised the issue.

MR PIERCE: And at the very least that would need to be tested a lot with us beforehand. And I wouldn't necessarily invite you to then go and express it in a way that invites them to tick off because if it's tested a lot with us then if people are concerned about it because it's already been said it will be raised, they wouldn't want to get into the habit of raising - of leading people to expect that you'd be asking permission for things all the time as we go through these annual updates. So generally I'm on side with Don and don't see that other than this GSP data, no great concerns about any of the purely data driven changes.

THE CHAIRMAN: I take the point about GSP data. I mean its shortcomings are well known. At the present time this assessment, if I've got it right, actually uses a combination of the broader data and the ABS data. The ABS has said the data's not fit for purpose so we propose to drop that out. So we deal with the data unreliability with minimal method change. I mean that's the logic of it. Yes, Peter.

MR DAWKINS: So Victoria supports all of your recommendations on this early implementation. I think on the process issues, this issue of the data driven methodological changes - I think we agree with what Don and John are

saying about you don't need to go to Ministerial Council for endorsement but we think that you would need to come to some kind of comment from the States as you're going through that process of what you're proposing to do because that may help you to even improve what you're doing.

THE CHAIRMAN: I'm just confirming that what we would do consistent with the way this process has always worked is that whether we call it a new developments paper or an issues paper or something, we would consult with the States before we did it in the course of the update. Yes, Gerard.

MR BRADLEY: I think we're basically similar. I think we agree on leaving the methodology changes to 2010 as a package. On the other hand we're comfortable with any update process improving the data quality as you're proposing, and the examples you've given we're reasonably comfortable with. I guess we have a view that where it's a mercurial change in methods driven by data it's one that we'd want to have input to as to whether that's appropriate to be incorporated in an update process. So I guess I have that reservation not knowing ahead of time what they might be.

THE CHAIRMAN: Sure. That's fine. David?

MR SMITH: Thanks, Alan. We also agree and support the Commission in the proposition about method changes being considered as a package and part of the 2010 Review. We also agree on the proposition about using improved data in updates where there's no method change. We would though register a couple of hurdles that the Commission has applied in the past and we would expect to continue to apply in that category, i.e. that it is new data and it's not new judgment or analysis of the data. There are some examples - roads, for instance, I think which have been problematic in the past and we probably expect that test to be applied rigorously - - -

THE CHAIRMAN: Continue to be problematic.

MR SMITH: - - - in that regard. We'd probably also look for a case that there's been a significant deterioration in the quality of the data and that improved data has only become available since the review was completed. That's an important hurdle in that category as well. The data driven method changes - it's more problematic for us. I mean I think it does take us into difficult territory. It takes the Commission into more difficult territory and I think in that regard I'd probably just put a plea for as much reassurance as you can provide to us and to Ministerial Council about your judgments as to why that's necessary. And probably the particular reassurance is why it's necessary in the categories that you've identified and not in other categories.

And I think you said, Alan, I'm not trying make too much of the particular choice of words in this forum, but you said the examples that are cited here are just - you know, there are other examples.

THE CHAIRMAN: The ones we've come across.

MR SMITH: Yes, and the sort of come across process is one we - - -

THE CHAIRMAN: Well, come across was one important caveat. We've come across them heavily influenced of course by the ABS identifying data that it has told us is not fit for purpose. Now, there is some ongoing discussion with the ABS about whether some of their judgments in that respect are right, but for the issues that we're talking about here and now, I mean that's been a predominant driver.

MR SMITH: And I can accept that and happy for that to be investigated by the Commission. But, as you say, the sort of assumption or the claims about fit for purpose need to be examined. But I think also the other test you've got to apply is, you know, what's changed since you made the assessments in the review in relation to that? Because I think - so my guess would be you could probably go through a lot of other categories other than these particular ones and find similar circumstances but it's not being proposed that the changes be made in those areas.

So I just, as I said, flagging that reassurance that needs to be provided in that context. And I suppose that's the way in which I'd see the role of MinCo in this. Like others, not approval per se but clear explanation as to why changes in these areas and not in others.

In terms of the specific examples, and I think the business register one is right. As you said, the fit for purpose needs closer examination. We're a little bit concerned I think that the new data doesn't have the same coverage for instance as the old data and that may have some problems for the reliability of your assessments.

In the other examples, both that one and the low alcohol one, we don't particularly have strong view, but I guess what caught our eye in the explanations was the justification on materiality. I think we feel less comfortable about justifying change in those areas based on not really explained and perhaps not applied consistently in judgment about materiality than we do about the data. So again just a caution about explanation.

THE CHAIRMAN: Thanks, David. Are there any other views? Michael, the comments that we got in writing from David Tune did note that business of the Ministerial Council can be conducted out of session. But before we think about that too much - I mean, I think I should make it clear that on this point - well, perhaps it's even debatable whether the business gets conducted in session. That I have no appetite at all for seeking to run these kinds of issues through a Ministerial Council decision process. I don't think that is a sensible

way to encourage ministers to gain growing confidence in equalisation, to ask them to be deliberating on issues like this.

And I think all of this discussion has to sit under the very first point that the Commission itself thinks that method changes should be introduced as a package in the 2010 Review. And the discussions about the what ifs and the maybes are all really very, very trivial - I won't use the word immaterial - but they're very trivial in that context. It's just a matter of exploring the extent to which you are comfortable with us tidying things up, particularly where ABS has indicated that we are using data that's not fit for purpose and our further consideration, working with you, leads us to agree with that.

So my own view would be package implementation 2010, data driven changes that don't require method changes just flow through, data driven changes that require some method change, consult with you in the course of the update process and come to a clearly understood position - whether it's fully agreed or not - a clearly understood position about what we are going to do. I mean I think that's the framework.

Paul, did I see you shuffling?

MR PAUL GRIMES: Yes, I was shuffling. I was just going to say we broadly support the approach the Commission is taking but we are nervous about the - as I think several others are around the table, about the question of data driven methodology changes. I've heard what you've just said about the operation of the Ministerial Council. I don't know whether this is a sensible suggestion at all, but whether the Ministerial Council - there can be a report to the Ministerial Council before the change is actually implemented. This is a data driven methodological change so that there isn't a formal approval by the Ministerial Council but everyone's got the assurance that the change isn't implemented until after there's been a report to the Ministerial Council.

THE CHAIRMAN: You won't be surprised that I am extremely unenthusiastic about additional reports to the Ministerial Council. And again, the notion of reporting to the Ministerial Council about a proposed change to low alcohol subsidies isn't consistent with my idea of strengthening the confidence of Treasurers about this process. I think it's far more sensible for us to work through these issues with heads of Treasury and at staff level. And then for the Commission, having done that, the Commission will take a view based on the consultations with you about whether we proceed or not. I just don't think that - I just don't think that the Ministerial Council should be used as a sounding board in this way for these sorts of things.

