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**TRANSCRIPT OF PROCEEDINGS**

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**COMMONWEALTH GRANTS COMMISSION**

**CONFERENCE WITH HEADS OF TREASURIES**

**MR A. MORRIS, Chairman**

**ARCHITECTURE OF HORIZONTAL**

**FISCAL EQUALISATION:**

**PRINCIPLES AND INTERPRETATION**

**MELBOURNE**

**9.43 AM, THURSDAY, 27 JULY 2006**

CHAIRMAN: I think perhaps we should get under way. I've had no further report of the whereabouts of John and his team, but hopefully they will only be here for a moment. So can I welcome everyone here this morning and thank you all for your attendance and your participation, and a particular thanks to Victoria for facilitating the venue and the arrangements for the meeting. It's likely, I think, that there will be some difficulty keeping the attention of those on that side of the room on the agenda for the morning, but I don't feel particularly upset about that. It might make things go more smoothly.

5

10 Welcome for the first time to Grant Hehir, in his capacity as Secretary of the Victorian Department of Treasury and Finance, and congratulations, Grant. Welcome.

15 And, I think, Tim, it's also your first time at one of these. I have no doubt you've been looking forward to this keenly for quite some time, so you're welcome. You're welcome indeed.

20 Can I also - on this side of the room, can I welcome Jennifer Westacott. Jennifer's formal appointment to the Commission is scheduled for Executive Council this afternoon. So, for those who are sticklers for protocol, she is here as an invited observer - thank you for inviting her - and her substantive appointment should be made this afternoon, together with that of Greg Smith. His appointment is also upon the Executive Council agenda for this afternoon, and we anticipate that he will come on board early next month after he finishes a delicate assignment for one of you - so, I think about the second week of August that he will be on board.

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30 We have an apology from Ross Williams. It was a tough call between Venice and here, and reluctantly he has gone with Venice. So you're faced with the quality rather than the quantity at this end of the table today.

We need to conclude our meeting no later than 1 pm, and morning tea will be around 11 or close to there, depending on the run of the discussion.

35 In line with normal practice, a transcript of the discussion will be made and will be provided to all participants in the normal way. Can I just warn you to the fact that all microphones are active, so no George W. Bush moments, please, because they will find their way into the transcript if you do. It looks like I've managed to pad for just long enough.

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MR PIERCE: Thank you, Alan. My apologies.

CHAIRMAN: Is there one more coming?

45 MR PIERCE: Yes. John is just checking out other rooms.

CHAIRMAN: Okay. Okay. As part of our work towards the 2010 Review, we have scheduled this conference today to consider the principles of

horizontal fiscal equalisation and the architecture behind the methodology underlying the Commission's assessments. We have also included contemporaneity on the agenda if there is any interest in discussing this issue. And in order to be able to participate in that discussion, you actually have to be able to say the word.

5

Issues papers on both of these topics were circulated and all States have responded, and our thanks to you for those submissions.

10

If you are happy to proceed in line with our customary approach, I will make a few opening comments on behalf of the Commission, and then invite an initial round from States. Those initial comments, which I expect will largely focus on the areas identified by States in their submissions, would then comprise the substantive agenda for further discussion, and in my letter of 20 July I indicated how I thought the agenda might unfold.

15

Are there any other issues that States wish to add to the agenda at this stage, or any comments anybody wants to make before I make a few opening remarks? Are you happy to proceed this way? Thanks very much. The Commission has taken the view that informed discussion of the principles and architecture of HFE is an important part of the 2010 Review and should be addressed relatively early in the review period. We are a new Commission and we have new terms of reference. We think that we're required to think very carefully about how we're to respond to those terms of reference.

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Of course, we acknowledge that consideration of issues of principle has some history. It was specifically ruled out by the Ministerial Council in giving terms of reference to Heads of Treasury in 2004 for their work, but in our informal discussions in November last year there was general, although certainly not unanimous, agreement that a more structured discussion as part of the 2010 Review was warranted. There was, of course, not a great deal of agreement about what we should do in relation to the substance of the issues that were raised.

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Unless otherwise directed by terms of reference, and this is certainly not the case, the Commission will adhere to the principle of horizontal fiscal equalisation. So that principle per se is not under discussion. However, as States' submissions indicate, there is no unanimous view on what the principle is, how it's to be interpreted, or how it should be applied in practice.

40

Given the balance of public comment and media reporting about the Commission's work over recent times, we think it would be sensible and appropriate to provide an opportunity to discuss these wider issues. We also think it would be helpful and informative for all concerned for our report to MINCO in February 2007 to include a report on our discussion of these issues, including any sense of whether there are particular matters that might remain on the table.

45

States' submissions cover a wide range of issues. As indicated in my letter of 20 July, we think it would be desirable to bring some focus to the discussion this morning. This could be done by agreeing that this morning we will concentrate on those issues which have been raised and do not clearly fall within the broad simplification agenda of the terms of reference. There is adequate time between now and 2010 to fully consider anything that does fall within a reasonable interpretation of those terms of reference.

Perhaps we can bracket the issues raised by States into three groups:

Group 1. Issues of implementation that can be considered as falling within the scope of the terms of reference for the 2010 review, whether or not they are subsequently taken up as that work progresses;

Group 2. Issues that go beyond implementation and, perhaps, further than the reasonable exploration by officials that might be contemplated by governments; and

Group 3. Issues or principle that might reasonably be the subject of consideration and which might be put in front of governments at some stage during the review process.

In the first category, States' submissions have raised a number of issues, including the scope of the assessments; simplicity and robustness as additional pillars; removal of cost weights, including locational disabilities; policy choices versus disabilities; removing unreliable assessments; and the use of broader indicators.

In dealing with the requirements of the terms of reference for simplification, including in such areas as data and method reliability, and particularly disaggregation, we have taken the view that these issues are to be included in our thinking for 2010. Without prejudice to the further work that is to be done and the conclusions we reach, the Commission's view is that these matters fall within the scope of the terms of reference and remain on the table for consideration as the review progresses.

The suggestion from New South Wales that indigenous issues be removed from the scope of HFE and treated via a new SPP, seems to us to be an example of group 2 - that is, an issue that falls outside of the scope of our work without some more specific indication from governments that it should be progressed by us in some way.

The third group possibly includes the brief list set out in my letter of 20 July, including exact or comparable equalisation; using something other than an all-State average; a broad or narrow view of what States do; policy neutrality; and, efficiency, as a pillar of equalisation. It is this group of issues that might most usefully be the focus of our discussion today.

5 Whatever the sense of today's discussion is about issues that warrant further consideration in our 2010 Review work, we all have to be practical in thinking through how these issues of principle could be applied. The logical approach would be to look at where States and others believe that the current approach causes problems; identify why those problems arise and if they are significant; and, if some change is warranted, then consider options, including their feasibility and practicality before coming to a final conclusion.

10 The Commission would emphasise this perspective because we are mindful of the need to have a workable methodology consistent with the quality of the available data and the need to use simpler methods. If change requires new complexity or placed dubious demands on data, then the gains to equalisation would need to be carefully considered before being adopted. Equally, if changes allowed existing complexity to be removed, but with some perceived loss of equalisation, that would also need to be carefully considered.

20 In our discussion today, I hope that when States address how they consider the principles should be changed, if indeed they do, that they also will address how those changes could be managed in practice, and comment on their implications for the complexity of our processes and their consistency with the broad objective of equalisation.

25 We have also included contemporaneity on the agenda. Contemporaneity has been raised from time to time in our discussions in the past, and there has been some attention over recent months to a claimed contradiction between the trend in grant shares and the trends in State economic performance. We circulated a brief issues paper on contemporaneity earlier, and most States have provided comments. Those comments suggest a lesser degree of enthusiasm to take this issue further than some recent public comments were suggesting. But there is opportunity this morning for us to hear what you think.

35 I hoped that from this morning we might be able to take some broad sense of the issues that remain on our work program and how we should proceed from here. Would my sole standing colleague like to add anything before I throw it open?

MR APPLEYARD: Thank you, Alan. Only, I guess, to emphasise that the reason for "con" - I can't even manage it now.

40 CHAIRMAN: Contemporaneity?

45 MR APPLEYARD: No. Compartmentalising the sections of the agenda was to give focus to those issues, which need to be taken forward and, if they need to be taken forward, to gain some practical sense of the way in which we might advance those. So I think, in terms of the focus for the discussion today, it's that third group that we're looking to take forward, in a practical sense, as best we can. Thank you.

MR CHAIRMAN: Thanks very much. Well, if might, in line with custom and practice - John, you know what's coming next, don't you? Can I ask you to lead off?

5 MR PIERCE: Thanks, Alan. I suppose I should say that we're quite pleased that we have the opportunity to have this discussion and to, sort of, you know, keep these issues around a bit and I particularly want to, I suppose, congratulate you on the nature of the papers that have been sent out, irrespective of the topic, but just the way in which they've been constructed and the issues  
10 identified and expressed. In contrast to some of the comments I've made around this table in previous years, I think, in recent times, we've seen a significant improvement in the way in which some of these papers are put together and expressed and made accessible.

15 Having said that, in raising these issues, it just begs the question, I suppose, about if we are going to change, what are we going to change to? And that's why the issues are on the table. It's hard, obviously, in addressing that, to really nail some of those practical implementation issues at this point than it is to, sort of, look at what we do now, because we can actually observe it. Hence, I don't  
20 have a complete, if you like, proposal about, "Well, here's what we should change to and here's how it would be implemented." There are a number of - I mean, I will comment, obviously, on some of the issues that are raised.

I should say, within New South Wales, within the jurisdiction, in making  
25 decisions about how much attention and effort to put into that, because it would require a huge effort to drill down into those practical issues of how changes might be implemented, you know, I get asked about the potential floor change to be accepted within the Commission's framework and its willingness to go in that particular direction. You know, for instance, one of the questions I get  
30 asked is, "Okay. You're going along to this. They're talking about this particular topic - about the architecture - you know, what can come out of it? What does the Commission see as being - other than if they did come to a view about the need for change, what would be the next steps in the minds of the Commission?"

35 Now, you, this morning, referred to making some reference to this issue within the report to MINCO and I think that's useful and, if you like, that's one potential output out of this process. But also, I'm flagging - in order to, I suppose, win some arguments about the need to dedicate resources and  
40 appropriate and gain additional resources to put into working through some of those very practical "how do you implement it" type issues for a proposed change. Perhaps people will certainly appreciate a clear idea from the Commission of what it does see as the next steps and how we cope with it.

45 Now, so that's very much, I suppose, a process issue, and I'm trying to get some line of sight as to where this might take us, from the Commission's view point, within this sort of structure. So I'm just going to make a few comments about the issues. I think the virtue of this process is not necessarily putting hard

proposals on the table, but really responding to some interaction and discussion amongst us.

5 Just to sort of start it off, as you would note in the paper, this process exists within an existing overall framework for Commonwealth/State relations and if we are going to say something about it in a report to MINCO - and whilst it is clearly outside of what the Commission is doing, it has a big impact - perhaps it's worth, you know, noting that the reason this process is so important, the reason that it has such an impact, that's the reason it gets the sort of public  
10 comments that it does and generates some of the conflicts that it does; is really, at its heart, generated by the degree of VFI we have.

We have to take that as a given for the moment, but we think it might be worth  
15 noting to MINCO that a lot of the issues that we're forced to have to address this process, we do so because of that. What they then do with it is up to them. The other is - and this is where I think we're a bit - which affects how you might approach the HFE question - is, I suppose, an element of what I would describe, I suppose, as a bit of schizophrenia within the Commonwealth/State financial relations, in the sense that the - I suppose, it goes onto some labels,  
20 but in one bucket you could put various people's notions of competitive federalism or cooperative federalism, which are different but in one bucket, as distinct from what you might describe as a more contractual model, where the Commonwealth decides what the policy settings are; what the services are that should be delivered, and in effect, uses the grants process in more like a - in a  
25 contractual fashion - to get those services delivered by the States and, you know, the States are then responsible for how efficiently those things are delivered.

