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FINANCIAL ARRANGEMENTS IN AUSTRALIA

A PAPER FOR THE CONFERENCE ON

FISCAL EQUALISATION AND ECONOMIC DEVELOPMENT POLICY WITHIN FEDERATIONS

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The author is a senior executive of the Commonwealth Grants Commission. However, views expressed in this paper are those of the author and cannot be interpreted as reflecting the views of the Commonwealth Government, the Commission or other staff of the Commission.

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FINANCIAL ARRANGEMENTS IN AUSTRALIA

1. The Australian federation was formed in 1901 by a voluntary agreement among the then six British colonies, which became States of Australia. Self-government was given to the Northern Territory in 1978 and to the Australian Capital Territory in 1989.

2. There are three levels of government in Australia (the Commonwealth, State[1] and local governments). This paper concentrates on relations between the Commonwealth and the States.

3. This paper provides:

(i) some background relating to basic features of the Australian States;

(ii) some background on the allocation of revenue and expenditure relationships in the Australian federation;

(iii) an outline of the Australian financial arrangements between the Commonwealth and State and Territory governments;

(iv) an outline of the equalisation processes in Australia; and

(v) some discussion of the current debate surrounding equalisation and other aspects of Commonwealth-State financial relations.

FEATURES OF THE AUSTRALIAN STATES

4. Australia is a reasonably large and sparsely settled country of about 20 million people. The population is spread unevenly around the country with the vast majority of people living within a small distance of the coast and most people living in the south-eastern parts of the country. This is shown in Figure 1.

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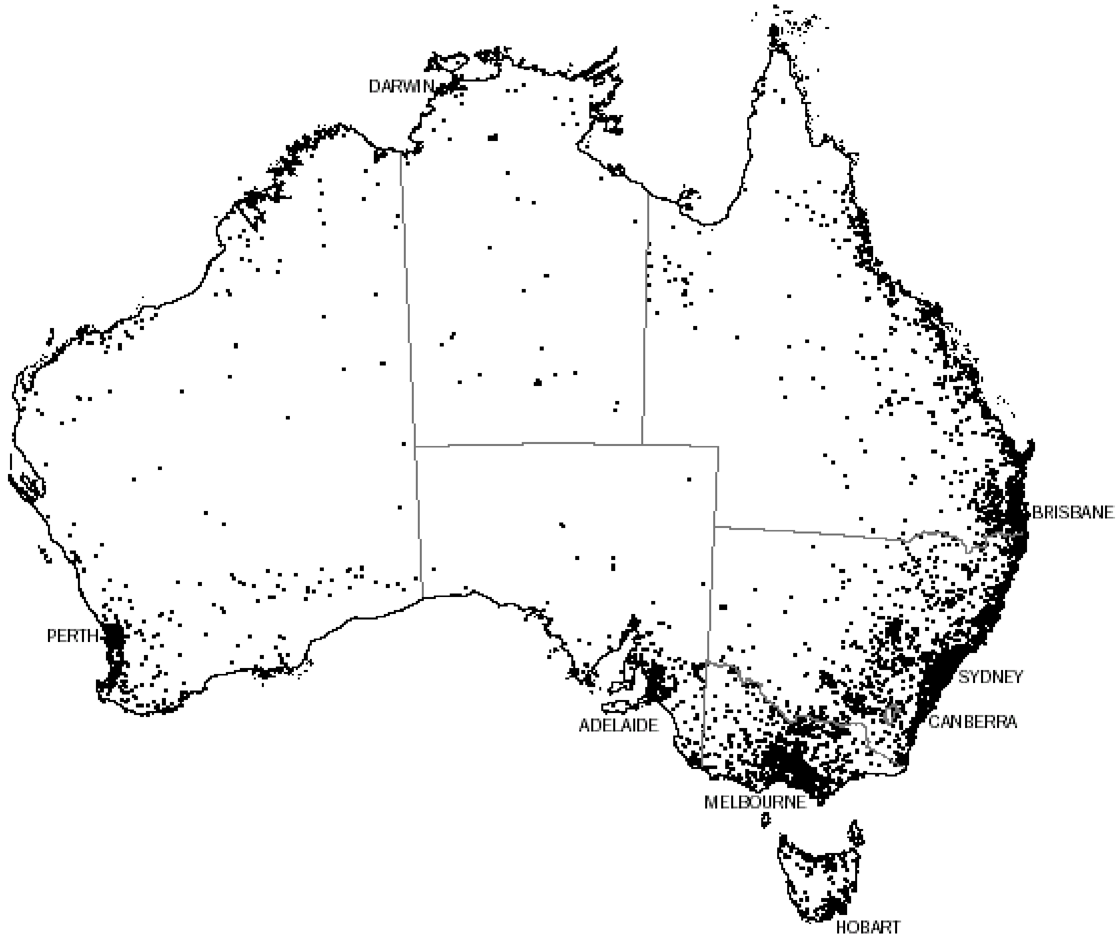
1 In the rest of this paper, the term State(s) includes the ACT and the Northern Territory, unless the context indicates otherwise.

(i) the most populous State is New South Wales and the Northern Territory the least populous;

(ii) the most densely settled area is the city-State of the ACT and the least densely settled area is the remote Northern Territory.

Figure 1 POPULATION[(a)] DISTRIBUTION, AUSTRALIA – 2000



Source: ABS, Regional Population Growth, Australia and New Zealand (3218.0).
(a) Estimated resident population. Each dot represents 500 people.

5. Table 2 contains some demographic characteristics including:

(i) the population, area and population density of each State (nowhere is the density very high but it is very low in the Northern Territory);

(ii) the proportion of the population who live in the capital city (about 70 per cent in Victoria, Western Australia and South Australia but 40 to 45 per cent in Queensland, Tasmania and the Northern Territory);

(iii) the proportion of the population who are Indigenous (very high in the Northern Territory, high in Tasmania (where there is debate about the accuracy of the data) and very low in Victoria and the ACT);

(iv) the proportion of the 15 to 69 year old population with post secondary qualifications (highest in the ACT and New South Wales);

(v) unemployment rates (highest in Tasmania and Queensland (but possibly for different reasons)); and

(vi) gross State product per capita and gross household income per capita[2].

Table 1 SELECTED DEMOGRAPHIC INDICATORS

		NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
Population 2000-01	'000	6 499.6	4 799.3	3 597.3	1 897.5	1 500.0	470.2	312.6	196.4	19 272.8
Area	'000 km^2	801.6	227.6	1 727.2	2 525.5	984.0	67.8	2.4	1 346.2	7 682.3
Population density	per km^2	8.1	21.1	2.1	0.8	1.5	6.9	130.3	0.1	2.5
Proportion of population resident in capital city[a]	%	62	70	45	73	73	41	99	45	63
Proportion of population who are Indigenous[b]	%	1.8	0.5	3.1	3.2	1.5	3.2	1.0	28.5	2.1
Proportion of population aged 15 to 69 with qualifications[c]	%	43.7	38.1	36.9	42.1	38.2	36.7	48.9	37.1	
Unemployment rate[d]	%	5.6	6.0	8.0	6.5	7.2	8.7	4.7	5.6	6.4
Gross State product per capita[e]	$	35 591	34 247	28 859	35 884	27 746	23 968	41 870	39 624	33 279
Gross household income per capita[f]	$	32 658	31 339	27 242	30 340	26 861	24 274	40 283	30 497	30 536

(a) ABS, Census of Population and Housing, 1996, customised data table.

(b) ABS, Experimental Estimates of the Aboriginal and Torres Strait Islander Population, Catalogue No. 3223.0, March 1998.

(c) ABS, Census of Population and Housing, 1996, customised data table.

(d) Rates are average for 2000-01 and calculated as the number of unemployed people expressed as a percentage of the labour-force. ABS, Australian Economic Indicators, January 2002, Catalogue No. 1350.0.

(e) ABS, Australian National Accounts, State Accounts, 2000-01, Catalogue No. 5220.0.

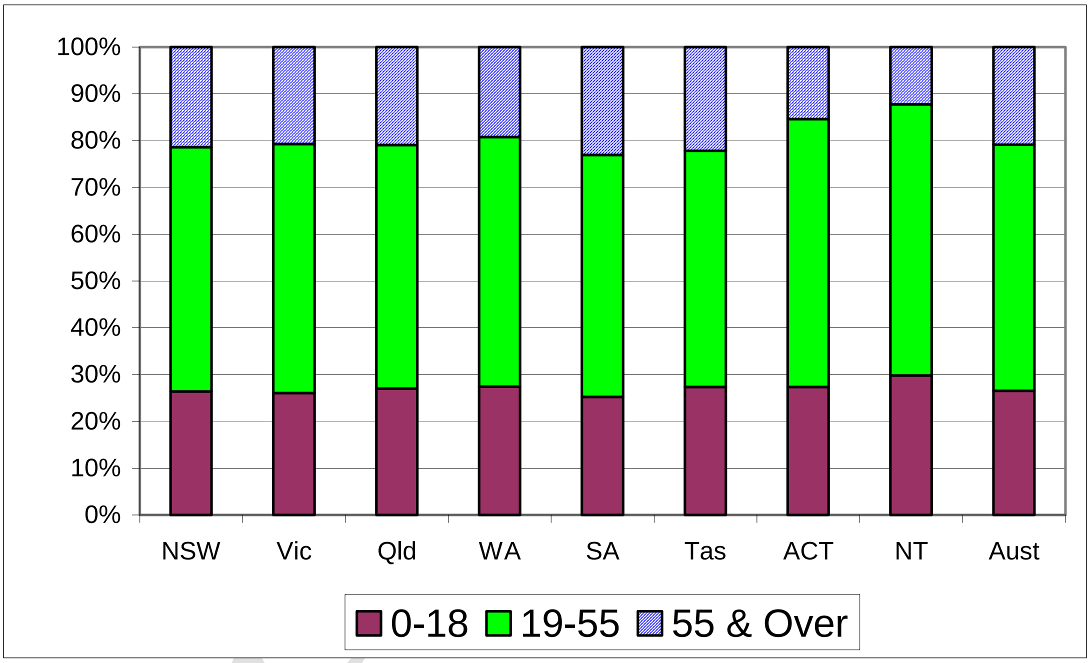
(f) ABS, Australian National Accounts, State Accounts, 2000-01, Catalogue No. 5220.0.

