



**Response to the
CGC Issues Paper 2006/03**

***“Architecture of Horizontal Fiscal
Equalisation: Principles and Interpretation”***

Department of Treasury and Finance

June 2006

INTRODUCTION

1. Tasmania supports the current principle of Horizontal Fiscal Equalisation (HFE) as the basis for calculating the per capita relativities used to determine the distribution of GST revenue and Health Care Grants.
2. Tasmania reiterates the point that it made at the November 2005 Conference that there is no basis in the 2010 Review Terms of Reference for the Commission to consider the principle of HFE. The Terms of Reference refer to 'the' principle of HFE, not 'a' principle. Tasmania interprets this to mean that the Terms of Reference refer to the existing principle of HFE. Without explicit instructions from the Ministerial Council for Commonwealth-State Financial Relations (MINCO), it is difficult to understand why the Commission has decided to open this debate.
3. The Commission quite rightly points out toward the end of its Issues Paper (in paragraphs 73 and 74) that the resolution of many of the issues it has raised is a matter for governments. In this context, the Commission should recognise that, in negotiating agreement on the Terms of Reference, the majority of states opposed reviewing the principle of HFE.
4. Nevertheless, Tasmania is always willing to argue the merits of the current principle and interpretation of HFE against other alternatives because it believes that HFE, as it is practiced in Australia, is the most effective and robust method to achieve equalisation according to the Australian community's expectations.

OBJECTIVES FOR REVENUE DISTRIBUTION

5. The Commission has posed two key questions under this topic. It has asked states what should be the objectives of the distribution of GST revenue and whether different objectives would have implications for Commonwealth-state relations.
6. Tasmania believes the objective for revenue distribution should clearly continue to be focused on equalisation.

Arguments in support of equalisation

7. The objective of HFE, as it is practised in Australia, is about equalising the capacity of governments to provide services. It reflects a belief that Australians should have access to a similar standard of service, regardless of the jurisdiction in which they live. This is a strong egalitarian principle, which has been widely held over time within the Australian community and has been reflected in the Commission's approach, in one form or another, since its inception in the 1930s.
8. Australians do not want the extent of regional disparities that exist in some other federations. This is clear in strong public opposition to policies, proposals and events, which result, or could potentially result, in unequal pricing and provision of goods and services. Two examples of strong

opposition to inequality within Australia involve telecommunications services and petrol pricing (where the primary concern is the differential between services and prices in rural and regional areas compared to larger, generally metropolitan areas).

9. A different definition of HFE that states its objective is something less than to provide states with the same capacity to provide services would result in greater regional disparities. It would also ignore the current and very widespread practice of all levels of government to 'in effect' equalise through complete locational independence between revenue raising and expenditure effort.
10. If states were not provided with the same capacity to provide services, inequality would increase over time, because disadvantaged states would not be provided with enough capacity to compensate for their disadvantages and strong states would be provided with a greater capacity than required to meet their needs. This would give the latter an ability to provide above national average standards of services across the board (all other things being equal).
11. In Tasmania's case, while there has been considerable economic and social improvement in recent years, Tasmania still remains well below national averages in a range of social and economic indicators (see Attachment A). Many of these indicators reflect structural problems or characteristics, which can only be resolved over the long-term (and specific circumstances may mean some will never be overcome). Efforts to implement the structural changes necessary would be significantly undermined by any change to the objective for revenue distribution, which reduced Tasmania's capacity to provide services.

Arguments in defence of equalisation

12. The main arguments against the current objective of equalisation (such as those highlighted in paragraph 12 of the Issues Paper) are flawed because they do not reflect what occurs in the real world. Most of these arguments focus on the alleged adverse impacts on efficiency and regional and national competitiveness.
13. However, fiscal equalisation is efficiency neutral. Under the current methodology, all states are assumed to incur the national standard (weighted average) level of expenditure to deliver a service. This is then adjusted for the disabilities faced by each state to deliver that service. No adjustment is made in relation to how efficiently a state delivers a service.
14. If a state is able to deliver the average level of service at a cost below the national average, its funding from the Commonwealth would only be affected by the minimal impact it would have through the national standard. In the case of the supposedly 'inefficient' states, the impact would be particularly limited. The state would have the benefit of the difference between the national average and its actual expenditure.

