



Australian Government

Commonwealth Grants Commission

**THE COMMONWEALTH
GRANTS COMMISSION:

THE LAST 25 YEARS**

2008

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PREFACE

The Commission has prepared this history to mark the 75th anniversary of its creation in 1933. It deals with the Commission's activities and the main issues considered since it was charged with the task of providing advice on equalising the financial capacity of Australia's six States and two Territories. The Commission's earlier history is covered in the first and second editions of its book *Equality in Diversity*.

The Commission wishes to thank Malcolm Nicholas, who has served as a member of the Commission's staff throughout the period covered by this history, for his efforts in preparing it.

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THE COMMONWEALTH GRANTS COMMISSION: THE LAST 25 YEARS

INTRODUCTION

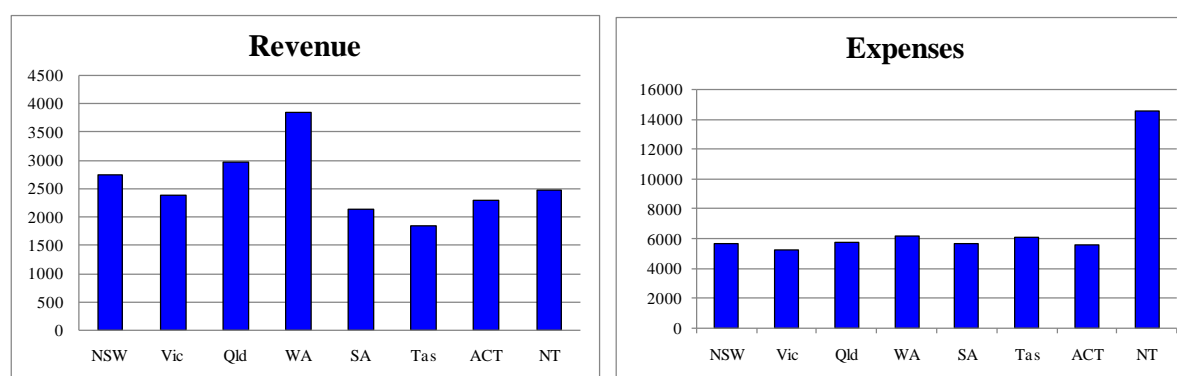
- 1 The Commonwealth Grants Commission was born in tumultuous times.
- 2 The Great Depression of the 1930s had plunged the country into severe economic difficulties and governments were struggling to deliver policies to restore prosperity and repair their own finances which had been seriously affected by falling revenue and rising expenses.
- 3 Even in this climate, the relative fortunes of the States in the Federation were important — a fact perhaps most clearly illustrated by the 1933 secession referendum in Western Australia, when 68 per cent of voters opted to leave the Commonwealth.
- 4 The Commonwealth had provided special financial support for weaker States, including Western Australia, since 1910. Deciding that support was often acrimonious and highly charged and done on the advice of a range of ad hoc advisory mechanisms. Against that background, the Commonwealth legislated for the establishment of an independent and ongoing Commission to provide impartial advice on the appropriate financial support for State budgets.
- 5 The Commission has fulfilled that role since 1933. During that time it has witnessed the transformation of Commonwealth-State financial relations from the infancy of the Federation to today's arrangements.
- 6 Throughout its existence, the Commission's its work and the underlying aim of equalising the financial capacity of the States has often been contentious but rarely topical. It becomes topical when State shares of the Commonwealth financial support change substantially, most recently since 2004-05 when rapid growth in Queensland and Western Australia increased their financial capacities and reduced their relative revenues from the goods and services tax (GST). Conversely, slower growth in New South Wales has seen its capacity fall and its relative GST receipts rise.
- 7 This document records the story of the Commission and, through it, aspects of Commonwealth-State financial relations in the last 25 years. It builds on previous publications which tell the story of the Commission's earlier years¹.
- 8 In addition to its main task of providing advice on Commonwealth assistance to the States, the Commission has had a number of smaller tasks relating to the financing of local government, funding for Cocos (Keeling) Islands, Christmas Island, Norfolk Island and the Jervis Bay Territory and the relative needs of Indigenous Australians in different regions. Information on those tasks is in Attachment C.

¹ Commonwealth Grants Commission, *Equality in Diversity, History of the Commonwealth Grants Commission, Second Edition*, AGPS, Canberra, 1995.

EQUALISATION IN AUSTRALIA

- 9 Like many countries, Australia is composed of jurisdictions with widely different fiscal capacities. Figure 1 shows that if all States and Territories had adopted the same revenue and service provision policies in 2006-07, per capita own-source revenue would have ranged from \$1847 (Tasmania) to \$3852 (Western Australia) and per capita expenses from \$5227 (Victoria) to \$14 535 (Northern Territory).

Figure 1 Revenues and expenses under the same policies: 2006-07



Source: Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2008 Update*.

- 10 Without external intervention, this is an unsustainable situation. State Budget outcomes would diverge, forcing States with weaker financial positions to reduce services and/or raise additional revenue. Experience elsewhere suggests that, in response, people either relocate or exert political pressure for some equalisation of services.
- 11 If the States are to be able to provide the same range of services to their residents with the same revenue policies, a mechanism is required to adjust their fiscal capacities. That could happen between the States, with the stronger ones transferring revenue to the weaker ones. Germany has such a system. But in Australia and many other federations, the system involves transfers from the Commonwealth Government to the States designed to recognise and adjust their disparate capacities. These transfers are designed to achieve horizontal fiscal equalisation.
- 12 The Commission's role is to advise Commonwealth Government on how transfers should be structured to achieve horizontal equalisation. The equalisation objective has been the basis of the Commission's work since its First Report in 1934. It transformed the policy aim of providing weaker States with sufficient revenue to make them fiscally comparable to other States into a workable analytical definition. That definition has survived with modification to form part of the framework for current Commonwealth-State financial relations. 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.

13 Or, more simply:

If States levied comparable taxes, then with their Commonwealth funds they would have the same capacity to provide comparable services.

14 This definition indicates that equalisation in Australia aims to equalise the financial capacities of the States to provide services. It does so comprehensively. It recognises interstate differences in the capacities to raise revenue and the costs of providing comparable services and examines all revenues and expenses included in State operating budgets and all the major underlying influences that affect them.

15 Horizontal equalisation is a feature of the financial arrangements in many federal countries, including Canada, Ethiopia, Germany, India, Malaysia, Russia, Spain and Switzerland. The Canadian Constitution commits governments to ensure provincial governments have sufficient revenues to provide reasonably comparable services at reasonably comparable levels of taxation. The German Basic Law also provides for a system to ensure a reasonable equalisation of the disparate financial capacities of the Lander and for supplementary equalisation grants from the federal government to the financially weaker Lander. However, equalisation is not confined to federations. It is also a feature of other countries where the national government delegates powers to regional (or local) governments, such as China, Indonesia, Japan, South Africa and South Korea.

16 Unlike some of these countries equalisation is not mandated in the Australian Constitution, nor is it set in legislation, rather it has evolved to be a key part of Commonwealth-State financial arrangements. The Inter-Governmental Agreements signed by the Commonwealth, States and Territories in 1999 and 2008 state that equalisation is to be the basis of distributing the GST revenue among the States.

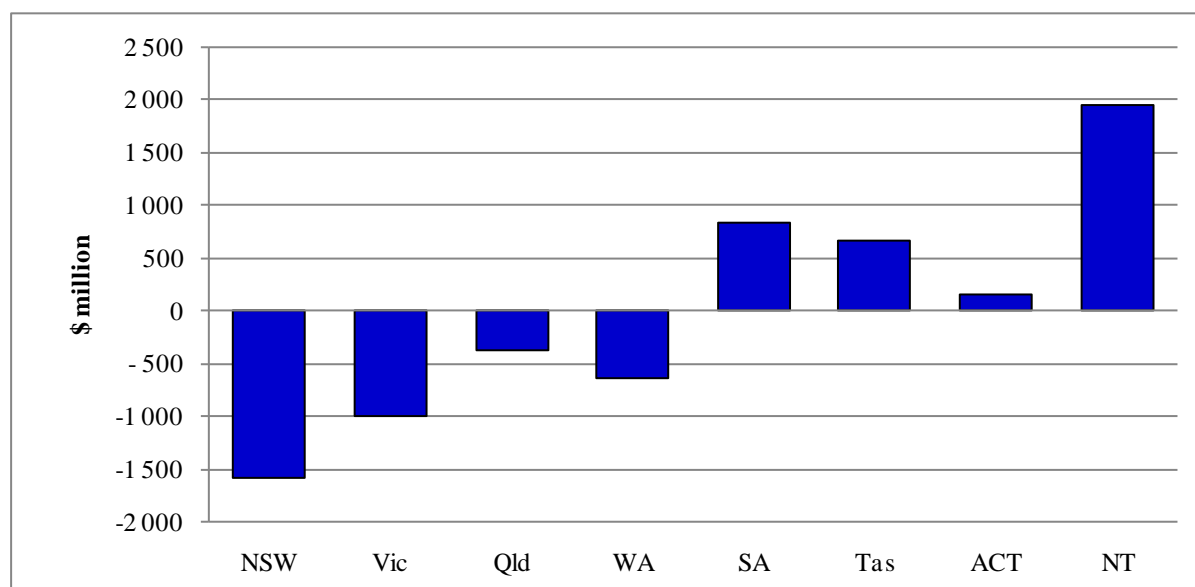
The size of the task

17 Equalising the fiscal capacity of the States in 2008-09 required \$6.2 billion or 11.2 per cent of the total general purpose funds transferred to the States. The remainder was distributed among the States according to their population shares, raising their fiscal capacity equally.

18 The baseline for comparing the distribution of funds is the State population shares: if the States had the same fiscal capacities, each would receive its population share of the available funds. Against that baseline, Figure 2 shows how equalisation has been achieved: the relatively strong States receive less than their population share, while the relatively weak ones receive more.

