

Department of Treasury and Finance

“Can the policy thrust of HFE survive
the politics of tougher fiscal challenges?”

address to the

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A few months back, on 30 May of this year, the Commonwealth Grants Commission passed its seventy-sixth birthday. The CGC – and, by extension, modern Australian horizontal fiscal equalisation – is now just shy of the life expectancy of the average Australian male. It looks likely that the CGC will outlive this milestone, but for how long? In this era of rapid and unpredictable change, does equalisation have a future?

HFE has been around for a long time, but despite this, it still remains poorly understood by most, and completely unknown to many. Even those in government circles generally have, at best, a vague knowledge of the Grants Commission process.

For the practitioners of HFE who work closely with it, this obscurity is often frustrating. Not only does it make it tricky for them to explain to strangers at barbeques what they do for a living, it also means that they have to sit and watch helplessly whenever the occasional debate on HFE does actually take place in the public arena, no matter how superficial or misleading that debate might be.

This has always been a feature of HFE, and it is tempting to attribute HFE's longevity to this obscurity, which has insulated it against public scrutiny and criticism. But I would argue that keeping the secrets of HFE hidden is not helpful at all, that there is perhaps an untapped army of people who would support HFE if they knew of it and understood it.

Indeed, Tasmanian Treasury's position in recent years has been that we should not be afraid to review HFE, to subject it to public scrutiny, to dissect it and closely examine its components so as to be satisfied that it achieves what it aims to do. We believe that robust debate about HFE is absolutely critical to its credibility. We also accept that in order to do what it is meant to be doing, and because the application of HFE is not an exact science, our approach to HFE needs to change and evolve from time to time with changes in data and the behaviour of governments.

The Commonwealth Grants Commission's 2010 Review has been an interesting test of this. The Review represents the most ambitious attempt since 1933 to simplify the HFE process, to give it the broadest possible coverage of state and territory finances and to base it on the most reliable and robust data available.

Why did governments decide to implement such a review in the first place? The answer is that the CGC's equalisation process was, in the eyes of many, becoming unwieldy, obscured by the volume of detail and complexity that had crept into the assessment methods over time.

The more complex HFE became, the more irrelevant it must have seemed to many of its clients, and to the wider public, notwithstanding its critical significance to state and territory government budgets. The hope was that the Review would broaden the acceptance of HFE through a better understanding of how it is achieved and why it remains important.

Forgive me but "states and territories" is a bit of a mouthful and I am going to have to say it often, so from here on I will abbreviate it to just "states" but on every occasion, I mean "territories" as well.

The 2010 Review began with a clean-slate approach. The Commission and the states began with first principles: what does HFE actually mean? What needs to be equalised? How can we achieve this in the simplest way possible? The Commission demanded more concrete evidence of disabilities. Where data were not available to measure a disability, or where the quality of the data was lacking, the Commission proposed to apply discounts, or indicated that they would not assess the disability at all. Materiality thresholds were introduced, to prevent the process from lapsing back into the old ways, where ever-increasing complexity had been pursued in order to achieve marginal improvements in the equalisation result.

On the eve of the conclusion of the Review, have the Commission and the states achieved what they hoped to achieve?

Certainly, when we look at the Commission's Draft Report, we can see obvious signs of simplification – the number of assessment categories has been whittled down; the number of calculations and steps in the assessment methods has decreased; immaterial assessments have been removed; and most of those assessments that remain are backed by data of some reliability. At every point that the Commission has made a decision to simplify an assessment it has, of course, by the very nature of the exercise, upset one state or another.

And, inevitably, some states may feel that they have reason to be more upset than others – the overall financial impact of simplification has not been distributed evenly. What we can now observe is that many of those assessments that were discarded due to poor data tended to work in favour of certain states. Likewise, many of the previous assessments that failed to meet the new materiality thresholds had worked in favour of some states more than others. Though these assessments were each immaterial by themselves, in aggregate the impact of removing them is likely to be significant.

All states should have foreseen that there would be winners and losers in the simplification process and should, perhaps, have had a rough idea who these might be. However, what many of us did not see was that one of the biggest changes to come about from the 2010 Review did not have a lot to do with simplification. It had more to do with solving a difficult problem through an innovative, but very controversial, change.

I am talking here about the way that the Commission is proposing to assess state capital needs. By "capital" I mean the physical capital, the infrastructure, that states use to deliver services, as well as the financial assets that they hold. The Commission's proposed capital assessments represent a significant shift in the way that HFE is achieved. It also involves a very different way of thinking about state service delivery.

