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### **Productivity Commission Public Inquiry into Horizontal Fiscal Equalisation**

I have researched, written and advised on fiscal federalism issues for many years and I would like to thank the Productivity Commission for the opportunity to make a submission which I do in a personal capacity.

In making the following points, I can make available on demand to the Commission related supporting publications as well as a conference paper currently in preparation on 'Dialling incentives into HFE to facilitate reform (and political risk) in a federation'.

#### **Points**

1. In all federations, vertical fiscal gap (VFG) and horizontal fiscal gap (HFG) are inevitable and it is essential for a well-functioning politically stable harmonious federation that there are accompanying vertical fiscal equalisation (VFE) and horizontal fiscal equalisation (HFE)<sup>1</sup> arrangements.
2. Fiscal equalisation is a process which should be undertaken by the Federation, not dominated by a single level of government in the Federation and needs to accord with and respect political and institutional arrangements.
3. Transparency of process, open-data access and transparent equalisation mechanisms are essential if there is to be a transparent and accountable equalisation process.
4. Effective equalisation cannot take place without transparent measures of effectiveness and performance such as insights provided by measures of tax capacity, expenditure disability, tax effort and expenditure effort.
5. Fiscal equalisation arrangements are inevitably country specific as they relate to institutional factors (e.g. Constitution) and political processes, however there are common lessons to be learnt about good design from quite different federation funding arrangements.
6. Full equalisation as applied in Australia is unique amongst federations and is not widely adopted because of concerns about the adverse impact it can have for incentives for subnational recipient

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<sup>1</sup> Vertical Fiscal Gap (VFG) is the difference between revenue raising capacity (or assessed revenue) and expenditure needs (assessed expenditure) of different levels of government (eg Commonwealth and State). Horizontal fiscal gap (HFG) relates to such differences where they occur across the same level of government (eg States). Horizontal fiscal equalisation (HFE) is the transfer of fiscal resources between units at the same level of government. Vertical fiscal equalisation (VFE) is the transfer of fiscal resources from the national to the subnational government.

governments arising from vertical and horizontal redistributions which fully equalise (e.g. Germany<sup>2</sup>, Canada)

7. In the past<sup>3</sup>, the Commonwealth Grants Commission (CGC) has not always applied such a rigorous application of HFE principles, the current arrangement being in place only since 1981. This 'relative' approach is framed around the requirement that for States (hereafter referred to as States) 'each would have the fiscal capacity to provide services and the associated infrastructure at the same standard'<sup>4</sup>. Since Federation in 1901, an 'absolute' measure has been applied most often based around some 'minimum' need.
8. The problem with a 'relative' measure is that any differences are compounded by the level of overall grant and not independent of the size of the need which leads to distributions which are distorted around relative needs<sup>5</sup>. Prior to 1981, Australia adopted 'absolute' measures where grants were designed to more directly address need through a formula based type of approach, ensuring some 'minimum' financial needs are met, sometimes accompanied with penalties and rewards.
9. The 'relative' approach to fiscal equalisation in Australia also has the downside that a central and pivotal role has been given to the CGC in the process, an agency without a direct and immediate financial interest in the outcome, only an interest in the principle applied. For States this removes their direct involvement in the process of deliberations with the Commonwealth, introducing a third party, the CGC, which can act to remove State and Commonwealth accountability from the grant allocation process. For the Commonwealth, the Treasury also has no direct role (in contrast to pre 1981) and the Commonwealth Treasurer's role is limited to writing a letter to the CGC requesting its advice on the per capita 'relativities' to apply when distributing the GST amongst States<sup>6</sup>.
10. What would be preferable is an arrangement which requires greater direct involvement by all governments. The move from an absolute or relative measure of needs has therefore acted to remove symmetry of responsibility that should necessarily go with good federation design, instead leaving subnational governments to negotiate with an independent agency which has neither responsibility for the quantum of grants nor normative judgements about what ought to be in relation to those grants.
11. Fiscal equalisation is not a single process but a multi-stage process and needs to be equally 'owned' and engaged with by all levels of government in the federation.