15. States therefore continue to have the incentive to reduce costs as they will retain the benefit of greater budget flexibility and will not be discouraged from improving efficiency by the equalisation process.
16. While the Commission's methodology is neutral in terms of the impact that it has on the efficiency with which governments provide services, it could be argued that fiscal equalisation has other efficiency impacts. For example, it could be argued that, by compensating states for disabilities such as scale and dispersion, equalisation encourages states to provide services to small, dispersed populations which would otherwise be uneconomic and it provides a barrier to the rationalisation of these services. This is where there is a fundamental trade-off between the notions of equity and efficiency.
17. However, research commissioned for the Garnaut-Fitzgerald Review demonstrates that any theoretical efficiency losses arising from the application of HFE are minimal. The research found that the welfare gains from moving to a per capita distribution were between \$150 and \$250 million a year. This is insignificant compared to Australian GDP of around \$870 billion a year.
18. Even these figures are based on questionable assumptions. More recent modelling, commissioned by Queensland and undertaken by Monash University's Centre for Policy Studies (which also undertook the Garnaut-Fitzgerald modelling), yielded strikingly different results. Based on slightly modified – though more realistic – assumptions, the Queensland modelling suggested that moving to an equal per capita (EPC) distribution would result in losses of up to \$620 million in national economic welfare, compared to a no-change situation.
19. It is sometimes argued that fiscal equalisation provides a disincentive for states to promote economic reform and development because the benefits of economic reform and development, through higher revenue, are equalised away. This argument overlooks that there are a range of incentives for state governments to pursue economic reform and development, the most significant of which is the desire to improve the welfare of their communities through the increased employment and higher incomes that are generated by economic development. It also overlooks the fact that governments are generally unaware of the fiscal equalisation consequences of their decision. These issues, therefore, simply do not factor into the decision making process.
20. If we consider what is happening today with regards to the resources boom, have those resource rich states that complain that their revenue from resources is being 'equalised away' stopped putting significant effort into supporting resource industries? The answer is clearly no and, therefore, the argument that equalisation acts as a disincentive to economic development does not hold.
21. The Interstate Investment Co-operation Agreement (IICA), which all states except Queensland are party to, is another practical example that demonstrates that the disincentive argument is false. This agreement is

aimed at restricting the practice of ‘bidding wars’ between states, where financial incentives are offered to attract major industries and employers to one state over another. Clearly, if the redistribution of GST were a disincentive as claimed, such bidding wars would not occur and there would be no need for the IICA.

22. Furthermore, no government would expect to be returned to office, and no opposition would expect to win government, if it did not actively propose and implement policies which are designed to increase economic development. There would need to be some form of collusion or agreement between political parties and acceptance from businesses and households in a state for the supposed disincentive to be realised. This is implausible and counter-intuitive to how political parties and businesses, in particular, think and act.
23. It is also argued that, because states are not responsible for raising a significant proportion of their revenue, they are not directly accountable to the community to the same extent for their taxing/expenditure decisions and that this could have an impact on efficiency. That is, if states had to justify their level of revenue raising to the community, they would have a greater incentive to provide services more efficiently in order to avoid imposing higher taxes than absolutely necessary. However, this is more a consequence of vertical fiscal imbalance than fiscal equalisation.

Arguments against alternative objectives

24. The Commission has highlighted two alternative objectives for the distribution of revenue that have been suggested in recent times. The first suggestion is that GST revenue should be distributed on the basis of where the tax is collected because that would be more conducive to an efficient allocation of resources.
25. The generation of GST is closely related to economic activity. For this reason, states with lower socio-economic status and lower average wages tend to generate less GST per capita relative to other states. Historically, such states also tend to have lower relative fiscal capacities. Distributing GST shares on the basis of the state of origin would negatively impact on these states significantly compared to the current approach, and lead to an outcome inferior even to that proposed by an EPC distribution. As it is, Tasmania opposes an EPC distribution of the GST pool for the reasons outlined in paragraphs 29 to 33 of this Submission.
26. Such a proposal would also be in contrast to how the majority of taxes (both Commonwealth and state) are raised and spent. That is, jurisdictions rarely spend revenue raised from their own taxes precisely in the areas from which they are collected.
27. An article by Saul Eslake, Chief Economist with the ANZ Bank, published in *The Financial Review* in March 2006, highlights this argument further (see Attachment B).

28. Obtaining robust data on the origin of GST collection is in itself problematic. Queensland Treasury has examined this issue in a series of published fact sheets on HFE. They point out that while the Australian Treasury produces records of GST collected from each state, the reality is that the state in which GST is collected and reported can differ. For example, many transactions take place in Australia between a firm located in one state and a resident located in another. Under these circumstances, it is possible that GST is subsequently remitted and reported through the state in which the firm is based. Given that most large national and multinational companies are based in either New South Wales or Victoria, it is likely that GST statistics overstate the proportion of the tax generated in these states.
29. The second suggestion is that GST revenue should be distributed on an EPC basis. This would undoubtedly result in a fundamental change that would undermine long-held community expectations regarding equality and opportunity in Australia.
30. It is questionable whether there would be a significant benefit to those states that argue that the objective of revenue distribution should be according to an EPC approach. The Commonwealth 2006-07 Budget Paper No. 3 published information, which showed that if GST revenue was distributed on an EPC basis, instead of under HFE, this would have extremely significant negative impacts on General Government revenue in some states, while there would be smaller positive impacts for New South Wales and Victoria (see Attachment C).
31. When considered in the context of total General Government revenues, a change to an EPC distribution would reduce Tasmania's revenue by 17.5 per cent and the Northern Territory's revenue by 53.4 per cent (based on 2006-07 estimates – see Attachment C). In contrast, the percentage increase for New South Wales and Victoria is much less significant, at around 4.5 per cent each.
32. The basis for an EPC distribution of GST revenue is often linked to the argument that the objective should focus on equalising individuals instead of the capacity of states. It is argued that empirical studies (such as the Garnault-Fitzgerald Review) demonstrate that overall (national) equity actually increases with a per capita distribution. However, as discussed above, this would have significant negative outcomes for small states in particular. This is not likely to result in improved outcomes for individuals in those states and, therefore, would only exacerbate inequality between individuals.
33. Equalising the capacity of states is also a central element of Australia's federation, as it protects states autonomy and enables them to provide services to their communities that reflect the specific priorities of those communities, which differ variously across the states.