But whether it's reassuring or not, I mean you know that the Commission has consistently articulated a very cautious and conservative view in this area. Nothing in this discussion should be taken to indicate that we would depart

from that. Can we leave that on that basis then? I don't think I need to summarise again. Thanks very much for that.

Item 5, State taxes. This is on the agenda because the Commission genuinely is unclear about what is happening and that makes us very uncertain about how we should be thinking about these issues. We're broadly aware of the proposal from some States in relation to the further abolition of State taxes. We don't know how that proposal is being progressed or whether it's being progressed. We understand that the proposal has different taxes and different timetables for different States and not all States are yet - as far as we know, not all States are on the table.

So it is just a touch difficult for us to think our way through what the appropriate methodology would be. If we phase out the taxes when they affect the data, which is basically what we are proposing, then I think there is no ..... for the 2006 update. We certainly cannot adopt the alternative of backcasting these taxes without considerable State data which we do not have. So I thought it important to put this on the agenda so that we could be informed if there were any recent developments which might affect our thinking. And if there are, and if that further information goes in the direction of second tranche of the IGA reforms, which is not language that actually is in the IGA I don't think, backcasting and so on, then to tell you that we don't have the information currently that we would need to do it.

So I'm sure you understand our dilemma. We've indicated how we think we are going to have to deal with the issue, but we - if you've got anything to say that will help us, please do so. Yes, Jeff.

MR BYRNE: I think the first comment is that those States that put forward a reform proposal to the Commonwealth Treasurer, virtually all of those have subsequently been implemented by States. That's certainly the case in Victoria and most of the other States have also actually done it through their budgets, through legislation, etcetera. The position of those States that did not provide a response to the Commonwealth - NSW and WA - well, they haven't provided any response so nothing has happened there. But for the others the changes are real. They have happened. Our view is therefore once that becomes standard policy, normal approach to the Commission is that it would then be incorporated in your assessment including through backcasting. So the issue is at what point does it become standard policy.

THE CHAIRMAN: Well, it's certainly - for us it's certainly at what point does it become standard policy. When you say that the States that were in this category have done it, my understanding was that doing it was different for different states over different years. So they won't have all phased out the same taxes at the same time.

MR BYRNE: The distinction here I think is between the timing of the actual doing and the decision and public announcement that they are doing the doing. I know that's sort of - that's an interesting difference. But it's not as though they have said we might or they've put a proposal to the Commonwealth and are waiting to see what happens, they've put a proposal to the Commonwealth and without getting any clear response from the Commonwealth they have announced implementation anyway. So based on the pillar of what States do, it seems to me if States have announced they are doing something, at the point when that happens, when enough of them have actually done it, it becomes standard policy.

THE CHAIRMAN: I don't have any problem with that and that's consistent with what we've said we would do. The question of whether we backcast as part of that process or not is something that we'd have to consider. The arguments don't seem to me to be overwhelming one way or the other but we could consider that. John?

MR BYRNE: Just come back quickly on that one. The precedent of backcasting I think has been set for IGA tax changes in the past. These are no different. The only issue becomes at what point does it become standard policy. It's a timing issue only.

MR CHALLEN: That's just plain wrong, Jeff. These are not IGA tax changes, right. They did not take place under the IGA, there is no intergovernmental agreement about them. All there is is a letter signed by six Treasurers to the Commonwealth Treasurer that has never been answered in which they set out their intentions to do certain things by certain dates. Now, the status of these tax changes is no different from any other tax changes that just happen in the normal course of events through the States and Territories over time and they have to be treated in the same way. So the Commission's got to make the normal judgments it would make when one State makes a tax change and over a period of six or seven years other States follow. Plenty of precedents for that. And in those cases it is not standard practice to backcast. And you probably can't anyway because the data isn't available.

THE CHAIRMAN: Well, the point I need to really emphasise is that if backcasting - at whatever point in time and for whatever taxes - if that does come into effect, we will need data which we don't have. I don't know whether you've got it or not.

MR CHALLEN: No, most of it we don't have either.

THE CHAIRMAN: So just leave that. John.

MR PIERCE: I was just going - I probably don't have the legitimacy to comment on the general issue possibly as yet but just to point out that we do provide - we are able to provide the necessary data. The issue about - - -

THE CHAIRMAN: But you have no case to do it.

MR PIERCE: Well, it really gets to the heart of the - you know, this issue about backcasting, the - whether they're IGA taxes or not, second wave of reform. I mean the arguments have been - look, I don't think that's settled. I mean the practical - there's a principle here which would probably take you in one direction, which some people have been trying to apply, the practical outcome though is that we're in this position because of the IGA irrespective of - perversely - whatever the words are that were written within the IGA. I don't want to open up a debate that actually should be taking place in another place, but you might just, when you do have to make a decision about this backcasting issue, note that (a) we have the data and (b) there might be a principle but there's also the practical way in which the IGA has worked out or the way it's actually worked out in practice.

MR WRIGHT: Alan, I just - - -

THE CHAIRMAN: Hang on, Jim. Gerard I think and then you. Gerard.

MR BRADLEY: Our view is very consistent with Don's. We think that it work in the same way as tax abolitions have occurred at the State level in the past. In our case we're enacting the tax abolitions in the relevant year in which they occur so this week for example we enacted the tax abolitions that occur from 1 July next year, as we did previously the debits tax in the previous year. There are still technical issues being worked through in relation to some of the tax measures which Tax Commission and others are working cooperatively on so it's uncertain in terms of the actual technical detail of that which will, as we get closer to enacting them, we will obviously seek to clarify. But we do have different timing across all the States according to their own priorities in accordance with their own review of the own tax bases. So our view would be same as Don's, that it's a matter to be treated in the way that I think the Commission has correctly identified in terms of its first option.

THE CHAIRMAN: Thanks, Gerard. Jim.

MR WRIGHT: I just wanted to say that I agree entirely with Don and Gerard.

THE CHAIRMAN: Okay, fine, thank you. David, then Paul. David first.

MR SMITH: Ditto.

THE CHAIRMAN: Ditto, thank you.

MR GRIMES: I was going to say that we agree very much with what John Pierce said. He said it much more elegantly than I could, so just wanted to say we support John's position.

THE CHAIRMAN: Thanks, Paul. Jennifer?

MS PRINCE: We support option 1 too.

THE CHAIRMAN: Okay. Michael, I have David's comments. Did you want to indicate a view from the Australian Treasury?

MR WILLCOCK: I think David's letter says it certainly. But to the extent that a backcasting option were adopted I think we'd echo what Jeff Byrne said in the first place, that the issue is that if you are going to be backcasting you need to be backcasting each tax when it's no longer the standard policy of the State to be levying that tax. So that then becomes a question of when that will actually be for each particular tax, which will be quite complex given the very varying timetables that are being introduced.