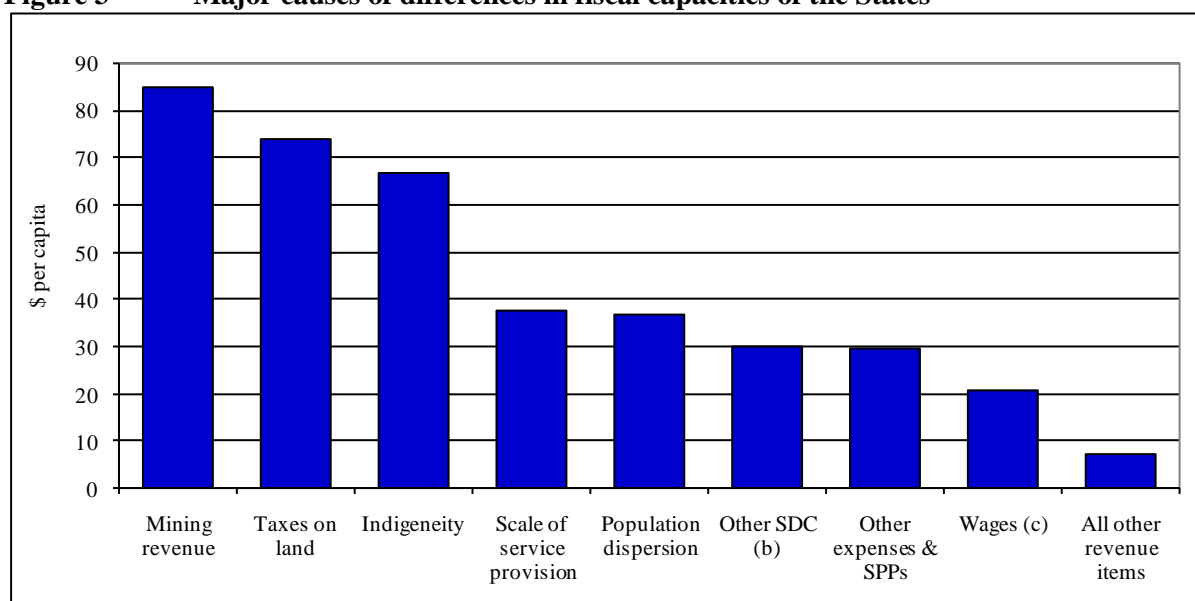
19 The differences in financial capacity were mainly driven by differences between the States in their capacity to raise revenue from mining and land and the costs of providing services to Indigenous residents and small communities widely dispersed in areas remote from major cities. Figure 3 shows the relative importance of those and other major influences.

Figure 2 Difference between equalisation and population based distribution of GST for 2007-08



Source: Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2008 Update*.

Figure 3 Major causes of differences in fiscal capacities of the States



- (a) The redistributions shown cannot be added because redistributions can be positive or negative for a particular State and may offset one another.
- (b) 'Other SDC' is socio-demographic drivers such as age, income and English fluency.
- (c) Wages is the combined impact of the ability to raise revenue from wages and disabilities associated with the level of wages States may need to pay their employees.

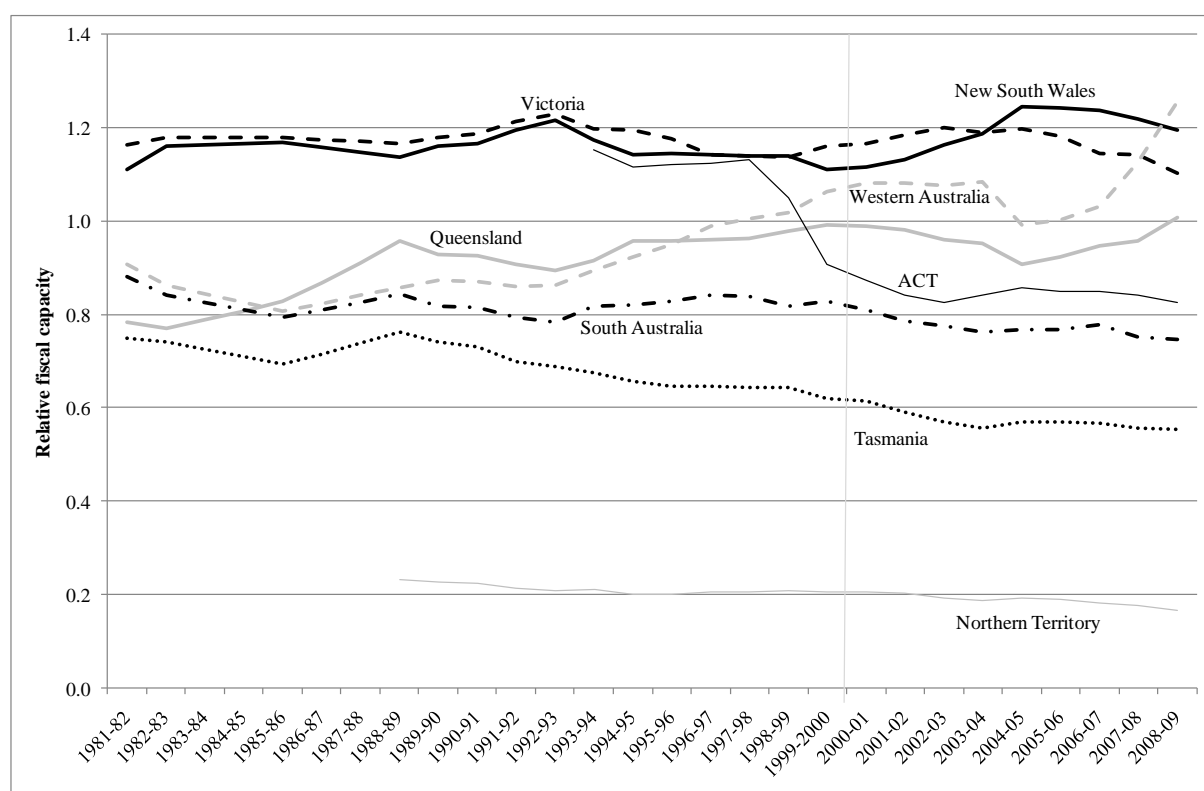
Source: Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2008 Update*.

Changing fortunes

- 20 At the time of the 1981 Report, the first time equalisation was applied to all States, Tasmania had the lowest fiscal capacity, followed by Queensland, South Australia, Western Australia and then the States with the stronger capacities — New South Wales and Victoria.

- 21 That picture had changed by the time of the 1993 Report which included the two Territories in the assessment. At that time, the Northern Territory had by far the weakest position, followed by Tasmania, South Australia, Western Australia, Queensland, the ACT, Victoria and New South Wales. New South Wales, Victoria and the ACT received less than their population share of the assistance because their fiscal capacities were above average. The others had below average capacities and received more than their population share.
- 22 Figure 4 shows that since 1993-94 the fiscal capacities of Queensland and Western Australia have increased to rival those of New South Wales and Victoria — Western Australia passed them in 2008-09. Much of the change has happened since 2004-05.

Figure 4 Assessed capacities, 1981-82 to 2008-09



Note: The vertical line between 1999-2000 and 2000-01 designates the introduction of the GST.

Source: Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2008 Update*.

- 23 The equalisation process has adapted to this change, with transfers to Queensland and Western Australia falling in relative terms to match the growth in their financial capacities. In the past New South Wales and Victoria helped meet the fiscal needs of other States, but now the task is shared between the four largest States.
- 24 The changes in the fiscal capacities of Western Australia and Queensland are driven by their stronger economic performance over the period. For example, over the past fifteen years, gross domestic product (GDP) per capita has increased by some 40 per cent nationally. But, in Queensland the increase was closer to 50 per cent and in Western Australia it was over 60 per cent. The strong mineral sectors in those States contributed to that story, as did their strong population growth and buoyant real estate markets.

- 25 It might be premature to see this change in relative fortunes as permanent, but even with some move back to the historical relative positions, two observations remain:
- the experiences of Queensland and Western Australia show that a system of equalising transfers by itself does not prevent, or necessarily discourage, States from improving their relative economic and fiscal capacities; and
 - the equalisation process does respond, albeit with a lag, to the changing relative fortunes of the States.

INFLUENCES ON THE COMMISSION

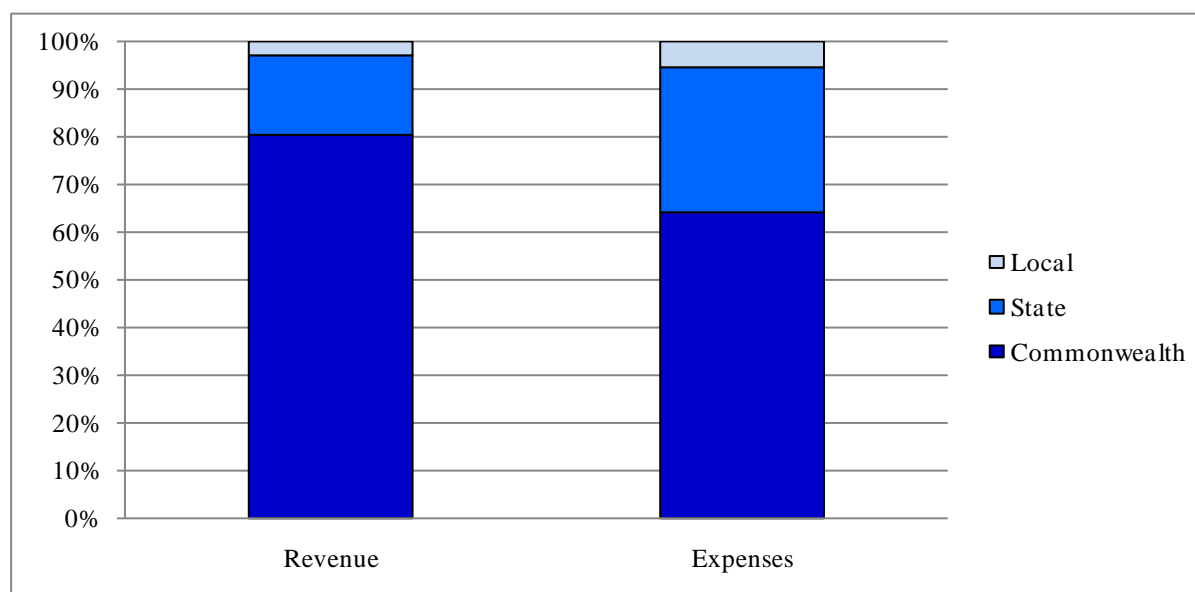
- 26 Since the Commission's 1981 Report on State tax sharing entitlements, its story has been shaped by three strands of activity:
- the evolution of Commonwealth-State financial arrangements, which set the context for the Commission's work and determined the size of transfers to the States;
 - the policy debate on the appropriate definition of equalisation, which defined the objective and scope of the Commission's work; and
 - the evolution of the Commission's methods, which reflected changes in the nature of State government activities and the analytical capacity available to the Commission.