Probably that's an observation of made to an OECD group many months ago  
30 and it's reflected in the way some of the SPPs are structured and the way in which we see things moving in a whole lot of areas, probably most recently articulated by the Commonwealth treasurer; that sort of contractual framework. And depending upon where you sit on that, I think, will drive you down different paths through this equalisation process, so that if you are more  
35 in that - let's say you're in that non-contractual view of federalism, I think that would tend to lead you away from establishing external standards or, like, measures of efficiency of - or bench marking efficiency of service delivery and having that influence this process.

40 That doesn't mean we're not concerned about the productive and likely efficiency effects of this process. I'll comment on that. That's a real different arena. But the other is the nature of - the other difference that that creates is in the nature of, what you refer to here as "preserving the political autonomy of the States". I don't think I formally presented it to him, but I certainly, I think,  
45 scrawled it on a napkin over a dinner and gave Ted a picture of it when we signed up on the GST deal, which was essentially a structure of the Australian treasuries that had him at the top and us leading the regional offices of the Australian treasury, because that reflected the more accurate depiction of what

the trends in - if you like, management accountabilities, which is in distinct contrast with whatever the two political ones are.

5 To give you, I suppose, one tangible example of how that plays out, you know, we often get hit with comparisons of New South Wales' own source taxes per capita compared to everybody else around the country. And you know, that measure, we end up with a - you know, towards the top of the scale, of course. You know, that's used as something to beat the government up with. If you do the same thing on the basis of total revenues, we're at the other end of the scale.  
10 Naturally, the difference is quite - you know, explained by the different sources of revenues we have and, hence, you can build a story about the effect of HSE on that.

15 We haven't yet got the need to focus on your tax burden indices. We don't want to seem to go in that particular direction. But that creates a sense of, if you like, political accountability, which can be in contrast to the things we can actually control and we can generally be held accountable for. There's really just three - a lot of that is about the framework and the environment we're in and depending on where you sit in that will drive you down different directions.  
20

In terms of the actual mechanics of this, with apologies to the original author, if we view this process as an example of a tax transfer system, the objective of trying to establish complete equalisation might be characterised as one of:  
25 from each according to his capacity and to each according to his need. In other tax transfer systems, we've long since learnt that we don't try and achieve complete equality, because of the incentive and barriers to moving resources around to the most productive part of the economy that that creates.

30 Whilst these sorts of dynamic efficiency gains are obviously harder to measure in a model, we generally accept that they exist, and in the other context, we were looking at taxing in one arena and transferring to another. So it's not a question of not doing it; it's a question of degree, and I would admit that if we were going to move away from complete equalisation to something, which was  
35 more along the lines of generally comparable standards of service. Even if they're generally comparable, the standards of service around some definition of what core services are. You know, hence there's two sets of issues there, which require a lot of work: the degree of transfer that people would be comfortable with and the sort of services; you know, how you might define,  
40 say, a set of core services, and there's a lot of difficulties in that.

Nevertheless, I don't think we should ignore that we're not going to be able to do as much as we can in promoting the growth of the economy, fulfilling the sort of productivity growth agendas that are being pursued through COAG,  
45 unless we try and identify what are all the barriers to resource movements from one sector of the economy to another, and that necessarily implies from one place to another. And that's just as valid an issue within States as between them. There's - I had to explain to a community, community representatives

recently who come from a town that doesn't have an economic basis.

5 The other aspect of it that we've certainly tried to think about is, if we move to, not appreciably different from, or comparable, then it's rather like I suppose the  
10 experience some of us have had in regulatory reform. You can go through a process of cleaning out the existing stock if you like, but the dynamics of the processes that we operate in tend to generate additional regulation on top of that. And similarly here, if we move to something which was not appreciably different from or comparable, what is the dynamic that gets set up that keeps  
15 you at that sort of standard rather than driving people down increasing levels of, you know, complexity and precision? But again, it's something that we should be pursuing.

15 That point that you raised about capacity utilisation being measured purely against, by reference to operating statements as distinct from trying to take into account in some way elements of the balance sheet, and I think it's quite an interesting one, particularly the issue of effectively expressing the objectives of your fiscal policy as maintaining a reasonably constant rate of growth of  
20 services in the wake of volatile revenues, but you want to maintain the rate of growth of those services equal to your trend revenue growth and absorb the fluctuations on your balance sheet.

25 Your ability to do that, your capacity to continue to maintain that rate of growth, constant rate of growth of services does critically depend on what the state of your balance sheet is. How the use of that should be done is something that I would certainly like to see the Commission and ourselves doing some more thinking about and some work on. I suppose you make a good point about the scope, which I think we should talk about, you having ruled out  
30 discussions about indigenous issues.

35 The other was about the three years, five years, one year averaging. I won't try and pronounce the C word. The way I think about that is, and I'm quite happy, I should say at the outset I'd be quite happy to see some further work on looking at the impacts of three years versus five or four for that matter. But against, or taking into account this particular objective function, which is of course certainty, and if you think about the way in which our other revenues, or the knowledge we have of our other revenues fits into our budget processes, we know a fair amount about what is happening to those tax bases in the lead-up to our budgets, and we know about year-to-date figures, and at various stages  
40 during the budget processes we have stabs at what those future revenues are going to be, probably beginning, as in our process, beginning around just before Christmas, which gives a view about some of the parameters we should be setting, targeting in the budget process. And, then, of course, at various stages it gets refined as you get closer to the date. If we were to have relativities that  
45 were very contemporaneous, if that's the right word, then it would be like - - -

CHAIRMAN: Close.

MR PIERCE: Close - you've always got the issue about, well, what is happening with the GST revenues, of course, but it would be like discovering in February what tax rates and thresholds you're going to have for your own taxes in the following year, and, as your paper shows, they can move around by a hell of a lot. And our ability to forecast what you're going to come up with is in nowhere near the same degree of confidence as within our own tax bases. So we can be, you know, travelling along expecting a particular outcome and then out comes a relativity which changes that, and, although we should be able to get the direction right, if it's a change of - you know, even if we said it's a - it might be a change of 500 million and it ends up being 800, that's a big deal.

So I'd quite - at least for everything else aside and going back to my previous point about the objective being to cast expenditure growth equal to trend revenue growths, the ability, at least the existing process, ABS deciding to change the way it measures pay roll tax bases, those sorts of issues aside, we've always got those sorts of revisions, but at least I've got a high degree of certainty what at least four of the inputs into that marginal tax rate in the following year is going to be, and, hence, even if our stab at what the final year is is wildly wrong, its impact on the numbers, and, then, hence, the decisions that government is making during that period of time on the expenditure side can be reasonably managed. I might just leave it there.

CHAIRMAN: Thanks very much, John. Grant, can I turn the floor to you?

MR HEHIR: Thanks. And I'd also like to thank the Commission for addressing the issues of principle in this review. I suppose, to start off with, I'd like to say that I think Victoria has always supported the need for significant reform around the HFE architecture. But I suppose what we're thinking, with respect to this review is, we also need to look at the limits to what can be addressed around the issues of principle and the issues that can be addressed through that forum. So, from that perspective, around the three categories or groups that you raised, we're focusing a little bit more on the first rather than the third, and, from that perspective, there's probably three issues that we think are the most important which can be addressed around reform, and those which could be driven most feasibly.

The first of that is the view that we can increase the robustness of the methodology and data, primarily around simplification, the implementation of materiality thresholds, elimination and aggregation and, doing that, we can produce more reliable equalisation outcome. We think the simplification issue is the one that probably needs to be addressed the most. And if, through this review, we can get that in place, then it becomes quite important to make simplification a pillar of the process so that we don't get a growth in the complexity of the process into the future so having it, well, we can keep going back to that.

The third issue would be that, once simplification is achieved and we can get more robust, less volatile assessments, then you can look at the issue of the

contemporaneity.

CHAIRMAN: Well done.

5 MR HEHIR: I almost didn't raise that third issue on the basis that I didn't  
think I could - and, really, that's where it comes down to. With respect to that  
issue, the contemporaneity, contemporaneous of the assessment basically  
comes down to how robust the data is which you're dealing with, and the more  
- the better the processes we have in place, simplification of some of those  
10 processes, the more robust the data, the more contemporaneous that we can get  
to, and we'd support moving in that direction. That's about it.

CHAIRMAN: Okay, thanks very much, Grant. Gerard?

15 MR BRADLEY: Thank you, Alan. I guess it comes as no surprise,  
Queensland has been a strong supporter of HFE and the principles that underlie  
that, and even as our relativity dwindles we remain a supporter, and, indeed, we  
think the current application of that demonstrates that, in fact, it's working in  
practice and we accept the outcomes that result from that. We support the  
20 existing principles that underlie that in terms of the three pillars, and, indeed,  
we think going forward our focus should be on how we can improve the way in  
which those pillars are applied in terms of the methodology.

The principles really guide us on what we're seeking to achieve. I think issues  
25 like simplification are how we can achieve it and how we can achieve it,  
perhaps, more robustly over time. I don't see them as additional pillars but I  
see them as important bases upon which we can improve our methodology. So  
we don't see the need to, in a sense, add that as a pillar or add additional pillars,  
and, indeed, people looking at issues of efficiency around how we apply those  
30 basic principles around horizontal fiscal equalisation.

I think, you know, John has talked about looking at alternative models, but, to  
be honest, there's is no robust alternative model which has been put forward or  
has been sensibly developed, and, certainly, we don't support any model which  
35 would, fundamentally, compromise the principles of the IGA which underpin  
the IGA, and, also, which underpin continued State sovereignty, so issues  
around attaching conditions or performance around that are issues that we  
would strongly oppose.

40 And, similarly, we wouldn't seek to support any model which tried to sort of  
take some sort of partial approach to the issues of partial equalisation, and, you  
know, choose to leave out things like indigenous disadvantage or whatever they  
might be. We just do not see that as an appropriate way to go. I think in terms  
of the point John mentioned about resourcing we would not support the view  
45 that we should try and resource some sort of process to look at alternative  
models when we have a much more meaningful and substantive work program  
ahead of us in terms of addressing the issues of complexity and simplification.

And while I note your point that you think there's adequate time to do that, we think there are some quite substantial issues around that which need to be worked through and we require our full resources to address them; issues of data reliability, there's a lot of work to be done around that. There are some  
5 key assessments which are quite contentious as which we're all aware of which we think need major work and need careful consideration and that should be the focus of our resourcing going forward.

In a sense then, I think we would agree with Victoria in terms of if we can improve the reliability, the robustness of data then we can address whether there's further ways we can improve the process in terms of the underlying equalisation agenda. As I think even New South Wales acknowledges, as we look at some of the attempts to add additional pillars or changes to the process they, indeed, would add greater uncertainty and greater complexity to the  
10 process.  
15

Looking at issues of how you measure efficiency versus equity raises a whole series of issues around completing objectives and increasing complexity and need for greater judgment of the Commission which we would really question the gains to be made from that, and, indeed, we think the argument for the need to, I guess, factor in productivity or efficiency as goals of this process are - really the case hasn't been made that the current process, actually, impacts adversely on efficiency and productivity.  
20

Other suggestions around, that we should redefine what States do to try and look at some sort of different standards, so the most efficient provider or the standard of three major States, perhaps, rate a whole series of major questions of uncertainty about, you know, who is the most efficient provider, how is that going to be measured, how do we look at the States with the lowest costs, do we drive the States to the lowest costs.  
25  
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Certainly, in our own case we've, arguably, been a low spender in some key areas like health, but we, obviously, see a major community debate about, well, is that a good thing for a State to strive to be and should we, in fact - we need to look at, obviously, the quality of those services and the outcomes for the community over longer periods and really if we just drove down the efficiency path that would, seriously, compromise outcomes for the community.  
35

And, indeed, those issues really get to the point of, I guess, State sovereignty and being accountable to their own population in terms of the services that you provide, and we don't see the Commission wanting to get into a position where it has to judge what States should do rather than what they actually do, in particular. In terms of the equalisation period or process, we remain of a view that this has been looked at, repeatedly, in the past and we remain of a view that the five year period provides appropriate stability and adjustment over time.  
40  
45

We don't think the case has been made that would suggest we'd move away

from that, and, indeed, to judge that at a point in time, the transition from one to the other, creates a whole series of anomalies which we would not see as being good for our support of the process going forward, so we remain convinced that that - the five year process - has stood the test of time again and it provides appropriate basis upon which the equalisation process can work. I might leave it at that, Alan, and happy to comment further as we go through.