THE DEFINITION OF EQUALISATION

34. The current definition of HFE has not led to states that receive above per capita distributions becoming relatively more wealthy than states that receive a less than per capita distribution, and there does not appear to be significantly better service provision in these states compared to states with below per capita shares. This suggests that the principle of HFE is generally operating soundly. That is, it is not designed to provide states with the ability to overcome disadvantage, it is only designed to compensate states for disadvantage.
35. In fact, it could be argued that the application of HFE, in practice, has erred on the conservative side and that disadvantaged states have not received funding to account fully for their disadvantages. McHugh observes that, *“When judgement is being heavily relied on in the assessment of a disability factor, the CGC will assess the cost weight conservatively ie closer to EPC”*.
36. Arguments have been put forward that the current definition of equalisation requires a level of precision that cannot be achieved reliably because of data and methodology constraints. This level of precision is sometimes associated with the term ‘full equalisation’.
37. These arguments are often the basis for suggestions that equalisation should be defined according to standards that are not ‘appreciably different from’ or ‘comparable to’ other states. Tasmania has yet to observe a detailed explanation of what either of these terms would mean in practice and how they could be consistent with equalisation.
38. In the absence of such clarity, Tasmania, and some other jurisdictions, have previously responded to these suggestions that such approaches would not remove the level of precision required to achieve the objective. Something cannot be judged to be ‘appreciably different from’ or ‘comparable to’ without knowing what it is being judged against. The only thing that it can be judged against is equalisation.
39. The use of the term ‘full equalisation’ and the suggestion that the Commission should not attempt to fully equalise is puzzling. Something is either equal or it is not – there is no such thing as partially equal. Therefore, if a different definition (such as the above two examples) were adopted, it would be wrong to label the new definition as equalisation because equalisation would no longer be the objective.
40. In paragraph 22 of its Issues Paper, the Commission questions whether the current proposal for simplification through aggregation and materiality tests would be an alternative way of achieving, in practice, an outcome where the result is ‘not appreciably different from’ or ‘comparable to’ other states.
41. What the current review is effectively doing is determining whether assessments are **materially different from** other assessments. There is a significant difference with this process on two grounds. Firstly, the process to understand whether an assessment is materially different from other

assessments is based on the ability to compare one possible assessment with others. Secondly, the process is consistent with equalisation because all that it is being asked to do is remove the level of complexity that is not needed and does not matter to the equalisation outcome (as judged by the materiality tests).

42. Therefore, the question raised in paragraph 22 of the Issues Paper would be true only if a relatively benign definition (ie, one that is consistent with equalisation in practice) of 'not appreciably different from' or 'comparable to' is intended by those that espouse them. Tasmania doubts that this is the case because there is still support from some jurisdictions for a definition based on 'not appreciably different from' or 'comparable to', which would exist in addition to simplification.
43. Other suggestions, such as providing assistance to only the financially weakest states, or to provide a 'safety net' approach to standard of services, are also, if not more so, suited to an objective that is not focused on equalisation.
44. With reference to the suggestion that the focus should change from equalising fiscal capacity to equalising the performance of states, there is a significant degree of ambiguity surrounding what and how this could be measured. Selecting benchmarks to use as performance measures would require subjective judgements based on a concept of 'what states *should* do', rather than 'what states actually do'.
45. Such a change would undermine state sovereignty, because states would have less flexibility to provide services according to their respective communities' preferences to the same degree that equalising states' fiscal capacities does. This would, in effect, result in GST revenue being distributed almost on a de facto SPP basis, rather than on a genuine GPP basis.
46. In contrast, the current approach is clear and preserves state sovereignty because it measures what states actually do. This is relatively easily measurable.
47. Furthermore, in terms of keeping the assessments contemporary, experience suggests that linking decisions on revenue distribution based on outcomes would result in a much greater lag than under the current approach. This is because it can take significant time for outcomes to be realised (sometimes decades).
48. In relation to the possible inclusion of efficiency as a principle to guide equalisation, Tasmania reiterates the arguments put forward in the previous sections (see paragraphs 12 to 15 and 20 to 22). That is, equalisation as it is currently practiced is efficiency neutral, and distributing GST revenue according to some notion of efficiency allocation would be completely inconsistent with the way in which all governments, federal and state, distribute the proceeds from other taxes.

INTERPRETING THE EQUALISATION PRINCIPLE

Capacity equalisation

Whose capacity?