EVOLUTION OF COMMONWEALTH-STATE FINANCIAL ARRANGEMENTS

Australian Commonwealth-State finances: the broader context

- 27 ***Revenue raising is concentrated in the Commonwealth.*** The Commission's task focuses solely on equalising the fiscal capacities of the States. However, transfers from the Commonwealth to the States also address another issue: the larger fiscal capacity of the Commonwealth relative to the States. This imbalance (often called a vertical imbalance) is illustrated in Figure 5. In 2006-07, the Commonwealth collected 81 per cent of total public sector revenue and was responsible for 61 per cent of outlays, while the States collected 17 per cent of revenues and incurred 33 per cent of the outlays.

Figure 5 Vertical imbalance between revenues and expenses: 2006-07



Source: ABS, *Government Finance Statistics Australia, 2006-07*, Catalogue No 5512.0 and ABS, *Taxation Revenue, Australia, 2006-07*, Catalogue No. 5506.0.

- 28 Consequently, the States are heavily reliant on the Commonwealth for funds. In 2006-07, almost 55 per cent of their revenue was received via the Commonwealth — 32 per cent was the GST and other untied revenue and 23 per cent was specific purpose payments (SPPs).
- 29 The substantial imbalance in the revenue raising powers and expenditure responsibilities of the Commonwealth and State governments is a major and long running feature of Australian federal arrangements.
- 30 At Federation, the Constitution gave the Commonwealth exclusive power to impose customs and excise duties, the largest taxes at the time. Its revenue raising powers were further strengthened through deliberate policy actions and High Court interpretations of the Constitution. For example:
- the 1942 Uniform Taxation Act enabled the Commonwealth to take control of income and company taxes to help finance the war effort in return for the payment of tax reimbursement grants to the States. The Commonwealth then acted to retain sole power to impose these taxes by making the tax reimbursement grants conditional on the States not imposing income taxes, a move that was possible because the Constitution gives Commonwealth laws precedence in areas of concurrent powers. The High Court upheld the Commonwealth's power to place conditions on reimbursement grants;
 - a number of other High Court decisions constrained the ability of the States to impose taxes. For example, it made rulings which gave a broad interpretation to customs and excise duties (thereby preventing the States imposing taxes on goods and casting doubt on the validity of the business franchise taxes they were imposing on alcohol, tobacco and petroleum) and it invalidated a receipts duty imposed by Victoria;
 - competition among the States led to a reduction in their ability to raise some revenues, for example, the abolition of death duties in the 1970s; and
 - the introduction of the GST in 2000 which involved the concurrent abolition of some State taxes and the phasing out of others.
- 31 These developments have produced a clear delineation between the taxes imposed by the Commonwealth and the States. The Commonwealth alone imposes all the major taxes while the States impose a number of narrower taxes on land ownership, various transactions (especially transfers of land and other assets), gambling and payrolls. They also impose royalties on minerals extracted in their jurisdiction, but royalties on offshore resources are collected by the Commonwealth. Unlike many federal countries, there are no major instances where the Commonwealth and the States impose the same taxes or 'piggyback' on each other's taxes.
- 32 The revenue raising imbalance between the Commonwealth and the States can be closed in many ways and Australia has used several of them as financial relations evolved. The Commonwealth has: passed taxes to the States (payroll tax was transferred to the States in 1971-72); assumed financial responsibility for some services (it took financial responsibility for tertiary education in 1974); given the States a share of the revenue from one or more of its tax bases (income tax revenue was shared with the States between 1976-77 and 1981-82 and States

were given the ability to impose State specific income tax surcharges); provided general revenue (funds the States can spend in accordance with their own priorities); and given the States the revenue collected from a complete tax base (revenue from the GST flows to the States). It has also provided SPPs to help fund specific State responsibilities.

- 33 *Processes for determining general revenue transfers to the States have changed.* The methods for determining the total amount of general revenue transfers to the States have varied significantly since the mid-1970s.
- From 1976-77 to 1984-85, the general revenue assistance was determined as a percentage of Commonwealth tax collections — initially, it was a percentage of personal income tax collections but became a percentage of total Commonwealth tax collections in 1983-84.
 - From 1985-86, the tax sharing entitlements were replaced by financial assistance grants with the total pool of grants determined by escalating the previous year's total in various ways — from 1991-92 to 1993-94, the previous year's total was maintained in real terms and from 1994-95 to 1999-2000 it was maintained in real per capita terms.
 - A major change in financial relations occurred in 2000. Some Commonwealth and State taxes were abolished or reduced and a new GST introduced by the Commonwealth. The financial assistance grants ceased and the net proceeds of the GST were distributed among the States.
- 34 While the way the size of the pool is determined has changed, that has not reduced the capacity to achieve horizontal fiscal equality. However, the introduction of the GST and the agreement that the revenue collected from it would be passed to the States has changed the environment in which the Commission works — since the total amount available for distribution is now determined by the GST collections, States have placed greater focus on how it is allocated.

THE DEBATE ON THE EQUALISATION OBJECTIVE

- 35 There is episodic debate about equalisation in Australia. While the frequency of debate has increased, it occupies a smaller political space than in some other countries. For example, in Canada equalisation is an explicit program in the Canadian Government's budget and its scope and methods are determined largely by political processes rather than independent analysis. Equalisation in Germany is also affected by ongoing political processes.
- 36 Differences of view on the desirability of equalisation have been a recurring theme of Commission engagement with the States over the last 25 years. While some State positions have changed, or moderated, there is still no unanimity. Those views are recorded in State Submissions and other documents, including the report of a Review of Commonwealth-State Funding sponsored by New South Wales, Victoria and Western Australia².

² See Review of Commonwealth-State Funding, *Final Report, A review of the allocation of Commonwealth Grants to the States and Territories*, August 2002 (also known as the Garnaut and Fitzgerald report).

- 37 Major aspects of the Australian debate revolve around whether equalisation is a desirable objective and the potential trade-off between equalisation and efficiency and lead to calls for partial equalisation of fiscal capacities.

Is equalisation desirable?

- 38 Many rationales have been advanced in the literature for adopting or continuing equalisation.
- 39 Many federations, including Australia, are unions of unequals brought together to achieve objectives that cannot be achieved in isolation or whose achievement is more manageable together. Common joint purposes include defence and the establishment of internal common markets. Many federations then deal with the residual disparity among their members and with any disproportionate costs imposed on members by the act of federation. Essentially, they trade off the benefits of federation with compensation required to gain the support of potential members. Many federations also recognise that persistent and severe differences between the members act as a corrosive on the fabric of federation itself. As a result, they have explicit or implicit transfers designed to reduce or eliminate differences between members.
- 40 Other things being equal, divergent fiscal capacities in a federation will trigger adjustment processes. The literature indicates people would move to States with stronger fiscal capacities to enjoy better government services or lower taxes. However, if people move to States where their productivity is lower, or they impose extra costs on existing residents, the federation will suffer a net loss. That loss may be avoided if instead of people moving, fiscal capacity is transferred thereby reducing the incentive to move. While conceptually valid, the strength of the case depends on the relative importance of State government services and taxes and private benefits (such as wage levels and house prices) in determining where people choose to live.
- 41 Another rationale for equalisation stems from the objective of treating all residents in a federation equally, at least in relation to public services and their funding, and a view that their membership of the federation construes benefits beyond that of their residency in any single State. That equal treatment extends beyond the activities of the federal government to equalising the capacity of State governments to provide comparable services with comparable taxes. It avoids the existence of second class States providing second class services.
- 42 Equalisation also has its critics. Perhaps their central concern is that equalising the capacities of the States leads to a misallocation of resources between and within States and blunts the incentives for economic development and improved efficiency in State service provision. Equalisation is also often criticised for failing to achieve outcomes beyond its policy objectives.
- 43 *Equalisation and economic efficiency.* As with other redistributive systems, equalisation raises concerns about its effects on efficiency, which arise because it drives a wedge between the benefits of State services and their prices. However, those effects depend on the exact form of the equalisation process and the possible magnitude of the adverse economic consequences. Measuring the effects, therefore, requires several judgments and the results are sensitive to them. Academic commentators have estimated equalisation may increase or reduce national welfare in Australia depending on the specific assumptions about how people and States react to

changes in the revenue they receive from the Commonwealth. To the extent that States adjust by better aligning the level of services they provide with the preferences of their citizens, national welfare is likely to increase. But if States faced with reduced revenue from the Commonwealth try to maintain service levels by increasing their own taxes, national welfare is likely to fall. Most studies indicate the effects are likely to be small.