6. Figure 2 shows the differences between States in the proportion of their populations in the age ranges 0 to 18 years, 19 to 55 years and over 55 years. It indicates

2 At the time of writing this paper, the A$ was worth about US$ 0.55.

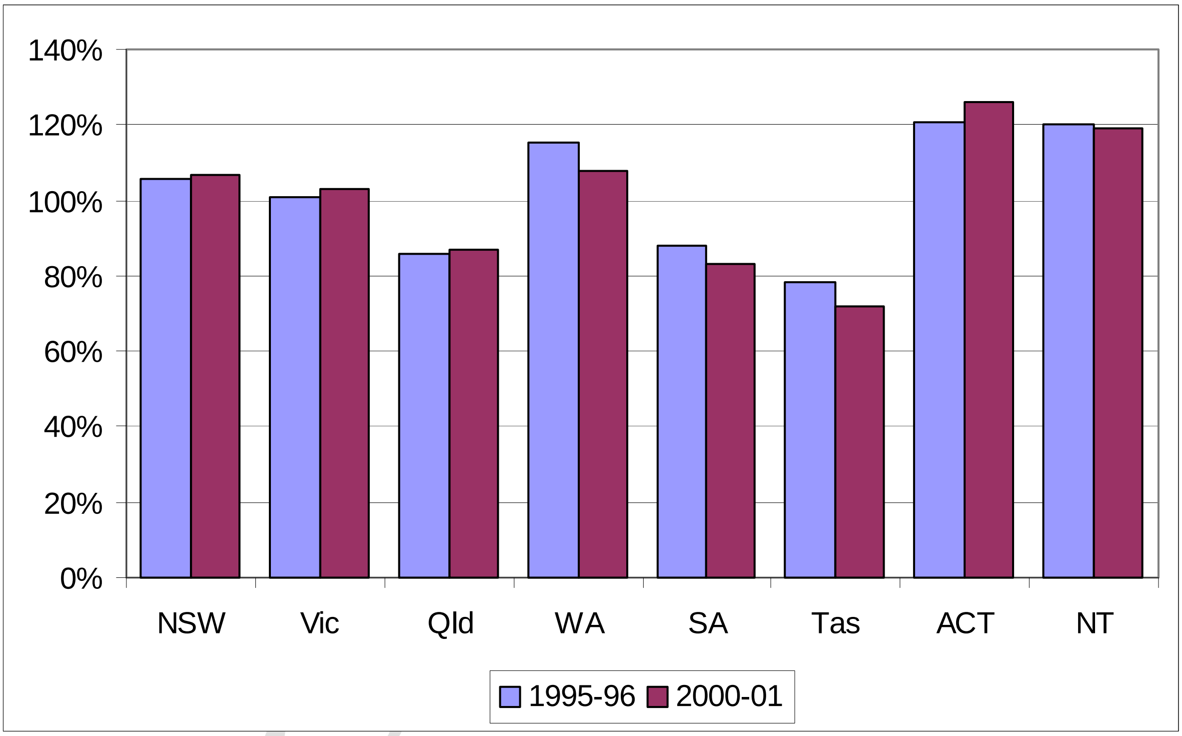
that Tasmania and South Australia have relatively older populations while the Northern Territory has a relatively young population.

Figure 2 AGE DISTRIBUTION OF POPULATION, 2001 CENSUS



7. Figure 3 shows the per capita gross State product of each State relative to the Australian average in 1995-96 and 2000-01. Gross State product is above average in the ACT (reflecting the high contribution of the Commonwealth government to its economy), the Northern Territory and Western Australia (reflecting the importance of their mining industries) and New South Wales and Victoria (reflecting the all round general strength of their economies). In recent years the broadly based economies of New South Wales and Victoria have strengthened but those of Western Australia and the Northern Territory have declined relatively (possibly reflecting declining commodity prices). On the other hand, low and declining gross State product is evident in South Australia and Tasmania.

Figure 3 STATE GROSS STATE PRODUCT PER CAPITA COMPARED TO AUSTRALIA: AT CONSTANT PRICES



8. Figure 4 shows the per capita gross household income of each State relative to the Australian average in 1995-96 and 2000-01. Gross household income in the ACT is noticeably higher than elsewhere reflecting the high labour-force participation rate, low unemployment rate and the relatively high wages paid by the dominant employers (the Commonwealth and ACT governments). The ACT also lacks the very high and low incomes found in some other States. The figure shows low and declining household incomes in South Australia and Tasmania (reflecting similar situations in gross State product). It also shows a low but static household income in Queensland — this is partly related to the low level of qualifications and the nature of industry which is oriented to relatively labour intensive, low skill and low income industries such as retail trade, tourism and primary industry. The industrial make-up of the States is shown in Figure 5 which shows the contribution of major industry groups to total income in each State.

Figure 4 STATE GROSS HOUSEHOLD INCOME PER CAPITA COMPARED WITH AUSTRALIA

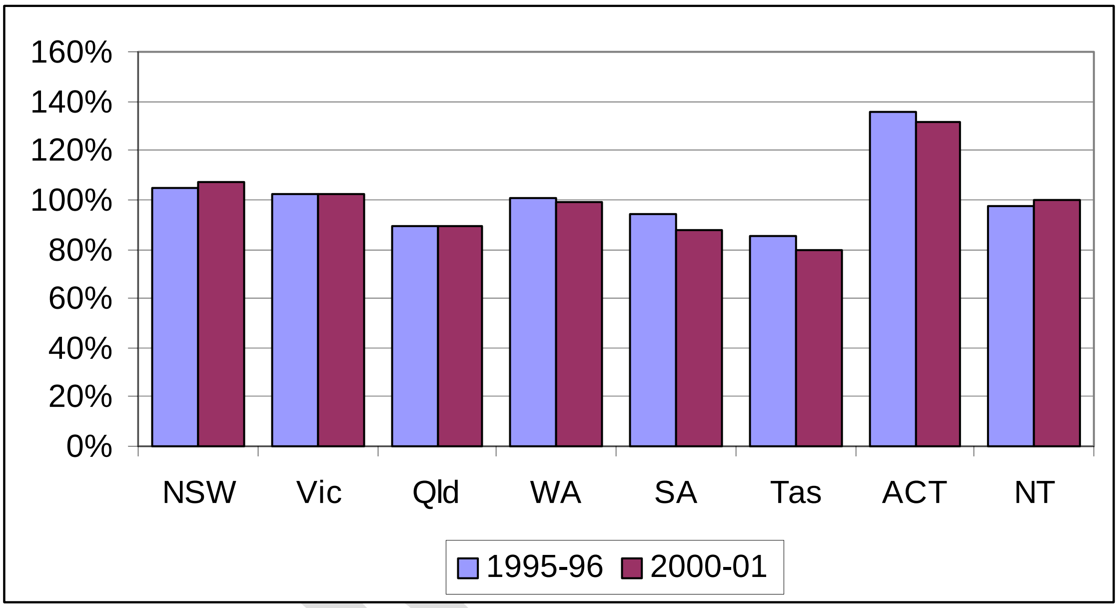
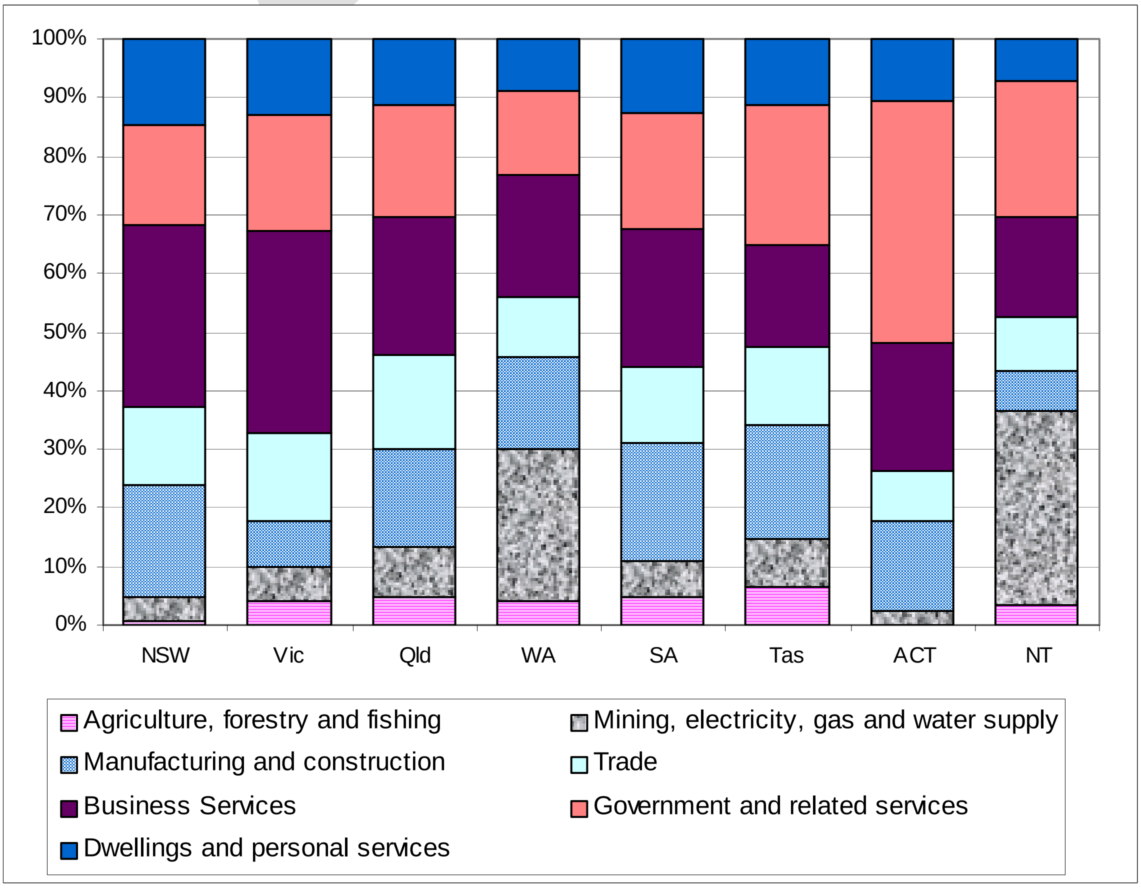