CHAIRMAN: Okay, thanks, Gerard. Tim, we're over to you and you are entitled to be heard in silence in your maiden speech, so - - -

MR MARNEY: Which would mean that I wouldn't be entertaining anyone so there doesn't seem much point in that. Thank you, again, for reiterating the point that it's a good opportunity to discuss the issues. I would like to do so in the context of five separate points, the first being simplicity and the terms of reference clearly require the Grants Commission to implement HFE as currently practised but in a simpler way.

We don't underestimate the complexity of the simplification task and I think, you know, if that was easy to achieve it would have been done by now, so it's quite a challenge. Having said that, issues of materiality and aggregation and I think Grant raised is, I guess, where we see there being prospective exploration. I'd also agree with Gerard's comments though that simplicity in itself is not a pillar, if you like, but it's a way in which the pillars are delivered.

The second point I'd like to make relates to efficiency. Our submission, clearly, articulates, and I think we have, over a number of years, made arguments around the issue of policy neutrality being interpreted, possibly, a little too narrowly and that there needs to be broader regard to all State policies including policies designed to encourage economic development. And the context of that is the substantial investment that particularly Western Australian experiences in terms of facilitating development of a broad nature through, particularly, common user infrastructure, for example, which then benefits the revenue streams down the track.

In light of that, we've proposed a fourth pillar, or, if you like a sub-pillar of policy neutrality which is that HFE should not create fiscal disincentives for economic development or improving the quality or price of services which is, I guess, a second concern that's been raised elsewhere in terms of service delivery efficiency and goes to the argument of do you take standard service as being the average of all States, a benchmark of three States, or, indeed, the most efficient however measured.

That's, I guess, a difficult area in terms of measurement and implementation that I think in the context of the reform agenda that we're all embroiled in, and, indeed, in some respects our key role in life, to not tackle those dynamic efficiency issues is to really miss the opportunity that the review presents. Having said that, we don't propose that that pillar would be a trade-off against HFE, but is an explicit recognition of the need to implement policy neutrality in

a broader way. And I note your opening comments that such issues would need very careful consideration by the Commission.

5 Third item goes to the issue of differences. HFE clearly requires all impacts on the States' ability to provide services to be taken into consideration, and that includes both demand and cost factors, and that goes to issues of location and indiginating; and we see that as fundamental to HFE. I think there is a difference between service standard and correcting indigenious disadvantage there, and probably the latter falls more in the realm of SPPs. But service  
10 standard definitely falls within the realm of HFE. And the fourth issue goes to that word which I like to see as same timed-ness - - -

CHAIRMAN: Timeliness, yes.

15 MR MARNEY: - - - which, I guess, we have mixed emotions about, and, as a result, not a strong position. Other than the benefit - and I think John's comments went to this issue - one of the benefits of the existing arrangements is the stability and the certainty that comes with a five-year process. The flip  
20 side of that is how that relates to our own source revenue cycles, and I think we're seeing for ourselves some potential train wrecks on the outer edge of our forward estimates.

And fifth point goes to the issue of completeness, as in complete equalisation or some variant. I guess, from our perspective, the issue comes down to the  
25 Commission's practice rather than, necessarily, that statement of words and how far the Commission seeks to go in seeking complete equalisation - and probably support New South Wales' comments in that regard. We'll leave it at that.

30 CHAIRMAN: Thanks very much, Tim. Jim?

MR WRIGHT: I'm sorry.

35 MR MARNEY: Obviously, I hadn't fully entertained him.

CHAIRMAN: Absolutely.

40 MR WRIGHT: I was absorbing your wisdom, Tim. Thanks, Alan. In the interests of brevity, I guess I could say that we have a lot of sympathy with what Gerard said, and I guess - I wouldn't like you to think that the brevity meant we weren't concerned, so I will say a few more things - - -

CHAIRMAN: I'm sure you will.

45 MR WRIGHT: - - - but not too many. Obviously, we support three pillars and we don't see any need for any extra ones. The question of the exact or comparable equalisation - I always find it interesting that people talk about this. It seems to me that it's - the comparable - is a real kind of weasel word in this

thing, and I just can't really get my head around what would - how the Commission would apply that phrase, "comparable equalisation." I mean, already there is this - kind of this process, I'm sure - and one which we agree - where some degree of equalisation is just not achievable in the sense that it's not practical to do the work to work it out; the data's not there, whatever.

5

Already there is a process where there is this trade-off that, in a practical sense, people have to go through. And we see no point in changing the goal posts and naming it comparable equalisation, in this case. I mean, I think equalisation is what HFE is about and the Commission needs to be aiming for that. But we all recognise that you're not going to get there for a number of very sound practical reasons, in an absolute sense.

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As I say, we agree with Queensland's comments on issues of using something other than an all-State average and the broad or narrow view of what States do. And, naturally, we are quite happy with the current approaches, and we think that they're well justified. On the contemporaneity - I mean, I think if we're starting off fresh, you could have quite a strong argument for maybe three years rather than five. I accept the transitional question is a tricky one, and in objective terms, just if you're starting it in an academic sense, it would be hard to come down strongly for five or three. I mean, if we had to vote, we would vote on balance for three, but we can't get ourselves too wildly excited about it. I will stop there.

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25 CHAIRMAN: Thanks very much, Jim. Don?

MR CHALLEN: Thanks, Alan. Again, I thank the Commission for the opportunity to discuss these issues today. It's difficult in this forum to say things that are fresh and new about a subject that's rather old, and I'm a bit reminded of the process that goes on with the rules of golf in which another crusty institution called the Royal and Ancient examines almost every year the entire rule book of golf, and it strikes me that although they could have done this on any one of a couple of hundred of occasions over the last few centuries, they've never decided to change the size of the hole. And that is the point of golf: it is a game in which you have to get a ball about that big into a hole about that big.

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CHAIRMAN: Which I've seen you not do very well on more than one occasion.

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MR CHALLEN: I did promise Malcolm that I would act as the chairman's straight man just once or twice. I think the parallels are interesting, though, because the Royal and Ancient has recently undertaken a major re-write of the rules of golf, and when you read them carefully, you find that nothing fundamental about the way the game is played has changed, but they put an awful lot of effort into redefining the instructions that you have to follow when you take a free drop and determine what is the nearest point of relief.

45

And it seems that that's the sort of process we're going through at the moment. And I must say, I'm much encouraged by Victoria's comments. Tasmania, as you know, is a major - I won't say a major beneficiary - we are dependent in a major way for our revenues, more so than most of you, through this process, and, consequently, we have a major incentive to help keep the system robust. For that reason, we are always willing to debate these issues and are not frightened by the debates at all; quite the contrary.

5

But in the climate that we're in at the moment, I think there's general acceptance around the country that the fundamental architecture of the system is working just fine, in the same way that the general principles of the rules of golf work just fine, and that the most benefit we can get from the resource effort that goes into the 2010 review will be in working out how you define the point of nearest relief when you drop your ball. And that's the major agenda for the 2010 review: the simplicity and all that.

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We've obviously read all the other States' submissions here, and I don't find any of the arguments for change around the fundamental architecture in any way persuasive, and I don't even find much enthusiasm driving them. That just tends to confirm my view that there is general acceptance that the focus of the 2010 review ought to be on that first category of issues that the chairman raised in his opening remarks. So it's good to have an opportunity this morning to discuss these issues again, but Tasmania's strong view - and, I think, supported by the nature of the submissions that the other States have made - is that the basic architecture as we now have it is working just fine.

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Can I just remind you - picking up a point John Pierce made in his remarks - that it isn't surprising that we've got the kind of architecture for HFE that we have, when you look at the whole context for inter-government transfers in this country. I mean, it's not just VFI, it's the whole constitutional and federal framework that we operate in. It's the way in which the financial relations in the Federation have evolved over 100 years or so. It's the way in which the High Court has interpreted the Constituted and very, very narrowly limited the revenue-raising capacities of the State.

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It's the way in which Commonwealth governments have behaved over many years to force States into that branch office of the Commonwealth that John spoke of. And, in a way, the kind of HFE we've got is just a natural consequence of all that. You couldn't really have anything else. Attached to one of our submissions was a little article by Saul Eslake, that no doubt you've all read, that ran a theme that I've run from time to time, and that is that all governments equalise. It's just that, at the State level, when you're equalising between Melbourne and Bendigo or the suburbs of Melbourne, it's just not too obvious.

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The kind of equalisation we do through this process is very obvious, but the way in which we do it has got to be seen in the overall context of the sort of financial arrangements we have and the environment we operate within. You

know, I just think that what we do is the natural consequence of all that, and to try and change the way we do the equalisation without fundamentally addressing the whole set of arrangements within which we work is doomed to failure; you will never make them work because there will be too high a level of resistance and the final point I want to make is that, if you look at that little table that we included in one of our submissions, and it was the theme of the contribution that I made to the conference that Alan organised through the thingummybob of the federations - - -

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10 CHAIRMAN: Forum of federations.

MR CHALLEN: Forum, thank you. The amounts that are equalised are extremely important to Northern Territory and Tasmania, and they are relatively unimportant to everybody else. The amount that Queensland gets above equal per capita and the ACT gets as a proportion of their total revenues are trivial. The amount that gets equalised away from New South Wales and Victoria are maybe not trivial but they're not large amounts in the scheme of things and they're less than 4 per cent of - sorry, less than 5 per cent of their revenues.

15  
20 So when you talk about things like dynamic efficiency and efficiency gains and perverse incentives and all that, it's pretty hard to get excited about that really, because it only matters to the Northern Territory and Tasmania; it doesn't matter to anybody else. That's all I want to say, thank you, Alan.

25 CHAIRMAN: Thank you very much, Don. Paul - oh, right here.

MR GRIMES: Yes. Thank you, Mr Chairman. I won't say a great deal. I think it's already been covered in some of the other opening statements but very much the ACT supports the current three pillars very strongly. We support the comments that were made by Queensland about making the distinction between the "what" and the "how". We would agree quite strongly that the subsidiary issues of simplification, robustness and transparency are all subsidiary issues that are about "how" rather than the "what" of HFE.

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35 We would also agree very strongly with Tasmania that the basic architecture of HFE is working very effectively at the moment. We have real concerns about the proposals to base HFE on efficiency grounds, and we agree with the comments that have been made this morning that that would be very, very problematic to do in practice, and we wouldn't support a change of that nature. On contemporaneity, we're similar to many of the other States. We don't have a very strong view on this matter between five or three years. We can see arguments running both ways.

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45 On balance, rather like South Australia, we'd probably come out in favour of three years, but it's not a particularly strong view on our behalf. In relation to the interpretation of the scope of the skill equalisation, whether it be a narrow or broad interpretation, we support a narrow interpretation because we think

that it fits most comfortably with the use of internal standards and the actual activities of States. I'll just finish my comments there, but thank you, Mr Chairman.

5 CHAIRMAN: Thanks very much, Paul. I just realised that Tasmania didn't comment on contemporaneity. I take it that's because you can't say the word.

MR CHALLEN: Well, I'd better say the C word. No, I didn't comment on it, because others have expressed our view but, you know, in the trade-off  
10 between contemporaneity and stability, we favour stability.

CHAIRMAN: Yes. Thanks. Jennifer.

MS PRINCE: Thanks, Alan. Don, I was looking forward to hear whether the  
15 rules of golf would be expressed more simply rather than just focusing on the free grog. I'm sure they will be. Alan, you started your remarks this morning by grouping issues into three groups: matters to be dealt with through the review, matters that were really off the table in the Commission's view, and matters to be discussed today., Matters of how the principle might be  
20 interpreted and those issues will then go through to Minco perhaps for some clarity or confirmation. Can I say that we very much agree with that approach.

We agree that the important game in the 2010 review is pursuing the matters that you outlined or the scope, efficiency, simplification, aggregation. They're  
25 really important, and they're the matters that we ought to be focusing on. We certainly agree that off the table is whether or not an indigenous factor should be included. It is - it's certainly within the focus of a number of comments in submissions and in other places, and the extent of redistribution that results from the inclusion of the indigenous factor is obviously a matter of major  
30 interest to us. Could I just say that it's important for a number of jurisdictions.

