

Horizontal fiscal equalisation and Equity

Summary

Horizontal fiscal equalisation (HFE) relates to financial transfers among governments, but since State governments provide services to, and raise tax revenues from, their residents, HFE obviously has flow on implications for the treatment of individuals and households.

HFE is relevant to the practical achievement of horizontal equity across Australia in the presence of State budget settings motivated by or embodying both horizontal and vertical equity objectives of State governments.

The equity case for HFE in Australia relies on the value judgement that residents of Australia, if otherwise to be regarded as equals, should not be regarded as not equal solely on account of their state of residence.

Concepts of equity

HFE relates to financial transfers among governments, but since State governments provide services to, and raise tax revenues from their residents, HFE obviously has flow on implications for the equitable treatment of individuals and households.

Equity may be considered to have both a vertical and horizontal dimension.

Vertical equity refers to the treatment of the less well off as compared with the better off in respect of taxes, transfers and the provision of services. (Both sides of the budget are relevant to distributional impacts.) Vertical equity is a concept which applies to individuals.

Horizontal equity refers to the equal treatment of 'equals'. It can apply to natural and non natural persons. The principle can also be expressed the other way around – as the avoidance of arbitrarily different treatment of persons considered 'equals'. That is, differential treatment of individuals and firms needs to be justified by different circumstances which are compelling on public policy grounds.

The two concepts do have a synergy in that measures taken in pursuit of vertical equity need to have a horizontally equitable application to be effective. For example the income tax free threshold represents a benefit to low income wage earners that should be (and is) available whether one is employed as a cleaner or a retail assistant. In any event, aside from its linkage with vertical equity, evenhandedness in government's dealings with its citizens is a desirable principle.

Value judgements are involved in the consideration of both vertical and horizontal equity. In the case of vertical equity those judgements relate essentially as to how much redistribution should occur from the better off to the less well off. In the case of horizontal equity, value judgements are necessary to distinguish which from a multitude of different

circumstances, are relevant sets of equivalent individuals, and, given that some unfairnesses and anomalies are inevitable, which classes of anomaly warrant measures or frameworks for their redress.

How does HFE assist equity?

Explicit intergovernmental HFE is relevant to the practical achievement of horizontal equity across Australia in the presence of State budget settings motivated by or embodying both horizontal and vertical equity objectives of State governments. (*Implicit* area fiscal equalisation occurs within the scope of the Commonwealth Budget, and in the hypothetical scenario of a unitary nation. HFE could be said to attack at source the effects of the arbitrary location of sub national government boundaries as compared with the outcomes which arise implicitly in a unitary nation.)

HFE does not introduce vertical equity objectives in its own right. For example it does not seek to supplement Commonwealth tax transfer settings by seeking to direct fiscal transfers in response to different average income levels in the States, unrelated as to how and why high or low income population groups have an impact in practice, on state government expenditure and revenue raising.

It is an accurate statement that HFE in Australia merely allows for various sub populations eg aged, young, indigenous, users of welfare services, payers of state taxes etc to be equally favourably or harshly treated by state governments.

HFE does however ensure that insofar as State government taxes and services are concerned, individuals in Australia will not face lower standards or higher taxes on account of differences in fiscal capacity arising arbitrarily from different natural resource, demographic and other characteristics of one's State of residence.

Further, since State government fiscal settings are in general vertically defensible and result in substantial 'in kind social transfers' the outcome of HFE is in fact to advance vertical equity consistently Australia wide.

Population mobility and Equity

The efficiency case for HFE (ie. to avoid fiscally induced migration which is inconsistent with the maximisation of national productivity) is based on the assumption of population mobility, and falls away if there is minimal mobility. An equity case for HFE however remains on foot even if there were no population mobility.¹

¹ Some go further and propose the inverse - that the equity case falls away if there is population mobility, since observed mobility implies a voluntariness to one's state of residence. If it is feasible to move interstate to escape the fiscal burden of an especially young or aged co located population what complaint can there be from those who don't move? In the face of potential outmigration if HFE were to be discarded, land rents are likely to be lower and wages higher in the State with higher services requirements, and this is presumably adequate compensation for those who choose to stay or in-migrate. This is analogous to the argument that while the income tax capital gains tax arbitrage available for geared property investment by households may have adverse consequences for the efficiency of housing markets it can't really be said to be horizontally inequitable since it is an option for all wage and salary earners; and those who don't take it up must consider it not worth their while. This argument seems to work best the lower are the transaction costs involved.

Assume for example that there were no risk of businesses closing or people being

induced to move from their preferred location of (say) Tasmania even if taxes were higher or education service standards lower as a result of the need to meet the public health costs of a higher proportion of the elderly. Could HFE transfers to Tasmania still be justified purely on equity grounds?