THE CHAIRMAN: Yes. Well, I think the conclusion of this discussion is that what we presented as option 1 I think, that is that we would phase out the taxes as and when they affect the data in the calculations, that that stands. That's what we will do. That's what we will certainly do in the context of the 2006 update which means that the - whatever arrangements, and whether these are arrangements of practice or principle or whatever words you want to use or not use to describe them, they won't have any impact in the 2006 update. And we will of course continue to track what's happening. I'm not myself persuaded that we'll get to a backcasting situation but if we do - if we do get to that point then we will require State data in order for us to be able to do that. But for now I think what we propose to do in 2006 is clear and that's about as far as we can take it.

MR CHALLEN: So just to be clear, Alan. We will give you whatever data you ask for that we've got but I'd like to hear from Victoria that if you want to get into backcasting and you ask us for data we do not have, does Victoria want us to invent it? Answer carefully.

THE CHAIRMAN: You're being asked a question, Peter or Jeff.

MR BYRNE: It sounds like a question that doesn't really require an answer.

MR CHALLEN: No, it's about the reliability of data. It's a very important question. If we can only backcast by having to estimate data that doesn't exist, do you want us to do that? But answer carefully.

MR GRIMES: I suppose the question for Tasmania is have you included estimates in your budget of what the IGA tax second round implications might be?

MR CHALLEN: No, we've just put estimates against heads of tax. For the Commission to backcast they will need to go back in time when it is not possible for us to create some of the categories of information that they would need to backcast. So how am I going to create that data? I'm going to use - - -

THE CHAIRMAN: In the same way as you create other data for us I guess.

MR CHALLEN: Well, exactly. I'll invent it. I will - - -

THE CHAIRMAN: And very fine inventions they are too.

MR CHALLEN: Well, I think - I mean, you know, there's a question about consistency here. Victoria is saying that they don't want the Commission using unreliable data. Well, here is a classic case. The data would be unreliable because the only way it can be created is by inventing us. So do you want us - if you want us to backcast, then effectively you're asking us to use unreliable data.

MR .....: What data are you creating, Don?

MR CHALLEN: Well, we'd have to create the component of stamp duty on conveyances attributable to non-real property business conveyances. Well, we haven't been collecting that data. I think we've just started actually. But historically we didn't collect that data.

THE CHAIRMAN: A bit of secret staff business here.

MR SPASOJEVIC: Can I make the observation that because we're not - unlikely to be doing backcasting this year, it'll be a couple of years in the future, were you to start collecting that data, it would be - - -

MR CHALLEN: We are collecting it now.

MR SPASOJEVIC: That's when it will probably become important. So we're asking people to think about collecting the data which we might need should we ever have to backcast in the future.

MR CHALLEN: Well, we will of course cooperate.

MR BYRNE: Just one - we do in fact have fairly extensive data on this - though they are estimates but they're information that has been provided to the Commonwealth, for example, when the proposal from the five States of what they were intending to do was put forward. There was data there. What's the status of that data, Don?

MR CHALLEN: But not backwards.

MR BYRNE: The comment that the Commission has made is that backcasting exists at a point in the future. So it's actually backcasting over data that may in fact be current data rather than data back to 2000.

THE CHAIRMAN: I think this discussion has probably gone past the point of - into the area of diminishing marginal returns or diminishing marginal utility certainly.

MR CHALLEN: I didn't succeed in flushing them out but I tried.

THE CHAIRMAN: Well done, Don, thank you. But I think we have made clear what we propose to do for 2006 unless we are instructed to do something else. And if we are instructed to do something else I think it's evident that there will be considerable difficulties.

Just before we break for lunch I just wanted to take a couple of minutes on data. It's obvious from the discussions this morning that data quality is a key issue this year. And I think the Data Working Party has been extremely helpful and we are very grateful for the participation and contribution of the States to this work. The Data Working Party has provided a report which you will have seen and we've looked at the recommendations and there are no issues arising from those recommendations that we need to talk about today.

But I have to say that the Commission cannot take responsibility for the quality of the data given to it. I mean, that is just not practical or reasonable. We have to rely on the data that's given to us and then our task is to use them consistent with their stated quality. So, in short, we are expecting that the data provided by the States will be of high quality and suitable for us to use in the way that you understand that we will be using it.

The report of the Heads of Treasury raised a number of data issues and Commission staff have been addressing these very seriously to see how important and how relevant the concerns raised by the ABS in relation to some of these data sets actually are. And work with the ABS on these issues is ongoing. In some areas, some of the things that we've talked about today, we've accepted that the data is not suitable for the purposes for which it has been used in the past. We've given a couple of examples. In some areas like the use of cross-tabulations in census data, the discussions with ABS and our own further thinking is leading us and the ABS in the direction of thinking that the purely statistical and methodological concerns raised by the ABS are really not as relevant and significant as they ABS thought they were, and the use of cross-tabulations for us is an important part of maintaining the existing methodology.

So without suggesting that we - I'm not suggesting either that we completely embrace unthinkingly everything that the ABS has said, nor that we unthinkingly reject what they've said. We are working with the ABS to work

out what is reasonable in the context of the actual use that the Commission makes. It's not surprising that in one or two areas it does seem to us that the ABS hasn't fully understood quite the way we use the data and what the impact of that use is. So I'm just telling you that that work is ongoing and we're doing it in a very genuine, cooperative way.

Recent ABS revisions to some data though will be of interest to some of you. The ABS has recently made revisions to the distribution of wage income across States which will play out, amongst other things, in the payroll tax assessments. We're looking at the implications of this for the 2006 update. On the data we've seen, the implications would be very, very significant and all that we can do is to suggest that if States are not already doing this, you might like to consult with the ABS about the implications for State data of these data revisions.

Now, that's really all I wanted to say about that. I'm hoping now that you're overcome with both hunger and you're stunned and I can declare this part of the meeting at an end. Are there any comments that anybody wants to make? We're about 15 minutes behind schedule which is pretty good. If there are no further comments then, we'll adjourn to lunch. I'm not - I've told - John, help.

MR SPASOJEVIC: I'm told there's a buffet next door and the notion was everyone go and - - -

THE CHAIRMAN: Go and get something, bring it back and we'll resume again in 10 or 15 minutes. Okay. Thank you very much for your participation - I'll thank you now in case it all gets out of hand over lunch and I storm out in high dudgeon. So thank you very much for your participation.

**LUNCHEON ADJOURNMENT** **[12.44pm]**

**RESUMED** **[1.06pm]**

THE CHAIRMAN: I don't want to put you off the enjoyment of the rest of your lunch and I'm only going to speak for just a couple of moments because I've got quite a bit still to get through here. When I met with each of you individually on my rounds earlier this year, we did talk about when - if and when there would be opportunity for some discussion about broader issues of principle in relation to fiscal equalisation, I do recall that the enthusiasm with which this question was addressed varied considerably from jurisdiction to jurisdiction.

But I also recall that through the Heads of Treasury process and my own discussions that I've had with you from time to time some States have made it clear that discussion about issues of principle and what the objectives of HFE

should be and should be post 2010 was something that had to come on to an agenda, and if it didn't come on to this agenda then it was certainly going to come on to other agendas. And I agreed with each of you and you agreed with me that it would be appropriate to have an early discussion and that if we could make time to do that in the context of our November discussion about materiality and reliability, then that was a sensible and appropriate thing to do.