The reason that it is particularly important to us is that indigenous people comprise about 30 per cent of our population. It's not a marginal group or a small group. We provide mainstream services to indigenous Territorians. It's  
35 not something that can be taken outside of the scope of what the Northern Territory does, and it should not be, so we certainly support the Commission's approach. On the matters that you've listed for discussion today, we also agree that it would be very useful for some of these issues to be considered by Minco and dealt with one way or the other so that we can focus through the remainder  
40 of the view on the matters in the first group.

I'd just like to comment on a couple of those matters. Should there be additional pillars for equalisation? We think not. The pillars that are there really are matters of high principle. The other potential pillars that have been  
45 suggested in our view are means of achieving that end. So efficiency, simplicity, all of those issues, that's how you achieve equalisation, and that's the process we're engaged in now. Standards: should standards be changed to being perhaps the standard that is based on a few States, perhaps three States,

the larger States.

5 If that was contemplated, the Commission would be required to make a  
judgment on what partial standard it would use and in many years - over many  
years, the Commission has been criticised for making judgments that are -  
where it would have information that was far more sound than choosing  
particular States. I mean, we've got a weighted standard now. That weighting  
requires a much greater emphasis to be given to the more populous States, and  
it's difficult to see how a more sensible approach could be adopted than the one  
10 we have now.

15 Three or five years: many of us will remember that this has been discussed on  
a number of occasions, and the reason that we have five years now is that that  
time period was chosen by the Ministerial Council as being the appropriate  
basis for equalisation. A number of us at that time argued for three years, given  
that that would give us more up to date relativities, but the balance of the  
argument was for five years because that would allow greater stability in  
relativities over the longer period. I think our concern is changing between  
three or five years, depending on whether the time period might suit you at the  
20 time.

25 So we think in terms of stability and relativities, then it's far more sensible to  
stay with five, noting that there would be some greater differences as compared  
with economic activity of the States if - in certain times, as there is at the  
moment. I think all of the other issues that we'd like to raise have actually been  
raised by Tasmania or Queensland, South Australia and the ACT, so I won't go  
through any more of those, but I'd just like to thank you again for the  
opportunity this morning.

30 CHAIRMAN: Thanks, Jennifer. David, does the Australian Treasury want to  
join in this free-flowing discussion?

MR TUNE: I'd love to, Alan, but I think I'll decline the offer, thank you.

35 CHAIRMAN: Okay. You can see morning tea approaching, can you? Thank  
you, very much, for those observations which, I guess it's some relief, are  
consistent with the line taken in the submissions that we received, and, while  
that doesn't necessarily make the task of coming to a conclusion later this  
morning any easier, at least there are no rabbits come out of the hat this  
40 morning. I just want to make - say a couple of things. The group one issues, as  
I referred to them, and they've been touched on by just about everybody, as far  
as the Commission are concerned, let there be no doubt that those issues are on  
the table for 2010. The terms of reference clearly require the Commission to  
develop, with the support of the States, a simpler approach to the delivery of  
45 fiscal equalisation.

And we have taken that seriously, and I really shouldn't let this opportunity go  
because, you know, we meet so infrequently - it just seems that we are always

doing this - I don't want to let the opportunity go to make it absolutely clear that, so far as the Commission is concerned, we are progressing for 2010 a simplification agenda. We give great reverence to our terms of reference. We have been directed to do it, and we will do it. You will recall that we gave  
5 great reverence to the terms of reference, that old Commission in 2004, which some of you found unpleasing in many ways, but we will do as we are directed by the terms of reference.

To that end, we have - as you know, you are already working with us on issues of data. We have put some proposals forward on materiality, and, in the space of the next week or so, there will be a further staff discussion issues paper on disaggregation which we are, as a Commission, I think we are finding actually more difficult to handle than the data and materiality and reliability of method.  
10 But that is coming out and we have another conference in November, if you can contain yourself for that long. We have another conference in November specifically to talk about disaggregation and other issues associated with the simplification agenda.

So can I pick up on Grant's focus, and it was the focus of the Victorian submission. We are doing that, be in no doubt about that, and we will not be turned from that agenda unless instructed to turn by terms of reference. Yes, there is a lot of work to do, and it's not going to be easy, but we are doing that. So the group one is on the agenda, so I suppose, for some of us here today, the game might be to get some of these issues slotted into group one, rather than  
20 group three, because that's on.

What I call group two, John, if I can just elaborate slightly. I was not expressing a Commission view about the merits of the proposal. I was not commenting on the substance of that proposal about an indigenous SPP at all. I was simply making a more processed response that we don't think we've got any right to trespass in there, unless we are told rather more clearly than we have been to date.  
30

The third point I would make is that I think, at this stage of the morning, we take contemporaneity off the agenda. I don't detect any appetite to devote resources to contemporaneity, and perhaps, John, you will pop up the street and have a word to the Governor of the Reserve Bank and just explain these things to him. But I think we take it off the agenda.  
35

40 MR PIERCE: I think others have done that for me, actually.

CHAIRMAN: Yes, at this stage. Pardon?

45 MR PIERCE: I think others have done that for me.

CHAIRMAN: Good. Good.

MR PIERCE: It's already been done, I understand.

CHAIRMAN: Okay. So where to from here? Can I just identify some things that I think have been raised that we should come back to after we have fortified ourselves with what I assume will be a sumptuous morning tea -  
5 Grant, will it - in keeping with the finest standards of Victorian hospitality?

MR HEHIR: Dry biscuits.

CHAIRMAN: Good, good. I hope it's got no gluten in it. The things that I  
10 think are still for further discussion, and it's as much a discussion across the table in any direction as it is this way, are these. The question of whether equalisation aims to be complete or less than complete, that is, generally comparable, not appreciatively different, whatever set of words you chose to use, I think we should come back to that. I distinguish that, but I also think we  
15 should come back to this from core service equalisation, or what I think in your submission, John, you call merit equalisation. You could regard those two things as the same, but you can look at them in different ways, and they're not. They're not.

20 We need to come back to have some discussion about efficiency. I'm not quite sure how that is going to go but I do think we need to come back and explore just what it is that people actually are conceptualising when they talk about efficiency, and then how it could be implemented. The question of an all-State or not all-State standard has been raised, and I think opportunity should be  
25 provided to come back to that. The issue of dynamic or second round efficiency - of course, I am putting up a list - an agenda list that I expect you to carry, not me.

I have mentioned complete equalisation, same, same, and I think, unless I have  
30 done someone a grievous injustice, they're the issues that have been raised that legitimately fall in my artificial construct of group three, but which I think warrants some further discussion because you identified them. John?

MR PIERCE: What about - and this is one more for yourself - what we might  
35 see happening in a process sense with any of these sorts of issues. You know, irrespective of what the outcome is, if there is a change, irrespective of whatever that change is, how do you see the process operating to be able to drive it down to that point where it turns into real numbers? I'm aware of the limits to that. It's the initial point I was making about, you know, trying to  
40 understand why you - you know, why are we talking about this in the first place? What sort of process it was leading to?

CHAIRMAN: I think that - I mean that's a fair point.

45 MR PIERCE: Of is it just, sort of, too involved - - -

CHAIRMAN: It's relevance comes - if we get to a point at which there is a sufficient agreement, which is a slightly new concept in these processes, a

sufficient agreement that something remains on the table, then clearly we do need to think about the process requirements and how they'll be managed. But if, for example - well, let's take - contemporaneity might have been on the agenda. If it had remained on the agenda, then we would have to think about how we were going to further develop this. It's off the agenda, so we don't need to think about that.

If we go around this morning, and all of these things remain on the Commission's agenda for 2010, then that has significant resource and process implications and significantly less predictable outcomes. So it's really a matter of where - I think we come back to this when we see where we end up - you know if we keep this going to just past 1 o'clock, Don has to go, so you know that will make things very much easier to settle.

MR PIERCE: No. I want to talk to Don.

CHAIRMAN: You do?

MR PIERCE: Yes.

CHAIRMAN: Well, please, feel free. I think this would be an appropriate time to break for morning tea. Fifteen minutes? Thanks very much.

**SHORT ADJOURNMENT** [11.05am]

**RESUMED** [11.36am]

CHAIRMAN: Welcome back. Let's see if we can sustain the momentum generated by morning tea into the next round of discussion. The list of issues for a second round I have distilled down to six things. Well, it would be six if I could count. It's actually five things. First off, the question that was initially raised by John and certainly canvassed in the New South Wales submission, and that is the question of the extent to which equalisation is directed to achieving equality in State fiscal capacities as distinct from equalising to a standard which makes the States not appreciably different or comparable services or whatever words you like to use.

I don't think - at this stage it's not necessary for the Commission to carry the initiative of this discussion, but I would like to say something just to clarify how we have thought about this issue. We don't pretend that what we currently do delivers exact equalisation. Now, there are a number of technical reasons for that. One of the technical reasons is that there are a range of issues where we don't make differential assessments because we don't think the argument is strong enough, the data is not good enough, or whatever.

5 So in that sense it is I think true that a literal reading of the current definition of equalisation is not really consistent with what we've done in the past, that we do not - it might be - it's really not even an objective because if it wasn't our objective to deliver exact equalisation then we would have to take up as best we could far more differential assessments than we do, and I don't think that's what you want us to do and it's certainly not we're intending to do, leading to 2010.

10 So the Commission is certainly open to, at the very least, a reconsideration of the precise language of the definition. And in that sense I think we need to explore a little more what is actually symbolic in this discussion and what is real. I mean, what is symbolic is an argument that we should replace the word "equal capacity" with something not appreciably different. I mean, in my view that is purely symbolic.

15 The issue of substance is whether we actually change what we do in terms of delivering a more simplified, more aggregated set of assessments, and as I said before morning tea, we are clearly going to do that because we are required to do it, and that is going to move us further away from this very literal reading of the existing definition. It may or may not move us further away from better equalisation. You simply don't know these things. I'm sure you've all thought about what the implications of more aggregated assessments, broader indicators and the like will do to the process and what it will mean for the outcomes.

25 So I would like - to the extent that there's an appetite for a discussion today, I would actually like to focus not on the symbolism of the words but for those who would like to see this process go further, what is it that you would actually like us to change in the way that we go about the process that then makes it more consistent with whatever the set of words is?

30 I mean, there is one other dimension of this, and that is if you were hung up on the words it would actually be easier to aim to achieve complete equalisation than it would be to aim to achieve something not appreciably different, because you have to decide what not appreciably different means, and you really can't do that until you have first figured out what equal is and then consciously tracked away from it.

40 Now, we don't want to be doing that, I don't think. So is this a symbolic - I mean, there's a symbolic element, but is there a substantive issue to be further considered aside from the symbolism of the actual words. John, you were the first one to raise this issue, perhaps I can tease you out a bit further.

45 MR PIERCE: Yes, sure. Look, one way of approaching it would be to probably pick up Don's point about the analogy back - not to golf but to what we do within States in the sense of Don referring to the - you know, that we equalise within States. And to a degree, yes, in a sense we do. But it's a question of degree, which is what this issue about the sense of equalisation is really about, the degree. And the reason - I think this is - well, there's two

reasons. There's two different sorts of examples, if you like and two other references, and perhaps at the end there's a - it's around framing the question and the task that the Commission is being asked to do and feeding that back to the people to ask you to do what you do, so that they're clearer about what it is that they are asking you to do because if I take the interest stake sort of, you know, sort of equivalent, and sort of pick a recent example that I've had to deal with.

You know, in discussions with people concerned about a particular community within New South Wales, where that community - and this certainly is an extreme example to make the point - who effectively don't have an economic base and haven't for some time. Separate from anything that you might - separate from any discussions about things that go directly to economic development and regional economic development policies, separately just focusing on the aspects that deal with the level of government service provision, you know, naturally the arguments coming back to me were about the inequality and the level of service provision in this community compared to major regional centres as compared to, you know, to Sydney.