49. Tasmania believes that capacity equalisation is already interpreted broadly to include the capacity of state governments, as well as certain other bodies, to provide services that are state responsibilities. The current approach sufficiently incorporates this broad interpretation as it captures some additional capacity provided through Commonwealth funding (through the inclusion of SPPs) and, as mentioned in paragraph 32 of the Issues Paper, takes account of interstate differences in the use of some private services.
50. States governments can, and do, benefit financially, both directly and indirectly, from the availability of privately provided services. However, the extent to which governments and the community can access these services varies between states. Moreover, this difference in access is not usually a matter of government control.
51. Consider the provision of school education. There is significant variation between the states in the proportion of school children enrolled at non-government schools. A number of historical, socio-economic, cultural, attitudinal and cost factors determine, in large part, the final proportion of non-government enrolments.
52. However, the final result has a significant impact on government capacity. State governments with lower proportions of non-government school enrolments face higher costs in educating the remaining school age population. That is, they do not benefit from the additional capacity provided by the private sector to the extent that other states do. It is important that any equalisation process recognises this.
53. The same principle applies to cases where Commonwealth and local governments provide state services. Again, Tasmania's assessment is that the current approach adequately incorporates this additional capacity. In particular, many services that states provide are supplemented by SPPs. In these instances SPPs increase state fiscal capacity and it is appropriate, in most cases, that this be recognised.
54. Given this, Tasmania does not see any need to broaden the interpretation currently used.

Equalising on the basis of net wealth or net debt

55. While it might be technically possible to incorporate net wealth or net debt into the assessment process, this would not improve the equalisation outcome. In fact, it could result in increased inequality, since these measures are likely to be a poor, or even misleading, indicator of current fiscal capacity.

56. Equalising on the basis of net debt would seem inconsistent with policy neutrality given the debate surrounding the current Debt Charges category. This assessment is often criticised on the basis that a state's debt is largely a result of policy choice – that is, a state's willingness to borrow to finance expenditure, regardless of whether that expenditure is on recurring or capital items. In this context, HFE would not be improved by expanding the role of net debt in determining equalisation grants.
57. A state's net wealth is a less timely indicator of its fiscal capacity than the per capita deficit on operating accounts. While it may bear some relationship to fiscal capacity in the long term, it is not an appropriate measure of current circumstances. Like an individual person, a state can be asset rich and income poor, and vice-versa.
58. Tasmania also has concerns over the robustness of data currently used to measure net wealth. Generally a *stock*, such as wealth, is more difficult to accurately measure than a *flow*, such as expenditure. This is particularly true for non-financial and physical assets, whose value often depends on the age and rate of depreciation of specific assets, information that may not always be available to the degree required for the Commission's assessments.
59. Tasmania does not support equalising on the basis of a concept such as net wealth or net debt principally because no rationale or benefit has been provided for such a change.

Internal standards or what States do

Alternative interpretations of 'what States do'

60. Tasmania is opposed to any change to the interpretation of 'what states do' that introduces additional judgement or that jeopardises state autonomy. Some of the suggestions put forward in the Issues Paper would clearly result in such an outcome. Furthermore, the Issues Paper provides little evidence that any of the suggestions would improve equalisation.
61. A standard based on what some states do – for example, the financially strongest states – makes the unsubstantiated assumption that it is somehow possible for the weaker states to deliver services or raise revenue as easily as the financially strongest states. If this were true, no equalisation process would be necessary to begin with. Such a standard fails to acknowledge the extent to which financially weaker states suffer disabilities, and that these disabilities are outside of state government control. In any case, the Commission's current method of determining standards is by way of weighted averages in which the large states have a proportionally greater influence on these standards.
62. Tasmania sees no benefits to the equalisation process in shifting from an average policy to a 'desired' policy. The current internal approach is transparent, objective, and limits the ability of states to individually influence national standards. A 'desired' standard would introduce judgement into the process, and with it less transparency, increased

complexity, disputes between parties over what is a desired level, and opportunities for states to affect outcomes.

63. Tasmania would also have concerns over the implications that a ‘desired’ benchmark could have on state autonomy, since the term implies that states should aim for a certain level of services.
64. In interpreting ‘what states do’, Tasmania believes that it is far more problematic to objectively define and measure various states’ policies and policy objectives than it is to observe the services they provide. Rather than being a broader interpretation, it is actually a more qualitative interpretation. It would not necessarily be a simpler approach, since the Commission would need to exercise judgement in identifying these policy objectives. It is difficult to see how it would operate in practice, since policy objectives are more likely to vary between states than service delivery, and may be diametrically opposed in some instances.
65. Broadening the definition of the ‘same effort to raise revenue’ would be a similarly problematic exercise. There is no evidence that incorporating state policies to expand their tax bases improves the equalisation outcome.
66. Individual states will logically seek to deliver services using the most efficient method available to them. Most of the time, states do provide services in a similar way since there is usually a common ‘best practice’. Where there is variation in the method used to provide a service, an average standard is still appropriate since the method of delivery has little impact on the type of service provided, the user of the service, and the final outcome.

Policy neutrality

67. Tasmania believes that the current approach to equalisation is policy neutral. While it is true that the policies of all states set the standards, the amount by which a state can deliberately alter the standard is limited. Tasmania recognises that there is some conceptual appeal in adopting a policy free approach. However, given that there is a high degree of similarity in the range and methods of taxation among the states, the current approach of measuring the common policy is consistent with both simplicity and transparency.
68. A concept of policy free would only be appropriate if there was wide divergence in taxation policy between states. A true concept of policy free would presumably need to measure the broadest range of possible taxes including those that are not currently levied by any state such as, for example, death duties, since all states could levy such a tax if they wished.