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<sup>2</sup>[https://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Oeffentliche\\_Finzen/Foederale\\_Finanzbeziehungen/Laenderfinanzausgleich/Eng-Der-Bundesstaatliche-FAG.pdf?\\_\\_blob=publicationFile&v=1](https://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Oeffentliche_Finzen/Foederale_Finanzbeziehungen/Laenderfinanzausgleich/Eng-Der-Bundesstaatliche-FAG.pdf?__blob=publicationFile&v=1)

<sup>3</sup> Williams, R. 2005, 'Fiscal Federalism: Aims, Instruments and Outcomes' The Australian Economic Review, vol. 38, no. 4, pp. 351–69; and Williams, R. 2012, 'History of Federal–State Fiscal Relations in Australia: A Review of the Methodologies Used', The Australian Economic Review, vol. 45, no. 2, pp. 145–57

<sup>4</sup> [https://www.cgc.gov.au/index.php?option=com\\_content&view=article&id=258&Itemid=536](https://www.cgc.gov.au/index.php?option=com_content&view=article&id=258&Itemid=536)

<sup>5</sup> Williams, R. 2012, 'History of Federal–State Fiscal Relations in Australia: A Review of the Methodologies Used', The Australian Economic Review, vol. 45, no. 2, Section 3.4, pp150-151

<sup>6</sup> The Treasurer in the letter can be quite prescriptive in the advice provided but typically is not, leaving most decisions on actual methodology to the CGC.

12. The Productivity Commission in its deliberations on HFE should support a basic 3-stage process for grant allocation with the Commonwealth having a central role as the principle agency funding VFG where:

- *Stage 1* would address vertical fiscal gap;
- *Stage 2* horizontal fiscal gap through partial horizontal fiscal equalisation (not full horizontal fiscal equalisation); and
- *Stage 3* would involve the allocation of special needs grants which are quarantined from *Stage 1* and *Stage 2* deliberations.

This 3-stage process has the benefit of segmenting financial support for individual states into its basic constituent parts: the first ensuring all states have the revenue they need to meet expenditure needs; the second a necessary horizontal redistribution based around capacity and disability; and the third taking into consideration special needs and national priorities.

13. *Stage 1* should therefore be designed to ensure that  $VFG=0$  in aggregate through some mix of unconditional grants and revenue sharing. States in aggregate (but not individually) will therefore have funds to match expenditure needs.
14. *Stage 2* fiscal equalisation grants should be made following direct consultation between the Commonwealth and the States using assessed revenue and assessed expenditure data prepared by the CGC working with the States which, in order to ensure transparency, should see all data and methodology made publicly available. Such data should also include a more transparent reporting of State performance through the production of relative tax capacity, expenditure disability, tax effort and disability effort measures, by the CGC<sup>7</sup>. This will bring transparency to State relative performance and accountability through the public being able to see how States are funded and how the funding was expended by different States.
15. Australia should move away from a full HFE relative needs-based model in *Stage 2* to a partial equalisation model which directly factors in incentives using either an absolute formula-based approach (as in Germany) or effect a similar outcome through a partial inclusion of selected taxes (as in both Canada and Germany) along with some acknowledgement of the relative contribution to State funding of local governments (as in Germany). Australia should also quarantine its *Stage 3* (specific purpose payments) from *Stage 2* grants.
16. Some direct consideration should also be given to ensuring any inconsistencies between the approaches adopted when allocating Commonwealth grants to State governments as against to local governments, so as not to lead to economic inefficiencies or gaming opportunities by States. This could, for example, involve adopting similar methodologies or combining (in part or full) local governments into State government grant allocation from the Commonwealth (as in Germany).
17. In terms of institutional arrangements:
- the CGC should no longer be central to fiscal equalisation in Australia but should oversee collation and preparation of data for input into direct intergovernmental consultations and negotiations on equalisation framed around an absolute approach (ie with all Commonwealth State and local governments involved);
  - COAG would assume a more central role in the allocation of Commonwealth grants to State and Local governments;

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<sup>7</sup> Such measures can already be calculated for 2013-14, 2014-15 and 2015-16 from the data published by the CGC in *U2017-The Assessed Budget - Category tables XLSX* spreadsheet available at: [https://cgc.gov.au/index.php?option=com\\_content&view=article&id=263&Itemid=542](https://cgc.gov.au/index.php?option=com_content&view=article&id=263&Itemid=542)

