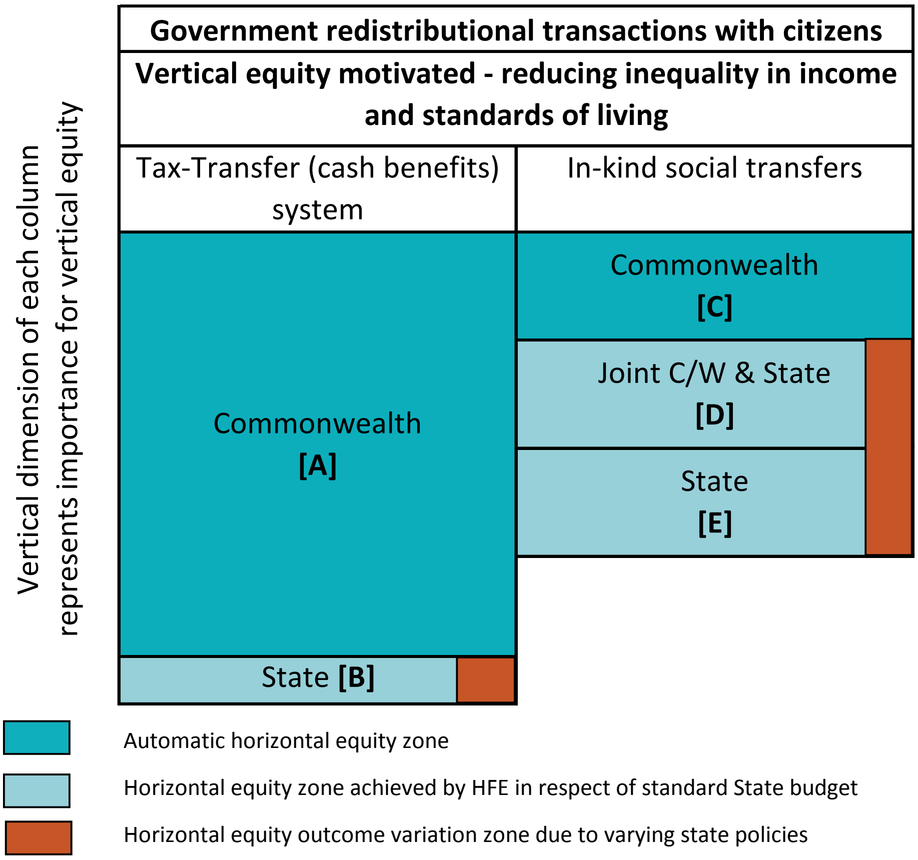
Appendix B: Aspects of vertical and horizontal equity in government policy action

The diagram and text below seek to explain how vertical and horizontal equity in government policy action relate to *Horizontal Fiscal Equalisation*. As Chapter 2 highlights, this perspective is held by some only.



Both the Commonwealth and the States engage in a range of transactions with their citizens which have a substantial redistributive character and motivation. Often this motivation is to reduce differences in incomes and living standards more broadly — what might be termed ‘vertical equity’ considerations. The most obvious and visible example of this is the Commonwealth’s tax and cash transfer system, which includes the progressive income tax system and means-tested income support payments (depicted by the rectangle marked ‘A’). The States also play a (considerably smaller) role in this form of cash redistribution, through the provision of utilities concessions and some cash assistance for needy individuals (see area ‘B’).

Vertical equity is also pursued through a range of policies that are known as *in-kind social transfers* (as well as public goods), funded by Commonwealth and State general taxation. In this category, shown in the second column, are such programs as Medicare, the Pharmaceutical Benefits Scheme (PBS), public hospitals, schools and so on. The redistributive effects of these programs often relate to more specific circumstances faced by households than just levels of income and wealth. Overall, the States play a bigger role in this area, often in partnership with the Commonwealth.[1]

When the observation is made that governments do not seek exact equality of private incomes and living standards, seeking only to modify or restrain unequal market outcomes to a degree, this is an observation about *vertical* equity. In pursuing vertical equity objectives however, they do so from a starting point of treating like individuals equally.[2] This kind of *horizontal equity* is automatically achieved at the Commonwealth level (where there is only a single government). The situation is different at the State level though, where there are eight separate governments operating with different fiscal capacities rather than one State type government. In these circumstances, explicit horizontal fiscal equalisation is necessary to enable the kind of horizontal equity that naturally occurs with a single government to be achieved.

While a necessary precondition, HFE does not guarantee that horizontal equity will actually be achieved. If individual State government policy settings are very similar, then close to strict horizontal equity will be realised. Some deviation in outcomes will occur to the extent that individual State policy settings vary from the average — some above and some below (see orange bars).[3]

1 The areas marked ‘C’, ‘D’ and ‘E’ depict, respectively, the roles performed in relation to *in-kind social transfers* by the Commonwealth exclusively, the States in partnership with the Commonwealth, and the States by themselves.

2 In respect of government services, services levels vary across regions (intra-nation, and intra-state) because of different supply costs – cost based differential treatment of otherwise equals occurs. Nevertheless ‘policy relevant equals’, that is those situated in comparable cost locations, are treated equally. It is not the case, for example, that the tax revenue generated from a particular suburb or region constrains the amount of public expenditure that a State government may choose to make there.

3 Interstate policy variation is an intrinsic feature of federal systems, and if of concern, can be addressed by greater conditionality attaching to national grants, or overriding COAG/ Commonwealth uniform national rules (such as the requirement for free treatment of public patients in State hospitals).