I understand that Malcolm Nicholas from the CGC will be providing a detailed overview of the Commission's capital assessments tomorrow, so I will try to avoid going into too much detail about the mechanics of it here. However, I think it is necessary to track how the Commission's approach to capital has evolved over the past few years.

In the 2004 Review, capital was assessed indirectly through its impact on states' operating statements. This was seemingly the only way that capital could be assessed, because equalisation for some time had been entirely based on the

recurrent revenue and expenses recorded in state operating statements. This made a lot of sense, because operating statements reflect the cost of providing government services. Capital shows up in state operating statements as depreciation and leasing costs, and, less obviously, through its impact on interest income and expenses – the more that states have spent on physical capital in the past, the greater their net interest expenses will be today.

Depreciation and leasing costs have generally been straightforward to assess, but net interest expenses – or debt charges as they were termed in the CGC world – have been trickier. Assessing these involved trying to work out what a state's interest expenses would be today if it had spent what it needed on infrastructure to provide average services in the past. Implementing this in practice was horribly complex, and required huge amounts of historical data.

The design of the debt charges assessment was controversial enough, but in 2004 a new problem emerged. As states became net debt free, they became net interest earners rather than net interest payers. It didn't seem to make sense to apply expense disabilities to interest revenue so, with the unanimous support of the Heads of Treasuries, the Commission switched the debt charges assessment off by assessing it equal per capita. Then for a number of years, capital needs were not fully assessed.

In the 2010 Review, the Commission and the states agreed that it would be best to avoid a debt charges assessment entirely. Western Australia proposed a new approach – rather than try to capture the cost of capital purchases through their indirect impact on the operating statement, why not assess capital needs upfront? Why not give the states the capacity to acquire new infrastructure in the same way that they are given capacity to deliver services?

The Commission eventually adopted this approach, arguing that if states are given the capacity to accumulate and hold average per capita levels of infrastructure, then this would give them the capacity to deliver an average level of services from that infrastructure. And the CGC reasoned that instead of trying to assess interest expenses or income, it would be simpler to equalise the per capita stock of financial assets that each state holds. If done correctly, states would automatically have the same capacity to earn or pay net interest from those assets.

This was a completely new way of thinking not only about capital, but also about HFE. It suggested that the operating statement approach was not necessarily the best way to achieve HFE; that a dollar spent on infrastructure really wasn't all that different to a dollar spent on recurrent services; and that both could be treated in much the same way for equalisation purposes. After all, there was no question that states spent recurrent revenue, including GST revenue, on acquiring physical capital.

This proposal initially took many states by surprise, and before long Tasmania and several other states questioned the wisdom of such a significant conceptual change. As we saw it, the Commission's method implied that the acquisition of infrastructure and financial assets were distinct activities in themselves, when in reality governments acquire infrastructure only to deliver services. Conceptually, the method seemed to take HFE backwards, because it moved away from an operating statement approach and, by extension, away from equalising capacity to deliver services.

Of course, the states that were uneasy about the new capital proposals were the same states that stood to lose significant amounts of GST revenue as a result. The states that suffered most were the states that had slower population growth, because the Commission's method recognised that the faster your state's population grows, the faster your stock of physical capital and financial assets are diluted, and the more capital expenditure you need to maintain average levels of stock.

While the impact of population dilution is real and needs to be captured in the CGC's assessments, the fact that the Commission now wants to assess dilution in the year it occurs, rather than when it impacts on the operating statement, means that the capital assessment will tend to redistribute very large amounts of GST revenue, and that the needs from year to year will be volatile. Given how much state governments value budget certainty, this is likely to cause further headaches in addition to the usual budget pain that inflicts the net 'losers' of a CGC review.

While we and a number of other states disagree with the Commission's capital assessment and believe it will move us away from a sound HFE outcome, we were happy to see that fresh ideas and thinking and rigorous debate can still emerge even after all these years of HFE refinement – for many states it was an important reminder that we cannot become complacent about the way HFE operates, or assume that there is no other way of doing things.

I mention capital and the way that it came about – in short, it came about partly in response to a previously unsatisfactory method – to illustrate that the emergence of a new capital method should be seen as separate to the wider issue of simplification. While the Commission's new capital assessment is easier to understand and simpler to implement than the method it replaced, and while simplification was partly used to justify the introduction of a new capital assessment, I think it may be the case that the capital assessment partly came about because the Commission's interpretation of HFE has changed somewhat since the last review.

Getting back to the issue of simplification generally, it's fair to say that the Commission has thus far done an admirable job of a difficult and unenviable task. But what has become apparent through this Review is that while you can make the HFE process *simpler*, you can't make it *simple*. Some disabilities *do* matter, they *do* materially affect state fiscal capacity, and they *are* difficult, complex or detailed to measure. We will never be able to fully avoid this if we want HFE to continue to be comprehensive.