And, you know, what was - well, we should be entitled to be receiving the same level of services. And the fact is we don't. We don't now, and the - you know, I tried turning that discussion around to again framing the question correctly. My suggestion to them was what they were asking, effectively what they were asking was that because of their unwillingness to move to somewhere that did have an economic base that could sustain employment, they were effectively asking the rest of the community to be taxed at a higher rate or having a reduction in their services in order to support them staying there.

And ultimately of course that's a question that you rightly put to governments to make that sort of call but it's a way of course around the core of it and their ability to clearly make that decision is around the way the question is framed. And framing it as to, "Are you willing to take from these areas to give to that area to achieve a comparable level of service," or are you willing to effectively facilitate growth in some of the major regional centres by not getting in the way of people moving to them. So we do equalise, but it's a question of degree and in some cases - and this is where I think we link into the, you know, the COAG, the general sort of pro-activity push, I think as we covered in our submission.

It's, you know, an illusion to think that we can achieve those productivity gains if we have mechanisms in place that become, if not an explicit barrier, then a disincentive to movement of capital and labour, people from one place to another, in particular sectors, and I think it's beholden on us to at least address this question about the degree to which the redistribution mechanisms that operate within this framework work against the movement of resources from into the more productive areas.

5 And I've frankly got no idea whether the answer to that is going to result in more for New South Wales or not. I can imagine scenarios where it would move into some - well, Western Australia and Queensland, for instance. But the - you know, it's all about the degree to which you want to achieve that level of equality, which, you know, rightly does belong to governments, but they've got to be informed about what it is they're being asked to do and what the consequences are.

10 And in assessing the relevance of that, of course, it's the meaning of life was found at the margin. It's the marginal decisions that actually move things around rather than what happens at the average and getting a sense of that, you know, impact. I don't think we can derive from just looking at the size of the redistribution relative to budgets. Yes, okay, it's relevant, but I don't think that is necessarily the end of the story because it's the effects of the margin that  
15 make the difference.

20 So, you know, when we talk about this - you know, the potential efficiency and growth effects of this process, it's really in that context of wanting to look at the degree to which it is a barrier to that movement of resources around the country rather than - and there was some possibility I see in the discussion - going down a track where we turn the Commission into a bigger, uglier version of the NCC. That sort of gets into when you say more or less a contractual world. If we did go down that path where the Commission is making those sorts of judgments, then the masochistic element of my personality would probably  
25 need to be tempered to desire your job more than mine. Well, with great sport.

CHAIRMAN: We could discuss that later.

30 MR PIERCE: But I don't think that's the path that we're talking about. I don't think that's the path any of us are really talking about. In saying that, I appreciate we're not talking - or, I admit that we're not achieving exact equalisation at the moment, but all the dynamics of the process have that, I would suggest, as an objective function limited by the practicalities of data and a few other things.

35 We just talked about that we don't have to worry about it for three years, five years, whatever, but just as an example I can imagine people arguing that, you know, we have already moved away from a complete achievement of equalisation by putting an averaging process into the system should one argue  
40 that complete equalisation would require each year's number being used.

45 So we do move away. The question I am raising is about degree and, as I said in my introduction, in every other tax transfer system that we operate, you know, we recognise that this question of degree is important and it's easier to express that when you're determining marginal tax rates and the delivery of specific services rather than a general level of funding. And, you know, I don't have a complete answer as to how that question of degree gets expressed through this process, other than, you know, without essentially a set of political

value judgments being imposed on you. And hence it might be, you know, loss of any question of degree is worth looking at - what would be the differences in outcomes if you didn't have quite the level of redistribution that goes on?

5 The other way of cutting it - I think you're correct in identifying questions of degree as separate from this core and non-core sort of issue that we have raised, but it could find expression through the same mechanism. If there was a consensus around, well, these are, if you like, the base level types of services that - given that we are a country - expect to be delivered in each jurisdiction and we will try and adopt the existing objective functioning around those levels of services, implicitly I was saying, yes, okay, those levels of services are important against the equality objective but we're recognising that things beyond those core services can be different, and we're happy for them to be different, in order to facilitate, as I say, or not to get in the way of or hamper resource movements to the same extent as we currently do.

CHAIRMAN: I've got core services or merit goods issues next, so come to that - I mean, you can look at them together or the same, just in a moment, Don.

20 In the first point that you raised, John, I was hearing echoes, I think, of one of the points that Western Australia has made in its submission, and that is this question about people in different parts of the State don't receive equal services. Now, that's absolutely true in every State. But what we do in our assessments is mirror what you do. If States, on average, provided all of their citizens, wherever they lived, with the same range of services, then that's what would drive the distribution of GST, but States don't do that. States don't do it.

25 MR PIERCE: Is that how it works? I mean you can imagine, let's say - when you average what happens, say, within New South Wales, you get a particular result, and, of course, that average has many different distributions attached to it, so - - -

30 CHAIRMAN: I mean if the average policy of the States was to provide a cultural centre come opera house in every community with more than 20,000 people, well, that would be a part of the shaping process of the distribution. So in that sense, you know, we are mirroring what States actually do.

35 MR PIERCE: Not in a distributional sense.

40 CHAIRMAN: Well, I think we are, but I am uncertain whether your broader point is that you think this question of the standard to which we equalise needs some consideration going beyond what will flow from the simplification/aggregation agenda or not. Perhaps, Don.

45 MR CHALLEN: Yes. Well, the first point you have made, Chairman, is exactly the point that I wanted to make, and you were just about, I think, to make my second point. The point is that we do not equalise in a way that

services - a remote community, or a community with a low economic base with the same services that you would get, say, in a regional centre or a capital city, we don't even equalise so that the citizen in Hobart can get the same services as the citizens of Sydney.

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What we do is, as the Chairman has said, is we equalise on the basis of what services States, on average, provide to particular communities and sort of in a rough and ready way that means that the sort of educational and health opportunities that you get in Hobart are similar to what you get in Ballarat. I mean, that's how it works. So the straw man that John put up, I think, is a very old, decrepit straw.

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But I think, listening to John's argument, Chairman, mostly what I'm hearing is a plea for materiality and simplification. I think most of the things that he really wants, when you strip it away, are not about this completeness argument. They're about the other part of the agenda altogether.

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You know, having read the submissions on this, you know, what is the standard, at the end of the day I think if you really tried to do that you would introduce a much higher need for judgment in the assessments, and a lot more complexity. And the debates that we have at the current time about the way in which the Commission exercises its judgments I think will just pale into insignificance by comparison with what we would have to do if they were sort of trying to work out, you know, what is some core level of services, or what is not appreciably different from, or what is the best standard, you know. These are extremely hard things to get your hands on, and the reality is that the way it's currently done is actually a fairly objective standard.

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Now, that said, as the Chairman has said in his remarks, what we do is very rough justice and, you know, to pretend that somehow or other there's a lot of artificial precisions is just that. It's a pretence. The reality is it's very rough and ready.

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CHAIRMAN: I want the record to show that I never used the words "rough justice"; in fact I banned them from the Commission's lexicon. Glenn?

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MR APPLEYARD: John, could I press you just a bit further, in the sense of how this might get translated into the Commission's existing methodology? I thought you were heading us in the direction that perhaps - well, the standard that we use at the moment, this weighted average national standard, either needs some bands attached to it, or else it needs to reflect differences - not differences amongst the States but differences in terms of service delivery. And I mean in the local - - -

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MR PIERCE: But that could be one possible way in which it's given expression. Yes.

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CHAIRMAN: Well, in the local roads exercise what we did was we

established standards that ran across urban, regional and remote, regardless of State boundaries. I was wondering whether that was what you were sort of postulating that we have a standard that reflects locations rather than the services on a national sort of average?

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MR PIERCE: Not uniquely. I could see that that could be possibly one way in which it's, you know, given expression, but, you know, I could also imagine it being given expression through some other forms as well, so that may well be something that's fruitful to look at. The sort of issue about judgments, which is the, you know, other mechanisms might lead us down, you know, it really - well, I think we should be exploring a number of different mechanisms in recognition of this where there are judgments that need to be made, thrown, and discerned between those that are capable of being judgments of a professional nature that the Commission might be able to undertake versus those that would be rightly within the hands of the politicians, and, obviously, asking them to make.

And, yes, something like if we did go down the core services path, for instance, you know, the definition of what is in that arena would come out of a ministerial process rather than a technical one, I'd suggest, as an example of where those sorts of lines might be drawn.

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CHAIRMAN: Jim?

MR WRIGHT: Thanks, Chairman. I was - I mean, I'm in support of Don's Hobart/Ballarat point to a degree, but the whole idea of attaching a qualifier to equalisation bothers me. I mean, I'm unhappy with, you know, talking about the exact equalisation as I am about talking about comparable equalisation. HFE has been adopted by governments as part of the IGA and HFE is about equalisation. And I think we need all to accept that there are practical limits to how well you could achieve this, and, okay, we are going to have a debate about what is the right trade off between simplicity, and, you know, all of that stuff, and, as everyone knows, we think that we're at one end of the spectrum, if you like, along with some of our friends in New South Wales and Victoria are at the other end of the spectrum about where the right trade off is.

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And that, at the end of the day, will be a judgment that, you know, the Commission, obviously, has got a big role to play. But the idea that somehow we should deliberately kind of get it wrong, well, just seems to be what's underlying the comparable equalisation argument. It seems very strange to me. The other point I wanted to make, John suggested that by deciding an average over five years we would - already accepted that we weren't following equalisation. I don't think that flows.

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I think you could argue that we're talking about equalisation over time and the idea that you want equalisation - the idea that you might want to equalise on a daily or a yearly or a five yearly basis is, you know, I think, comes back into this: what is practical, what they sense type of thing, which does qualify what

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the outcome of our equalisation process is, but our process is about equalisation. It is just modified by the realities of the world.

CHAIRMAN: Grant?

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MR HEHIR: I think I wanted to say something similar to Jim's but probably from a slightly different perspective, as he said. It seems to me that you asked the question earlier that we talk about this upon actuality rather than symbols and I find it very difficult to do that for the reasons that Jim just said. If you talk about exactness as being an important issue then does that mean it's more important than simplification?

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And these things are trade offs all of the time and while, I suppose, we don't see this particular issue as being sort of fundamentally important, on balance, when we're looking at the issue between trade offs between simplification and the accuracy of the process we'd sort of lean towards making sure that we get it, roughly, right rather than spending all of our time getting the last element of data to try and get it exactly right when we all know that that can't be done.

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So in the processes that we're going through if the result of talking about equality - exactly equality - as to undermine the capacity for simplification, our balance would be at one end of the spectrum, I suppose. That's on that issue. I just wanted to go back to another one off the topic for a second. I was, I suppose, a little bit surprised that the contemporaneity stuff was taken off the table so quickly for a similar perspective of what we've just been talking about.

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It seems to me that the whole idea of equalisation is not about equalisation over a long period of time but it's about equalisation for what's happening now, and as the position as I think I put it at the beginning and what Victoria supports is that we should be doing it as currently as the data allows us to do it robustly. And like the judgment with respect to equality versus non-appreciably different or comparable or whatever, those things have to be balanced and to take it away now before we go down the path of looking at our ability to be robust in the data, seems to be a bit strange from our perspective.

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CHAIRMAN: On that - on the contemporaneity point, Grant, the question that we asked in the issue statement was whether there was interest in bringing forward consideration of contemporaneity in the light of some issues that we raised. I take this morning's discussion to be no there's, on balance, there is not strong interest in bringing consideration forward, that is, forward ahead of 2010. That does not take it off the agenda for the 2010 review.

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There will be - there are four more years. A lovely thought, four more years in which, if people - and lots more lovely opportunities to give us submissions, and, I mean, if people want to come back to contemporaneity then they will and they should and they can, but we're taking it off the agenda in terms of something that might be accelerated, particularly leading perhaps to some recommendations to the Ministerial Council that there should be an earlier

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change.

So that was what I meant by being off the table. I don't know if that helps.

5 MR HEHIR: Well, my understanding was off the table meant we weren't making a decision about it now.

CHAIRMAN: Correct.