- 44 ***Equalisation and development.*** A particular interest is the impact equalisation might have on incentives for economic development. Equalisation as practised in Australia effectively shares the potential revenue from State tax bases between all the States (and shares the cost of delivering comparable services). Consequently, policies that lead to a stronger tax base in one State do not translate dollar for dollar into higher revenue in that State. This reduces the marginal revenue gain from those policies and theoretically might reduce the incidence of those policies. However, many States argue this is not the case in practice in Australia. They remain keen to exploit opportunities for growth because State Governments are not corporations driven by a profit motive. They seek to improve conditions for residents and a strong and growing economic base is seen as an important element in that approach.
- 45 In some other countries, however, concerns about disincentives for development have been instrumental in revisions to their equalisation processes. For example, in Canada they influenced the decisions to include only half the revenue from natural resources in the determination of provincial financial capacities and to make agreements with two provinces to quarantine revenue from offshore mining activity from equalisation. In Germany, increasing the incentives for Lander to increase efficiency and promote growth was part of the rationale for reducing the level of equalisation sought.
- 46 ***Equalisation and service delivery efficiency.*** There are also concerns that equalisation dampens incentives to improve efficiency. Conceptually that might be true but, given the way equalisation is implemented, there is little practical scope for it. If transfers to a State depended on its own efficiency, inefficiency would be rewarded and efficiency penalised. However, in Australia, equalisation transfers depend on average efficiency. States with above average efficiency reap a dividend while those with below average efficiency bear the fiscal burden.
- 47 Getting the balance right between the potential benefits of equalisation and its possible adverse impacts on the economy is a decision for the Commonwealth and State governments. The Commission has put this issue before Government several times. (For example, the Commission's 2004 Report suggested governments conduct a review of equalisation, including its underlying objectives, and its 1988, 1990 and 1993 Reports suggested governments consider reviewing the relationships between equalisation and efficiency.) However, there has been no change in the objective of equalising State fiscal capacities. It remains an issue for future consideration in Commonwealth-State financial arrangements.
- 48 ***What equalisation does not do.*** Some critics of equalisation are concerned that it does not:
- overcome the disadvantages faced by groups within the community, such as the aged or Indigenous people, or result in the same services being available in urban and rural areas;

- result in the average level of services or taxes in all States; and
 - ensure States spend the funds received in accordance with the Commission's assessments.
- 49 Each of those objectives would take equalisation beyond its current aim of equalising the capacity of States to provide services. Achieving them implies constraints on how the States spend the funds. Such constraints would be inconsistent with the general revenue nature of the funds. The IGA that accompanied the introduction of the GST and the one agreed in November 2008 make it clear the GST revenue is untied in the hands of the States and may be spent in accordance with their priorities.
- 50 Policy neutrality is a fundamental feature of equalisation in Australia, meaning:
- the standards to which States are equalised reflect the collective policies of the States — if those policies leave some unmet needs within State communities or result in different services in urban and rural areas, equalisation will not bridge the gaps; and
 - equalisation processes should not provide the States with incentives to vary their policies.
- 51 In any case, the Commission's detailed calculations are only a means to an end — a mechanism for deriving and explaining the relative financial capacities of the States. They do, however, provide information people may use to evaluate State policies and lobby States to vary them.

Partial equalisation

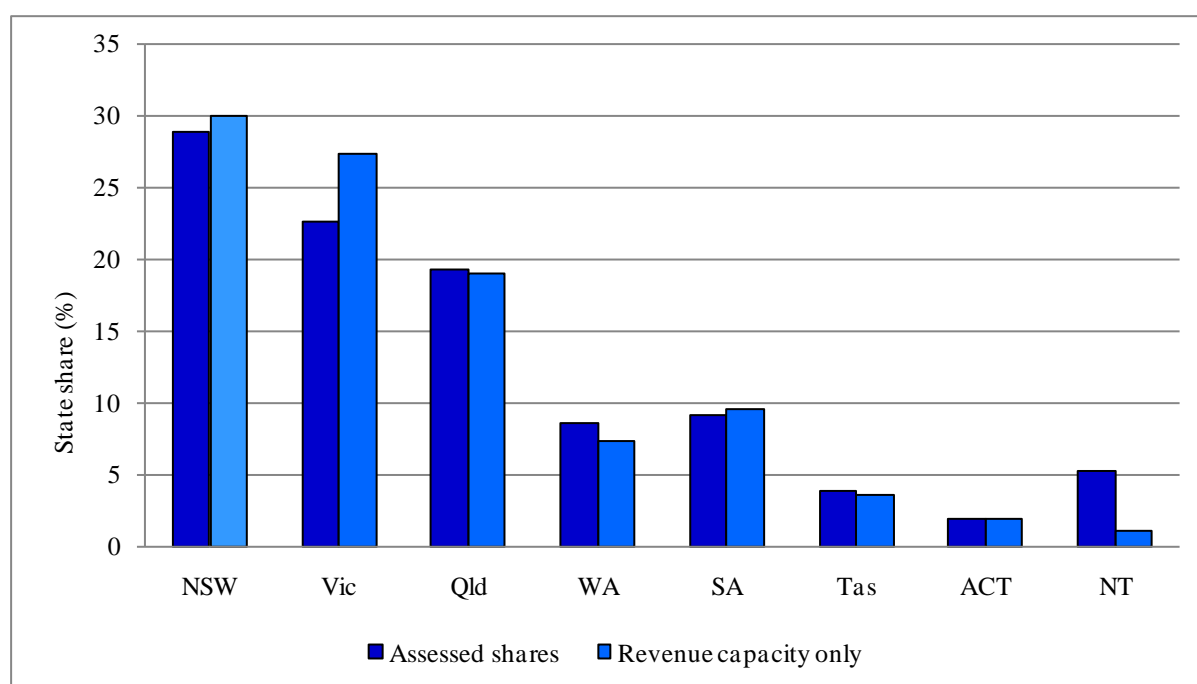
- 52 Some critics of equalisation advocate reducing the degree of equalisation. For example, they may seek a strengthening of incentives for States to foster economic development by reducing the transfer of consequent improvements to State tax bases. Some point to the parallel with welfare reform, where partial equalisation is the norm. Some, usually from States with stronger fiscal capacities, may seek to limit transfers only to weaker States.
- 53 Partial equalisation could occur in several ways. The simplest would be to specify a target level of equalisation. For example, instead of the current aim of equalising all States to the average financial capacity, weaker States might have their fiscal capacity raised to say 80 per cent of the average. However, since the choice of the equalisation percentage requires judgment it would be a matter for governments.
- 54 Other countries have different definitions and aims for equalisation and, unlike Australia, many do not aim to fully equalise the capacity to deliver services.
- Canada's equalisation program uses federal funds to raise the revenue capacities of the weaker provinces. The Canadian equalisation process does not address differences in the costs of services because they are considered to be less important than the differences in revenue capacity and there are fears that it would make the program more complex and lead to indirect federal intrusion into provincial responsibilities. Moreover, it excludes half the revenue from natural resources from the calculation of revenue capacities and does not directly adjust the capacities of the stronger provinces. In 2008-09, provincial per capita revenue capacities ranged from 62 to 177 per cent before equalisation and from 89 to 167 per cent of the average after equalisation.

- The German processes, with their combination of a differential distribution of the revenue from the value added tax, equalisation payments from the richer to the poorer Lander and supplementary equalising grants from the federal government to the poorer Lander aim for less than full equalisation of revenue raising capacities. Data for 2007 indicate these processes raised the per capita revenue capacity of the poorest Lander from 43 to 95 per cent of the average and reduced that of the richest from 168 to 135 per cent of the average. The German equalisation processes do not allow for regional differences in the costs of services other than some small allowances for the costs of providing services to residents of other Lander and the effects of low population density on costs. Further supplementary federal grants are paid to some Lander for some special needs.
- The United States do not have explicit equalisation processes, but some equalising effects are achieved by distributing specific purpose payments on a differential basis.

55 Within the debate in Australia, several issues have been raised at different times which affect the scope or basis of equalisation.

56 **Revenue only equalisation.** At times, a revenue only approach, has been suggested on the grounds that it would be simpler and capture the largest interstate differences. Such an approach would have big effects on State revenues. As an example, Figure 6 compares the State shares of the 2008-09 pool with those that would be assessed if only interstate differences in the capacity to raise revenue were assessed. In that case, Victoria would receive extra funds because its relatively low costs of providing services would not be taken into account. Conversely, Western Australia and the Northern Territory would receive much less because their high costs would be omitted.

Figure 6 Comparison of assessed and revenue only relative capacities, 2008-09



Source: Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2008 Update*.

- 57 **Core services.** Others have suggested confining the expense comparisons to the major services provided by all States (education, health and law and order). That too could have substantial effects on State shares. However, since the States are able to determine how they spend their untied funds, it is not clear how the Commission would determine what those core services are.
- 58 **Omitting the effects of location.** Some advocates of partial equalisation have been concerned that equalisation should not act to blunt price signals to users of State services and encourage them to live in high cost areas. To reduce this effect they proposed the effects of location on service costs be excluded from the measures of State fiscal capacity.
- 59 Such a change would imply States with people living in high cost areas would: provide fewer services to those areas; seek cost recovery from those residents to offset the above average costs; raise general taxes; or bear the additional debt servicing costs on their budget. However, efficiency gains would arise only if States reduced services in high cost areas, or charged residents in those areas the additional costs of service provision. If the higher costs were met through a cross-subsidy arrangement, the efficiency gains would not occur.
- 60 **The impact of Indigenous residents.** The higher costs of providing many services to Indigenous Australians are one of the main determinants of differences between States in their fiscal capacities. These factors redistributed about \$1.4 billion relative to an equal per capita distribution in the Commission's 2008 Report.
- 61 Within the debate on equalisation, some have said the differential costs of servicing Indigenous people would be better addressed outside the equalisation framework, for example through Commonwealth specific purpose payments to the States.
- 62 How funds should be provided to meet the cost of providing 'appropriate' services to Indigenous people, or any other group of people (such as recent humanitarian migrants), is an issue beyond the reach of equalisation. However, if States are to have the same capacity to deliver services, any differences in costs not captured by other funding streams should be included with the equalisation framework.
- 63 **A State of origin approach.** Since the introduction of the GST, some parties have supported a system of returning revenue to the States where it was generated. Similar suggestions were also raised when States received a fixed share of income tax collections. However, this was not an issue in the intervening period when the pool was not tied to any tax base. This is a common issue in federations where constituent States seek to receive revenue in line with the revenue raised by the federal government in their States. It is also sometimes raised by regions within States to demonstrate the inequity of State revenue and expenditure policies.
- 64 Those who advocate a complete return of revenue to its State of origin are really advocating no equalisation, a position which runs counter to the revealed political compromise underpinning the Federation over the last century. It is also a situation that does not exist in many other federations — countries where revenue base sharing is a feature of the intergovernmental arrangements (such as Canada and Germany) generally also have equalisation processes.