My view is that this is a discussion that would fall outside of the broad understanding and interpretation of the terms of reference that we hold, but that conclusion depends very much on how clause 1 of the terms of reference in particular is interpreted. And I don't think it would be sensible in the wider scheme of things to decline to undertake some discussion to establish whether this kind of forum and the Commission's agenda, working from 2007 onwards through to 2010, would in fact encompass issues, wiser issues of principle.

I note that there is no specific reference to horizontal fiscal equalisation in clause 1 of the terms of reference or to the principles that are to apply. There are very specific references to the current principles in subsequent clauses 4 and 5, but not in clause 1. Now, you can read what you like into that. But I note that clause 1 in these terms of reference is effectively the same - for all practical purposes it is identical to the wording in clause 1 of the 2004 Review terms of reference. So if it is to be understood by the Commission to mean something other than the broad understanding of 2004, then I think that guidance needs to be given to the Commission. Given the similarity in the wording, the default position for us would have to be that it means essentially the same sorts of thing. And that's precisely why we think there's some value, associated with no doubt considerable pain, in having a discussion about issues of principle at this time.

So I think it's important to distinguish this question from the very specific requirements of reliability, materiality, aggregation and data and early implementation where they are specifically constrained in the terms of reference - where early implementation is being considered they're constrained to the 2004 principle.

We haven't established an agenda for this discussion. I think we'd be getting far too much ahead of the game in order to do that. We are proposing that the issues paper which is to come out in February of 2006 will open up discussion from the Commission's point of view on broader issues of architecture and in the current timetable you have the opportunity to contribute to our thinking in submissions which are due in June 2006.

So I always get nervous when I ask whether States would like to give the Commission some guidance, but that's what I think is appropriate and it's what I said that the Commission would do when I met with you earlier in the year. So I'm now going to endeavour to finish this gluten free lunch and I'm hoping that you can carry the conversation - it's going to take me about 35 minutes at

least to get through this, but if I don't get through this I'll have to eat one of Qantas' special gluten free meals and if you've ever faced those, you'll know that this is a far more appealing option. So I'm now going to enjoy the rest of my lunch. I'm hoping that staff will be scribbling furiously away. The tape is still running and I invite you to put on the table those issues and those views which you would like to guide us as we think about these wider questions. And I'm the only one with food still in front of me so that's very good. We're going to have to get someone to get us started. I think, John, we let you off this time unless you want to go first. I was going to throw to Victoria.

MR DAWKINS: Thank you very much. I think probably where we think the discussion should start is around the issue of sort of complexity, transparency, simplicity which has been an important part of the discussion this morning and does come directly out of the terms of reference I guess. And we are fully supporting the endeavours to move to more transparent and credible and less complex system. And that leads us in terms of the principles I think to at least float the idea that simplicity is an important enough issue to perhaps warrant being thought of as a principle. So I think that's the first point that we would want to make.

And a sort of a related point - and incidentally we would support the existing three principles, though I might make a comment about them - - -

THE CHAIRMAN: The pillars?

MR DAWKINS: Sorry, the three pillars, yes. So yes, I'm talking about the idea that simplicity could be a pillar. Sorry to not use the right language. So to join the existing three pillars although I might make a comment about one of those later on. I think in the same spirit, we think that robustness is also worthy of consideration as a pillar and this again relates to the whole issue of sort of complexity and transparency and credibility that the assessments that come out of the process should be robust.

And I guess what we mean by that could be thought of it two ways: one is does it pass the sort of reasonable person test? Would it be verified by an independent party? So that's one angle on robustness. A second angle on robustness is quite similar really - replication. If the test of formulating an assessment was given to a separate independent group of employees in the CTC for example would they deliver assessment results that were pretty much the same? And of course that relates to some of the issues we've been talking about this morning: use of sound data, minimal use of judgment, and data massaging. So the idea that the outcomes should be consistent with a reality check and independent verification.

I think that the next thing we'd say relates to the existing pillar of internal standards, what States do, that we would, again in the spirit of making things less complex and simpler and transparent, would question sort of the degree of

comprehensiveness in the way that this is approached. So we think that perhaps you should be thinking of modifying the internal standards pillar to examine areas of significance that affect all States or most of the States and where there are significant differences across the States.

So whether that particular pillar should be approached in such a comprehensive way and whether the complexity that that implies is justified. And that might lead you, for example, to consider whether the issue of indigeneity, remote indigeneity is best dealt with within HFE or dealt with in some other way, just to give you an example of where that might lead.

I suppose the issue that New South Wales raised earlier and we said was worthy of thinking about a bit more was to do with the definition of equalisation. And whether the current definition that you use about the capacity to provide services of the same standard really is the right one. And I know - I think when you commented on this view that perhaps this should be discussed I think you expressed some doubt about whether moving something like “not appreciably different” would be consistent with simplification.

I guess we think it would be consistent with simplification and less complexity and the way we come at that is that it’s just - it sort of implies a false precision in a way and it’s unreasonable to expect that you’re going to have a precise answer to the same standard of service. And I think some of the discussion we’ve had this morning about materiality for example is in that spirit, and reliability, that that level of exactness really can’t be expected. And it’s I think our view that something like using “not appreciably different” would flow naturally from a view that we should be pursuing reliable and material differences.

So I think probably they are - I don’t know if my colleagues have anything else you think we should add. Jeff, do you think that covers it? So we might leave it there for the moment, Alan.

THE CHAIRMAN: Okay. Thanks very much, Peter. Gerard?

MR BRADLEY: I think first off I think that it was significant that the Ministerial Council didn’t endorse the view that we had to have a review of the HFE principles and I think it’s important that references to it are embedded obviously in the IGA and indeed in this terms of reference. Our view would be that the principle of HFE as defined in the 2000 Review has stood the test of time and remains very robust and sound. I think in terms of what Victoria’s raising isn’t so much about the principle of HFE, it’s about how it’s actually applied in terms of issues around simplicity and comprehensiveness and complexity and so on. And really they’re not part of the issue of the principles of HFE, they’re the way in which you might seek to apply.

But I think as you mention in your paper, I don't think we take simplicity as a reason to override principles of HFE in terms of seeking to achieve appropriate equalisation or equity outcomes across all States. In adding more words which add greater uncertainty such as "not appreciably different" I'm not sure are going to be a very useful contribution to the principles or definitions of HFE and I don't see any compelling argument as to why we'd want to go and actually make - add greater uncertainty to the way in which HFE is defined or adopted. And indeed I guess it fills us with a fair bit of concern when we actually start identifying areas we might usefully try and leave out, like Aborigineity which are pretty fundamental in terms of service outcomes across Australia I think and a critical - certainly a critical issue we need to have regard to rather than sort of marginalising it in some way.