Figure 5 CONTRIBUTION OF INDUSTRY GROUPS TO TOTAL INCOME



9. Overall there are some noticeable differences among the Australian States in their demographic and economic features. We have:

(i) some well populated States with broadly based economies based on manufacturing, trade and financial services where much of the established wealth is concentrated and whose relative rate of growth has increased slowly in recent years (New South Wales and Victoria);

(ii) two States that have been experiencing relatively high growth largely because of natural resources or tourism but their rate of growth has slowed in recent years (Western Australia and Queensland);

(iii) some States with declining relative economic performance and populations that are ageing (South Australia and Tasmania); and

(iv) the two territories are special cases. The ACT has high gross State product and high household income, reflecting the predominantly skilled, labour intensive and relatively stable government activity. The Northern Territory's high gross State product is affected by its mining industry and government activity, but the high proportion of comparatively poor Indigenous people in the population reduces average income.

10. However, the differences between the Australian States are small relative to those in some other federations.

GOVERNANCE AND THE RESPONSIBILITIES OF THE COMMONWEALTH AND THE STATES

Governance

11. At the Commonwealth level, Australia has two houses of parliament:

(i) a House of Representatives – the government of the day must hold a majority of this house, where the 150 members are elected using a preferential system; and

(ii) a Senate (upper house) — originally envisaged as a State's chamber with ten senators from each State (regardless of the population of the State) and two from each of the self-governing territories, but it has not operated that way. Senators are directly elected on a proportional basis and in recent years the government generally has not controlled the Senate.

12. At the State level, most States have a two-house parliament, although some such as Queensland and the two territories have single houses.

13. Interaction between the two levels of government takes place through a variety of means. Financial matters are dealt with in the Ministerial Council for Commonwealth-State Financial Relations, which is a meeting of the Commonwealth and State Treasurers. Its responsibilities relate to the operation of the Goods and Services Tax (GST) and the allocation of untied assistance among the States.

14. For other major matters where co-ordination of government actions is desirable, there is the Council of Australian Governments, consisting of the Prime Minister and the Premier or Chief Minister of each State and Territory.

15. There are also many Ministerial Councils that are attended by the relevant Commonwealth and State functional ministers. These councils are responsible for establishing national policies and for co-ordinating Commonwealth and State actions in their relevant areas.

16. Most of the ministerial councils have supporting meetings of officials. For example, Heads of Treasury meet at least three times a year to consider issues and initiate research in support of the Ministerial Council for Commonwealth-State Financial Relations.

Responsibilities of Each Level of Government

17. Section 51 of the Australian Constitution specifies the powers of the Commonwealth. These include defence and external affairs, social welfare, international and interstate trade and commerce, immigration, and post and communications.

18. All non-specified powers are the responsibility of the States. They have the major responsibilities for providing most of the services that affect the daily lives of people, such as education, health, law and order, transport, essential services (water, sewerage and power — often delegated to local government), and the control of local governments.

19. The Constitution was intended to preserve the financial independence of the States. However, it has not prevented major shifts in the balance of powers nor has it prevented the Commonwealth assuming the dominant financial position.

20. Within ten years of Federation, the Commonwealth had 'surplus' funds and a system of fixed per capita grants to each State was introduced. These grants were provided under *Section 96* of the Constitution, which gives the Commonwealth power to:

> '**….** make grants of financial assistance to any State on such terms and conditions as the Parliament thinks fit'.

21. Section 96 has been a major avenue through which the Commonwealth has transferred funds to the States and expanded its influence. This expansion of the Commonwealth's influence was made possible by the following events.

(i) The Constitution gave the Commonwealth exclusive power to impose sales taxes, and customs and excise duties, which were the largest taxes.

(ii) In 1942, the Commonwealth took total responsibility for income taxation, as a temporary measure to finance the war effort. This power has remained with the Commonwealth despite:

- two legal challenges by the State of Victoria in the 1950s; and
- a Commonwealth policy in the late 1970s to allow the States to re-enter the income tax field. However, no State did so, because the Commonwealth did not reduce its own tax rates. A State that took up the option would have had to impose a surcharge.

(iii) In 1997, the High Court ruled that some State taxes on liquor, tobacco and petroleum products were invalid because they were excises and reserved to the Commonwealth. The Commonwealth agreed to compensate the States for the lost revenue by increasing its excise duties on those products and passing the revenue on as untied grants.

(iv) In 2000, the Commonwealth Government introduced its New Tax System in which a broad-based Goods and Services Tax (GST) was introduced and offset by reductions in income tax, the abolition of wholesale sales tax, the abolition of some State taxes and increases in some welfare payments.

22. Table 2 uses revenues and expenditures in 2000-01 to illustrate the current distribution of powers between the three levels of government. It shows that revenues are generally specific to one level of government, but expenditure is mixed.

Table 2 AUSTRALIAN PUBLIC SECTOR 1999-2000

Item	Per cent of item at level Commonwealth	State	Local	Item as per cent of total
REVENUE (a)				
Income Tax				
Individuals	100.0			40.5
Enterprises	100.0			14.3
Non-residents	100.0			0.6
Pay-roll Tax	27.8	72.2		6.0
Taxes on property				
Land tax		100.0		0.9
Municipal rates			100.0	2.9
Financial & cap trans.		100.0		4.7
Other property taxes		100.0		0.8
Taxes on provision of goods and services				
Sales Tax	100.0			7.6
Excise & Levies				
Commonwealth Excise Act	100.0			6.8
Agricultural Production	100.0			0.3
On Public Corporations	59.6	40.4		1.6
Taxes on International Trade	100.0	0.0		1.8
Taxes on Gambling	0.0	100.0		2.1
Taxes on Insurance	0.0	100.0		3.2
Taxes on activities and use of goods				
Motor Vehicle Taxes		100.0		1.9
Franchise Fees		100.0		2.9
Other Taxes	56.7	43.3		0.4
Mining Revenue(b)		100.0		0.6
Total Revenue	74.8	22.3	2.9	100.0
EXPENDITURE (c)				
General Public Services	54.1	31.3	14.6	6.8
Defence	100.0			4.1
Public Order and Safety	11.8	85.3	2.9	3.7
Education	30.7	69.1	0.1	12.9
Health	53.3	46.1	0.6	16.9
Social Security and Welfare	90.7	8.1	1.2	24.2
Housing and Community Amenities	20.4	42.0	37.6	3.5
Recreation and Culture	24.3	43.8	31.9	2.3
Fuel and Energy	69.9	29.7	0.4	0.9
Agriculture, Forestry, Fishing and Hunting	41.2	58.5	0.3	1.7
Mining, Manufacturing Construction, etc.	63.0	26.8	10.2	0.5
Transport and Communication	13.5	58.8	27.7	5.8
Other Economic Affairs	49.4	42.2	8.3	2.5
Public Debt Transactions	62.3	35.1	2.5	6.5
Other Purposes	93.0	5.7	1.3	7.8
Total Expenditure	59.3	35.0	5.7	100.0

(a) Australian Bureau of Statistics, *Taxation Revenue Australia, 1999-2000* Catalogue No. 5506.0.
(b) Commonwealth Grants Commission, *2001 Update Report Supplementary Information* p 78.
(c) Australian Bureau of Statistics, *Government Finance Statistics Australia, 1999-2000* Catalogue No. 5512.0.

23. ***Economic development activities.*** The economic development function is a good example of the divided responsibilities. The latest comprehensive data relate to 1994-95[3] when the split of responsibilities was:

(i) the Commonwealth government provided assistance equivalent to $547 per capita, two thirds of which was tariffs and other market protection and the other third was selective assistance;

(ii) the State governments provided $137 per capita of mostly selective assistance and $176 per capita of payroll tax exemptions (much of which went to small businesses); and

(iii) local government provided various forms of selective assistance amounting to $12 per capita.

24. The Commonwealth assistance is generally not regionally based, although its impact may not be equal across all regions. For example, in earlier years the tariff policies probably provided relatively more assistance to the economies of New South Wales and Victoria, but tariffs have been greatly reduced in recent years. The Commonwealth provides some assistance aimed at helping specific areas – for example it provides subsidies aimed at ensuring freight costs on business inputs in Tasmania are similar to those on the mainland. It also provides other industry or region specific assistance on a case-by-case basis, especially if it considers it in the national interest – it provided considerable assistance to encourage a major natural gas project offshore from Western Australia.

25. The assistance provided by States takes many forms, including:

(i) direct assistance, such as tax concessions, low interest loans, subsidies, contracts guaranteeing government purchases, providing land at concessional costs and so on;

(ii) undertaking or sponsoring research and exploration;

(iii) providing basic infrastructure (water and power) to businesses or regions, with less than full cost recovery;

(iv) providing social infrastructure (schools, hospitals) to support employees in areas where industry is being encouraged to operate;

(v) pro-development economic, legal and regulatory policies that create an environment conducive to development; and

(vi) investment in education and training aimed at ensuring a skilled workforce in the long term.

26. The 1996 inquiry by the Industry Commission largely stemmed from concerns that States were competing against each other for projects and major events with

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3 State, Territory and Local Government Assistance to Industry, October 1996, Industry Commission, p. xxv.

little or negative impact on national well-being. A survey conducted by the Industry Commission found that in two-thirds of the cases of firms receiving assistance, the assistance was not influential in their location decision, and in a further 18 per cent it had only some influence[4]. New South Wales, Victoria and South Australia have recognised this issue and signed an agreement under which they share information on the proposals companies have made and the offers made to the companies. This agreement is said to have prevented large amounts of assistance being paid to companies for no net investment gain to the country.