Incentives and disincentives arising from equalisation

69. There is no evidence that equalisation encourages ‘rent-seeking’ behaviour by states. It is unsurprising that the rent-seeking argument has never been empirically realised, given that voters would likely punish any government

that avoided economic reform and development on the basis that any gains would be equalised away.

70. Tasmania has earlier outlined its arguments in relation to incentives and disincentives to promote economic growth and perform efficiently in paragraphs 12 to 22 of this Paper.
71. An equalisation process that deliberately provided incentives for states to behave in certain ways would be an outcome-driven exercise. This may be appropriate in a case where the aim of HFE is to equalise outcomes. However, it is not consistent with the current definition of HFE, which explicitly refers to equalising capacity. It is for this very reason that Tasmania supports the current definition of HFE – it protects state autonomy by removing the ability of the Commonwealth or other states to influence a state’s policy in a way that is inconsistent with its residents’ preferences.

Should there be more pillars?

72. There is a fundamental difference between the Commission’s current three pillars and those suggested in the Issues Paper. While simplicity, robustness, transparency, stability, and to some extent efficiency are each important aspects of a sound equalisation process, the absence of one of them does not result in HFE ceasing to function adequately. However, if, for example, capacity equalisation is removed, then the equalisation process becomes internally inconsistent and effectively collapses – hence the label ‘pillar’.
73. The above-mentioned principles can be incorporated readily into the equalisation process without formally establishing them as pillars, and indeed some of them are explicitly listed in the terms of reference for the 2010 Review. Others – for example, transparency – are already guiding principles in the current equalisation structure.

Including efficiency as a pillar

74. Tasmania supports an equalisation process that does not discourage efficiency. For reasons discussed previously in this Submission, the current equalisation process provides strong incentives for states to improve efficiency. Even if one assumes that states do consider the implications of equalisation when making decisions, a basic cost-benefit analysis will always lead to states promoting efficiency over avoiding it, because any gains from efficiency will always be greater than the subsequent loss in a state’s grant share.
75. Nevertheless, Tasmania acknowledges that there is an inevitable trade-off between perfect efficiency and full equalisation, both in an allocative and a technical sense. As outlined in paragraph 17 of this Submission, the theoretical losses resulting from HFE – if they do exist – are minimal as a proportion of economic activity and, in Tasmania’s opinion, a small price to pay for an equitable federation.

76. Tasmania sees no benefit in including efficiency as a pillar. The concept of efficiency is often misused to undermine both the principle, and the implementation, of equalisation. While including efficiency as a pillar would not improve the validity of this argument, it would raise its profile in a counter-productive way.

The scope of HFE

Merit goods

77. A concept of ‘merit’ goods or core functions is unworkable in practice because states are unlikely to agree on what constitutes such a good. Tasmania considers all the functions that states perform to be core functions – otherwise, there would be no incentive to provide them.
78. Limiting the scope of equalisation to merit goods – ignoring for a moment that a definition would require an arbitrary value judgement at some point – would mean that the process would no longer reflect ‘what states do’. Furthermore, it would fail to equalise the states’ capacity to provide services. In other words, a concept of merit goods runs contrary to two of the three pillars of equalisation. Given that it would also be a backwards step in the simplification of assessments, there would seem to be little merit in equalising on the basis of merit goods.

Public trading enterprises (PTEs)

79. Public trading enterprises operate in a market environment and their costs in producing goods and services are recovered from customers. The assessment of these activities should reflect the impact they have on the general government operating budget – that is, where transactions occur between PTEs and the general government sector. An example would include instances where states provide payments to offset concessions that PTEs are required to provide. Likewise, tax equivalent payments, guarantee fees and dividends are a source of revenue in general government operating statements and should be included in the equalisation budget accordingly. The current scope of equalisation achieves this effectively.

Disabilities

80. One of the aims of equalisation – indeed, one of the Commission’s three pillars – is the equalisation of capacity. This necessarily includes both the capacity to respond to the level of demand for services in a state (differences in use) as well as the capacity to provide that service within a state’s budget constraints (differences in the unit cost of service provision). Tasmania fails to see how removing one set of disabilities in the assessment process is rational given that they are both, by definition, disabilities. Both are beyond the control of governments and both have real impacts on residents’ access to services. Both logically and comfortably fit into the current definition and interpretation of equalisation and the removal of either would seriously diminish the equalisation outcome.

81. Similarly, Tasmania cannot understand the rationale for discriminating between location-based disabilities and other types of disabilities, as they are all equally legitimate. Tasmania would support the omission of a separate location-based disability only where this occurred as a result of the Commission's top-down, simplified approach to the equalisation task. That is, a separate assessment of a disability should not be made where the conceptual case for its inclusion is weak, the effects of the disability are immaterial, or the assessment lacks robust data.

Use of broad indicators

82. While Tasmania supports the use of broader indicators where this is consistent with HFE, it agrees with the Commission that the use of single broad assessments to cover all revenue or all expenditure categories cannot provide a sufficient measure of state fiscal needs. Tasmania accepts that the number of indicators measured will reduce in future due to simplification and the application of materiality thresholds, and supports this provided that the process still captures the material drivers of relative fiscal capacity.