The value in the Review, though, will be as much about what it won't likely change as much as what it will. Even after going through a process of effectively reinventing the equalisation process from scratch, the end result will probably look quite familiar: revenue assessments are likely to remain very similar to existing methods, albeit with fewer categories; and while some expense categories are to be significantly aggregated and altered compared to their predecessors, most of them will still look reasonably familiar and it is expected that most of them will continue to distribute GST revenue in much the same pattern as they have in the past.

If anything, this confirms that the CGC's existing approach is perhaps not as outdated and clumsy as some might have claimed; that their methods have evolved the way they have for good reason; and that the most important aspect of the Review has been to simplify assessments and to base these on more robust and reliable data and to minimise the use of judgement.

In this sense, the Review has been very successful. On the other hand, HFE is still likely to remain a mystery for most people.

While this mystery and obscurity may have insulated HFE from public scrutiny in the past, it may now be the biggest threat to its survival, because it allows HFE's critics to take cheap and untruthful shots at it. It is also the case that most people are unlikely to tolerate a flow of GST revenue away from their state if they feel that the reasons for it are not transparent – and their tolerance is likely to decline further if their own fiscal environment is becoming tighter.

But we have to recognise that most state governments, let alone the wider public, do not necessarily want to know the details of the payroll tax assessment, or whether the Commission assesses capital needs up-front or over time. They are more likely to want to know how much GST revenue their state receives, and, in very broad terms, why. This is where it is important for us, as HFE practitioners, to be able to explain the link between equalisation and equality of services.

This would be an important first step in ensuring that everyone has a chance to evaluate HFE properly. The next step is to reassure those in 'donor' states that, in fact, the CGC is not some sort of glorified inter-governmental charity. Rather, the CGC goes to great pains to design a framework and assessments that are policy and efficiency neutral, and are not a barrier to competition or growth.

We should also make sure that we don't exaggerate the cost of equalisation to the larger states. In 2008-09, of the \$41 billion in GST revenue that was transferred to the states, just under \$3.4 billion – barely 8 per cent of the pool – was actually redistributed to achieve HFE. The rest of the pool was distributed strictly in proportion to states' populations.

More than half of the \$3.4 billion that was redistributed went to the Northern Territory. For the NT, this equalisation component of their GST revenue comprised 44 per cent of their total revenue. The equalisation component was also significant for Tasmania's budget, where it made up 15 per cent of our revenue. For South Australia and the ACT, it was less significant, comprising a little over 5 per cent of their revenue in each case.

Interestingly, the equalisation burden on the 'donor' states was not quite as large as they tend to make out:

For New South Wales it was 3 per cent of its revenue in 2008-09;

For Western Australia it was also 3 per cent;

For Victoria it was a whisker over 2 per cent; and

For Queensland it was less than 1 per cent.

Few ordinary Australians would begrudge this little bit of help from the bigger States to allow the Northern Territory and Tasmania, in particular, to offer government services of comparable standards to the rest of the country.

Taken together, I think that wider knowledge of some of these facts would be very influential and win HFE many supporters in all parts of Australia. Of course, Tasmania has long taken a leading role in trying to educate Australians about HFE.

But if we want to ensure HFE's survival, we will need to ramp up our efforts, and to make sure that the message is absorbed much more widely. This is harder than it sounds, because we are competing with a host of other people, governments, corporations and organisations for the average person's ever-shrinking attention span.

Any Commonwealth government could happily discard the CGC process on a whim if the vast majority of people had no idea that it existed in the first place. But no government would be willing to throw out an age-old institution that the majority of Australians supported, no matter how hard its critics might lambast it. Australians are an extremely conservative bunch, as the results over the years of failed referenda demonstrate – and while they would think nothing of losing an obscure institution that they knew nothing about, they would be wary of any change that they felt might impact on Australia's social and economic fabric – regardless of which state they happen to live in.

We see this time and time again. For example, the vast majority of Australians who live in urban areas generally support financial assistance being provided to those in rural areas for a variety of economic and social challenges. And while Australians don't look too kindly on those that they see as not doing much to help themselves, Australians do have a strong underlying belief in giving people a fair go. They believe in equality of opportunity, which is often delivered in practice through particular forms of government assistance such as social housing, welfare payments and specialised services.

Perhaps one of the most powerful ways to illustrate the value of HFE is to consider what Australia might look like without it, and without state governments. We would need to consider these two scenarios together, because without HFE it is hard to see that the smaller states could continue to exist in any recognisable form. So suppose, just for a minute you understand, that Australia abolished states and moved to a unitary system of government.