27. Other functions that have an impact on economic development, such as industrial relations and wage setting are also shared, although Commonwealth policies arguably have a more widespread influence. For example, in wage setting the current Commonwealth government has a strong policy for wages to be set following bargaining at the enterprise or individual level. All States eventually followed this policy, although some are currently considering moving back towards more centralised systems.

28. ***Summary.*** Australian Commonwealth-State financial arrangements, including the equalisation arrangements, have developed in a context where:

(i) all the major taxes (income taxes, company taxes, sales and excise taxes) are Commonwealth taxes and there is no sharing of revenue bases — although the Commonwealth has agreed with the States that since all the revenue from the GST will flow to them, changes in its rate and coverage will require their unanimous agreement;

(ii) the revenue to be distributed on the basis of equalisation is collected by the Commonwealth — the States do not actually contribute revenue to the equalisation pool;

(iii) the Commonwealth's strong revenue position has resulted in it providing substantial levels of grants to the States for specific purposes — for example, the Commonwealth has no constitutional power in education and health, but nearly 60 per cent of outlays in those areas are funded from its budget; and

(iv) responsibility for funding many services is split between the Commonwealth and State governments.

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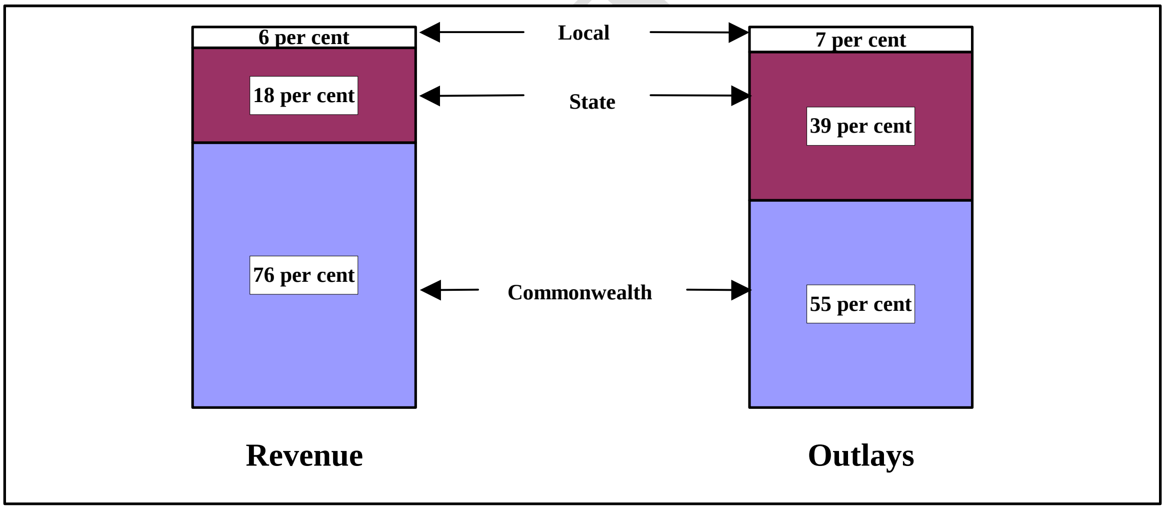
4 State, Territory and Local Government Assistance to Industry, October 1996, Industry Commission, p. 44.

Vertical Fiscal Imbalance

29. Figure 6 (which summarises the material in Table 2) shows that the Commonwealth raises more revenue than it spends and that the States rely heavily on grants from the Commonwealth to fund the services they have responsibility for[5] — that is, there is a high degree of vertical imbalance in the Australian Federation.

Figure 6 GENERAL GOVERNMENT OWN-SOURCE REVENUES AND ADJUSTED OWN-PURPOSE OUTLAYS, 2000-01



(a) Own-source revenue excludes the receipt of payments from other levels of government.

(b) Own-purpose outlays exclude payments to other levels of government and Public Trading Enterprises (PTEs), except that SPPs 'through' the States (other than those for local government purposes) have been treated as Commonwealth outlays.

Source: *Commonwealth Financial Relations with other levels of Government, 2000-01, Budget Paper No.3, p 15*. Australian Government Publishing Service, Canberra.

Commonwealth Transfers to the States

30. In these circumstances where the Commonwealth has the dominant financial capacity, Australia has developed an extensive system of payments from the Commonwealth to the States. These payments take two main forms.

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5 Figure 6, like the Australian Bureau of Statistics and the Auditor-General, treats the GST as a Commonwealth tax because it is imposed under Commonwealth laws. However, the Commonwealth Government considers it a State tax because all revenue is passed to the States and changes in the rate of the tax or the base require the unanimous agreement of the Commonwealth and the State governments.

(i) **Untied assistance,** which the States may spend according to their own priorities. This is primarily the payment of GST revenue[6].

(ii) **Specific Purpose Payments,** which are payments that fund activities which are the constitutional responsibility of the States. These funds must be spent on particular functions and generally have conditions which may limit the ability of State governments to set their own priorities. They may be paid to State governments or through them (when the final recipients are local governments, non-government schools, other bodies or individuals). In the 1990s, there have been over 120 different SPPs.

31. There is also a growing tendency for Commonwealth agencies to directly spend money on State-type Services. In these cases the Commonwealth funds statutory bodies established to oversee services or non-government bodies that supplement services provided by State government agencies.

32. In total, the payments to States are large and represent about half the revenue of the general government sector of the States. The levels of untied and specific purpose payments in 2000-01 and 2001-02 are shown in Table 3. Figure 7 shows the make-up of total Commonwealth assistance to the States since 1970-71.

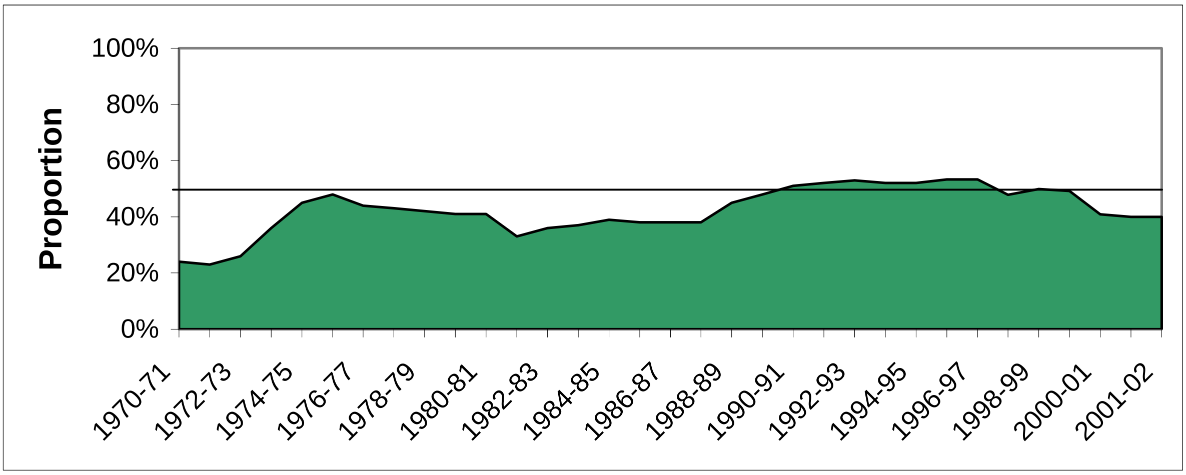
6 There are also some other payments which include amounts paid under the transitional assistance provisions of the *Intergovernmental Agreement on the Reform of Commonwealth-State Relations* (IGA) where the Commonwealth guaranteed each State that, for a transitional period following the introduction of the GST, it would be no worse off than if the previous financial arrangements had continued and other amounts paid under the Commonwealth's National Competition Policy.

Table 3 COMMONWEALTH TRANSFERS TO OTHER LEVELS OF GOVERNMENT(a)

Transfer		2000-01	2001-02
		$m	$m
Untied Funds			
GST payments		24 180	26 852
Budget balancing assistance		2 958	3 857
Other untied assistance(b)		911	1 018
Tied Funds – Specific Purpose Payments			
To the States	Current purposes	12 047	12 435
	Capital purposes	2 522	3 144
'Through' the States			
	Current purposes	4 687	5 442
Total		47 305	52 748

(a) Based on data in *Commonwealth Financial Relations with Other Levels of Government 1999-2000, Budget Document No. 3, AGPS, Canberra, 1999*, and Commonwealth Grants Commission sources.
(b) Includes payments in lieu of franchise fees, National Competition Payments and special assistance to the ACT.

Figure 7 - SPPs AS A PROPORTION OF COMMONWEALTH TRANSFERS



Untied Assistance

33. For most of the time since federation, untied assistance has been the main form of Commonwealth transfers. Its importance has declined in the last thirty years, and as Figure 7 shows, in some years it has been less than half the total assistance.

34. Over the years, Australia has had many different ways of determining the total amount of untied assistance to be provided to the States and of distributing it among them. The processes have included the following[7].

(i) Up to 1910, the Commonwealth's 'surplus revenue' was paid to the States and distributed in accordance with where it was generated.

(ii) An equal per capita grants system with the per capita amounts decided politically, but with additional payments to some States because of their difficult budgetary circumstances.

(iii) When the Commonwealth first took responsibility for income taxes, it paid the States tax reimbursement grants. Initially the total amount and the distribution were related to the tax previously raised by the States.

(iv) Various formulae have been used including escalating the amount paid in the previous year by:

- increases in the Australian population and increases in average wages;
- increases in each State's population and average wages, and a fixed percentage betterment factor;
- movements in the consumer price index and national population increases; and
- specified and pre-determined real growth rates.