Averaging relativities and their application

83. These issues are addressed in Tasmania's response to *CGC Issues Paper 2006/04 Contemporaneity*.

The treatment of SPPs

84. Arguments can be made for either an inclusion or exclusion approach depending on views held of Commonwealth-state roles and responsibilities and the efficacy of SPPs as a vehicle to achieve "national" objectives.
85. Tasmania considers the reasons for the provision of SPPs are largely political. They give the Australian Government the opportunity to obtain credit for providing funding for a particular service and, through the imposition of conditions, give it the opportunity to influence expenditure in areas of state responsibility. However, they are also a source of increasing contention within Commonwealth-state relations around such issues as state sovereignty, grant design effects and compliance costs.
86. Tasmania supports the current "hybrid" approach to the treatment of SPPs in preference to an exclusion approach.
87. On balance, Tasmania considers it more appropriate that, across the standard budget, equalisation is based on a roughly comprehensive approach that considers both expenditure needs in the provision of services and offsetting revenues available to assist with their provision. Under the current "hybrid" system, while the inclusion principle supports the horizontal fiscal equalisation principle, the capacity to exclude specific grants provides the necessary "safety valve" to make this work in practice. That is, this provides the capacity for national objectives or other considerations associated with specific SPPs to take primacy over equalisation where this is considered appropriate.

88. A full exclusion approach to SPPs would result in a fundamentally different and less complete form of equalisation. It could be argued that this would be the more appropriate approach were there evidence that typically the interstate distribution of SPPs needed to reflect an intrinsically different distribution base than that realised under HFE. However, there is little apparent evidence to support such an argument at present. The current relative distribution of SPPs treated by inclusion, in aggregate, appears to largely reflect the direction of HFE expenditure disabilities assessments in aggregate. That is, the apparent distributional objectives of those SPPs treated by inclusion appear, on balance to largely reinforce, rather than work in opposition to, an HFE distribution.
89. Pragmatically, the exclusion of SPPs would act to diminish rather than enhance the credibility of equalisation while offering little in the way of simplification benefits. It would have major ramifications for Commonwealth-state financial relations more broadly and could be expected to result in a greater politicisation of SPP processes. It is noted this option was included in the Preliminary Scan of Options for the Limited Review of HFE, but was not short-listed.

IS EQUALISATION BEING ASKED TO DO TOO MUCH?

90. Tasmania considers that equalisation, as currently applied, is not being asked to do too much but rather that some observers misinterpret what its role is or should be.
91. The current application of HFE has withstood the test of time.
92. The approach to assessing relative needs is internally consistent with this equalisation objective. That is, it uses state budgets as the basis for measurement, standards are established on a policy neutral basis.
93. The Commission has no mandate to change the existing HFE definition. This is a matter for governments (refer to paragraphs 2 and 3 of this Paper). Commitment by governments to such a change would entail a fundamental re-examination of the whole underlying structure of Commonwealth-state financial relations and financial transfers within Australia. Within this context, there is no collective appetite for a change to the current application.
94. Fiscal federalism, HFE, the general purpose nature of this funding, and the divisions of roles and responsibilities in terms of service delivery are based around fundamental notions of state sovereignty and subsidiarily principles. Alternative equalisation objectives are in contradiction to these notions.
95. Tasmania is not aware of any widespread evidence to suggest that Australians generally believe that all individuals, regardless of location should have access to the same services. Tasmania considers the more common view is, rather, that individuals in like situations should have access to like services. This reflects a general recognition that capacity is limited

and that it is not viable to provide major tertiary hospitals within small rural communities or major urban rail systems in the smaller capital cities.

96. One area in particular of the Commission's assessments is often debated in the context of the argument of whether equalisation is being asked to do too much – that is indigenous disadvantage. Redressing indigenous disadvantage is clearly a desirable objective. Achieving it is problematic.
97. Tasmania firmly believes that the current equalisation approach is appropriate in recognising the additional demands and costs associated with service provision to indigenous populations within the equalisation framework. While this creates measurement issues (data outliers, data deficiencies and judgement issues) this does not justify removal of this sub-group from the equalisation system as suggested by New South Wales on the grounds that equalisation is perhaps being asked to do too much (refer to comments by New South Wales Treasury Secretary, Mr John Pierce, at the November 2005 Conference, p 59 of the Conference Transcript).
98. Equalisation as currently applied only provides a starting point to address indigenous disadvantage by providing states with the capacity to provide services to the average national standard. It does not provide them with the capacity to overcome such disadvantage. While this is supplemented from outside the equalisation system through additional targeted measures, indigenous disadvantage remains a major issue.
99. However, an alternative approach that required states to directly address the underlying causes of indigenous disadvantage through the equalisation pool is unlikely to receive the support of state governments or their constituents.
100. Such an objective is not only outside the ambit of equalisation as currently defined, but also outside the capacity of the equalisation funding pool to achieve, in the absence of radical shifts in budget priorities (and related service delivery priorities and objectives) at the level of state governments. Politically, states' constituencies are unlikely to support such shifts. For such objectives to be achieved, the Australian Government would then have to drive the policy at a national level. The likely result is performance based tied funding for states, in lieu of general purpose payments, or, alternatively, a major realignment of areas of responsibility and related funding arrangements between the states and the Commonwealth.

