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Fiscal Equalization in Australia

By Roger Wilkins

Ron Watts once remarked to me that Australia is one of the most egalitarian-minded federations in the world. One of the Australian Premiers was less polite when he described the fiscal equalisation process in Australia as "equality gone mad!".

Egalitarianism, equity is certainly deep in the psyche of Australians. Perhaps as a result of our convict origins and significant Irish immigration. It was not really until I went to study in London that I understood something of what made Marx angry about class systems. Australians also tend to be suspicious, sceptical about people who succeed (except maybe in sport). We are accused of having a "tall poppy" syndrome – the media and the public try to "cut them down" – bring them back to earth.

Australia is a vast continent with a small population. 18 million people, most of whom are clustered along the coastline in a few large cities. (Sydney, for example, has a population around 4M and an area as large as LA).
Geography and history are really the basis of Australian federalism – what one of our historians has called "the tyranny of distance." The States grew up as, and remain, convenient administrative units. A way of dealing with governance in such a vast continent. (There are 6 States that federated in 1901 and 2 Territories).
For Australia the rationale for federalism looking into the future has to do with the efficiency of devolved decision making and administration on the one hand; and competitive federalism on the other. Once again an efficiency argument.

The demographic profile of the Australian States is relatively similar. A large capital city on the coast and a sparsely populated hinterland. The fragility and inhospitality of the interior of Australia is distinctive. It distinguishes Australia from US for example. The main divide in Australian society has been and continues to be that between "the bush" and "the cities and towns". And a good deal of the politics of equalisation has to do with "bridging" this divide. Australia's wealth has traditionally come from primary production.

Accessing national resources and agriculture has been a key feature of the economy.

Australians see government more or less as a “necessary evil”. There is no underlying spiritual or philosophical or nostalgic attachment to institutions (the Queen?). Government is a very practical matter of delivering services. Pre-eminently that means provision of infrastructure in a country of vast distances. We talk about “harnessing private capital” etc but government administration and publicly funded services are probably an inevitable feature of the Australian continent.

The main features of the fiscal equalisation system in Australia has to do with the underlying conviction that equity, even equality, is of enormous value. We have an independent body called “the Grants Commission” which carries out an annual inquiry about what financial transfers would have to occur between the States and Territories to arrive at a situation where all Australians can have more or less access to the same level of public goods and services. This is the key objective. Distinctive.

The CGC carries out an exhaustive inquiry looking at all the relevant features of States and Territories that have a bearing on this objective. The Commission looks at both the capacity to raise revenue and the costs of delivering services – the “needs” of the States & Territories. It considers the disadvantages or “disabilities” that lead to higher costs of services. For example, a State that is more sparsely populated or where the population is more “spread out” will generally find it more expensive to provide goods and services. More recently, it has also been noted that greater population density also brings added infrastructure costs and law and order problems.

The Grants Commission makes a recommendation to the Federal Government. Normally the vertical transfer payments from the Federal Government to the States and Territories are adjusted to reflect the Grants Commission’s recommendations.

Under the revenue system in Australia most tax is raised by the Federal Government. Income tax and GST or VAT is raised by the Federal Government. The States have no robust revenue base of their own. Some 50% of State income comes through transfer payments from the Federal Government. Vertical fiscal imbalance is a much greater issue in Australia than horizontal imbalance. Recently the Federal Government and the States have agreed that in return for the States giving up certain inefficient taxes they will get all the proceeds of the GST or VAT tax. So the size of the “fiscal pie” is now more certain and predictable. But the way it is sliced up includes an equalization factor determined by the Grants Commission.

Every year the Grants Commission makes a report and every 5 years it reviews its methodology and considers what factors to take into account and how to measure them. The reports run to thousands of pages and are highly detailed and technical.

The Grants Commission process has led to significant transfers between States and Territories, though, importantly, not as significant as in other federal systems. Historically money has moved from the more populous and developed States in South-East Australia to the more sparsely populated and less developed States and Territories.

The current transfer is probably around $2bn. About $1bn comes from NSW. The State budget is about $30bn. Modelling studies (commissioned by New South Wales and Victoria) suggest that the system has a negative effect on GDP of around .25 per cent
($920 million).