(v) As a percentage of Commonwealth tax collections — initially a percentage of income tax and later a percentage of total tax revenue.

(vi) Presently the total amount is the total proceeds of the GST plus some additional transitional payments to ensure no State receives less than it would have under the previous arrangements.

35. An equalisation process has operated in Australia since the 1930s to even out the financial capacities of the State governments through the distribution of the untied assistance. Initially small supplementary grants were paid to the financially weaker States on the recommendation of the Commonwealth Grants Commission. However, since the early 1980s virtually all the untied assistance has been distributed on the basis of relativities recommended by the Commission and intended to equalise the financial capacities of the States. The *Intergovernmental Agreement on the Reform of Commonwealth-State Relations* (IGA), signed by the Commonwealth and all States in 1999 and attached to Commonwealth legislation implementing the new tax system, states that the GST revenue is to be distributed among the States on the basis of equalisation principles.

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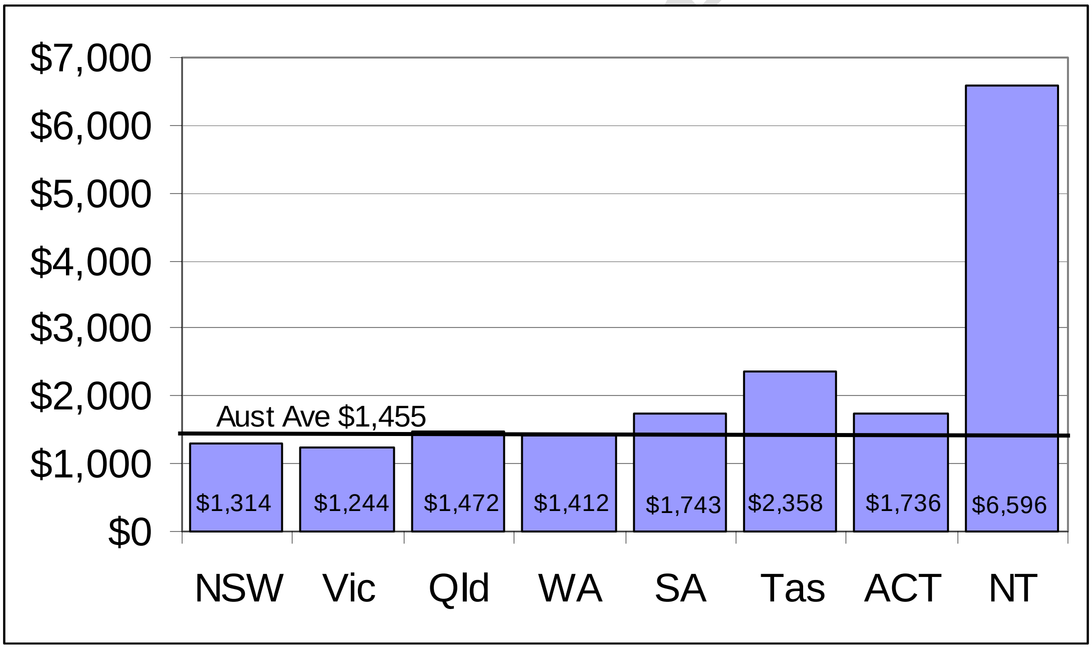
7 Throughout most of the period, there were also numerous short-term adjustments to the total amount available or the amount paid to each State to reflect particular economic and political circumstances.

36. Figure 8 shows the per capita distribution of untied assistance among the States in 2000-01 and compares it with the equal per capita distribution. It shows the very high per capita amounts paid to the Northern Territory, largely because the equalisation process indicates that the comparative costs of providing services to its small and highly dispersed population are relatively high. At the other extreme, Victoria the second most populous State with its compact and urbanised population has relatively low costs of providing services.

Figure 8 PER CAPITA UNTIED ASSISTANCE(a) – 2000-01



(a) Untied assistance includes GST revenue, budget-balancing assistance, National Competition Payments, Special Assistance to the ACT and small amounts of revenue replacement payments.

Specific Purpose Payments

37. SPPs are a large and important element of the Commonwealth payments to the States in Australia. They are currently about 40 per cent of the transfers from the Commonwealth to the States. This contrasts with their importance in other countries. For example, in South Africa grants from the central government represent more than 96 per cent of provincial revenues, but SPPs are only 11.3 per cent of those grants[8].

38. In Australia, SPPs are used for many reasons including:

(i) to achieve national standards or policies;

(ii) when the Commonwealth wants to influence State expenditure priorities in areas that are State responsibilities;

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[8] Republic of South Africa, *Draft 2002 Division of Revenue Bill and Explanatory Memorandum*, Government Gazette No. 22920, Volume 438, 6 December 2001.

(iii) to pay States for providing services on behalf of the Commonwealth or to compensate them for expenses imposed on them by Commonwealth initiatives; and

(iv) to pass on to the States revenues collected by the Commonwealth on their behalf or to share Commonwealth revenues with them.

39. The conditions attached to SPPs take many forms, including:

(i) policy requirements — providing free public hospital treatment to public patients as a condition of receiving health care grants;

(ii) the funds must be spent on a specific purpose;

(iii) meeting broad Commonwealth-State agreements on principles and program delivery mechanisms; and

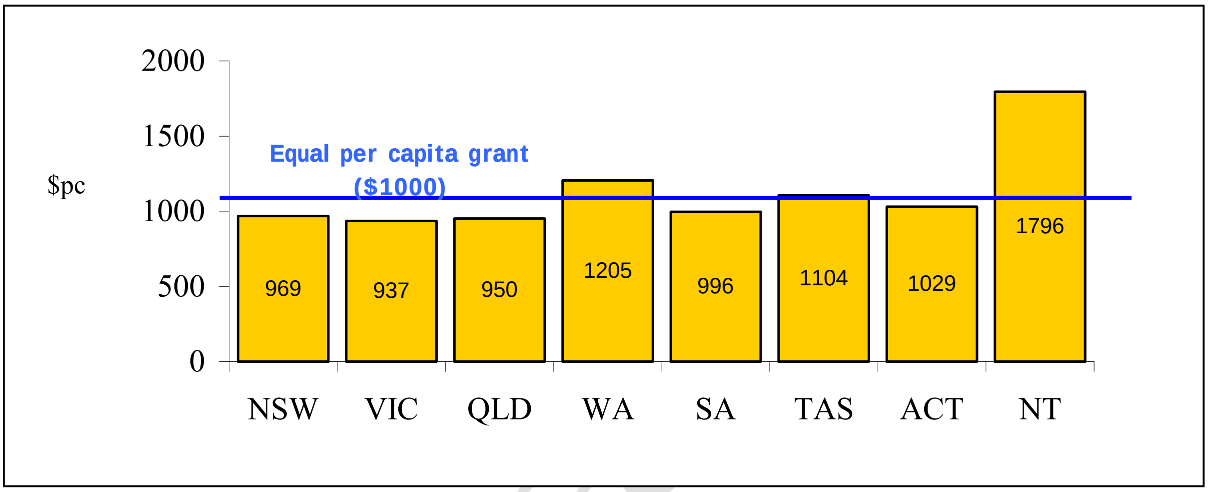
(iv) meeting specific conditions of joint expenditure programs — such as providing matching funding and performance reporting.

40. ***Determining the Size and Distribution of SPPs.*** The Commonwealth determines the total value of SPPs. The size of individual SPPs is influenced to some extent by the outcome of negotiations between the relevant Commonwealth Ministers and their State counterparts and between officials. Consequently, the total value of the SPPs is little more than the accumulation of the individual outcomes of those negotiations. However, the negotiating teams involved in the consideration of each SPP presumably have instructions or guidelines from the Commonwealth Treasury and the Department of Finance and Administration, which reflect the Commonwealth's budgetary and other policies.

41. The interstate distribution of SPPs is generally decided through inter-government negotiations. There are many distribution mechanisms varying from Commonwealth discretionary allocations, to population shares, to a variety of formulae which often attempt to reflect the relative need for the service across the States — generally measured in terms of interstate differences in the cost of or demand for the service.

42. Figure 9 illustrates the interstate distribution of SPPs in 2000-01 and compares it with an equal per capita distribution.

Figure 9 INTERSTATE DISTRIBUTION OF SPPs — 2000-01



43. The interstate pattern in the distribution of these grants is broadly similar to the Commission's assessments of the relative costs of providing services, except that the payments to the Northern Territory are not as high. (SPPs are high for Western Australia because it receives a share of the royalties from offshore oil and gas as an SPP. The figure for the ACT includes payments for costs arising from its status as the National Capital.)

Summary

44. Australia has an extensive system of transfers from the Commonwealth to the States. About half the funds States have to spend are transfers from the Commonwealth.

45. The transfers take the form of both untied funds and specific purpose payments – about 60 per cent of total transfers are currently in the form of untied assistance.

46. A wide variety of approaches have been used to determine the amount of untied assistance over the years including a per capita entitlement, various formulae and a percentage of Commonwealth tax collections. Currently the amount is primarily determined as the proceeds of the GST. Horizontal equalisation principles have been used to allocate almost all the untied assistance among the States since the early 1980s.

47. The total amount of SPPs is not so strongly controlled being largely the sum of the amounts provided under each payment (there have been over 120 different SPPs during the 1990s). However, the amounts are controlled indirectly through the Commonwealth's annual budgeting processes. SPPs are distributed among the States on a variety of bases, including negotiated outcomes, equal per capita amounts and needs.

EQUALISATION IN AUSTRALIA

48. As noted previously, for about the last 25 years the main form of untied assistance has been distributed among the States on the basis of horizontal equalisation principles. A principle intended to equalise the financial capacities of the State governments to provide services to their populations. Before considering the concepts and basis of equalisation applied in Australia, it is worth outlining some of the administrative and procedural arrangements because many of them are different from other countries.

Administrative and Procedural Arrangements

49. The main features of the Australian processes are as follows.

(i) State shares of untied assistance are based on advice prepared by the Commonwealth Grants Commission but the shares are formally determined by the Commonwealth Treasurer after consulting the Ministerial Council on Commonwealth-State Financial Relations (which consists of the Commonwealth and State Treasurers).