10 MR HEHIR: And you don't - you just say we don't need to make a decision about it. Yes. Okay.

MR PIERCE: I just want to make - - -

15 CHAIRMAN: Yes, John.

MR PIERCE: - - - another point about that. The simplicity and transparency and the, you know, the specifics of a task in the terms of reference giving you now, I mean, the point I'm trying to put on the table is not that - I don't know, this border is not contradictory to that. Everyone, I presume, will remember that in, you know, the issues being discussed when that was written into the terms of reference or agreed by ministers to go into the terms of reference, were what are the objectives of this simplicity and transparency?

25 And there is certainly a view that, yes, we want a simpler, transparent, you know, we will have materiality tests on individual components and we think that is a good thing provided there isn't any difference in the actual outcome. And that's the issue, I suppose, I'm putting on the table. Or why I don't think just simplicity and transparency and the sort of agenda to a specific work that you've got will necessarily, you know, address the issues that I'm raising, because it will be judged against whether it's different to the current outcome.

35 It will be judged against whatever people's perception of the objective function is, and, you know, I'm putting a separate set of issues on the table about - or questioning the objective function that's being pursued which I think you can separate from the simplicity and the transparency stuff, which is if, you know, even if the existing objective function is maintained, you know, we all agree that needs to be done. There's no - and I haven't referred to it, because I've just taken as a given, as you've said yourself, Alan, it's going to happen.

40 This I saw as an opportunity to address - you're providing an opportunity to ask the question about, you know, a simpler, more transparent, more easily understood system that achieves what?

45 MR WRIGHT: And could I just say, I mean - - -

CHAIRMAN: Yes, Jim.

MR WRIGHT: In terms of - this question about - I think I'm agreeing with John on one bit here. The objective - there shouldn't be a presumption that the simplicity transparency requirement requires you to look at the objective function. I mean, the simplicity transparency requirement is - in a way, it's a tidying up. It's - I would see it as going back, looking at judgments that have been made in the past, looking at decisions that have been made in the past about whether these things actually do work. They do give you the right - you know, a sufficiently accurate result to be worth doing.

10 It's that kind of action. You don't have to - you can do that without saying, "What is", you know, "the objective function". You know, how do we have to change it in order to achieve simplicity and transparency. That's not the question. I don't think the objective function is necessarily on the table in this exercise.

15 CHAIRMAN: I, at the risk of plagiarising, I think that our terms of reference establish some core and non-core things. They certainly establish core things. I think we are open to consider non-core. The simplification agenda quite expressly requires us to look at materiality, data quality, reliable methods, and aggregation or disaggregation. So they're core. We are directed by the terms of reference to look at those things and to progress an agenda consistent with equalisation that encompasses those elements of a more simplified assessment approach but I don't think that that necessarily rules out consideration of other things - - -

25 MR WRIGHT: And I'm not saying that.

CHAIRMAN: - - - that are consistent with the principle of equalisation, but I think the point of difference that I might have with John on this is that the objective function is equalisation. I don't start from the position that the outcomes that were generated in 2004 were perfect and therefore the only thing that we can measure the next round against, are the 2004 outcomes. I mean, I think that's a mistake to think that way. The Commission's view, and we have embraced this, is that a simplified approach which addresses all of those - which incorporates all of those elements is totally compatible with delivering robust equalisation.

40 To what extent that approximates or is different from where we were in 2004 is an issue that will take care of itself. We don't see a contradiction between the simplification agenda and fiscal equalisation. Quite the contrary, so - - -

MR PIERCE: I wasn't suggesting that it was.

45 CHAIRMAN: Yes, well - look - - -

MR PIERCE: But I think some people were suggesting that you can achieve what I was talking about purely through that agenda, and I'm questioning that.

CHAIRMAN: Well, that's - this is what I'm trying to explore with you now. Just how far - whether you are setting another objective other than the delivery of what we will call horizontal fiscal equalisation but delivered through this 2010 agenda that we have been mandated by the terms of reference. I'm trying to get clear - I mean, my view is that this simplification agenda will move us in the direction that you're espousing, and I'm not quite sure what else you would like to see included in that agenda to take you to the point that you would like to see. That's what I'm trying to establish.

MR PIERCE: Well, I think as you said last time we met on this, there was nothing sacrosanct about the existing definition at the time it was created by the Commission - - -

CHAIRMAN: Correct.

MR PIERCE: - - - to be endorsed and maintained by governments, and it's an existing definition that people have in mind when they read those terms of reference around the table. The issue that I'm raising, and it's probably best, most tangible, I suppose, expressed in terms of the - well, done in two ways, it's equalisation to, you know, of degree, of what standard, and that could take you down that sort of path of, you know, rather than, you know, an average or a middle group or some other way of expressing that, but it could also be through, you know - and I admit that this is a question we have to put back to governments, if we're trying to - if they can't get away from achieving similar standards as we currently understand that, with all its pragmatic and data and practical constraints around it so we're not being exact - we use these words, "same standards", and know what all the constraints around them are - you know, do they want to do that across all of government services that we do or in recognition of - and this is a key question which I think we have a degree of obligation to address, in recognition of whether this provides a - whether doing that provides some constraints on dynamic efficiency gains and movements of resources.

Whether you want to confine that to a set core of services and apply our current processes and standards in a simpler more transparent way to a smaller group of things, and it was really that sort of thinking that led us to this issue about dealing with indigenous issues, for instance, and doing that - like, giving one extreme, but you could come to a whole bunch of areas, even within particular portfolio areas, the nature of the education services that you - that we deliver, can be and in some cases are different. You capture that through measuring enrolments, but to the extent that we are doing different things that would generate different enrolment numbers.

So it's that sort of mechanism which, you know, I admit you would not be able to resolve, but if - and you're reporting to MINCO about issues that are being discussed in a way that - which that impacts on your work, then I see it as legitimate to, you know, identify that these issues are there, and if they want to pick it up and do something with it, fine; If they don't - well, we'll talk about it

again in other places.

CHAIRMAN: Well, someone will. It may be easier - it gets very difficult to conceptually grab hold of this issue from time to time. It may be easier if we  
5 move to the narrower, but related, issue of core services or merit goods versus -  
that is, the scope of the assessments. Can I ask a question about this? We'll  
leave aside the discussion you'd need to have about actually what are core  
services, what are merit goods. Let's, for the moment, just - and because I think  
there would be strong divergences of view around the table about that, but if  
10 just for the sake of exposition, we say that they are only education, health, and  
law and order. Just keep it simple.

They were our declared merit goods. So far as the Commission's process, and  
now we get down to practicalities and implementations. So far as the  
15 Commission is concerned, that could lean us in one of two directions, I think.  
The natural inclination of the Commission would be to say, well, in those three  
areas, you would make differential assessments and the rest would be treated  
equal per capita. The alternative would be say, no, let's not have any of this  
equal per capita nonsense. Let's just do the assessments on the basis of three  
20 categories only, and so the differential assessments in those three categories  
would constitute the relativities. Now, which of those did you have in mind?

MR PIERCE: Probably more the first than the second. I presume the second,  
which until you mentioned it I hadn't really thought about, that would apply to,  
25 effectively, the differentials across - yes, effectively, of taking the differentials  
across those pre-defined services and applying those same differentials across  
the whole of the government. And that's the idea. That would be the  
consequence of that second way of thinking, magnifying - - -

CHAIRMAN: Well, that's one way of thinking about it, but I mean,  
30 technically, what we would do is construct a new budget. But in practical  
outcome terms, I mean, I think you're on the right track, in terms of what it  
would mean.

MR PIERCE: Yes, that wasn't the idea we were trying to capture.

CHAIRMAN: No.

MR PIERCE: No, it was essentially saying, let's establish some standards  
40 across those three services and accept that we're all going to be different every  
where else; have different capacities, different levels of service delivery and  
that's fine.

CHAIRMAN: Isn't that, sort of, at one end of the spectrum of the  
45 disaggregation agenda? That is, that you have four categories. Education,  
health, and law and order are assessed differentially and the rest aren't, and I'm  
not suggesting that's a likely outcome of the disaggregation process, but I think  
that's the disaggregation agenda.

MR FREELAND: It's certainly consistent with that disaggregation and simplification agenda, Alan, yes. This more just trying to make it a bit more explicitly, I suppose, in terms of, if you like, a first cart or a first bid of degree of disaggregation. Coming at it also, though, from a slightly different theoretical angle of rather than just looking for disaggregation on a pragmatic basis, trying to put a theoretical underpinning, as well as the pragmatic basis. But at the end of the day, it certainly is not inconsistent with the broad aggregated, simplified structure.

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MR PIERCE: I just didn't think you were interpreting it that way.

CHAIRMAN: Well, disaggregating is on the agenda and the Commission has a completely open mind as to where that agenda will lead. You'll be getting a staff paper from which I wash my hands, which has a six category structure, in the next week or so. But I mean, that's a live debate, I mean, which - - -

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MR PIERCE: But if those six categories are formed by aggregating the totality of what we do, just under six headings, that's different from saying, "We're going to take this part and what we'll do is we'll equalise on that and we're not going to worry about that."

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MR FREELAND: And applying a differential assessment structure also to all those six categories.

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CHAIRMAN: Well, that's correct, but - - -

MR FREELAND: That would be - - -

CHAIRMAN: - - - that's a two step process. The first is to decide the blocks in which you want to look at what it is that States do. That's the first step, and the second step is to decide how you actually want to construct assessments within those blocks; whether you want to differentially assess or not and how and so on. So in that sense, others don't get me wrong. I'm not saying that the merit goods argument is front and centre of the Commission's agenda, but it is consistent with the work we know we all have to do together. It is one of the possible outcomes of the work we all have to do together on disaggregation.

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MR WRIGHT: But Alan, that bothered me a little bit. It seems to me that the motivations are totally different. I mean, the aggregation/disaggregation story, from our point of view, should be driven by questions of whether you're simplifying or, you know, those kind of trade offs about accuracy of outcomes and all of those things. It shouldn't be modified by the idea that we're going to kind of get to some merit good level. I mean, that's what concerns me about this, is: the motivations of these two approaches should be totally different, in my view, and if you got to the same outcome, it would be purely by coincident. You know, one would be driven by your consideration of data availability and ease of calculation and the other one would be kind of driven by this other set

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of motivations entirely.

CHAIRMAN: It depends on what you set up at the start as being your objective. We haven't had that debate yet. That's November.

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MR WRIGHT: Okay. I look forward to it.

MR CHALLEN: I think in a way, though, the way you chose to simplify the argument at the outset turned this into a discussion about aggregation and simplification. I mean, the merit goods argument, at the end of the day, is about which goods have merit and who's to say that the provision of health or education services is any more important than, say, environmental protection or the provision of roads and infrastructure? I don't know. And I mean, I think the problem with this merit goods argument is that you would just have another endless debate in which you're relying on another set of judgements about what are the merit goods.

I mean, at the end of the day, the services that States provide evolve over time in response to their communities and all our governments get elected by their communities and they express through the ballot box what services they want provided. And over time, governments respond to them. I mean, I think some of the things governments do are absolutely balmy, but the reality is and the evidence is that communities want them. So how could you possibly have, other than a totally academic, sterile debate in the Commission about which are the meritorious that States do and which aren't?

CHAIRMAN: Well, we have lots of academic, sterile debates in the Commission, why shouldn't we have one more? Why shouldn't we have one more? Tim?

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MR MARNEY: I guess, going back to John's earlier comments, I have some attraction, if you like, to the issue of the movement of resources across borders in an allocative efficiency sense.

CHAIRMAN: Yes, I thought you might.

MR MARNEY: But I think that's a - I take your advice, but I think that's way beyond the scope of this current discussion or debate, in that it is a completely different principle to equalisation, as such. But it's nonetheless - I'm attracted to it and keen to explore. On the issue of merit goods, I support Don's comments. You know, how do you split out child protection, which you know, has the same differential issues around it as health care or education, in WA's case. But we would be happy to explore the issue of merit goods and, you know, in essence, we're talking about equalisation of a subset of services. Happy to do that if both sides of the ledger are treated the same and we look at a subset of revenues.

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CHAIRMAN: Would you care to nominate some of those revenue items.

MR MARNEY: We can give you a list. We can do that by 1 o'clock, no worries.

5 MR APPLEYARD: I guess that is part of the issue: that if you take a set of  
core services then do you then extrapolate those to cover all outlays so that you  
do have a balance with all of the revenues or whether, in fact, you say, "Well,  
we're only taking core services, so we need to take a commensurate and a  
10 smaller basket of revenues to look at." And that's a difficulty as well, I would  
have thought.