OTHER CONSIDERATIONS THAT MAY AFFECT THE DISCUSSIONS

101. It is worth considering, in the context of the debate on HFE, how government services might be distributed if Australia were not a federation. If a single level of government provided all government services, it would almost certainly seek to provide services at a broadly equal level across Australia and would impose taxes at the same rate. This is what the Australian Government does now in relation to the services that it provides and taxes it raises.

102. Quite clearly, a change in the objective of revenue distribution to anything other than equalisation would result in significant implications for Commonwealth-state financial relations because the Australian Government would be obliged to equalise the states through other means. This could be through reducing other grants and subsidies (primarily SPPs) to those states that would gain a share of GST revenue greater than they require to provide an average level of services to their population, and increased other grants and subsidies to those states that would end up with a GST revenue share that is below that required to provide an average level of services.
103. This would significantly undermine the nature of the Australian Federation because it would result in a reduction in the autonomy of disadvantaged states while increasing the influence of the Australian Government. The inverse would be true for those states that benefit from moving away from the objective of equalisation for GST revenue distribution. The result of this would be that disadvantaged states would have a lesser capacity to address the particular preferences of their community while strong states would have a greater capacity to do the same. This in itself would be another form of inequality between the states.

Conclusion and future work

104. While Tasmania is content to debate the merits of the current principle and interpretation of HFE, it considers that HFE, as currently practiced in Australia, is the most effective and robust method to achieving equalisation according to the Australian community's expectations.
105. The arguments and issues presented in this submission strongly support that notion.
106. Leaving this aside, it is not clear where the Commission intends to go with this process. Aside from providing states with another opportunity to air their views, there appears to be no proposed course of action as to how this work will resolve any of the issues that are the focus of debate between states. The Commission's timetable simply outlines a work program where states comments will be sought, Heads of Treasuries will discuss them at a meeting in July 2006, and further comments will be sought from states later in 2006.
107. The reason for this may be that the Commission does not have the authority to examine and resolve the issues, as there is no basis in the 2010 Review Terms of Reference to do so. It is therefore puzzling as to why the Commission is progressing this work, particularly given the considerable work that is required to be done by the Commission and the states to meet the 2010 Terms of Reference. Raising issues regarding HFE adds further to this workload but does not contribute to the Review.
108. States that are unsatisfied with the current arrangements are likely to continue pursuing their cause outside of the Commission's work, making the current exercise superfluous to an even greater extent.

109. Ultimately, Commonwealth-state financial relations and the principles that govern them are matters for governments, and will be debated by governments if they are of the view that debate is required.

ATTACHMENT A

SELECTED TASMANIAN SOCIAL AND ECONOMIC STATISTICS

<i>Social Statistics</i>		
	Tasmania	Australia
Infant mortality (per 1 000 live births) ¹	7.0	4.8
Male life expectancy to age 70 ²	76.3%	78.7%
Female life expectancy to age 70 ²	84.5%	87.1%
Persons with a disability (% of population) ³	22.6%	20.0%
Causes of death – cancer (per 100 000 persons) ⁴	211	187
Causes of death – heart disease (per 100 000 persons) ⁴	144	129
Persons who did not complete Year 12 (% of persons aged 15-64) ⁵	44.1%	32.3%
Persons with a bachelor degree or above (% of persons aged 25-64) ⁵	15.8%	21.9%
Sources of income (% of persons receiving government pensions and allowances) ⁶	37.6%	26.6%

Source: ABS catalogue no. 4102.0, *Australian Social Trends 2005*

Notes:

1. Data are for calendar 2003
2. Data based on the average of the years 2001 to 2003
3. Data are according to the reference period in 2003 for the Survey of Disability, Ageing and Carers.
4. Data are calculated using the average of three years of deaths data between 2001 and 2003, divided by the population of the middle year.
5. Data are measured at May 2004
6. Data are for year ending 2002-03

<i>Economic Statistics</i>			
	Tasmania	Australia	Difference
Participation Rate	60.1%	64.4%	-4.3pp
Unemployment rate	6.1%	5.1%	1.0pp
% of unemployed who are long-term unemployed	24.9%	17.7%	7.2pp
Average length of unemployment	65.2 weeks	39.6 weeks	64.6%
Average weekly ordinary time earnings	\$898.5	\$1026.18	-12.4%
GSP per capita (real)	\$31 801	\$42 437	-25.1%

Note: all data are for calendar 2005 and are in original, year-average terms (except for GSP per capita, which is for 2004-05).

ATTACHMENT B**“THE GRANTS COMMISSION IS PART OF THE GLUE THAT HOLDS THE AUSTRALIAN FEDERATION TOGETHER”****Saul Eslake (AFR Article, March 2006)**

The recent release of the Grants Commission’s annual update of the relativities used to distribute GST revenues among the States and Territories was accompanied by the usual litany of complaints from New South Wales and Victoria that they are ‘unfairly’ subsidizing the rest of Australia.

Although making such complaints has long been part of the job description for the Treasurers of these two States, it nonetheless always comes as a surprise to hear Labor politicians, as both of them now are, complaining about the redistribution of taxes from the rich to the poor.