- A new independent agency would be formed to:
  - a) communicate and monitor not only grant performance against expectation (like the role of the recently abolished COAG Reform Council), but also enunciating economic and social outcomes against objectives;
  - b) oversee advice on the allocation of a reward-related grant pool tied to performance against expectation, with the focus on reward and not penalties in that performance to expectation (based on intergovernmental agreements) would be rewarded<sup>8</sup> and non-performance left to the political process which would be made effective because of the greater transparency arising from the communication and education of performance by the independent agency.
- 18. In terms of the design of a formula-based *Stage 2* fiscal equalisation approach, this must be determined by negotiation across all governments to engender greater ownership, accountability and transparency. Much can be learnt from the German multi-stage process of using revenue sharing and grants to address VFG and HFG<sup>9</sup>. In a 3-stage process for Australia, *Stage 1* should be designed to ensure that VFG=0 in aggregate through 'topping up' States in aggregate through equal per capita (EPC) grants or revenue sharing, with *Stage 2* applying a fiscal equalisation formula with redistribution rates which do not fully 'top up' those States with relative disabilities or 'pull down' to the average those States with a relative advantage.
- 19. The formula agreed and adopted should be in place for a set period (e.g. five or seven years) and that formula should be applied to contemporary data, not the current Australian approach of relativities applied in one year being based on data which is lagged two years and then based on a three-year moving average. This would help to make grants contemporaneous and address how currently, a State's grant entitlement can be potentially fiscally destabilising when there are highly cyclical taxes such as property conveyancing duties and mining taxes.
- 20. Where State disadvantage is persistent and extreme or where there are national priorities, direct action is warranted through *Stage 3* specific purpose conditional grants (e.g. to address health, education and indigeneity disabilities). These grants would typically involve outcome-based contracts and therefore have related performance agreements with potential rewards and penalties. Because of those agreements, such grants should be independent of *Stage 1* and *Stage 2* deliberations. This is unlike the case in Australia where specific purpose payments to States by the Commonwealth are in effect pooled with the GST related grant by the CGC approach when measuring State relativities, which completely undermines any agreed independent objectives for these conditional grants between the Commonwealth and the States. Quarantining *Stage 3* grants would also prevent the current outcome with specific purpose payments where States can not only game such grants (eg by trying to maximize the pool) but also reallocate these conditional grants to other purposes without fear of financial sanction because the CGC methodology measures 'what is' and not 'what ought to be' where the latter underlies most specific purpose payments.

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<sup>8</sup> Much as the National Competition Council did with the Hilmer competition reforms in the 1990s

<http://ncp.ncc.gov.au/pages/home>

<sup>9</sup>[https://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Oeffentliche\\_Finzen/Foederale\\_Finanzbeziehungen/Laenderfinanzausgleich/Eng-Der-Bundesstaatliche-FAG.pdf?\\_\\_blob=publicationFile&v=1](https://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Oeffentliche_Finzen/Foederale_Finanzbeziehungen/Laenderfinanzausgleich/Eng-Der-Bundesstaatliche-FAG.pdf?__blob=publicationFile&v=1)

## Summary

Australia must have a system of fiscal equalisation which:

- is 'owned' by all levels of government;
- has data transparency in that all States make or have available data of a similar standard;
- has a 3-stage process which is transparent to the community and to the participants with a formula based ('absolute') rather than needs-based ('relative') fiscal equalisation approach;
- removes conditional specific purpose grants from the fiscal equalisation process, and;
- encourages accountability through an independent agency publishing and communicating performance measures and evaluating rewards and penalties arising from performance against agreement on conditional grants.