MR PIERCE: No, indeed. I think that's - you know, that doesn't give what I  
said - you know, what I said it should, to have to deal with it. Exactly.

15 CHAIRMAN: Jared?

MR BRADLEY: Yes, just very quick points. I don't know the HFE, but I find  
it hard to accept the New South Wales argument that that's impacting the  
mobility of resources. In fact, perhaps New South Wales wants to limit its  
20 success in actually achieving that, because obviously mobility of resources is  
already occurring, certainly between our States. The only thing I - so I don't  
know, even going back to John's original example, I don't know that we've  
given up on the view that we shouldn't try and deliver equal services across  
regional and rural areas, certainly in our own State. That's a very active topic.  
25 It may be though that governments make judgements about the types of  
services that are needed in different communities.

So in some communities they really need strong communication and road  
infrastructure as opposed to a nice civic centre, perhaps. And indeed, I think, if  
30 you made judgements about what are core services, when those core services  
are different in different communities, you then potentially disadvantage  
communities by actually excluding their consideration or assuming they're not  
required to address particular issues that surround those communities, in terms  
of their location or otherwise. So I guess I would agree with Don's views about  
35 the need to - that really going down this path is really sort of a - really it, I  
guess, fundamentally undermines or, at least, impacts the, sort of, core thing  
we're trying to achieve in terms of equalisation. But I'm sure that's a topic for  
further debate.

40 CHAIRMAN: John, if I was to suggest that the definition of equalisation  
might include something like - so that all States - so that any State would have  
the capacity to deliver 80 percent of the services of another State, or something  
like that. Is it - - -

45 MR PIERCE: Expressing the equivalent of marginal tax rates.

CHAIRMAN: Yes, is that the sort of thing you are trying to get at.

MR PIERCE: Yes, when we talk about the degree, that's exactly the point in my analogy. We would say, income tax with - say an income tax and welfare system, and I know that is - and we don't try and tax income - to achieve - and transfer to the welfare system so everyone has the same level of disposable  
5 income, because you know that that has consequences that we're not prepared to face up to it, so we tax them a bit but not totally. Similarly here, in the sense that, you know, if you put this in that tax and transfer system, the tax is likely to ..... the GST part of it.

10 The distribution of that so as to achieve the capacity for a standard level of service, that's the point that I'm questioning and whether it should be put to quite the same extent because, in every other area of quality, when we look at this question, we don't try and achieve that. We know it has negative  
15 consequences, and I readily admit that the - if it was to be simplified into deciding that particular number, then perhaps that's a question for Ministers to answer rather than the Commission, and you are given it and told to implement something for that number.

20 CHAIRMAN: Yes, because that would be horizontal fiscal approximation, wouldn't it?

MR CHALLEN: Do you mean by that that, on average, we would provide 80 percent of the services in Hobart that we provide in Sydney, or do you mean that 80 - - -  
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CHAIRMAN: You'd get more money.

MR CHALLEN: Yes. Well, do you mean - I think you're going to mean the second option. I always like to give someone a choice. Do you mean that we  
30 would provide Hobart school children with 80 percent of the quality of education that they get in Ballarat. Now, you have to choose one or the other. Or 80 percent of those school children the quality of Sydney?

35 MR PIERCE: Oh, yes.

MR CHALLEN: It comes out of the same place.

MR PIERCE: It's the same thing, Sydney and Ballarat.

40 MR CHALLEN: My point is it's a nonsense concept.

MR PIERCE: No, no. See, it's about framing the questions correctly, and it might be that that's what the Governments think is appropriate, in the same way - you know, that this particular community, what you're asking is for the rest of  
45 us, for the rest of the society to support a level of service delivery in this locality that that place can't support in itself. Now, that might be fine, and, you know, they might pick 100 or they might pick .8 as being the revealed preference. We should ask the questions.

MR CHALLEN: Yes, but this comes back to - you know, we've had this debate many times before. We are only doing this for Jennifer's benefit because she hasn't been here 100 times before to hear this. But - - -

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CHAIRMAN: It feels like she has, I'm sure.

MR CHALLEN: No, no.

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MR PIERCE: Don says to me quite often, you know, do you believe a child in Hobart should have a different level of educational services available to it than a child in - well, I'll call Bathurst or something, you know, and - - -

MR.....: Well, I don't know. That's the point.

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MR CHALLEN: Or an old lady in - - -

MR PIERCE: Well, that's the point. We should be asking the question.

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MR CHALLEN: An old lady in Burnie have a worse level of care than an old lady in Coffs Harbour, and go out and ask the people in the street. Get out there in Collins Street and ask them.

MR PIERCE: No, well, that's - - -

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MR CHALLEN: And they will say - all politicians are doing, John, is making a call about what their communities think. That's what they do. That's why they get elected. So go and ask the communities and I will tell you what they will tell you. They will say, "No, that's a preposterous idea." It's a preposterous idea, they will say.

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MR PIERCE: If you go, well, this is where it comes back to this full services stuff. I think there are elements in that where you can - people will express those preferences as, yes, we want those sort of level of services and we're prepared to pay for it to be available across the State, but as you move from the spectrum of the services, the way people vote will tend to reflect it and pretend to be able to determine where that, is or that can be answered in a technical sense by the Commission, I don't think is a legitimate issue for - in explaining to Ministers what is it we're actually doing here. That's why we're spitting it back to them, to see whether they're comfortable with it.

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MR CHALLEN: Yes, I must say I disagree. I think this is a perfectly legitimate way of looking at things and I don't think any Minister in the country would have any difficulty with these concepts whatever, because they are very appealing to ordinary people. This is what Australian society is about.

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MR MARNEY: I think they would, at a political level, they would support all communities receiving the same level of service except some communities

should receive better service than others. None should receive worse but some should receive better.

CHAIRMAN: And all at minimum levels of taxation.

5

MR MARNEY: Yes. I guess, I'm kind of losing track of the threads of the debate here a little bit and wonder whether or not the paper that's coming from Commission staff will provide guidance to structure - - -

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CHAIRMAN: It might provide guidance on this particular issue, because this aspect of the question goes beyond the principle of HFE. That is leave the words aside in the definition of the principle. I mean, they got changed the last two reviews but the principle didn't change - the words. So leave the words aside, but, I mean, the principle is equalisation not approximation.

15

MR MARNEY: But equalisation of capacity. So the jurisdictions make a decision.

20

CHAIRMAN: Yes, equalisation of capacity and what, you know, what I'm trying to get clear in my own mind is the extent of interest there is around the table in carrying this issue beyond the things that will naturally fall out of the simplification agenda. I mean, and there will be - there will be some changes. I can't anticipate what those changes will be, but a simplification agenda will make the incongruity between the precise words in the current definition and what we actually do just a little bit starker.

25

So I'm saying to you that I think the Commission - whatever you think the Commission will have to reflect on the words of the definition. As I say, to my mind that's largely symbolic and what I've been trying to tease out is which direction and how far you want us to head beyond the symbolic.

30

MR CHALLEN: My proposition, Chairman, is that the simplification and aggregation work will take care of most of the real issues that are under what John is talking about and the rest of it, which is the rather academic debate we've been having the last 10 minutes, is not - - -

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CHAIRMAN: Ten years I think.

40

MR CHALLEN: - - - worth wasting our time on any more. We won't make any useful progress, but there is some - - -

MR PIERCE: Ten years and five months.

45

CHAIRMAN: Ten years and five months and how many days?

MR CHALLEN: I've got a nasty feeling you're filling in the time until I have to go. I do think - I do think that the work that's being done on aggregation, in particular, and simplification to a lesser extent will make some real difference

on these sorts of issues.

CHAIRMAN: The aggregation work will unquestionably make a difference.

5 MR CHALLEN: Yes, I don't think there's any doubt about it. Yes.

CHAIRMAN: The issues raised by aggregation dwarf the issues that we looked at last year.

10 MR CHALLEN: Yes.

CHAIRMAN: Materiality and reliability and data. Yes. I think we need to move on. The third heading I had was the question of efficiency. The question of whether efficiency should be a pillar of equalisation and I am a bit - I  
15 continue to be slightly amused by the reverence with which these pillars are held. Some of you will remember that they were made up by the then Chairman of the Commission at a Priorities Issues Conference in about 2001 or 2002 or thereabouts.

20 They were made up on the spot. They have come to be sanctified in a quite unexpected way, although, having said that, I think they're pretty robust, and, I mean, I think they're pretty good blocks on which to sustain this edifice. But I guess before we can decide whether efficiency, you know, gets up there into that pantheon of pillars we actually need to be clear about what it is that people  
25 are talking about, and, you know, just what - I mean, are we talking about administrative efficiency, are we talking about allocative efficiency, and, you know, what's the Commission's business and what isn't?

30 So, I mean, I really need to understand more clearly what the pro-efficiency people actually want us to do. Grant, I think John is yielding the floor to you and you're looking meaningfully at him.

MR PIERCE: Well, I - this is my comments about - ..... we had to do this without being back to where we were before.

35 CHAIRMAN: Do it quick because Don is not here.

MR PIERCE: Well, yes, it was - I don't want to take us down a path where you become a bigger and uglier version of the NCC, and my issues about  
40 efficiency were not primarily driven by thoughts of equalisation to some pro-activity commission type efficiency benchmarks.

CHAIRMAN: Some external benchmark, yes.

45 MR PIERCE: Yes. It was more about the recognition of the effective redistribution on allocated efficiency and which is more differential, if you like, more subservient to the notion of State sovereignty than would be efficiency benchmarking type notions of efficiency be. If you provide States with a

certain level of capacity, and, as Don said, they choose to do stupid things with it, well, then, that's their right. That's why they get elected and unelected.

5 And that's not the type of business we're in, or the direction that we should be going down through this process, as distinct from other processes. So I was more about this idea that we were expressing in our submission about, you know, what are the road blocks? If you grow the national economy more and we need to close a gearbox manufacturing plant in Albury and the people and the people should go and work in an aluminium smelter in Gladstone, how do we help that happen? Or how do we at least not get in the way of that.  
10

MR BRADLEY: I guess the question is what's stopping it from happening now?

15 MR PIERCE: Well, I think it cuts both ways, because at the moment, if you like, it may provide, depending upon where those sources of productivity are, it could provide a level of services that make it attractive to go to different parts of the place, but it can also provide the capacity to do things in that place that stops them moving.  
20

MR CHALLEN: I tell you what we should do. We should close their civic centre and reduce the frequency of their buses, and that will get them to move to Gladstone. Wages do that, not government services.

25 MR PIERCE: Well, as it was part of my - I don't really want to go back into history but we've taken away tariffs, we've got rid of paying electricians the same in Adelaide as we do in Sydney - even one place in Sydney or another.

30 MR CHALLEN: Should I remind you at this point you're on the record and you've got a Labor government, before you go any further and commit suicide?

MR TUNE: Can I ask him for his IR powers?

35 MR PIERCE: IR reform has many versions. It's interpreted in many, many ways. So, you know, there's one institution of original federation left is this and what it does.

CHAIRMAN: Grant, if you can come to a 1930 sense.

40 MR HEHIR: I'll just add to what John was saying. It seems to me that the thing that we should be concerned most about with respect to efficiency is the negative impact to the process as we go through. You would expect that what we would be aiming for through this type of HFE process is that it at best, or at worst - worst - we would be neutral with respect to efficiency, or trying to aim  
45 in that direction. And it would seem to me that there's a whole pile of activities - whole pile of incentives that the process imposes at the moment which reduce efficiency within our economy, even if they are at the margin. And, yes, they are about the level of services that you provide.

5 Governments make that type of decision every day, every Cabinet, committee they go to, of how they allocate resources, and that's fine, but you would think that we'd be trying to minimise the impact of efficiency of this allocating device and leave some of those things to a more political process.

10 CHAIRMAN: I must genuinely confess that I have not grasped what it is that our processes do that are so detrimental to efficiency, and I say that quite genuinely. There are arguments about fiscal equalisation placing road blocks in the way of the efficient use of resources. And whenever I stop to sort of think my way through that, you know, two or three times a day every day, I can't actually - I can't join up the dots. And it does seem to me that if some of the dots are joined up, our contribution to undermining the efficiency of the nation is negligible compared to other structural issues in the Australian economy.