National citizenship equity principle

The equity case for HFE in Australia indeed relies on the value judgement that residents of Australia, if otherwise to be regarded as equals, should not be regarded as non equals solely on account of state of residence.

It seems likely that in modern Australia, this principle would be agreed as a quasi constitutional principle determined behind a 'veil of ignorance' as to one's State of residence. (One variant of the veil of ignorance thought experiment is to hold one's address constant but consider a variation in the number and boundaries of states. Residents of Perth could consider a scenario of there being a SWA and a NWA.)

Confederation only argument

All value judgements are contestable however, and some might seek to contest this view on the basis that the Australian federation retains more or at least some of the character of a confederation of independent states rather than a seamless nation.

This may well be a feature of the USA, even a continuing modern day preference which accounts for the minimal degree of HFE in that country and the acceptance of considerable local variability in standards of public services. (It is acknowledged that the needs of the populations of various American states may be being addressed through a variety of programs, and regional interventions by the US Federal government, albeit in a less systematic way than through formal HFE.)

For the 'confederation' claim to stand up in the Australian context however it would need to be confirmed for example, that that it is acceptable that residents of Wodonga, other things equal, should experience lower state service standards or higher taxes than in Albury on account of substantial exportable black coal deposits in the Hunter as compared with minor brown coal deposits in Yallourn; and residents of Tweed Heads (and Albury) should experience lower service standards or higher taxes than in Coolangatta on account of even larger *open cut* black coal deposits further north of the border in the Bowen Basin.

Also it is not clear that such an argument would be consistent with a longstanding trend in Australia for passage of legislation through state parliaments specifically designed to achieve integrated nationally consistent social and economic regulation across the states. And at the grass roots level a genuine national solidarity that has been revealed with local communities which experience natural disasters in various parts of the country from time to time.

Equity and high cost locations

Note that the 'national' horizontal equity principle as described above does not require that all services in high unit cost locations should necessarily be provided to the same standard as in lower unit cost locations eg major cities. The principle merely requires that residents of comparable cost locations across states have equal service standards, based on the average level of service standards in low and high cost locations in practice.

The observed situation is in fact that while state government expenditures per capita are higher in non metropolitan locations than in metropolitan, they are not as high as would be necessary to ensure equal standards for all and every type of public service. This is however an empirical observation. If the community, through State political economy processes, revealed a preference in the future for a higher or lower non metropolitan expenditure gradient than currently is apparent, HFE transfers would merely follow suit.

Capacity for equitable outcomes versus actual outcomes

It should be acknowledged that individual State governments may adopt different spending patterns than the average State position on which the HFE assessment is based. It has been suggested that this detracts from the horizontal equity case advanced for HFE in that differences in treatment of equals can nevertheless be introduced by different policy settings of state governments.

In response to this observation it can be noted that this relates to the marrying of the principle of horizontal equity to another high level principle viz that of subsidiarity. It is still a reasonable claim to make that HFE means that departures from horizontal equity arising from the accident of state boundaries, are much less than they otherwise would be, and that any departures are presumably in the direction of greater alignment with local value judgements to the extent they differ as between states. The principle of equals treated equally is not inconsistent with equals consuming different baskets of goods, incl the level and mix of in kind social transfers.²

Experience also tells us that community preferences are very alike across Australia, and this tends to reinforce the confidence that one has about the outcome of the 'veil of ignorance' thought experiment.

There may be instances where national imperatives outweigh the principle of subsidiarity and local preferences. Such national imperatives can be achieved through adjustments to Federal and State roles and responsibilities and/or intergovernmental agreements and do not undermine the equity case for equalisation of horizontal fiscal capacity .

Observed outcomes

² Nor is the migration efficiency case weakened if capacity equalisation allows for variation in actual outcomes across states. Capacity equalisation prevents Buchanan inefficient migration in a federation but preserves Tiebout efficient migration, which is unavailable if outcomes are strictly equalised, and local preferences suppressed.

It is sometimes observed that standards of living for the lower socio economically strata are generally similar across Australia, (except for circumstances of remote and fringe dwelling indigenous) due mainly to Commonwealth level tax transfer mechanisms, Medibank etc. While the \$ value of HFE transfers may seem small by comparison in aggregate national terms, those transfers are nevertheless very significant in the context of state services, particularly for transferee states. It is highly likely that HFE has in fact contributed significantly to that similarity in living standards. HFE transfers in appropriate proportion by transferor states, and changes to those proportions in line with changes in circumstances have also contributed to equity. It would seem perverse for the need for thoroughgoing HFE to be called into question on account of a degree of success of longstanding Australian institutions in achieving observable equitable outcomes eg in ensuring access to education services contributing to human capital formation over a span of generations.

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