CHANGES IN THE COMMISSION'S METHODS

- 65 Within its area of operations, the Commission has continued its original mandate of providing impartial advice based on the best available data. Its work has been done in close consultation with the States, but its recommendations are not determined by them. The Commission weighs State proposals according to the available evidence.
- 66 A central tenet of the Commission's approach is to base the coverage of its assessments on what the general government sector of States as a whole does in raising revenue and delivering services. That has changed significantly since 1981. Part of the change reflects changing State revenue and expenditure priorities; but that is automatically reflected in the Commission's comparisons when it includes the most recent data on State revenues and expenses.
- 67 In the period covered by this narrative, six main themes encompass the evolution of the Commission's methods.
- 68 *The two Territories were included in the equalisation processes.* The Northern Territory has been included in the distribution of general revenue assistance in the same way as the States since 1988-89 and the ACT since 1993-94. Both bring some unique characteristics.
- The ACT's revenue raising capacity is substantially reduced because it, like other States, cannot raise payroll taxes from the Commonwealth which is the single largest employer in the Territory. It also faces some unique costs by virtue of its role as the national capital. Further, being surrounded by New South Wales, it provides substantial services to residents of New South Wales which the New South Wales Government does not fund.
 - The Northern Territory has by far the highest concentration of Indigenous people in its population (31.6 per cent of the population was Indigenous in 2006). That together with its small, highly dispersed population and challenging geography, means it faces very high costs of service delivery. In 2008-09, one third of the amount redistributed under equalisation was distributed to the Northern Territory.
- The inclusion of the Northern Territory in the equalisation processes led to increased recognition of the extra costs of servicing Indigenous people. The assessed impact of Indigenous people on State financial capacities has grown since then because the proportion of Indigenous people in the Australian population has grown (Indigenous people were 1.54 per cent of the population in 1986 and 2.5 per cent in 2006), more information became available on the levels of Indigenous disadvantage and more resources were directed at Indigenous issues.
- 69 *The way States discharge their responsibilities has evolved.* This evolution has changed the range of functions covered by the equalisation processes and the sources of interstate differences in measured financial capacity.
- 70 The first review of State financial capacities in 1981 covered the activities most States included in their recurrent budgets, which included activities of some business-like services such as suburban transport, irrigation services and country water supply (because they were often run by

State departments or made regular calls on State budgets). To ensure a comprehensive coverage, it also included 'State-type' services provided by the Commonwealth or local government. However, it excluded activities such as roads, housing and capital because they were subject to separate Commonwealth-State arrangements or were usually accounted for in government trust funds or similar funds outside State recurrent budgets.

71 Since then, the comparisons have been affected by structural changes made by the States in their operations and in the way they accounted for and provided services.

- The States made many changes aimed at providing services on a more business-like basis (such as creating government business enterprises and privatising some activities) and implemented the National Competition Policy and other reforms. These changes led the Commission to refine its approaches in the 1993 and 1999 reports. It omitted the detailed activities of business undertakings and recognised only their net impact on State budgets. It also changed the focus of its comparisons for their services (especially urban transit and water services) away from factors that affected the costs and revenues of the undertakings towards those which drove the size of State subsidies for them. It also began allowing for factors that caused interstate differences in subsidies for electricity services but eliminated them for services (such as freight transport) where it considered differences in expenses reflected differences in State policies rather than underlying disabilities.

In the 2004 report, the Commission concluded equalising the capacities of the States to provide services meant its comparisons should include only those services and revenues that have a direct impact on State general government operating accounts. It excluded the activities of State trading and financial enterprises and State-type services funded by Commonwealth payments to local government and non-government service providers which had no direct impact on State operating accounts.

- During the late 1980s, States moved to consolidate their budgets by reducing the use of trust and similar funds. Among other things, this resulted in road maintenance expenses, motor tax revenue and the net expenses of housing operations having direct effects on State budgets. So, in the 1993 Report, the Commission decided to include those activities and associated Commonwealth specific purpose payments in its assessments.

The combined effect of interstate differences in the cost of providing the average level of road services, the capacity to raise motor taxes and receipts of roads-related specific purpose payments has a substantial effect on State shares of the GST revenue. These assessments redistributed about \$380 million relative to an equal per capita distribution in 2007-08 — they redistributed funds to New South Wales, Western Australia and the Northern Territory and away from Victoria, Queensland and South Australia.

- The States have progressively reviewed and adapted service delivery through the increased use of technology. The effects of these developments on State budgets were examined extensively in the 1999 and 2004 Reports. The Commission found the use of technology had increased, had improved services (especially in the more populated areas) and had affected State costs — reducing costs in some areas and increasing them in

others. Those effects were reflected in the methods used to measure the allowances for diseconomies of small scale and the effects of location.

Box 1 Issues in comparing road maintenance costs

Road maintenance expenses were first included in the 1993 Report. At that time, allowances were made for interstate differences in road length and road use. Allowances for the higher costs incurred in large urban areas and the combined effects of topography, rainfall and temperature were introduced in the 1999 Report.

States generally agree on the factors that affect road costs, but the assessment has been bedevilled by difficulties in obtaining accurate, comparable data on the length of State highways and other State roads and their use. While obtaining data on the length of roads may not seem a difficult task, available data are prepared by each State for its own purposes and are not comparable across States. For example, the data often cover all roads (whereas the Commission is only interested in those for which States are responsible) and are affected by different State policies on how responsibility is shared with local government and where roads are built. Dividing road lengths into those in urban, rural and remote areas has also been problematic.

The Commission has attempted to overcome these problems by conducting a mapping exercise to measure a commonly defined group of roads in each State and by using alternative indicators of the size of the road maintenance task in urban areas.

Other issues have concerned the inclusion of depreciation expenses and how changes in the Commonwealth programmes for assisting State transport activities affect State fiscal capacities.

- 72 *State financial policies have changed.* The most important of these changes were: the movement in the 1990s to fund capital acquisitions from the recurrent budget; the increased use of leasing as a way of acquiring assets; and the introduction of accrual accounting to better reflect the full costs of State services. Those changes blurred the distinction between capital and recurrent transactions. They, together with changes to Loan Council processes which increased the reliance on market processes to regulate State government borrowing, resulted in a major change in the scope of equalisation in the 1999 Review — the inclusion of depreciation expenses, which have been almost 4 per cent of State expenses since 1998-99.
- 73 The resulting depreciation assessments aimed to allow all States to fund the annual depreciation on the capital stock required to provide the average level of services, after allowing for factors that affect the costs of the assets and their average lives. While the conceptual basis of the assessments has been broadly accepted by the States, the implementation has been subject to intense debate and research. In the 1999 Review, capital related transactions (depreciation and net interest expenses) had a large effect on the distribution of funds among the States. Compared with an equal per capita distribution, they redistributed over \$520 million (about 31 per cent of the total amount redistributed). However, their effects have declined to about \$200 million in 2007-08 because interest is now a smaller impost on State budgets (on average, States have had net interest revenues since 2003-04) and methods of comparison now use better data and recognise the effects of recent population growth on asset requirements and costs.
- 74 *Data availability has increased.* The measurement of State financial capacities is data intensive. It requires accurate and comparable data on State revenues and expenses, State populations, revenue bases, the users of State services and their effects on the costs of services. Changes in data availability have affected the way the Commission and the States have approached the equalisation task and the range of factors measured.

- 75 In the 1981 review, the limited availability of comparable data constrained the range of factors taken into account and led to the extensive use of judgment. Since then, the Commission has tried to reduce the use of judgment and base the assessments more firmly on data by emphasising the need for the States to back their claims for allowances with evidence and data, and by instituting extensive data collections.
- 76 During the 1982 and subsequent reviews, it undertook major surveys to collect information from each State on service delivery policies and resources and activity at each school, health facility and police station. Some of those collections, especially those in the health field, were taken over and expanded by other agencies, such as the Australian Institute of Health and Welfare (AIHW). It also sought information prepared by other agencies (such as the ABS, the Productivity Commission and the AIHW) and encouraged them to improve the regional aspect of their collections. Improvements in administrative data sets, as part of government-wide trends towards more data driven decision making and the reporting requirements attached to SPPs to the States, also increased data availability.
- 77 The availability of more and better information, plus the inherent zero sum nature of equalisation, encouraged all parties to seek more precision in the assessments. It also encouraged the States to identify more areas where disabilities may exist. In many cases, these trends helped improve the comprehensiveness and accuracy of the comparisons. Increased availability of data allowed the Commission to better allow for the factors that drive interstate differences in the use and cost of hospital services, the largest area of State expenses in 2006-07.
- 78 However, better data also increased the complexity and detail of the comparisons. In the 2004 Report, the Commission questioned whether the increased detail was producing a better result.
- 79 Subsequently, the 2004 meeting of the Ministerial Council for Commonwealth-State Financial Relations asked Heads of Treasuries to examine the equalisation methods to see if equalisation could be achieved more simply and reliably. They concluded the methods were generally robust but a program of simplification would be beneficial.
- 80 The Commission is examining the issues as part of the 2010 Review. Progress so far suggests there may be fewer and broader categories of revenue and services and fewer disabilities.
- 81 *There has been vigorous debate about the issues.* The Commission's work is characterised by full and open debate of issues, which typically occurs in several stages and involves a range of participants, including the Commission, its staff, the States and Commonwealth agencies.
- 82 The issues considered during an inquiry may stem from the terms of reference, State submissions and Commission initiatives. The processes generally begin with extensive internal research that is assisted by considerable input from the States, including information gathered during Commission discussions with State officials responsible for delivering services and collecting revenue. That research is often supplemented by expert external advice. The research findings are subject to extensive and vigorous debate within the Commission and its preliminary conclusions are published in discussion papers and progress reports (such as the 1990 and 1991 reports on issues in equalisation and the 1994, 1995 and 1996 reports on

research in progress). Final decisions on each issue are made and implemented within the Commission's assessments after it gives further consideration to Commonwealth and State responses to the issues raised in those publications.