For that is precisely what the Grants Commission’s assessments are all about. The Commission is required by its terms of reference to recommend a distribution of GST revenues which would allow each State or Territory to provide services to its population at the same standard as the average of all of them (after taking account of differences in the usage of various services and the cost of providing them in each State and Territory) if each made the same effort to raise revenues from its own sources (after taking account of differences in the capacity of each State and Territory to raise revenue) and operated at the same level of efficiency.

In other words, the distribution of GST revenue recommended by the Grants Commission recognizes that some States or Territories have a lesser capacity to raise revenue from the typical array of State taxes because they have, for example, lower average wages or lower average land values than others; and that some States or Territories face proportionately higher levels of demand for services typically provided by State Governments, or higher unit costs of providing them, because of the characteristics of their populations (for example, a higher proportion of Indigenous inhabitants) or their dispersion.

NSW and Victoria get less out of the GST pool than they would if the pool was distributed on an equal per capita basis because they are relatively rich States – with, for example, wage and salary incomes (subject to payroll tax) and land values (subject to land tax and stamp duty) above the national average, and below-average proportions of their populations of Indigenous origin or living in remote areas. Conversely, Tasmania, South Australia and Queensland (yes, Queensland) have below-average incomes and land values, above-average proportions of low-income households and (in Tasmania and Queensland) persons of Indigenous origin.

On the basis of the values which they traditionally espouse, one would have expected Labor politicians to have applauded redistributions of economic resources in this way.

At the Commonwealth level, no-one seriously suggests that those who pay the top marginal income tax rate are entitled to have their tax payments returned to them in the form of an equal amount of Commonwealth Government spending on them or their families.

The Labor Governments of NSW and Victoria do not believe that the full amount of the land tax and stamp duties which they collect from the well-heeled citizens of Pymble, Killara and Double Bay or from Toorak, Brighton and Camberwell should be spent in those suburbs rather than in, say, Mount Druitt or Broadmeadows, or in the Hunter and Latrobe Valleys.

So why on earth do they believe that the GST paid by the relatively affluent citizens of NSW and Victoria should be entirely spent on them?

It is true that the current mineral boom is significantly enhancing the capacity of the Queensland and Western Australian Governments to raise revenue from mineral royalties and other taxes. And that is reflected in the Grants Commission's latest assessment, which reduces their share of the 2006-07 GST pool by 1.1% and 1.5%, respectively, from what they will get from the 2005-06 pool.

Indeed, if the distribution of GST revenues in 2006-07 were to be made on the basis of the assessed revenue-raising capacities and expenditure disabilities for 2004-05 (the latest year for which data are available) alone – rather than, as the Grants Commission's terms of reference require, on the average of these 'relativities' for the five years 2000-01 through 2004-05, then Queensland and WA would also be 'net contributors' to the GST pool. Assuming the current mineral boom lasts for another two or three years, Queensland and WA probably will be 'net contributors' after the mineral boom has peaked.

The redistribution (over many years) of revenues collected by the Commonwealth Government in accordance with the Grants Commission principles is one of the reasons why the differences in living standards – including access to services such as education and health – are much smaller between, say, Tasmania and New South Wales than between, say, Alabama or Mississippi and Connecticut or Vermont in the United States, or between Newfoundland and Alberta in Canada.

In that sense, the Grants Commission's principles are part of the glue that holds the Australian Federation together. It is thus both surprising and disturbing once again to hear Labor politicians, especially, from Australia's richest States, suggesting that these principles should be jettisoned.

- Saul Eslake
Chief Economist, ANZ
6th March 2006

ATTACHMENT C

COMPARISON OF GST FUNDING SHARES, on HFE and EPC BASES

	HFE	% Share	EPC	% Share	Difference	GG Revenue	Diff as % of Revenue	Population	Per Capita Distribution
	(1)		(2)		(1)-(2)	(3)	(1)-(2)/(3)	(4)	(1)-(2)/(4)
	(\$m)	(%)	(\$m)	(%)	(\$m)		%	(million)	(\$)
NSW	13728.3	28.9	15 726.7	33.2	-1 997.9	43 186.0	- 4.6	6.9	- 290.1
VIC	10 477.3	22.2	11 703.6	24.7	-1 226.3	30 624.0	- 4.5	5.1	-240.0
QLD	9 573.9	20.2	9 354.6	19.7	219.4	26 604.0	1.5	4.1	53.0
WA	4 745.1	10.0	4 724.3	10.0	20.7	14 218.0	.8	2.1	10.1
SA	4 231.6	8.9	3 561.6	7.5	670.0	10 721.0	6.5	1.6	430.9
TAS	1 735.4	3.7	1 120.5	2.4	614.8	3 404.0	17.5	0.5	1 256.8
ACT	863.3	1.8	753.8	1.6	109.5	2 459.3	4.2	0.3	332.8
NT	2 067.7	4.3	478.0	1.0	1 589.7	2 751.9	53.4	0.2	7 617.9
TOTAL	47 423.0	100.0	47423.0	100.0	0.0	na	na	20.7	na

Source: Commonwealth 2006-07 Budget Paper No.3, Federal Financial Relations 2006-07, p.12; State 2006-07 Budgets