Now, these transfers are something that Treasurers and Treasuries get very excited about. There is public posturing and a good deal of talk about fairness and efficiency. But mostly Australians do not get very excited about equalisation. This is partly a function of their attitude to ”fairness” or “equity”. It seems to be accepted as a reasonable objective. It is also partly a function of the obscurity of federal-state financial relations.

The Grants Commission process itself is a paradigm of independence, <u>and</u> a paradigm of obscurity! Except for a handful of technical experts no one really understands the details of its findings and calculations.

It is a sort of “glass bead game” to use an analogy from Hermann Hesse.

Apart from the obscurity of the process the main issues that circulate about the process have to do with efficiency. Does the process reward inefficiency? It clearly has some effect on allocative efficiency and on GDP. But that may be a price one has to pay for the sort of fairness or equity Australians seem to value.
The Grants Commission purports to distinguish between disadvantages or “disabilities” that could be addressed through government policy, and disadvantages and disabilities that could not. But there is a massive and critical area where that distinction is contested and unclear and problematic. Economic disadvantage, the location of industry – to what extent is this a function of policy, and policy over how long a term?

Then there is the issue of whether goods and services are delivered efficiently, and whether recipient States have the incentives to innovate and improve their performance. There is the related issue of whether equity between the States translates into equity at the level of the individual citizen.

In Australia we now have a process that attempts to measure and compare and publish annually the outcomes achieved for public goods and services (health, education, policy, prisons, community services). Finding adequate definitions and measures is not simple. But it will show how Victoria's education compares in terms of literacy rates with NSW etc. It is also a form of benchmark competition among the States.

This is also carried out by an independent body – the Productivity Commission. It is a critical adjunct to the Grants Commission because it also shows how well States are actually performing.

As you can see Australia stands at one extreme in terms of the amount of inequality a federal system is prepared to tolerate between its member states. It is an open question as to what extent or degree of difference a federal system can tolerate if it is to be sustainable. Probably that requires an understanding of the costs and benefits of federating. But it also seems to me to be important to understand that for a federal system to work, maybe even to continue to exist, the member states and probably the people across the federation need to feel they have a real stake in the larger entity. That is not always about wealth or money. But very often it will be at least connected with that.

Although the payments themselves are theoretically untied and unconditional, implicit in the Australian Grants Commission process is the idea that there should be a certain standard of education or health care etc. enjoyed by all Australians. And that is also becoming much more explicit. Inter governmental agreements articulate standards and outcomes for public goods and services. We try to avoid highly prescriptive agreements. We try to say what outcomes should be achieved and leave it up to individual States to decide how to achieve those standards and outcomes.

But the idea that there could be significant variations in the standard of services around Australia would not be tolerated. That means that we are looking at a federal system where States really cannot make significant trade-offs between different goods and services. And given the way the tax system works with a significant level of vertical imbalance, there is not much room for fiscal competition. The essence of Australian federalism then becomes more one of efficient delivery of goods and services. Some would say that the States become sort of "agents" or "subsidiaries" of the federation. Insofar as they have a significant part in setting national standards and goals, one might see them rather as "partners" in a joint enterprise.

Still it is a type of federalism that, it seems to me, reinforces and is reinforced by the Grants Commission process, and which limits the sorts of choices individual states can make. The main areas of competition then become how you deliver services.

One development in Australia that raises interesting issues for a federal system is a possible shift to the use of direct payments to individuals and communities instead of to the States. For example, we have a system of public housing where the States and Federal Government both put in money for capital and maintenance and the States provide the houses and administer the scheme. The Federal Government is now looking at giving direct rental assistance to disadvantaged people and withdrawing from the agreement. The same thing has been mooted for students at training colleges and schools and patients at hospitals. It is a sort of "public choice" model. And you can see that it does have economic advantages in terms of choice and competition. But it also tends to relegate States to the role of provider of goods and services competing with private hospitals, private schools, private housing providers. If that is what States mainly do then over time the impact of this on the federal system will be problematic, whatever its efficiency effects may be.

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