- 83 In almost all cases, logic and available data (often supplemented by judgment) enabled the Commission to reach decisions on a unanimous or consensus basis. However, a few decisions have been taken on a majority basis and on two occasions members registered minority views.
- 84 The processes serve to maintain the rigor and objectivity of equalisation by ensuring all views on issues are examined and evaluated and that decisions are soundly based in logic and well supported by data or experience.
- 85 The debates have covered a range of conceptual issues relating to the principles and aims of equalisation. For example, debate has considered whether equalisation should place greater weight on the services provided and taxes imposed by State governments (often called State budget equalisation) or State-type services provided by State governments and other providers and the overall contributions by State communities to them (often called State community equalisation). The Commission and most parties agreed the Commission's terms of reference made it clear that its focus was on the revenues and expenses of State governments not those of the wider State communities. That is, the task was to equalise State budget capacities, implying the Commission should not:
- make allowances for differences between States in the extent to which services are provided by State governments but it should consider the underlying factors that affect the demand for or cost of State government services, with all those influences measured using Australia wide data on service use and cost levels; and
 - assess revenue raising capacities using a global measure of revenue bases but should focus on the revenue bases actually taxed by the States.
- 86 However, most debate has covered technical issues relating to the revenues and expenses to be examined, the factors that affect them and how those factors are best measured. Boxes 2, 3 and 4 outline aspects of the debates on allowances for interstate differences in wage levels, population dispersion and mining revenue.

Treatment of SPPs

- 87 SPPs currently provide about 20 per cent of State revenue and those that fund services for which the Commission assesses needs (about 98 per cent of all SPPs by value) are included in its comparisons. To do otherwise, would omit aspects of State services from the comparisons and may not give all States the financial capacity to deliver the average level of services³.

³ This approach adjusts each State's general revenue assistance when the interstate distribution of the SPP differs from the Commission's assessment of the relative cost of providing the service. If a State's SPP receipts exceed the Commission's assessments of the cost of providing the service, its general revenue assistance is reduced. Conversely, its general revenue assistance is increased if its SPP receipts are below the Commission's assessed costs.

Box 2 Issues in the assessments of interstate differences in wage levels

Arguments in support of allowances for higher wage levels were first made by New South Wales in the 1981 Review. The Commission declined to make the allowances because it considered they were heavily influenced by State policies and neutral measures could not be found.

However, in the 1993 Review, it was convinced there were unavoidable wage differences between the States and that it could make reliable measures of them using ABS data on private sector wage levels and judgment.

This allowance and its measurement have been debated extensively in every review since 1993. States that opposed it in the 1993 Review continued to do because they considered:

- the private sector was an unsuitable benchmark because it was not sufficiently free of State policy influence and many private sector occupations were largely irrelevant to the public sector; and
- the available data were not sufficiently reliable, especially for the smaller States.

Research during the 1999 and 2004 Reviews, some of which was done or refereed by external experts, found economic theory strongly supported the existence of regional variations in wages for similar employees.

Quantitative analysis confirmed their existence. The exact positions have varied over time, but the analysis has consistently shown underlying private sector wage levels were: above average in New South Wales, the ACT and the Northern Territory; below average in Queensland, South Australia and Tasmania; and close to average in Victoria and Western Australia. Analysis for the public sector produced broadly similar results.

The interstate wage differentials have a large and growing effect on the distribution of funds. In 1992-93, they redistributed about \$150 million of the funds compared with an equal per capita distribution. However, the redistribution grew to about \$880 million in 2007-08, partly due to the increasing spread in relative wages — wage differentials ranged between 2 per cent above and 1.5 per cent below average in the 1993 Review but were 3 per cent above and 4.1 per cent below average in 2006-07.

Not unexpectedly, the States continue to hold diverse views and the methods are being reviewed again.

Box 3 Issues in allowing for interstate differences in where people live

Interstate differences in where people live affect State expenses in many ways. Differences in population dispersion, urbanisation, the number of small communities and distance from major national centres can all be relevant. Whether these effects should be assessed and, if so, how it is best done has been debated in every review, with specific issues including.

- *The implications of assessing location factors for economic efficiency.*
- *What costs are affected by population location?* The case that population dispersion affects communication, freight, travel and some staff costs is generally accepted. Debate centred on whether it affected repairs and maintenance (the case was accepted in the 2004 Review) and staff costs through unproductive travel time (the case has not been accepted). The case that urbanisation affects costs has been harder to prove. Apart from areas like road maintenance and police, it has been hard to show that urbanisation imposes costs over and above the demand effects included in other allowances.
- *How large are the costs affected by location?* Obtaining data on the freight, travel, communication and other costs affected by location required special surveys because the data was not easily extracted from State financial systems and many of the costs are embedded in other payments.
- *How do costs vary with distance or remoteness?* Dispersion has very different effects on different costs and many issues are involved in measuring them. The methods have evolved from simple relationships between distance and costs to more sophisticated measures that take account of distance, population, time and the actual charges made by transport, freight and telecommunications providers.
- *How do changes in the way States provide services affect costs?* The regular updating of data captures many of these effects and the effects of the increasing use of technology were extensively researched in the 1999 and 2004 Reviews.

Box 4 Issues in assessing capacity to raise mining revenue

Differences in capacities to raise mining revenue are currently the largest cause of differences in State fiscal capacities. How they are best measured has been debated in most reviews, with the issues including:

- *The extent to which mining revenue should be disaggregated.* Minerals are unevenly distributed across States and some minerals are taxed more heavily than others. For example, oil is taxed more heavily than coal which is taxed more heavily than metals. Accurately measuring revenue capacities, therefore, requires some disaggregation. The level of disaggregation has varied over time to reflect changes in State policies and other aspects of the methods.
- *Differences in the way States collected revenue.* In previous years, New South Wales and Queensland raised some revenue from coal miners through profits on rail haulage rather than royalties. Achieving a policy neutral comparison required above normal profits to be treated as royalties, a task that had conceptual and practical measurement issues and required expert independent advice.
- *How the revenue base is measured.* Up to 2004, profitability was used even though most States levied royalties on the value of production because: States considered profitability in setting their royalties; it allowed for interstate differences in mineral types and quality and production costs; and it avoided some data problems. But, there were questions about how it should be estimated (for example, should exploration and capital costs be included) and there were growing data difficulties.

In the 2004 Review, value of production was used because it better reflected how the States imposed royalties and data difficulties meant the estimates of profitability had become unreliable. It was also simpler, even though disaggregation was needed to reflect the higher royalties levied on oil and coal.
- *Data reliability.* Data are often not comparable across States. For example, different approaches are used to value mineral production, which necessitated independent advice during the 2004 Review.

- 88 The Commission has been criticised in the past for its approach to SPPs. Critics said the Commission's approach overrode agreements between Commonwealth and State Ministers and complicated negotiations leading to those agreements. It is true that the Commission's processes may affect the total resources available to individual States (general revenue is distributed in a way that offsets part of the interstate differences in the distribution of the funds provided by SPPs). However, they do not change the conditions of the SPPs or prevent their objectives being achieved.
- 89 The terms of reference received by the Commission provide an open and transparent means by which SPPs may, in special circumstances, be excluded from its equalisation assessments. The references for the 1985 and subsequent reviews instructed the Commission to ensure nominated SPPs did not affect the relativities. Initially, those directions related to health care grants but, in the 2004 Review, 14 payments were to be quarantined. While the number of payments subject to quarantining has increased, they are only a small proportion of payments to the States — less than 2 per cent of SPPs by value in 2006-07.
- 90 This quarantining approach greatly reduced the intensity of debate about the treatment of SPPs. The reforms of Commonwealth-State financial arrangements agreed at the November 2008 meeting of the Council of Australian Governments (COAG) should further reduce it.
- 91 Under the November 2008 reforms, most SPPs will be broad banded into five national SPPs (one for each of healthcare, schools, skills and workforce development, disabilities services and affordable housing). The agreements covering each new payment will contain objectives,

outcomes, outputs and performance indicators to help clarify the roles of each level of government and provide the States with flexibility in determining how the objectives will be achieved. The interstate distribution of these national SPPs will progressively move to an equal per capita basis over five years, commencing in 2009-10. The IGA says they are to be included in the Commission's comparisons.

- 92 A new group of payments, called national partnership payments, will be introduced to fund specific projects, to facilitate action by States on nationally significant reforms and reward States which deliver on the reform process. The IGA states National Partnership project payments are to be included in the Commission's comparisons and the National Partnership facilitation and reward payments are to be excluded. However, the IGA also gives the Commission discretion, following consultation with the Commonwealth and the States, to treat any National Partnership payment or general revenue assistance differently if it considers that treatment is more appropriate. It also states the Treasurer may direct the Commission on the treatment of individual National Partnership payments, if he considers that appropriate.

Realism and simplification

- 93 The Commission's methods have evolved over the last 25 to 30 years to reflect changing State practices and data availability. They have also evolved in response to proposals to better capture the inherent differences between the States — that is, to be more realistic.
- 94 These attempts to better capture the innate complexity of State activities have also increased the complexity of the methods — a development which has attracted considerable criticism. Much of that complexity stems from the assessments of the relative costs of providing services.
- 95 The Commission has attempted to simplify its methods and the presentation of them in each of the 1993, 1999 and 2004 Reviews. The 1993 Review managed to reduce the number of separate services and revenues subject to comparison but the 1999 Review's attempts to improve the transparency of the comparisons increased the level of detail.
- 96 The Commission said improving the understanding and simplicity of equalisation were priorities for the 2004 Review. Understanding was advanced through the development of what were called 'equalisation pillars' to explain the essence of equalisation and a set of assessment guidelines to clarify the decision making framework (shown in Box 5).
- 97 The Commission also proposed approaches to simplify the comparisons and reduce the detail. While all States provided in principle support for simplification, it proved hard to achieve because they also thought equalisation should be based on what States collectively do and that it should be fair. Many States were also concerned about the possible implications for their grant shares. They rejected the Commission's proposals and most argued for more complex and detailed comparisons, if they benefited them.
- 98 The Commission's 2004 Report concluded that simplification should be a priority going forward. The examination of equalisation methods done by Heads of Treasuries during 2004 also concluded a program which included aggregating assessments, addressing issues relating to

data quality, eliminating assessments found unreliable and reviewing the scope for the use of more general indicators of needs would be beneficial.