## Selected Publications

- 2017 Eccleston R. and Warren N., 'The failure of the federalism reform process and its financial implications for the Australian States', in Bruerton, M, Hollander R. and Levy R. *A People's Federation*, Federation Press (*forthcoming*)
- 2015 Warren, N.A., and Eccleston R., 'The devil is in the detail: The distributional consequences of income tax sharing in the Australian federation', *Australian Tax Forum* 30(4):713-33
- 2013 Warren, N.A., 'National fiscal consolidation and the challenge to Australian Federalism', *Economic and Labour Relation Review*, 24(2):161-180 (June)
- 2013 Warren, N.A., Eccleston R., and Woolley T., 'Beyond the Blame Game: Political Strategies for State Funding Reform', *Australian Journal of Public Administration*, 72(1):14–30
- 2012 Warren, N.A., 2012, 'Fiscal Federalism under Review (at Speed)', *eJournal of Tax Research*, 10(1):5-11.
- 2012 Warren, N.A., 'States ponder own-tax reform options post Forum', *Economic Papers*, 31(1):8-12 (March).
- 2012 Warren, N.A., 'State Taxes: From a problem acknowledged to a problem addressed?', *Australian Tax Forum*, 27(2):235-256.
- 2012 Warren, N.A., 'Fiscal equalisation and State incentive for policy reform', *eJournal of Tax Research*, 10(1):165-81.
- 2012 Warren, N.A., 'Designing Intergovernmental Grants to Facilitate Policy Reform' in Kildea P., Lynch A. and Williams G. (eds) *Tomorrow's Federation: Reforming Australian Government*, Federation Press: Sydney, pp 131-51 (and also published as *UNSW Law Research Series No. 2011-22*)
- 2010 Warren, N.A., 'Tax devolution and intergovernmental transfer policy options in a budgetary crisis: UK lessons from Australia', *eJournal of Tax Research*, 8(2):215 – 255
- 2010 Warren, N.A., 'Henry Review, State Taxation and the Federation', *Australian Economic Review*, 43(4):409–21
- 2010 Warren, N.A., 'The challenge of managing the disproportionate regional impact of the GFC on the Australian Federation', Paper Presented at the *Federalism and the Global Financial Crisis: Impacts and Responses* at the 2010 Concurrent Meeting of the International Association of Centers for Federal Studies and IPSA Research Committee on Comparative Federalism and Federations, Philadelphia, Pennsylvania, United States of America, 16-18 September 2010.
- 2010 Warren, N.A., 'Intergovernmental fiscal arrangements as a constraint on State tax reform under Henry' in Evans, C.E., Krever, R. and Mellor P., *Australia's Future Tax System: A Post-Henry Review*, Chapter 14, pp305-363, Thomson-Reuters:Sydney.

- 2010 Warren, N.A., 'Fiscal Federalism Transparency and State Leadership on Reform', Paper presented at the ANZSOG 4th Annual Public Leadership Workshop, 25-26 November 2010, Parliament House, Hobart, Tasmania
- 2008 Warren, N.A., 2008, 'Reform of the Commonwealth Grants Commission: It's all in the Detail', *UNSW Law Journal*, 31(2):530-552
- 2008 Warren, N.A., 'Fiscal equalization in Australia: High level VFI and equity focused HFE', *CESifo DICE Report 2008/1*, pp10-15
- 2007 Collins, D.J. and Warren, N.A., 'The States and the GST: Demystifying Australian Federal/State financial arrangements', *Information Paper No 4*, Australian Tax Research Foundation, (ISBN 978-0-9752067-8-2 ISSN 0 817 4679)
- 2006 Warren, N., *Benchmarking Australia's Intergovernmental Fiscal Arrangements: Final Report, Report Commissioned by the NSW Government*, 29 May 2006, pp225, ISBN 0 7313 32563
- 2004 Warren, N.A., *Tax: Facts Fiction and Reform*, Australian Tax Research Foundation: Sydney, Research Study Series 23, pp289
- 2003 Dahlby, B., and Warren, N.A., 'The Fiscal Incentive Effects of the Australian Equalisation System', *Economic Record*, 79(247):434-445.
- 1999 Warren, N., (ed), *State Taxation: Repeal, Reform or Resignations*, ATRF Conference Series No 21, Australian Tax Research Foundation:Sydney, pp254.
- 1997 Warren, N., (editor), *Reshaping Fiscal Federalism in Australia*, ATRF Conference Series, Australian Tax Research Foundation:Sydney, pp168.