(ii) The Commission is an on-going Commonwealth independent statutory authority, but it does not have any constitutional status. It is established under Commonwealth legislation — the Commonwealth Grants Commission Act, initially a 1933 Act but revised several times.

(iii) The Governor-General appoints Commission members on the advice of the Commonwealth Government for periods of one to five years[9]. However, the Commonwealth seeks considerable input from the States in the selection of potential members. The Commission is supported by a permanent secretariat of Commonwealth officials.

(iv) There is usually between three and five members of the Commission. They are selected for their experience and expertise and make their decisions independently of political processes and pressures — they are not advocates of individual States.

(v) The Commission conducts inquiries in response to specific terms of reference provided by the Commonwealth but drafted in consultation between the Commonwealth and the States.

(vi) Commission inquiries are conducted in an open manner with extensive input from, and feedback to, the States. Decisions are supported by objective analysis, although in practice the judgement of the members is an inevitable input to decisions. Nevertheless such judgement is made on an impartial basis.

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9 These are the statutory limits on appointments but individual members can be reappointed.

(vii) The Commission works in five yearly cycles. It conducts reviews of its methods every five years. In between those reviews it updates the relativities annually by applying the latest available data to the methods of the last review.

(viii) Commission reports are formally provided to the Commonwealth but are also given to the States and are the subject of discussion at the annual meeting of the Ministerial Council on Commonwealth-State Financial Relations.

50. In general, the process is independent of political pressures, as objective as possible and conducted in an open manner. Commission decisions and the basis of them can be scrutinised by the States and interested commentators. The recommendations of the Commission are considered by governments in the context of the Ministerial Council but are almost always accepted. In many ways the Commission is an integral element of Australia's federal structure and is often seen as an independent arbitrator of the competing claims of the States.

Equalisation Concepts and Methods in Australia

51. The Commission developed the equalisation principle used in Australia in 1936. The initial definition was that the distribution of funds among the States should:

> make it possible for [a] State by reasonable effort to function at a standard not appreciably below that of other States.[10]

52. The concept has been refined since then reflecting input from the Commonwealth, the States and the Commission. Horizontal equalisation is currently defined as:

> State governments should receive funding from the Commonwealth such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.[11]

53. The 1999 Intergovernmental Agreement is the most recent indication that the Commonwealth and the States accepted the Commission's approach to equalisation. Clause B2 of that agreement states:

> 'The pool of funding to be distributed according to HFE principles will comprise GST revenue grants and health care grants …….. A State or Territory's share of the pool will be based on its population share, adjusted by a relativity factor which embodies per capita financial needs based on the recommendations of the Commonwealth Grants Commission.'

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[10] Commonwealth Grants Commission, Third Report, 1936, p 75.

[11] Commonwealth Grants Commission, Report on General Revenue Grant Relativities 1999, p 4.

54. The most recent statement by the Commonwealth in support of the current approach to HFE is held in Commonwealth Budget Paper No. 3, *Federal Financial Relations 2002-03*. Among other things, that document says:

> 'HFE gives practical effect to Australians' concerns about equity and substance to the Federation by giving each State a more equal capacity to provide their citizens with access to essential services (such as health and education) at a standard that is not lower than other States.'[12]

55. The definition of equalisation is based on what the Commission describes as 'three pillars':

(i) **Capacity equalisation.** Equalisation is about equalising the fiscal capacity of State governments. It is not about equalising the States' performance or the outcomes they achieve.

(ii) **Internal standards.** The standards applied are an average of those actually applied by the States — what States do. The Commission does not try to guess what level of service might be appropriate, even where it can be demonstrated that a level of service is below public expectations, professional guidelines or United Nations standards. The fiscal capacity calculated for each State would enable it to provide the average level of services being provided by the States, if they so chose.

(iii) **Policy neutrality.** A State's own policies or choices on the services it provides or the revenues it raises should not directly influence the level of grants it receives. Policy neutrality is implemented by undertaking assessments on the assumption that each State follows standard policies in delivering services and raising revenue.

56. Equalisation is not about:

(i) ensuring that each State actually provides the standard level of services — there is no mechanism for doing this because the funds distributed on equalisation principles are untied funds[13];

(ii) ensuring interpersonal equity — the main means for promoting interpersonal equity are the social security provisions and the income and related taxation arrangements which are Commonwealth functions. Equalisation does no more than provide equal financial capacity for all States to provide similar levels of services which is usually an element of interpersonal equity;

(iii) ensuring that the same levels of services are provided in different regions of States or to different groups of people (such as ensuring Indigenous people receive the same services as other Australians). It

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12 Commonwealth Budget Paper No. 3, *Federal Financial Relations 2002-03*, p 18.

13 The Intergovernmental Agreement makes it clear that GST grants can be used as each State see fit.

equalises capacity to provide the standards of services actually provided in different regions and to different groups — what is actually provided reflects the decisions of each State government.

Implementing Equalisation and the Equalisation Formula

57. To implement equalisation, the Commission identifies and measures differences in per capita costs of providing services and capacities to raise revenue.

58. A State's requirement for untied assistance to achieve equalisation is an equal per capita share of the total amount available for distribution plus the State's expenditure, revenue and SPP needs (those needs may be positive or negative). A simplified formula is in Attachment A.

59. In these calculations:

(i) an expenditure need is the impact on State expenditure of demographic, economic and geographic influences that are beyond the influence of the State which result in it spending more or less than the average amount to provide the average standard of service – it might include more schoolchildren, more Indigenous people, more people living in remote areas or diseconomies of scale;

(ii) a revenue need arises if the per capita revenue base (defined on a standard basis) of a State is larger or smaller than the average; and

(iii) a SPP need arises if the State receives more or less than the Australian average per capita revenue from SPPs.

60. Calculations at this level require large amounts of data. That data is only available for past periods. So the Commission translates its calculated requirements into per capita relativity factors[14] which can be applied to future amounts of available assistance.

61. To provide some stability in the relativities and hence in State untied assistance, the calculations are done for the five most recently completed years and averaged. This averaging process implies that there can be a lag of up to seven years between the earliest year for which data is used in the calculations and the year the relativities are applied. For example, the relativities used to allocate untied assistance for 2002-03 were based on data for the five years 1996-97 to 2000-01[15].

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14 This is done by dividing the assessed per capita requirement for untied assistance for each State by the total per capita amount of untied assistance available for distribution among the States in the assessment year.

15 The existence of this lag has several implications. It means that the assessments might not be an accurate reflection of the requirements for assistance in the year they are applied if there are long-term trends in the economic circumstances of some States. It also means it can take up to seven years before any particular event is fully reflected in the assessments.

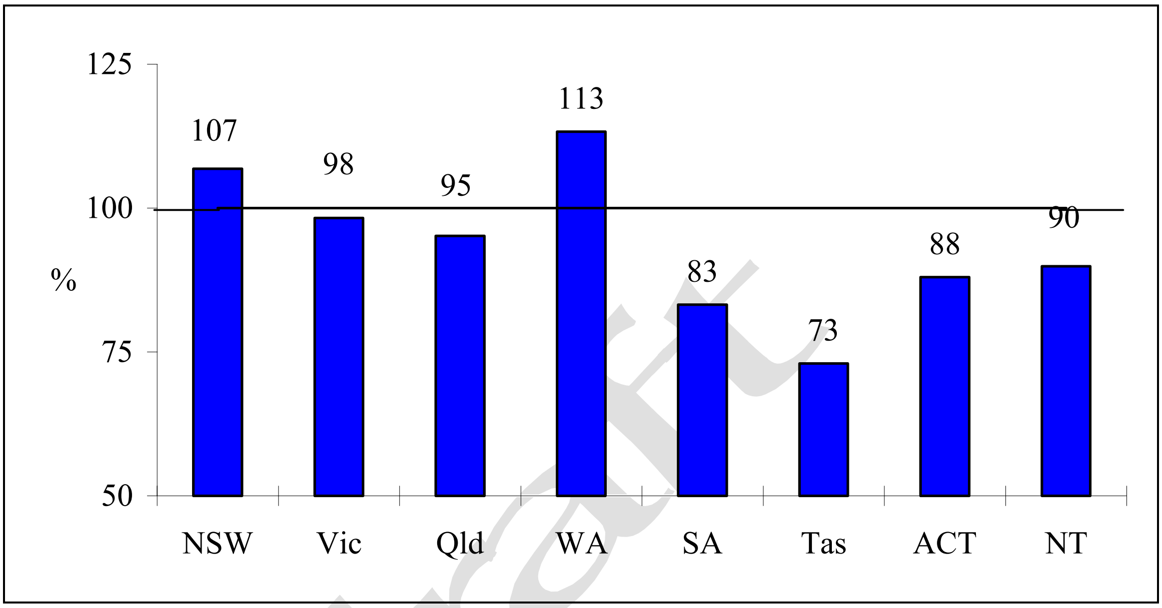
62. Figure 10 shows differences in the relative cost of providing services[16] as assessed by the Commission. Apart from the special case of the Northern Territory (where costs are 134 per cent above average because its small population is scattered over a huge area and a large proportion are Indigenous), there are not great differences between the States. Victoria has the lowest relative costs (about 7 per cent below average) because its population is large enough to generate economies of scale, few people live in areas that are difficult to service and a very low proportion of its population are Indigenous.

63. Figure 11 shows relative revenue raising capacities[17]. Tasmania, the poorest State, has a capacity that is 27 per cent below average. Only two States are above average — Western Australia (due to its large mining industry) and New South Wales (due to its high land values and the nature of its economy).

Figure 10 RELATIVE COST OF SERVICE PROVISION RATIOS – 1999-2000

16 A State's needs are indicated by the extent to which its cost of service is above or below 100.
17 Revenue needs are indicated by the extent to which revenue raising capacities are above or below 100.