So from our point of view we think the terms of reference do lend themselves to continue with the same fundamental principles of HFE, that hasn't been put in question by the Ministerial Council. We're happy to constructively explore issues around simplicity and complexity in the process of looking at the methodology of HFE but that's the appropriate path as we see it.

THE CHAIRMAN: Thanks very much, Gerard. John? Jim?

MR WRIGHT: I'm happy to go. I mean I'm quite supportive of what Gerard was saying of course and the point of course you aren't under an obligation to rethink this other than the one that arises from individual states raising it with you.

The point of substance I'd like to take up is this "not appreciably different" thing. I did address it earlier and I don't want to go over it all again except for - I mean I think basically it's weasel words going on here in the sense that what they mean is have redistribution that results in the recipient States ending up with standards that are below what they have. And if we had "not appreciably different but slightly above", I think Victoria's view of what is false precision would be quite different.

So I mean I just think this idea that somehow the quality can be achieved by getting other States to a level that's below the people like Victoria is a - if that's what they mean they should say it. I think this is - as I say, I think it's a dishonest presentation of the view and if you took it literally it's not operationally feasible because you have to know what the correct outcome is otherwise you don't know what's appreciably different. So I'll stop there.

THE CHAIRMAN: Thanks, Jim. John?

MR PIERCE: You noted in the terms of reference the particular - as distinct from other parts of the terms of reference that the principle of HFE to be applied is not specified. And I mean - as I'm sure you're aware of the way with these sorts of things, the reason for that was that if people had tried to specify

that you wouldn't have got a terms of reference. So there are different views as to just what definition of HFE could be applied and I think you're correct in providing an opportunity for those views to be aired.

Of course having - I mean there's nothing really sacrosanct about the current definition of HFE except that it's the one we've got. And but moving away from it or moving to something else, there's certainly already acknowledged a non trivial issue that we're not going to - we're certainly not going to resolve today even if I had the authority to. But it does need consideration and I certainly look forward to your paper in February and the opportunity next year to put some - have issues put down on paper and worked through in perhaps a more systematic way than we can through this sort of round discussion. This discussion could descent into just simply a statement of religion and, without trying to go down that road, I think we should note today that the current definition that we have is just one possibility and that there's nothing sacrosanct and the reasons they haven't been specified in the terms of reference, or on our reading of the IGA for that matter, recognises that there are differences one day or another that has got to be resolved in way fashion or another.

In the meantime, being able to - if you were looking at other ways to define this and essentially other objective functions that we're trying to achieve, being able to - I suppose being attracted to or influenced by definitions that are simpler to measure, simpler to apply, perhaps is one guidance. I think one of the things about the current definition that it is prone to measurement and data issues because of the need to try and show complete equalisation. If the objective was not complete equalisation then perhaps we wouldn't have to put as much effort into those issues.

Also we sort of agree on the scope, I suppose under the heading of whether we're asking equalisation to do too much, the ability to look at well, what are the most common major things that we all have to do and how does equalisation get applied to that, where there are differences between us that are at the extreme then I think it is worth asking the question that whether through HFE as distinct from other policy instruments is the best way of achieving those, which is obviously outside the scope of the Commission, as a bit simultaneous equation here, but being able to - you know, there are serious service delivery and policy issues associated with Aboriginality for instance. I just raise the issue as to whether by including those Aboriginality factors within the HFE process, if that's the best way to resolve or deal with those issues. There are perhaps different ways of doing it which will then allow it to be taken out of the HFE process.

But I do think we need a systemic way of approaching this and the only way that's going to I think get done is by having papers written, having them distributed, debated and over the course of next year. So I'm really making an appeal for that process to be a fairdinkum one.

THE CHAIRMAN: Thanks, John. Don, you've already signalled that you have a clear view that this is a discussion we shouldn't be having.

MR CHALLEN: No, no, no. No, I'm happy to have this discussion today and any day. Indeed I think it's an important debate and it's very valuable because as people move in and out of this group it's important for us to rehearse these lines again and again and again to make them feel included. No, seriously, our position on this is HFE is extremely important to Tasmania. We think the system has to be robust. Part of having a robust system is being willing to expose yourself to debate about the system. So I'm happy to debate these issues any time you like.

What I was puzzled about was the first paragraph of the attachment to your paper in which you draw attention to the fact that the 2010 terms of reference leave open the question of how the principle of HFE would be defined post 2010. And then you go on to say that you believe it's important there be a consideration of the appropriate principles governing HFE earlier in the review process. In fact that's a tiny non sequitur. I don't mean that in a rude way.

I don't understand why you drew attention to that and why in a way you used it to set the scene for today's debate because there's nothing in the 2010 terms of reference about anything after 2010. The important thing about the 2010 terms of reference is that it doesn't ask you to reconsider the question of HFE. And you've correctly drawn attention to the fact that the wording, particularly of paragraph 1, is identical to the 2004 terms of reference. And I don't think that's an accident. I think that reflects the fact that nobody has been able to come up with a better definition of HFE than the one that the Commission came up with a couple of reviews ago and has been embedded in the 2004 and no doubt will now be embedded in the 2010 Review.

And the reality is that it's a very good definition, it works operationally, we understand what it means, and we don't need to have these debates about what exactly do we mean by it and tweak it at the margin. And when we sort of get into these little debates about, you know, standards of service that are not appreciably different, I mean the reality is it's already there like that. We don't equalise so that the citizens of Hobart get access - or could get access - assessed as if they could get access to the same level of services as the people of Sydney. I mean they definitely don't. They get access to the same level of service as the people of Ballarat.

And in effect what the current terms of reference and the current pillars do is to assess the services that government provides in like circumstances around the country. So people that live in country towns get roughly the same level of service as for country towns of that size regardless of where they are in the country, and remote indigenous get the same level of - or assessed as if they got the same level of service regardless of where they are. And the suggestion that

somehow or other that's the same level of service that is made available to the citizens of Sydney and Melbourne is palpable nonsense. There aren't many Opera Houses in Hobart. There aren't many Telstra Domes and MCGs in Hobart.

So I think there's just a bit too much passion about this issue when at the end of the day we've got a perfectly workable system that's evolved over many years and while people criticise our system as being the most advanced, the most elaborate of any of the fiscal equalisation arrangements around the world, in other places around the world they look at us jealously and think how clever Australians have been to develop this really smart system. And yes, they know exactly what they are doing and they've got a very effective operational definition of what it's all about.

Just to remind people, not everybody was there, but Alan hosted a forum a couple of months ago.

HE CHAIRMAN: September.

MR CHALLEN: September. Which a number of us and some academics and other people got an opportunity to have a rather free-wheeling non-jurisdictional focused discussion about fiscal equalisation and I mentioned some numbers there which I'd just remind you of. I didn't bring them with me so I'm going from memory and I mightn't have it quite right, but we've got a pool of GST and hospital care grants, whatever that program is called - he's got the numbers, thank you. Which is about \$45 billion big and the amount that gets equalised in that \$45 billion pool is about three and a half billion. And if you look at where that three and a half billion goes, \$1.7 billion of it is needed to do the equalisation that goes in favour of Tasmania and the Northern Territory. So well over half of it is just what you need to look after the special circumstances of Tasmania and the Northern Territory. And about - it's roughly about 1.2 for the Northern Territory and about half a billion for Tasmania.