99 Those concerns and conclusions have been reflected in the terms of reference for the current 2010 Review, which require the Commission to:

- simplify its methods, provided that it is consistent with the equalisation principle; and
- report progress to the 2006 and 2007 Ministerial Council meetings.

Box 5 2004 Review: equalisation pillars and assessment guidelines

The equalisation principle reflects three pillars of equalisation.

- The financial capacities of States, not their performance or outcomes, are equalised.
- States are equalised to standards that reflect what they all do on average.
- A State's own policies or choices should not directly influence its grant.

The Commission will make an assessment when:

- a conceptual basis for the existence of the disability is established — for example, it has been established that States experience different use and cost imposts when they apply the standard policy; and
- either:
 - there is empirical evidence that differences exist between States in the levels of use and/or unit costs in providing services or in their capacities to raise revenues; or
 - there is incomplete evidence that the identified influence is causing a difference between States, but the 'in-principle' case is strong, and it judges that sufficient evidence exists and that including the assessment improves the equalisation outcome; and
- the assessment is material; and
- the margin of error associated with the assessment is acceptably small.

If the application of the guidelines leads to a decision that an assessment should be made, it will undertake a reality check of the results.

SUMMARY

100 Overall, changes in the way States discharge their responsibilities, in the circumstances they face and the availability of data have had the most impact on the evolution of equalisation in Australia. The significant and continuing changes in Commonwealth-State financial arrangements have set the context in which the Commission has worked but have had limited direct effect on its methods. The broad ranging debate about equalisation has had little impact on the Commission's objective because, with the major exception of the requirement in the current reference to pursue simplification, it has not greatly affected what the Government directs the Commission to do.

STATE OF PLAY

- 101 This history is written as the Commission moves to the second half of a review of methodology due to be finished in early 2010.
- 102 There are strong expectations surrounding this review. The terms of reference make it clear that the Commission should simplify its methods and some States seek significant changes in that direction — they seek equalisation with less concern for some of the historical differences between the States. Other States, with no less passion, are concerned that all important differences between the States are recognised and that the quality of the equalisation outcome is not compromised.
- 103 The simplification agenda is not unique to this review. However, reflecting the terms of reference and the Commission's conclusions in the 2004 Review, it has greater acceptance among all participants in the review.
- 104 The 2006 and 2007 Progress Reports state the Commission is approaching the 2010 Review with the clear objective of seeking equalisation through simpler, more transparent and more reliable assessments. The 2006 Progress Report said it would do that by following a 'clean slate and top down' approach and adopting a revised set of assessment guidelines, which stress the need for reliable data to support any assessment and for that assessment to make a material difference before it is accepted as part of the final method.
- 105 In adopting this approach, the Commission aims to steer a path between extremes. It has rejected calls for:
- simplification for its own sake — some favour that approach, not because it leads to simpler, easier to understand assessments, but because their real aim is to neuter the process of recognising real and substantive differences in the fiscal capacities of the States; and
 - the 2010 method not to change the interstate distribution of the pool — some favour that approach because they seek to protect their current position, regardless of the quality of the data that support it.

The way forward

- 106 To clarify its aim, the Commission, in an information paper circulated to the Commonwealth and the States in May 2007, has proposed modifying its definition of equalisation to:
- State governments should receive funding such that, after allowing for material factors affecting expenses and revenues, 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 fiscal capacity to provide services at the same standard.
- 107 This proposed definition indicates the Commission's aim is to provide all States with the same fiscal capacity through a comprehensive analysis of expenses and revenue. However, reflecting

the emphasis in the terms of reference, it also signals the intention to assess only those factors that have a material effect on relative fiscal capacities.

108 The Commission also proposed replacing the 2004 Review equalisation pillars with new assessment principles and guidelines. The proposed principles indicate equalisation should:

- *reflect what States collectively do.* This means the standards to which States are equalised are based on the range and level of services provided, and the range and severity of taxes applied, by all States. The standards do not reflect the actions needed to overcome unmet needs or the costs States would incur if they provided services with optimal efficiency;
- *be policy neutral.* This means the assessments are based on the premise that each State adopts the average policies in raising taxes and delivering services and so a State's share of the funds is not directly influenced by its own policies;
- *be practical.* This means the assessments must concentrate on the major issues, be based on sound data and methods and be simple and well constructed; and
- *deliver relativities most appropriate to the application year.* This means that, as far as possible, equalisation should reflect State circumstances in the year the funds are used.

109 The proposed assessment guidelines indicate the Commission will:

- follow a 'top down' approach under which it will consider a State service or revenue for separate assessment only if it is a major service or source of revenue that is distinct from others, affected by disabilities that are markedly different from those affecting other services or revenues, satisfactory assessments can be made and have a material effect on the GST required by at least one State — if these conditions are not met the service or revenue would be assessed with other broadly similar ones; and
- include a disability in the assessments if there is a presumptive case that it affects State expenses or revenues, a conceptually rigorous method of measuring it can be derived, the data available to measure it are fit for the purpose and of suitable quality, and its effect on the GST required by at least one State is material — it exceeds \$10 per capita.

110 The Commission is currently undertaking the consultative and research phases of the review, prior to circulating a draft report in mid-2009 outlining its intentions relating to the conceptual equalisation principles and how it will measure the relative financial capacities of the States. Its final report for the review is to be completed in February 2010.

CONCLUSION

- 111 In 1933, the founders of the Commission established a mechanism to deal with the policy problems of their day. It has served that purpose, with both commendation and criticism, since that time.
- 112 The next 25 years will be different. Today, some 87 per cent of the population reside in States with strong fiscal capacities. Whether that weakens overall support for equalisation, or because the task is spread over a larger part of the population blunts criticism of its costs, is impossible to foresee. However as long as there are weaker States in the Federation there will be two questions to answer:
- should innate differences be nullified or modified to give all Australians the capacity to have similar levels of State services, and if so
 - how should advice on the size of fiscal transfers among the States be provided?

SUPPLEMENTARY INFORMATION

CHAPTER 1

INTRODUCTION

- 1 The Commonwealth Grants Commission was born 75 years ago in 1933 and given the job of providing advice on Commonwealth grants to the States. Up to 1981, the advice related to applications by the financially weaker States (initially Western Australia, South Australia and Tasmania and later Queensland) for what were known as special grants. Those grants supplemented other financial assistance provided by the Commonwealth. They were intended to allow the recipients to function at a standard not appreciably below that of other States.
- 2 The passage of the *States (Personal Income Tax Sharing) Amendment Act 1978* and the *Commonwealth Grants Commission Amendment Act 1978* broadened its role to advising on the allocation among all States of the share of Commonwealth taxation revenue made available to them. Its role has remained broadly unchanged since then. The introduction of the Goods and Services Tax (the GST) in July 2000 changed the basis of determining the amount of funds distributed among the States, the amount of them and the context in which the Commission works, but it did not change the Commission's fundamental task — advising on the allocation of a given amount of funds among the States.
- 3 This book follows on from the First and Second editions of *Equality in Diversity* which commemorated the Commission's 50th and 60th anniversaries.
- 4 It begins with an overview of the Commission's history and the evolution of the equalisation principle that underlies its work. Chapter 3 outlines the approach the Commission currently follows in fulfilling its main task of advising on how the revenue from the GST should be allocated among the States and Territories¹. Chapter 4 discusses the major issues addressed by the Commission since 1981. Chapter 5 provides some observations on recent trends in State finances. Chapter 6 compares Australian Commonwealth-State arrangements with those in other selected countries.

¹ In the rest of this paper, the terms State or States include the Australian Capital Territory and the Northern Territory unless the context suggests otherwise.

CHAPTER 2

A BRIEF HISTORY OF THE COMMISSION

INTRODUCTION

- 1 One decision faced by federations and countries with decentralised government, is how the responsibility for providing services and revenue raising powers should be allocated among their various governments.
- 2 In general, they aim to allocate powers to the governments which are best placed to discharge them. However, achieving that aim and also balancing the expenditure responsibilities and revenue powers of each level of government is difficult. Maintaining the balance in the face of changing social, economic and technological circumstances is even more difficult.
- 3 Countries seek to achieve these vertical balances in one or more ways, including reviewing and reallocating powers, sharing the proceeds of some taxes, and transfers between governments.
- 4 In addition, differences in the circumstances of regions within countries bring differences in the financial capacities of the sub-national governments. Many countries try to reduce these horizontal imbalances in the belief that it will strengthen their union and improve equity and economic efficiency. They often do so through equalising transfers, which generally take the form of differential grants from the national to the sub-national government. In some countries (such as Germany) there are transfers among the sub-national governments.
- 5 Both types of imbalances exist in Australia and intergovernmental arrangements have been developed to overcome them.

The allocation of powers among governments in Australia

- 6 Australia was formed in 1901 by a voluntary coming together of the previous six British colonies. Part of the process was to develop a Constitution which, among other things, specifies the powers of the Commonwealth. Unlike some other countries, such as Canada, the Constitution does not list the powers of the States. It was intended that all residual (unspecified) powers would remain with the States.