What we would find is that the underlying demand for services in each state would not go away. For example, because of its demographic and socio-economic mix, Tasmania, as a region rather than a state, would continue to need greater provision of services than other regions. Similarly, per capita less revenue would be raised in the Tasmanian region than in the more densely settled or affluent parts of the country. Older people, people on low incomes and indigenous people would continue to be greater users of many services. Delivery of services would remain more expensive in less populous regions, small towns and remote areas. The national government would need to meet the different demands of the residents of each region, just as state governments previously did. The national government would have no alternative but to spend more in servicing communities in some regions of the country than they were able to raise in revenue from the citizens and activities in those same regions.

The important difference under such a scenario is that the process would be less transparent. Under the CGC process we can see and measure what each state needs and receives to deliver services. Indeed, a lot of useful information can actually be gleaned from the CGC's assessments about the cost of providing government services and what drives these.

But, importantly, under a unitary system of government, the level of so-called 'cross-subsidisation' would, if anything, be even greater. And it would be far from transparent – there would be no data on the regional redistribution of tax revenue underlying the national government's spending decisions just as there is no way of knowing now how much more the Victorian government spends on servicing Bendigo in excess of the revenue it raises from the citizens of Bendigo.

In reality, the CGC process is a form of rough justice, in that it cannot hope to capture every disability. As I have already discussed, the Commission will not recognise disabilities that appear immaterial or for which reliable data are not available. Where there is some doubt about the impact of a particular disability, or where it is difficult to measure, the CGC tends to exercise cautionary judgement, or not to assess it at all. So the CGC process is inherently conservative – in reality, the underlying disabilities that states face far exceeds what we see in the GST distribution.

But we also shouldn't underestimate the community's expectation that institutions need to move with the times. Even though we view some of our most sacred institutions – our Constitution, our parliamentary system, our legal system – as being immovable and unalterable – the reality is that they change regularly – sometimes the changes are obvious, sometimes they are barely perceptible. Where these institutions have failed to adapt and keep up with changing times, the result has often been widespread frustration or discontent. No one, for example, has mounted a convincing argument throughout the Australian Tax System Review that Australia's tax system should remain as it is.

So we have to be prepared to accept that in order to remain relevant, HFE needs to adapt to the changing standards of the day. And we have seen this happen. The 2010 Review terms of reference, for example, recognised that higher standards of evidence were expected if the CGC process was to continue to redistribute from one state to another as much of the GST pool as it does.

Experience suggests that change is not something we need to fear. The way HFE has been implemented has changed constantly since its inception in Australia 76 years ago – in some ways it would now be barely recognisable to the first Commonwealths Grants Commission. In this regard it remains, and will continue to remain, in a state of evolution. Even the basic objective of HFE has changed somewhat, although its central purpose would still seem familiar to those first Commissioners. We need to embrace opportunities to review HFE, to see these as opportunities to strengthen equalisation rather than as threats that it might be diluted or dismantled.

The 2010 Review has revealed, then, that while it is important to make sure that we are always looking to improve the implementation of HFE at the detailed level, the most important element of its survival will be to illuminate it, to educate people about its broad nature, and to ensure that it is allowed to adapt to meet their expectations. If we can do that, the future of HFE looks healthy.

These very same principles apply to the local government grants commissions' processes. The LGGC processes do not appear to attract the same controversy that the CGC does, perhaps because different council needs are more obvious, perhaps because the amounts distributed are smaller, and perhaps because it is not as easy to pinpoint where the funds originated. Local government relies much more heavily

on its own source revenue than do the states, which is also likely to take some heat out of the 'equalisation' debate for your sphere of government.

Nevertheless, we cannot take HFE for granted at any level. The frustrations that some state governments feel about the GST distribution are no doubt mirrored by some councils, even if we don't tend to hear these frustrations vocalised quite as loudly. But we need to be aware of them, because if some of these grievances are legitimate, then the LGGC process needs to be able to adapt enough to address these in order to remain relevant.

Neither local government nor grants commissions should fear change. Inevitably, many of the ideas, developments and changes in the CGC process will in due course trickle down as options for LGGCs to consider. Grants commissions should not be afraid to embrace these if they will improve the process, but they shouldn't be afraid to discard some of them either – one advantage that the LGGCs have is that they can watch and learn from the CGC's successes and rare mistakes.

And as it is the role of states to educate the public about the importance of HFE, so it is the role of local governments, rather than grants commissions, to educate ratepayers about HFE and what it means. I am not sure whether most councils are currently doing this, but there is never any harm in getting on the front foot in these unpredictable times.

Thank you for your attention. I wish you well for the remainder of your Conference and trust your time with us in Tasmania is pleasurable and relaxing.