Figure 11 RELATIVE REVENUE RAISING CAPACITY RATIOS – 1999-2000



64. The impact of equalisation on the distribution of untied assistance can be seen from a comparison of the assistance each State receives with what it would have received under an equal per capita distribution. Table 4 shows comparisons for 1992-93 and 2001-02.

65. It is interesting to note that over that period, the amount available for distribution has more than doubled, but the distribution away from the two financially strongest States (New South Wales and Victoria) has remained fairly constant. The strengthening financial positions of Queensland and Western Australia are also evident.

Table 4 EQUALISATION AND EQUAL PER CAPITA GRANTS

	Equalisation Grant		Equal Per Capita Grant		Impact of Change to Equal Per Capita	
	1992-93	2001-02	1992-93	2001-02	1992-93	2001-02
	$m	$m	$m	$m	$m	$m
New South Wales	3 583	9 401	4 646	10 426	1 063	1 025
Victoria	2 623	6 394	3 466	7 341	843	947
Queensland	2 746	5 411	2 374	5 297	-371	-114
Western Australia	1 583	2 824	1 297	3 000	-286	177
South Australia	1 520	2 767	1 137	2 286	-383	-481
Tasmania	577	1 163	3 67	729	-210	-434
ACT	(a)	584	(a)	484	(a)	- 99
Northern Territory	787	1 380	132	361	-655	-1 019
TOTAL	13 419	29 924	13 419	29 9240	0	0

(a) In 1992-93, the ACT was not covered by the equalisation processes.

Source: Budget Paper No.4, *Commonwealth Financial Relations with Other Levels of Government 1992-93*, and Budget Paper No. 3, *Federal Financial Relations 2001-02*, Canberra, 2001.

66. Table 5 provides some insights into the influences that caused revenue and expenditure needs in 2000-01. It shows that the revenue and expenditure assessments have about the same influence on the level of redistribution. It shows that interstate differences in levels of mining activity are by far the largest single source of redistribution. The second most important influence is the impact on costs of providing services of diseconomies of small scale. The third most important influence is the effect on revenue raising capacity of differences in the level of activity in the real estate market[18].

Table 5 CAUSES OF MOVEMENT FROM AN EQUAL PER CAPITA DISTRIBUTION, 2000-01

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total[(a)]
	$pc	$pc	$pc	$pc	$pc	$pc	$pc	$pc	$pc
Revenue									
Mining revenue and grants	51.3	75.4	-46.3	-310.1	27.7	60.5	81.8	-170.8	41.0
Taxes on asset sales	-84.2	47.3	12.1	10.0	107.6	163.8	7.3	92.5	28.4
Taxes on payrolls	-36.3	-43.8	50.6	11.9	79.9	137.8	119.6	100.3	23.1
Taxes on asset holdings	-57.7	8.6	40.3	9.4	67.4	103.1	38.0	55.3	19.5
Other taxes	-2.7	5.0	17.1	-66.3	40.1	25.1	18.5	-93.7	8.5
Total revenue	-129.7	92.4	73.8	-345.1	322.6	490.3	265.2	-16.5	78.1
Expenditure									
Scale of service provision	-49.8	-44.2	-17.9	35.1	47.6	278.4	369.4	1095.8	31.2
Features of population	-12.0	-68.2	50.9	16.9	41.7	176.8	-142.7	452.3	23.3
Aboriginality	-11.8	-41.0	21.7	5.9	-36.8	25.0	-34.7	1208.9	17.6
Where people live	8.5	-23.3	-13.9	39.0	-26.1	-58.7	-63.3	600.7	12.9
Wage levels	29.4	-2.6	-45.3	10.0	-38.9	-18.6	59.1	65.2	12.6
Other disabilities	20.0	-105.1	-45.0	144.4	31.8	-34.9	-216.0	1502.8	38.8
Total expenditure	-15.6	-284.4	-49.5	251.4	19.3	367.9	-28.2	4925.9	85.6
TOTAL REDISTRIBUT'N	-145.4	-192.0	24.3	-93.8	341.9	858.2	237.1	4909.4	106.1

(a) Total movement from EPC. It is calculated by dividing the total redistribution by the Australian population.

Summary

67. Some major features of equalisation in Australia are:

(i) it is comprehensive in that assessments are made for differences between States in:

- capacity to raise revenue from all sources used by States; and
- the demand for and costs of providing all services States provide.

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18 Many States in Australia are currently experiencing unprecedented levels of activity in the real estate market, especially residential property, so the importance of this revenue base may always be so high.

(ii) differences between States in their per capita revenue from many specific purpose payments from the Commonwealth are taken into account in deciding the allocation of untied assistance[19];

(iii) it results in full equalisation (States with above average financial capacity receive below average untied assistance per capita and States with below average financial capacity receive above average untied assistance per capita); and

(iv) recommendations on States shares are provided by a permanent, independent and non-political commission.

THE CURRENT DEBATE ON COMMONWEALTH-STATE FINANCIAL ARRANGEMENTS

68. In Australia an untied grant process, which provides the States with about 30 per cent of their total revenue, is used to reduce the vertical imbalance and to remove the horizontal inequality among States. There is also a large SPP system, representing about 20 per cent of State revenues, which further reduces the vertical imbalance and enables the Commonwealth to impose national standards and to fund national priorities.

69. There are some long-standing concerns about the overall system. In early 2001, a combination of the size of the assistance being dependent on independent movements in collections from a broad based tax, which has grown more slowly than expected, and reductions in their relativities led New South Wales, Victoria and Western Australia to argue for major changes in the approach to allocating funds. They engaged some economists to review Commonwealth-State Funding[20]. This review was asked to consider whether the current system is effective in relation to:

(i) efficient allocation of resources across Australia to enhance national employment and economic growth;

(ii) achievement of equitable outcomes for all Australians; and

(iii) simplicity and transparency.[21]

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19 Consequently, over the longer term, the Commission determines the interstate allocations of both untied assistance and most specific purpose payments. That is, to the extent that the allocation of SPPs among the States was inconsistent with the Commission's assessments its financial impact on the States is effectively overridden. They do not, however, affect the level of expenditure on the function covered by the SPP.

20 They also attempted to raise public awareness through newspaper advertisements attacking what they saw as unwarranted subsidies to Queensland and the ACT.

21 Terms of reference for the Review of Commonwealth-State Funding, as published in *Background Paper: A review of the allocation of Commonwealth Grants to the States and Territories*, Review of Commonwealth-State Funding, Melbourne, December 2001.

70. Some of the issues the more populous States have raised over the years and which are reflected in the deliberations of their inquiry are considered below.

Are the Processes Inefficient?

71. In recent years, Australian governments have emphasised efficiency, and many aspects of the processes have been said to be inefficient at one time or another. Consequently, there are many strands to the arguments about inefficiency.

72. ***The impact of vertical imbalance.*** The high level of vertical imbalance is often cited as a source of inefficiency in that it results in each level of government taking insufficient account of the full consequences of their decisions. The usual example is that the States may make inappropriate decisions on service provision because they are not responsible for the taxes that finance much of the expenditure.

73. Conversely, it can be argued that at the margin additional expenditures are likely to be financed by additional State taxes, which the States will evaluate rigorously. In addition, if the Commonwealth controls the major taxes and thereby influences the level of State expenditures, decisions on macro-economic issues may be easier and more efficient.

74. The balance of opinion seems to be that, despite the conceptual possibilities, the extent of vertical imbalance is not a cause for major concern in practice[22].

75. ***The impact of the equalisation process.*** Equalisation has been said to result in four types inefficiency.

(i) Equalisation is said to encourage the geographic misallocation of resources by discouraging people from moving from high-cost to low-cost areas and therefore raises costs overall. There are no reliable estimates of this impact.

Others argue that equalisation aids allocative efficiency because it minimises inefficient migration that would otherwise occur from high tax, low service States to low tax, high service States. Also, it is consistent with policies the States apply within their own boundaries.

(ii) Some argue that equalisation provides incentives for misallocation of resources across services. A study done for Victoria said 'this system encourages a State to over-provide services which are relatively expensive for it to provide and to under-provide those services in which it has a cost advantage'[23]. However, a 1994 report by the State Treasuries noted 'in most cases ... the incentive is minor and is unlikely to affect government decision making'.

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22 Hancock J and Smith J, *Financing the Federation*, The South Australian Centre for Economic Studies, 2001.

23 Swan PL, and Garvey GT, *The Equity and Efficiency Implications of Fiscal Equalisation*, Swan Consultants Pty Ltd, 1996.

(iii) Equalisation is said to stifle incentives for improvements in efficiency in service delivery because it bases its assessments on an average of the policies of all States and uses cost functions that assume constant returns to scale.[24] Proponents of this argument want the Commission to use best practice standards or other processes to reward efficiency.

However, equalisation is not the best means of encouraging State governments to improve their efficiency. If incentives are to be provided through a grant process, conditional grants, not untied ones, are required. It is also not clear why the Commonwealth should pay States to improve their efficiency of service delivery.

(iv) Equalisation is said by some, such as Western Australia, to reduce the incentive for States to invest in encouraging economic growth. It is argued that by measuring revenue bases using the actual level of taxable activity, equalisation redistributes most of the benefits of a State's economic development policies to other States. In addition, the current process does not allow expenditure needs for the additional costs incurred in developing the enlarged revenue base.

The mechanics of much of this argument are essentially correct – up to now the Commission has considered that there were no non-policy reasons for States to incur different per capita levels of expenditure on economic development. That is, every State has policies aimed at encouraging economic development or assisting existing industries, but it is not clear what needs might be associated with the expenditure, or how any needs might be measured.

The argument that equalisation creates disincentives to economic development activities also implies that a major, if not the only, reason States have economic development policies is to increase their revenue base, which is highly unlikely to be the case. Finally, it is noted that New South Wales and Victoria, (two of the States currently opposed to equalisation) do not support this argument.