And there's a bit of overlap in this next number, but about a billion dollars of it you need just to deal with indigeneity. So if you look at the amount that New South Wales and Victoria contribute, if you like, the amount that's equalised away from them - again I haven't got the - yes, I have, I've got the exact numbers. In New South Wales' case it's 4.6 per cent of their revenue. In Victoria's case it's 4.5 per cent of their revenue. The amount that goes to Tasmania is nearly 18 per cent of its revenue. In the Northern Territory's case it's 53 per cent.

Now, the other States when you express the amounts that are equalised to them as a proportion of the revenue, they're very small. Queensland, one and a half, Western Australia, less than one per cent, South Australia, six and a half, the ACT, 4.2. This is a system that doesn't redistribute much money and nearly all

of it is needed for two small jurisdictions and one national problem. And when you express the amounts that get redistributed in terms of the revenue bases of the States that they're going to and from and you take out those two small jurisdictions, we're talking about very small amounts of money.

So, you know, I think in some ways we get - we just put too much heat into what, at the end of the day, is an issue that 99.9 per cent of the Australian population think is a perfectly good system that suits their society and produces the sort of outcomes that they want to see in their societies. We've said these sort of things before, but if you go out and ask a person at random in Martin Place out there whether they think the idea that an elderly person in Hobart should have access to a lower standard of health care than an elderly person in Sydney they'll say no. And if you ask them should a pre-school child or a primary school child in Northern Territory have access to a lower level of education services than an equivalent aged child in Melbourne they'll say no. I mean, these are silly ideas and yet we beat ourselves to death endlessly about this.

I think we should just relax, get on with it. We've got a perfectly good system. It works well, it delivers the sort of outcomes our community wants and lets focus on the sort of things that we've got spelled out in the 2010 terms of reference, not spin our wheels endlessly arguing about the definition of HFE at the margin because at the end of the day it's not going to make any difference. End of speech, thank you very much.

THE CHAIRMAN: Thanks, Don. Yes, Jim.

MR WRIGHT: Just on the - I can never say the word - indigeneity issue. I mean, I think we need to recognise that the only plausible alternative if you take it out of the HFE system is that you effectively give the Commonwealth the responsibility for telling Northern Territory and South Australia and WA and Queensland and all those places that have this issue exactly how to spend the money they get, because that's what the alternative will be. We'll get SPP. Now, that may not be a bad thing, I'm just saying this is the alternative. At the moment, States are given the money to solve the problem how they think best. If we take it out of the system we'd have it as an SPP which is the only other horse I think there is out there, we'll end up with the Commonwealth telling us how to do it. Which, as I say, may be a good idea.

THE CHAIRMAN: It is possible to think of other ways but we won't go into that just at the moment because they're a bit touchy. Yes, Jennifer.

MS PRINCE: Alan, just picking up on Jim's point, not surprisingly we're a bit sensitive about what should happen to the indigeneity factor. It's often quoted as an issue that perhaps brings the HFE system into some level of disrepute and our numbers are often used in that example. We do get a very high relativity in part because of the indigeneity factor. In terms of our total

revenues, about 43 per cent of our revenue can be attributed to indigenous factors however applied, either through the HFE processes or by SPPs. We spend more than 50 per cent of our budget on indigenous purposes. Thirty per cent of our population is indigenous, most of those live in remote areas.

Would it be reasonable for the Northern Territory government to have that level of control applied to it if the processes that are currently applied to HFE are changed if the indigenous factor is taken out of it? What do we do for indigenous students in primary schools. In Darwin, we would have about 20 per cent of our primary school students are indigenous. In remote townships like Tennant Creek, about 60 per cent of those students are indigenous. More than 60 per cent of our bed days are used by indigenous people. We're either part of the system or we're not. And that is a very large proportion of our population and they overwhelmingly determine where the Territory puts its priorities for spending. I don't think there is any option but for the Commission to continue to assess indigenous needs in the way that it is. And if we were to remove that factor, then HFE would be a very different beast to what we have now.

The situation that applies to us applies in a number of other jurisdictions although not as extreme, but it just simply wouldn't be the same system of equalisation and it is not the sort of system that Don's random person in Martin Place would agree should apply.

MR CHALLEN: I might say, Jennifer, I wasn't suggesting that we should take indigeneity out of the system. The point I was trying to make was that if you take out the amounts needed to keep the sort of services we've got in the Northern Territory and Tasmania and you accept that indigenous communities have to be properly serviced, there's nothing much left. And we're talking about trivial amounts of money.

MS PRINCE: I know you weren't, Don, but others have made that suggestion.

THE CHAIRMAN: Thanks, Jennifer. David?

MR SMITH: Alan, we have serving not seeking and have no expectation that the Commission will apply a different definition of HFE than has been applied in the past. So we're comfortable with the position you outlined at the start, if I took it correctly, that unless you're told otherwise you would use what you used in the 2004 Review. I, like others, think probably with a bit of imagination we could tweak a bit and we probably wouldn't agree on how best to tweak it, but we can tweak it a bit. But we probably wouldn't end up with a different practical application. So I'm not sure that that's worth it.

I think there is probably benefit to all of us trying to at least reach a more common understanding of even what that definition means than we currently do because I think we do a disservice to the process by questioning, in a way,

that definition. Where I think - and this won't be of use to anyone and I think it's consistent with some other comments - the application of that principle is the area where it probably needs further consideration and refinement. And I won't be putting new arguments on the table when I say this, but the three pillars we're not convinced work as they should for the Commission's assessments. The capacity - sorry, the arguments about the policy neutrality for instance, I mean we've had longstanding concerns and we'll continue to put those concerns to the Commission about the disincentives that the current assessment approach provides for economic development, especially in a State like Western Australia.

On the capacity issues, I'd probably take a little bit of issue, if I understood again with Don's comment about Hobart being equalised with Ballarat. I mean our understanding of the way in which the Commission's process is applied in relation to capacity is that in fact to disadvantage States with a large proportion of their population in remote areas because remote areas provide - you get a lower standard of service. So I think there's some issues around capacity which also need to be addressed. Again not new issues but we'll be bringing those up and expecting them to be considered in the Commission's assessments.

And the last one, the what States do, the internal standard pillar, probably especially in an environment where indicating this morning the Commission working to broader based assessments, I think the application of that internal standard consistently and transparently by the Commission will be more important than it has been in the past, because I think in the past with a micro approach, the Commission's probably focused more than it should on sort of the legislations and so on that apply in particular States and you might need to revisit that kind of approach in an application of the internal standard in a broader based assessment.