15 So, I'm wondering - I need to understand that this isn't being overstated, that this is of substance rather than just rhetoric.

20 MR HEHIR: It would be hard to rate it as the most important issue with respect to efficiency of the economy. I think I have to agree with you there. But that doesn't actually remove it from - just because it's not in the top two, three, four or 10 issues with respect to efficiency, doesn't mean that we shouldn't consider the implications of efficiency in the allocation of the resources that the processes we put in place have. I just think that would be negligible.

30 CHAIRMAN: I'm sure. Look, if there are things that we can do to address efficiency impediments consistent with our mandate to deliver equalisation, if I can understand what they are, I mean, I'm happy to have them on the agenda. But I genuinely am not at all clear. I can't sit here on the basis of having read the submissions and other things, I can't actually sit here and tell you that I've grasped what these issues are.

35 MR CHALLEN: I mean the empirical evidence that's around suggests that HFE per se, having a distribution of grants that is not equal per capita, either has negligible impact on efficiency and welfare, or it may actually have a positive impact depending on which bit of work you look at.

40 CHAIRMAN: Depending on the assumptions you use.

45 MR CHALLEN: Exactly. So, you know, again it's very hard to actually look at what goes on within the way in which the Commission implements HFE to find out anything that has an impact on efficiency, because the whole system probably doesn't, and if it does, it's absolutely tiny.

MR APPLEYARD: Some of - - -

MR CHALLEN: This debate has been around for probably 20 years - certainly

well over a decade, and no-one has been able to make anything out of this debate ever. Why it keeps coming back is that some people have just got a vague suspicion that maybe there might be a physical impact to this, but that's all we ever get. We don't ever get anything - - -

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MR APPLEYARD: Within the detail, some of the submissions were directed at the disincentive in terms of taxation reform, that States might be a little more courageous in terms of tax reform if they were comforted that they enjoy all of the benefit that came from growing their tax bases as opposed to diluting some of it. But I just wonder whether in pragmatic terms that really is an issue when it comes to tax reform.

10

MR CHALLEN: Then I go back, Glenn, to my opening remarks that these things we do are the consequences of the overall constitution and federal environment we find ourselves in and there are very few opportunities for States to indulge in tax reform that would make a difference because we don't control the taxes.

15

MR PIERCE: This is sort of in a - having got rid of the last five or six.

20

MR APPLEYARD: But it's the one step remaining - - -

MR PIERCE: It's certainly true when you do look at what you can do with your taxes - I'll personalise it. When we do look at what we do through our taxes, we think about, "Well, how can I make that structure more efficient? What is the impact on my budget?" And in that consideration, one of the first things you've got to look to is the blue book in terms of who's got what advantages or otherwise through this sort of process so as to provide advice about what actually becomes the bottom line impact of those tax changes, and because they do vary across the taxes, it influences the decisions that are made about which taxes are addressed and by how much.

25

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MR CHALLEN: But you would have that even if we had a per capita distribution of the federally distributed taxes. This is about competition between jurisdictions. It's got nothing to do with equalisation.

35

MR PIERCE: Depending upon what you do, you can have different - on the tax front you can have a different impact on what becomes your budget bottom line because of this process.

40

MR BRADLEY: And the key area is payroll tax. It's negligible, the impact you can have.

MR PIERCE: Yes. I mean, I'm referring obviously - most starkly in recent times - to the IJ taxes. That's what we just went through, and those sort of considerations were certainly brought to the table when timetables were being looked at, "We will do this one earlier rather than that one."

45

MR BRADLEY: That problem will be solved by 2010.

5 MR PIERCE: Yes, I appreciate it. Yes, I appreciate - I mean, I'm just not referring to the others because I don't have in the top of my mind what the those differences are.

CHAIRMAN: Tim?

10 MR MARNEY: An argument that's probably been made previously, and you're all sick to death with the issue of dynamic efficiency, to give a tangible example, Burrup Peninsula gas processing will add 3.6 billion to national GDP, 600 million in net fiscal benefits to the Australian government. After we take into consideration WAs expenditures in facilitating that project though, WA will actually incur a loss of 60 million, so that's, you know, the remaining  
15 States will receive a net fiscal benefit of around 450 million, so when we talk about dynamic efficiencies, it's about settings that encourage the development of the revenue base over time and that there be an appropriate sharing not only of the benefits of that development, but the costs of that development in the equalisation process.

20 CHAIRMAN: Tim, as far as I am concerned, the broader economic development arguments that Western Australia has put in in the past remain on the agenda, and I have actually asked staff to bring forward a paper which just conceptually deals with the issue, not in implementation terms. So that bit is  
25 still on the agenda, because that's a legitimate assessment issue. When you move to, sort of, dynamic and second round effects, then my question really is very simple. How would we do that?

30 MR MARNEY: Well, recognition - - -

CHAIRMAN: How would we include the dynamic effects of State policies in our assessment process?

35 MR MARNEY: Yes, I mean, that's - - -

CHAIRMAN: My guess is if we acceded to your arguments on economic development, you wouldn't be too fussed about pressing further the dynamic agenda.

40 MR MARNEY: Oh, yes, progress is progress, and recognition of the actual costs incurred and things like provision of common use infrastructure, provision of geological survey and stuff which is linked to market failure, you know, that sort of recognition would be - and appreciated still.

45 CHAIRMAN: I remember Mark's ear-bashing, I think, that he gave us on the Burrup Peninsula several years ago, will live with me forever.

MR MARNEY: Well, that's on the agenda, anyway.

MR.....: It's in Canberra.

5 MR CHALLEN: This issue, though, when you think of it in dynamic efficiency terms, you mustn't think in terms of there is only one project in Australia.

CHAIRMAN: No, no.

10 MR CHALLEN: There are projects like this going on in every State all the time, and so Western Australia is as much of a beneficiary as what is going on in other States, including States like Tasmania, as it is, if you like, a payer from its activities at the Burrup and other places to others. So what you have to ask yourself, when you're talking about dynamic efficiency is what are the  
15 incentives for States to do these sorts of things. I mean, the fact is that Western Australia has gone ahead and invested in that infrastructure, has made this. Well, why did they do that? Well, the reason is that there are other incentives other than trying to maximise their share of the GST pool for doing this. It's

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20 CHAIRMAN: Yes. No, look, I - I mean - and that's why we concluded in 2004 that we weren't doing a, sort of, a global equilibrium model and you really couldn't handle this issue, but I'm certainly, I think it would be totally out of court for me to say, well, we refuse to entertain those arguments again. I mean,  
25 we have to entertain every argument that you choose to put to us, and we do. So I'm not ruling it - you know, I'm just saying it's on the agenda, mainly because Western Australia is going to insist it's on the agenda, so I might as well roll over at this point. It's on the agenda without prejudice to where we come out.

30 MR CHALLEN: But I think, Jim, it should be on the agenda as is there an economic development assessment issue to be dealt with. It shouldn't be on the agenda as a dynamic efficiency issue.

CHAIRMAN: No, no, that's - I mean, well, I made that - - -

35 MR CHALLEN: Because there isn't a dynamic efficiency.

CHAIRMAN: I made that distinction to Tim that if we found an economic development assessment issue, then the dynamic bit could just sit quietly off to  
40 the side.

MR MARNEY: I mean, we've got that very issue with the Gordon gas project where 18 months ago, I recall sitting in front of the treasurer, and saying,  
45 "Well, from a State perspective, why would you do this".

MR CHALLEN: Yes. No, we are extremely supportive of Western Australia's position on the Burrup, because that's finished, and we're just about to start the Gunns pulp mill.

MR MARNEY: But we raise this issue in an altruistic way recognising Don's comments - - -

5 MR CHALLEN: As am I. As am I.

MR MARNEY: - - - about other States where they've got similar such investments.

10 CHAIRMAN: And Tasmania is very grateful for your contribution to their revenue.

MR PIERCE: I sometimes feel at a disadvantage living in a State where you can't just look out the window and see where these major projects - - -

15 CHAIRMAN: Yes. The witching hour has arrived, and I'm going to do a very, very brief summing up because I think that's all that's required from today. There was, I think, a general acceptance that the identification of the issues that you raise in your submissions into three groups was an adequate way  
20 to deal with them, and no one has argued that the groups were incorrectly specified or compiled, so that those group 1 issues that clearly remain on the agenda, and the Commission is genuinely very open-minded about progressing the simplification agenda, and we are determined to do it.

25 We are open-minded as to the content that - it will contain, and we're certainly not even thinking about outcomes. So - and we're taking a very broad view about what fits within that group so that, for example, some of the elements of that group confusing discussion about complete versus not appreciably  
30 different versus core service, merit goods and so on. Some of that is in there. I think we've established that not all of it is, but we don't have, I think, a sharp common understanding about what isn't it there. We have - you have not challenged my view that the group 2 issue should not - it can't be on our agenda without some further indication from governments that they want us to look at  
35 it.

Of the group 3 issues, exact or conquerable equalisation is in part on the agenda, because it's part of the simplification agenda, and I would certainly invite any State that wanted to do so to make a further submission to us directed towards sharpening just what it is that people would like to see the  
40 Commission think further about and keep on the table, as a 2010 matter. Using something other than your State average didn't get a lot of work-out today, so that I think as matters currently stand and unless something - unless this matter is brought back before the end of the year, we would include it in what we say to the Ministerial Council, include it in the sense that it was raised, but we  
45 wouldn't be taking the issue in any particular direction.

Contemporaneity, a sufficient lack of enthusiasm to accelerate consideration of it, so - and it just remains as one of the issues that States might take up in the

run of the 2010 work program. Efficiency, again here I think that I'd have to say that we need to understand more clearly just what it is that States believe the Commission should or should not be doing, in order to contribute to the national efficiency agenda. If I leave with you the Commission's current  
5 position that we have - you know, we have searched our hearts, and we don't actually understand what it is that we should do or what it is that we should not do that would give comfort to this wider efficiency agenda. So - - -

10 MR APPLEYARD: Sorry, just to interrupt on that. I thought perhaps John at least gave us an indication that in terms of the performance efficiency, they weren't looking for a larger ANCC type exercise.

CHAIRMAN: Yes, he used that word "ugly" a few times but I thought I'd let that slide.

15 MR PIERCE: I did covet your position, if that's how it's moved to - - -

CHAIRMAN: Yes, you did - yes. You did, and I must say that's the first time you've said anything that nice to me. We - I indicated at the start of the  
20 discussion that we thought it proper that our 2007 report to Minco should include the fact that we've had this discussion. It was never my intention that that would go to the point of making any recommendations to Ministerial Council about these group three issues, and it wasn't my intention because I rather thought that we would not get to the point where there was such  
25 overwhelming agreement about any of them that they could reasonably be put before Ministerial Council, and my expectations I think have been met fully in that regard.

So I don't intend to - I don't think we will be saying in that 2007 report that  
30 we've had a discussion about efficiency or contemporaneity or all-State average, and we therefore recommend that the terms of reference be amended to enable us - I mean, I'm not envisaging doing that, but I think, given the intense interest that flares up at certain times of the year about what the Commission has been doing, I think it's only fair and reasonable for all  
35 concerned that everyone is informed about what we've been discussing and a sense of where we are with those things, and I think that's about where we are.

I should provide a final opportunity for people to add or subtract to those  
40 remarks, so if I have not fairly reflected the sense of the discussion, please let me know. Thank you very much. It's amazing how much easier these meetings are when Don leaves, isn't it. So thank you very much. As I said, you will get in the next week or so a staff paper on disaggregation.

We have November scheduled for again back to backing with Heads of  
45 Treasury, I think, for a discussion of the simplification agenda, and the specific issues that the terms of reference requires us to report on in February 2007. So thank you very much, and don't drink too much tonight, will you, because I won't be. I won't be able to, so I would hate to think that anybody else was.

Thanks very much, and again, Grant and Geoff, thank you very much for the facilitating of these arrangements.

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**ADJOURNED INDEFINITELY**

**[1.09pm]**