Nevertheless, the Commission is currently reconsidering its approaches in this area. It is considering whether:

- there are needs associated with expenditure on economic development and if so how they might be measured; or
- it should adjust State revenue bases to exclude activities that are reasonably considered to result from explicit State economic development policies; or

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24 Tasman Economics, *The Impact of Changes in Public Administration*, Discussion Paper prepared for the Department of Treasury and Finance (Victoria), 2001.

- it should adjust its revenue assessments to allow States to make a standard rate of return on their expenditure associated with economic development.

76. There may be some conceptual validity in each of these possibilities. But, it is not clear that they have any practical impact. It is also necessary to consider whether equalisation brings other more worthwhile benefits in terms of the relatively high level of harmony in the federation and the possibility of diversity in the services provided.

77. ***The impact of SPPs.*** There is widespread acceptance of the need for SPPs to promote national standards and to set strategic directions in a federation, but the States and some others argue that they are inefficient because they result in:

(i) a blurring of the lines of responsibility for the provision of services (a blurring which the Constitution attempted to avoid by listing Commonwealth powers) which creates opportunities for cost shifting, blame shifting when some aspect of service delivery is found wanting and other inefficient policies;

(ii) Commonwealth priorities and perspectives on service delivery being imposed on the States which are better placed to know what their population want and how services are best provided;

(iii) States may not be so interested in spending funds efficiently if the purposes do not align with their priorities; and

(iv) duplication and high administrative costs because both the Commonwealth and the States must establish reporting and accountability processes which can be very detailed.

78. Governments often state their intentions of moving to an outcome focus and reducing the number of payments and conditions attached to them. But little has happened.

Are the Processes Inequitable?

79. Statements by the Premiers of New South Wales, Victoria and Western Australia announcing their Review of Commonwealth-State Funding claimed:

> 'Commonwealth-State financial arrangements are no longer providing a "fair go" for all States and Territories.
>
> This grossly inefficient and unfair distribution is holding back national economic development and jobs growth and is potentially harming service delivery in our three States.'[25]

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25 *Donor States carry an unfair burden*, in The Financial Review, 30 November 2001.

80. These statements primarily reflect the fact that these three States receive less than an equal per capita share of the untied assistance and of the SPPs[26]. This simple view of fairness has support and was the basis for the interstate distribution of hospital funding grants. But, if outcomes are the focus of public activity, it is easy to demonstrate that equal per capita levels of inputs will not lead to equal outcomes if there are differences in the per capita levels of demand or in the unit costs of providing a service.

81. It is also notable that the New South Wales Government has itself received much criticism over a decision to increase tolls on the Sydney Harbour Bridge and use the proceeds to fund road works in rural areas[27].

82. Politics aside, there have been conceptual arguments that equalisation, with its focus on the financial capacity of State governments, does not achieve fairness between individuals - it does not ensure people in different regions or different groups of people receive similar services. A grants system could be devised to overcome these criticisms but it would require conditionality on the grants and extra resources to raise service standards. Arguably, these objectives are better dealt with through SPPs than equalisation.

Do the Processes Cost Too Much?

83. It is often claimed that the administrative costs associated with equalisation and SPPs are too great. The Commission's budget is about $5 million a year and it is estimated that the States and the Commonwealth Treasury collectively spend a similar amount participating in the inquiries. This total of about $10 million is small compared with the amount it distributes.

84. A 1994 Australian National Audit Office examination of SPP arrangements found that they were relatively expensive to administer. Considerable effort has been devoted to simplifying the arrangements. But they are still costly.

Is the Equalisation Process Unrepresentative and Too Complex?

85. The Premiers of New South Wales, Victoria and Western Australia:

> The CGC is an unelected, unaudited and unaccountable body that distributes $30 billion a year in GST revenues according to a complex, poorly understood process.[28]

86. It is true that the Commission is not elected. (As noted previously, members are appointed by the Governor-General following selection procedures involving the Commonwealth and the States.) This criticism is contrary to the conventional wisdom that the existence of an independent body of experts to provide technical advice on the

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[26] Western Australia actually receives an above equal per capita share of SPPs. But the State documents point out that is because its share of royalties from offshore oil and gas operations is received in the form of an SPP.

[27] *Bridge toll fury mounts as bus users get caught in the net*, The Sydney Morning Herald, 20 December 2001.

[28] *Donor States carry an unfair burden*, in The Financial Review, 30 November 2001.

allocation of untied assistance is a positive feature of the Australian system. It is also noted that the Commission's recommendations are only advisory. The Ministerial Council for Commonwealth-State Relations makes the decision on the allocation of untied assistance.

87. The Commission is open with and accountable to its stakeholders (the Commonwealth and the States). While its assessments are not subject to a formal audit, the procedures for the conduct of inquiries provides many opportunities for States to provide input, to comment on the Commission's thinking or to scrutinise the its results.

88. That the Commission's assessments, as opposed to its aim of giving all States the same financial capacity, are complex is a valid criticism. This is inevitable for a process that systematically examines each State revenue source and each service. Nevertheless, the Commission has for many years had an aim of simplifying its assessments, but its attempts have been met with criticism from most States.

The Report of the Review of Commonwealth-State Funding

89. Many of these issues have been echoed in the report of the inquiry set up by New South Wales, Victoria and Western Australia[29]. That report concluded that the current Commonwealth-State financial arrangements (including the SPP arrangements) inhibit growth in several ways:

(i) the equalisation processes reduce incentives for States to pursue growth-enhancing policies;

(ii) the equalisation processes reduce incentives to improve efficiency in service delivery; and

(iii) the SPP arrangements blur lines of responsibility between the Commonwealth and the States, thereby reducing accountability and the focus on performance.

90. It also considered that both the equalisation and SPP arrangements lacked simplicity and transparency.

91. The report recommended a new system under which:

(i) all Commonwealth specific purpose payments would be abolished with the funds transferred to three cooperative national programs for health and aged care, education and training, and Indigenous Community Development – all other services previously partly funded by SPPs would be solely the responsibility of the States;

(ii) the equalisation process would be abolished and replaced with a system in which each State would receive a small fixed sum to cover

[29] *Review of Commonwealth-State Funding, Final Report*, The Committee for the Review of Commonwealth-State Funding, August 2002, Melbourne. (See: www.reviewcommstatefunding.com.au)

some of the fixed costs of government and the rest of the GST revenue would be allocated on an equal per capita basis;

(iii) each State would be guaranteed that the sum of untied funds and the Commonwealth contributions to health and aged care and to education and training in each future year would be at least as high in real per capita terms as the sum of these payments in 2002-03.

(iv) The Grants Commission would return to the role it had in the 1970s when it advised on supplementary grants to financially weak States.

92. Debate on this report is just beginning. However, other States and interested observers dispute many of its findings. In particular, the conclusions regarding the incentive effects of equalisation are considered untested at best.

93. For its part, the Commonwealth has adopted the attitude that issues surrounding the allocation of the GST revenues are ones for the States to resolve. It has stated a preparedness to change the allocation processes if there is unanimous agreement among the States. Of course, the other States are currently opposed to any changes. The Commonwealth's attitude to the suggestions for SPPs is currently unknown but it is unlikely to support them.

94. Many aspects of Australian Commonwealth-State relations are not perfect and it is appropriate that we do stop to ask: are the equalisation and SPP arrangements achieving what governments think they are; what do we want them to achieve; can they be varied to achieve those aims or are different processes required? It would seem that any such debate would have the maximum benefits if it were conducted in a fully inclusive manner involving the Commonwealth, all States and any other interested parties[30].

95. We shall have wait and see what unfolds. For its part, the Commission has indicated a preparedness to undertake its tasks in whatever way governments request.

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[30] The Review of Commonwealth-State Funding did not have these characteristics. While it did call for and receive public submissions, it did not receive input from the Commonwealth or from States other than the three who commissioned it, paid for it and provided much of its secretariat.

ATTACHMENT A

EQUALISATION NEEDS FORMULA

In simplified terms, a State's equalised grant for a year is an equal per capita share of the total amount available for distribution, as adjusted by the State's expenditure, revenue and SPP needs (those needs may be positive or negative). It can be calculated as:

$$\text{Equalised Assistance per capita} = \text{Aust average per capita amount available} + \text{Expenditure needs} + \text{Revenue needs} + \text{SPP needs}$$

where:

$$\text{Expenditure needs} = \sum_{i=1}^{40} \text{Aust average per capita expenditure for service } i \left(\text{State's disability } i - \text{Standard disability } i \right)$$

$$\text{Revenue needs} = \sum_{i=1}^{20} \text{Aust average tax rate for tax } i \left(\text{standard per capita tax base } i - \text{State's per capita tax base } i \right)$$

$$\text{SPP needs} = \sum_{i=1}^{30} \text{average per capita receipts for SPP } i - \text{State's per capita receipts from SPP } i$$

Calculations are done separately for about **40** services, **20** revenues and **30** specific purpose payments

Calculations are done using historical data but the CGC is required to advise on the allocation of future grants. So equalised assistance is converted to relativities, which are assumed to be applicable in the future. A State's relativity is:

$$\text{Relativity} = \frac{\text{Equalised assistance per capita for State}}{\text{Aust average per capita amount available}}$$

The equalised amount of untied assistance required may also be calculated as:

The expenses the State would incur to provide the average level of services provided by the Australian States, assuming it operated at an average level of efficiency. There is a separate calculation for each service.

Less

The revenue it would raise if it applied the Australian average tax policies to its tax bases. There is a separate calculation for each form of State tax.

Less

Its actual revenue from SPPs.

Less

The average budget result of the Australian States.

In this context, the expenditure incurred in providing the average level of services is

$$= \sum_{i=1}^{40} \begin{array}{l}\text{Aust average per}\\ \text{capita expenditure}\\ \text{for service } i\end{array} \left[\text{State's disability } i\right]$$

The revenue raised under standard tax policies is

$$= \sum_{i=1}^{20} \begin{array}{l}\text{Aust average tax}\\ \text{rate for tax } i\end{array} \left[\text{State's per capita tax base } i\right]$$