I think there are some other issues as to lay out the full pallet. I think there are probably some other pillars that probably have been neglected that might need to be considered. Victoria talked about simplicity. I think inter-generational issues are also ones that are not addressed adequately in the current three pillar approach, and that's something that we can probably raise in our submissions.

THE CHAIRMAN: Thanks, David. Paul.

MR GRIMES: Maybe just for completeness, it's worth noting that the ACT is completely comfortable with the established well tested definition of HFE, and after Don's speech I don't think I've got too much more to add. It was very instructive for those of us who are new to the group, however.

THE CHAIRMAN: Yes. Those of us who are not have maybe heard just the odd bit of it before. John?

MR PIERCE: Look, I just sort of make the point that ultimately the notion of equality that we're going to apply sort of probably belongs elsewhere and certainly is a point for discussion in the body of politics, but every other time we get together in different forums one of the major things we're talking about is issues around the productivity of the economy and of different sectors, how to promote growth. And we won't get very much better at that unless we find ways to facilitate the movement of capital and the movement of people from one place to another, one sector to another, one job to another, and the application of the notion of equality that we apply here and its influence on that, there's a question that some people are asking well, is there an impact on this equalisation - does this equalisation process have a detrimental impact on the ability of resources to move around the country to find its places of highest productivity.

And that means the issues become not so much what are the average amounts that are moved around, it's the sign on the second derivative that matters. It's how does this process change growth rates and movements that are perhaps relevant to that question. And we will not, I suppose in the broader historical context having dismantled trade protection, having undertaken a whole bunch of - this room's not bugged I hope - labour market reforms which are continuing and some of the notions behind that, I think it's inevitable that people will eventually go through the institutional structures that have been around for a long time and eventually get to this one and say well, how's this one affecting the future long term growth of the country? And we've got to be able to provide some advice about that and the trade-offs that there may be between Don's examples about schools and hospitals in Hobart and in other places that may be involved.

MR BRADLEY: But, John, it does work at the moment because people can move from Queensland - or New South Wales to Queensland in the knowledge that they can get roughly equivalent standards of service and not restrained by the fact that they don't think they can get health care if they go to Queensland or if they don't think they can get other services. So it actually assists in people going to where the employment or economic opportunities might lie.

MR PIERCE: Or possibly - I mean this is going to work against us. This will work against New South Wales I'd expect over the next period of the economic cycle, but for instance about a third of - not the level - but about a third of the growth of rates in our transfer duty certainly during the upswing of the property market got redistributed away, which I suppose is just a mirror image of what's going to happen in Western Australia on the resources side. Now - - -

MR BRADLEY: But you're not a low growth State so you'll be a beneficiary over the next - - -

MR PIERCE: I know, and that's why I prefaced the remark.

MR .....: We're low growth on GSP figures.

MR CHALLEN: We're the highest in the country so we'll be giving some back to you all anyway.

MR PIERCE: I'm just saying I think we need to be able to say well, what are the efficiency consequences of moving the allocation of those resources from one part of the country.

MR CHALLEN: But we know the answer to that question. That ground's been extremely well honed.

MR PIERCE: In very static sort of terms.

MR CHALLEN: Oh, no, we've got the best general equilibrium modelling in the world on the job and the answer is it makes bugger-all difference.

MR PIERCE: Well, you just said it, it's static.

THE CHAIRMAN: Peter?

MR DAWKINS: Perhaps if I come back with a couple of comments. One is to - I'm sure Ian Leckie would be keen for me to say this - that I think the kind of concerns that John has raised and David for Western Australia about the incentive effects of the system should be constantly under consideration. And that we should have a system of equalisation that doesn't jeopardise efficiency and economic development. So that's a very legitimate concern that we think should be thoroughly looked at beyond the sort of the narrow scope of the kind of modelling work that Don was referring to there from the CGA type modelling that's been done on this before and more into the dynamic and incentive effects.

But I think the main point I wanted to just come back to is the point we started off with which is the simplification point. That is a major thrust of this review and we'd like you to consider whether or not to sort of embed it firmly in HFE going forward that it's worthy of considering as a pillar of the system.

THE CHAIRMAN: Thanks, Peter.

MR CHALLEN: The point Peter makes about incentive effects and being constantly vigilant of re-examining whether any of the things we are doing are having incentive effects I think is a very fair point. But I don't see any evidence - in fact I haven't even seen a good case study that anything in the system as it is at the moment has had an undesirable incentive effect. Indeed, the one thing that's out there I think is the endless harping from New South Wales and Victorian politicians on how evil the system is because that does penetrate the public consciousness and it does affect the perceptions about the

system. And what they say is not fair and it's not even well justified. It's just political claptrap that is trotted out endlessly because it suits them. And if they had a half decent argument it would be worth listening to, but they never have.

THE CHAIRMAN: It appears that neither New South Wales or Victoria are exercising their right of reply at this point. Let me just say a couple of things. My colleagues may well want to add to this.

I start with a point that Don made right at the end. It is a fact that equalisation and its handmaiden, the Commonwealth Grants Commission, have been subject to carping criticism which has been increasingly ramped up over recent years. I won't say that the ramping up seems to have mirrored the growth in the size of the pool and the absolute amount of dollars that are being redistributed. I won't say that. But you are all aware that equalisation and the Commission have been subject to very public criticism, criticism which the Commission could not accept as being valid while ever the existing principle of horizontal fiscal equalisation is the principle to which we are expected to work.

In what we do we set out to deliver no more and no less than fiscal equalisation. And arguments about the growing subsidies that some States are providing to others can only be justified if they are built around an argument that the existing principle which we are charged to deliver is not appropriate, should be changed, and something should be done about it.

But this criticism, apart from being galling, clearly does have some impact on the broad public consciousness about equalisation and that impact is detrimental. It is one argument whether the citizens of Hobart should have access to the same level of services as the citizens of Sydney. Don may well be right, but if you then ask the random Martin Plaza person in that case do you agree that you should pay for it you may well get a different answer. And this process is not helped by the somewhat artificial debate that goes on about whether the GST is a State tax or a Federal tax, and in which case who's paying who. It simply is not helpful. It has spawned a new industry that suggests that the GST should be distributed on a derivation basis which is simply incompatible with equalisation.

Now, in all fairness, I think it has to be said that the Commission in its 2004 Review Report was remarkably forthright in suggesting that it thought that it was appropriate for there to be a wide-ranging reconsideration or reaffirmation of the principle of fiscal equalisation. But it noted that that was a matter for governments not for the Commission. And one of the reasons that I would encourage - have encouraged this discussion today is to provide the opportunity to make the point that the Commission cannot do what it has no mandate to do.

If it is given a mandate to participate in or undertake a review based on different principles of equalisation it will do so and it will do so enthusiastically. But it does not have the mandate to do that. I agree with John

that there is nothing sacrosanct about the existing definition of equalisation. It's the Commission's definition. We made it up. Mind you, for all practical purposes it's the same one that's been in place since the 1970s. So it's not as though we are suddenly doing something new as a matter of principle.

So there's nothing sacrosanct about it but it does have some history. For a considerable period of time it had a wide measure of support and it does seem to me that it represents the natural starting point for the Commission unless otherwise guided. And in this regard I still struggle to see the practical meaning, and indeed the simplification benefit of moving away from equalisation to the not appreciably different. It seems to me that intellectually it's easier to equalise than to undertake a transfer system to leave people not appreciably different. I mean, for a start you then have to have a debate about what appreciably different means. If you are setting out to equalise, then there's no debate about what it is that you are trying to achieve.

So I have taken the view to this point that the not appreciably different is in reality a bit of a furphy, that it doesn't actually get you anywhere. And unless we were, as a Commission, to get clear signals that we were to look at that kind of concept and principle, then I see no value to anyone in us going down that route.

Much of what's been said around the table I think has more to do with implementation than it does with principle. Peter, you referred to simplification and complexity and robustness and reliability and so on, I have no argument with that. And whether you call them principles or not, I think in the end probably becomes just semantics and a choice of language. I see no reason - and I'm not now going to bat for the three pillars because they only got made up a few years ago. I'm not going to bat for them but you can put simplicity, robustness and so on with each of those pillars and deliver the sorts of thing that was in your mind I think when you were raising those points, and the sorts of things that are in our mind because the terms of reference tell us to do them. So there's no debate about that.

But I think - and I think it was David who suggested that that is more about the implementation than it is about different principles or different objectives for equalisation. And the Commission will not be backing away from progressing an agenda that embraces the simplification requirement of the terms of reference.

Remote indigeneity or indigeneity in general. I think Jennifer's points are well taken. It is I think unarguable that equalisation has to strain a bit to deal with outliers. It does have to strain. Intellectually it's quite clear cut. It makes sense. But in practical implementation it does have to strain, particularly for areas like indigeneity where the data is not always robust, it's not always consistent across jurisdictions, and the judgments that the Commission is called on to make quite reasonably are quite material.

Heads of Treasury in the working party process and in your report to Ministers noted that the special circumstances of the Northern Territory did warrant some thought but declined to take that matter any further. And I think that before you progressed too far the notion that you would take indigeneity, for example, out and deal with it some other way, you'd also have to progress the well, how are you going to deal with it. I mean, to just take it out on the assumption that someone would come along and fix it up in some other way would in fact leave the Northern Territory very under-equalised. So I mean I recognise and am very conscious of the fact that for the Northern Territory particularly but not exclusively - I mean there have been assessments in the past where a degree of judgment has been required and the size of the transfers required in consequence of that have been quite large.

John indicated that he looked forward to the papers we were going to write in February of next year about this. I was actually looking forward to this discussion to give us some guidance about what to put in those papers. And this has been a fairly tentative discussion. It's almost a "you show me yours first and then I'll show you mine." You can expect that in the absence of any clear guidance at the outset, that the Commission will take its usual conservative and cautious view about this, particularly in this area when we are considering things that are outside the mandate of the Commission itself.

The final point that I would make is that on the points about efficiency and growth and so on, it seems to me that it's entirely in the eye of the beholder. I have not seen - and I have looked - I have not seen anything definitive and authoritative to indicate that equalisation was a dead hand on economic efficiency, on allocative efficiency, on growth. You can go back a number of years. I mean this issue has been round, and round, and round again. The answer you get depends on the assumptions that you use to construct the case.

Efficiency of course is not part of the mandate of the Commission. So we would need to be told that it was part of the mandate and then we would need to think with your help about just what exactly this meant in an equalisation context. If that is what the stakeholders want, then we do need to be told. But as I've said to some of you, and indeed as I've said to some of your Treasurers, it is not reasonable to expect the Commission to do what you are unable to achieve in your forum and what the Ministers, the Treasurers are unable to achieve in theirs. And I don't think that's cowardly. I think it's just pure common sense.

And to come back to where I started, for doing that, for doing what we're asked to do it does get a bit galling to be called high priests of voodoo economics, fail first year undergraduate studies, it gets a little galling. So if you have further thoughts in this area ahead of our issues paper in February, we would be delighted to hear from you. Glenn, do you want to say anything?

MR APPLEYARD: Just a couple of observations if I could. The Commission of course is only one part of the jigsaw that goes up to make the federation, and the federation as we see it, rightly or wrongly, has services such as education and health split between the two levels of government. And if one postulated the circumstance in which either or both were transferred back to the Australian Government, then we'd have a different set of relativities amongst the States but we'd still have a distributional issue as to how those funds ought to be distributed amongst the areas within the country.

Likewise on the revenue side of the equation, had the High Court chosen not to overturn the excise taxes, nor to impose the offshore oil royalties decision, we'd have a different set of tax bases being reflected which would have led to a different mix of taxes that we currently have. So we've got a federation in which we've got a high degree of imbalance, we've got a federation where we share a range of services in terms of funding between States and the Commonwealth, and the Commission of course is only playing one part of that. So issues of economic reform and efficiency consequences perhaps go beyond just what it is the Commission's being expected to do.

THE CHAIRMAN: Thanks, Glenn. Ross.

MR WILLIAMS: Just a brief comment. In some ways the definition of horizontal fiscal equalisation goes back to the 1930s rather than as much as the '70s, and if you were a lawyer I think you'd almost require some authoritative decision to overturn the broad thrust of the definition. But I think it's in the pillars that there is certainly room for agreement. I mean we haven't really discussed that a great deal amongst ourselves, but the pillar what governments do for example is open to interpretation. I mean some governments build toll roads, some use public/private partnerships. That interface between what governments might do and what they actually do for example is - there's room for manoeuvre in that area.

THE CHAIRMAN: Are there any further comments? If not, I think - are the State Heads of Treasury meeting here?

MR .....: Yes.

THE CHAIRMAN: So that gives us 10 minutes or so to clear the room and for you to pull out the other set of briefing notes that the staff have given you. Can I conclude by thanking you all for your participation today. Robert, if you would again convey my thanks to John for making these facilities available and for assisting us with the organisation of the day.

We will be writing to you shortly to let you have a look at the draft of a proposed assessment guidelines and a transcript of the day will be sent to you. But in terms of the things that were specifically on our agenda, I think I have summarised as the day has gone on and so we are as clear as we need to be

about the bases on which we will continue our further work. But there's a long way to go and I think we are scheduled to look each other in the eye again across the table in August of next year. I know that it's a long time between drinks but August of next year when we'd be specifically looking at the issue of aggregation, a bit on data, and then putting together all of these things leading to the report to the Ministerial Council in 2007.

So thank you very much. Thank you for your continued involvement with the Commission and for the work that you've been doing through working parties, submissions, contact at staff level. We really do appreciate it. And I'm terribly disappointed that I'm going to be leaving you now but I look forward to seeing you all en masse in August but I guess I'll see some of you individually before then. Thank you very much.

**ADJOURNED INDEFINITELY**

**[2.19pm]**