- 7 Powers explicitly allocated to the Commonwealth include defence and international affairs, interstate and international trade and commerce, banking, immigration, family law and social security payments to individuals. State powers include the delivery of services, such as education, health, public law and order and intrastate transport. The Commonwealth and the States have concurrent powers in some areas but Commonwealth laws are paramount if there are conflicts.
- 8 The Constitution gives the Commonwealth exclusive rights to impose customs and excise duties, the largest taxes at the time of federation, and the ability to impose other taxes. The framers of the Constitution anticipated this would give the Commonwealth more funds than it required to discharge its responsibilities. So, they included clauses which: required it to pass three quarters of the revenue from customs and excise duties to the States for the first ten years of federation (section 87); required it to pass surplus revenue to the States during the first five years of uniform duties (section 94); and allowed it to give financial assistance on terms the Parliament thinks fit (section 96).
- 9 The expectations of the drafters of the Constitution have proven correct. Substantial imbalances have developed between the revenue raising powers of the Commonwealth and the States. These stemmed from actions by the Commonwealth to ensure it had no surplus revenue, action to take and retain control of personal and corporate income taxes, and broad interpretations of Commonwealth powers by the High Court, which prevented the States returning to the income tax field and broadening their range of taxes.
- 10 Currently, all the major broad-based taxes (personal and corporate income tax and sales and excise duties, including the GST) are imposed under Commonwealth legislation — but the total proceeds of the GST are passed to the States. The States have been left with a narrow range of taxes on land, certain transactions (such as the transfer of ownership of land and other assets), gambling and payrolls. They also impose royalties on minerals extracted in their jurisdiction, but royalties on offshore resources accrue to the Commonwealth.
- 11 The growth in the financial strength of the Commonwealth is illustrated in Table 2-1, which shows the proportion of revenue collected under the laws of each level of government, the proportion of revenue transferred to the States and the final proportion of revenue in the hands of the States for selected years. Revenues were highly centralised at the end of the Second World War. The extent of centralisation fell somewhat after that. However, it rose following a 1997 High Court decision, which cast doubt on the legality of State business franchise fees, and the July 2000 introduction of the GST and subsequent abolition of some State taxes.
- 12 The remaining funds necessary for the States to discharge their responsibilities come from Commonwealth transfers, which take two main forms:
 - transfers of general revenue funds which the States may use as they see fit; and
 - specific purpose payments (SPPs) where the Commonwealth seeks to achieve national aims in areas of State responsibility or provides funds for particular purposes.

- 13 There have also been adjustments in the responsibilities of the Commonwealth and the States. For example, payroll taxes were transferred to the States in 1971-72 and the Commonwealth took full responsibility for funding universities in 1974.

Table 2-1 Proportion of revenue collected under Commonwealth and State legislation

	Proportion collected under Commonwealth legislation	Proportion collected under State legislation(a)	Proportion transferred to States(a)	Final proportion in State hands (a)
	%	%	%	%
1901-02	41	59	34	93
1909-10	41	59	27	86
1946-47	85	15	13	28
1981-82	64	36	18	54
2006-07	81	19	21	40

(a) Includes local government.

Source: 1901-02 and 1909-10 from Commonwealth Grants Commission, *Equality in Diversity, Second edition*, AGPS, 1995; 1946-47 from Mathews and Jay, *Federal Finance*, Thomas Nelson Ltd, 1972; 1981-82 and 2006-07 from ABS and Commission calculations.

EQUALISING STATE FINANCIAL CAPACITIES — THE SPECIAL GRANTS

- 14 It quickly became apparent that financial capacities differed substantially among the States. To overcome the financial effects of those differentials, the Commonwealth used section 96 of the Constitution to make special grants to the financially weaker States from 1910.
- 15 Those grants were often contentious because they were determined using various ad hoc processes and varying criteria¹. The dissatisfaction with the grant processes together with the threat by Western Australia to secede from the Federation resulted in the Commonwealth creating the Commonwealth Grants Commission in 1933 and giving it the role of inquiring into applications by the States for special assistance.
- 16 The Commission's first task was to devise consistent principles for the special grants. Its First Report said special grants should enable the claimant States 'with reasonable effort, to put their finances in about as good order as that of the other States' but they were not aimed at equalising incomes or living standards of individuals in the States.
- 17 The principle was refined in the 1936 Report to:
- Special grants are justified when a State through financial stress from any cause is unable to efficiently discharge its functions as a member of the federation and should be determined by the amount of help found necessary to make it possible for that State by reasonable effort to function at a standard not appreciably below that of other States².

¹ In some cases, they were based on the financial effects of federal policies. In others, they were intended to offset the adverse financial circumstances of the States.

² Commonwealth Grants Commission, Third Report, 1936, p75.

- 18 It implemented that principle by comparing the per capita deficits of the claimant and the standard States (generally New South Wales and Victoria). To ensure like was compared with like, the deficits of the claimant States were adjusted to remove the effects of differences between them and the standard States in accounting practices and policies on tax efforts and services provided. Up to 1945, the adjustments also included penalties for claimancy which implied the claimant States should make above standard efforts to raise revenue.
- 19 The Commission provided advice on claims for special grants by one or more of Queensland, Western Australia, South Australia and Tasmania in every year from 1934-35 to 1982-83.
- 20 Initially, the special grants represented a substantial proportion of Commonwealth payments to the States (they averaged 15.3 per cent of annual payments in the seven years 1934-35 to 1941-42). However, rapid increases in the size of other general revenue and specific purpose payments reduced the importance of special grants — over the eleven years 1972-73 to 1982-83, they were only 0.3 per cent of average annual payments to the States.
- 21 Moreover, assessing special grants on an equalisation basis did not mean the financial capacities of all States were equalised. While claimant States were equalised to the average of New South Wales and Victoria, the capacities of those States were not compared and some of the other non-claimant States were over equalised³.

INTRODUCING REVENUE SHARING AND EQUALISATION FOR ALL STATES

- 22 The Commonwealth's 1976 'new federalism policy' made major changes in Commonwealth-State financial arrangements. As part of the policy, the Commonwealth and the States agreed a proportion of personal income tax revenue would be shared among the States in a way that equalised their financial capacities.
- 23 Each State's share was initially based on its share of the previous financial assistance grants. However, the shares were to be reviewed by 1981 and periodically thereafter.
- 24 After some debate, the Commission was given the task of assessing the relative financial capacity of all States. This major expansion of its role marked the beginning of full and comprehensive equalisation in Australia.
- 25 The first review of the financial capacities of all States was completed in 1981. It found the shares of New South Wales, Victoria and Queensland were too small and those of the other States were too large. Those findings would have reduced the grants of Western Australia and Tasmania by about 20 per cent and that of South Australia by about 10 per cent.
- 26 Not surprisingly, the report was supported by New South Wales, Victoria and Queensland but strongly opposed by the others. Given the level of concern and the potential effects on State budgets, the 1981 Premiers' Conference asked the Commission to review its findings.

³ States often ceased applying for special grants because the Commonwealth increased their general revenue grants by more than the special grants.

- 27 Further reviews of the State shares were completed in 1982, 1985 and 1988. The results of the 1982 Review were to be phased in over three years, subject to a guarantee that each State would receive a specified minimum increase in its grant each year. That guarantee prevented most of the adjustments to the recommended relativities. The results of the 1985 and 1988 Reviews were accepted and implemented immediately.
- 28 After the 1988 Review, governments decided the period between reviews could be extended to five or six years — reviews were completed in 1993, 1999, and 2004 and another is to be completed in 2010. To ensure the shares remained up-to-date, the Commission was asked to update them each year in between reviews by introducing the most recent data. The results of each of those reviews and annual updates were accepted and implemented, although on some occasions the total amount of assistance was increased and/or transitional assistance provided by the Commonwealth to States whose shares were reduced.

Evolution of the equalisation principle

- 29 The *States (Personal Income Tax Sharing) Amendment Act 1978* said the Commission's first review of State shares was to be based on equalisation principles, which it defined as:
- (i) ...payments to which the States are entitled ... should enable each State to provide, without imposing taxes and charges at levels appreciably different from the levels of the taxes and charges imposed by other States, government services at standards not appreciably different from the standards of government services provided by the other States;
 - (ii) taking account of:
 - differences in the capacities of the States to raise revenues; and
 - differences in the amounts required to be expended by the States in providing comparable government services.
- 30 Similar definitions of equalisation were in the references for the 1982, 1985, 1988 and 1993 Reviews. However, debate during the 1993 Review suggested a more precise statement of the aim of equalisation might improve the understanding of it. Consequently, the 1999 Review reference said equalisation meant the grants to which States were entitled:
- should enable each State to provide the average standard of State-type public services assuming it does so at an average level of operational efficiency and makes the average effort to raise revenue from its own sources.
- 31 The Commission's 1999 Report rephrased that definition 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.
- 32 It considered its revised description was simpler and emphasised the key aims were to:
- equalise the State financial capacities to provide services, not their performance; and
 - equalise all States to the same standards which, as the reference required, were the average of those applying across the States.
- 33 The Commission's expression of the definition was applied again in the 2004 Review.

- 34 The terms of reference for the current 2010 Review do not define equalisation but they make it clear that simplification should be a focus of the Review, provide it is consistent with equalisation. Reflecting the emphasis on simplification and more aggregated assessments, a Commission information paper circulated to the Commonwealth and the States in May 2007⁴, proposed modifying the definition to:

State governments should receive funding such that, after allowing for material factors affecting expenses and revenues, 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 fiscal capacity to provide services at the same standard.

- 35 This proposal indicates equalisation aims to provide all States with the same fiscal capacity but it also signals the intention to assess only those factors that have a material effect on State revenues and expenses. The final definition to be used in the Review is still to be determined.

Evolution of Commission methods

- 36 At the same time as the expression of the equalisation principle was evolving, so were the methods used to implement it. As described in Chapter 4, the methods have evolved to reflect:
- the implications of changes in the way States fulfilled their responsibilities (such as the increased use of technology in the delivery of services, increased outsourcing of service provision, the corporatisation of some services and other changes arising from the joint Commonwealth-State micro-economic reform agenda of the 1990s);
 - the changes in State financial policies, including an increased use of recurrent funds to finance capital acquisition and the move to accrual accounting;
 - the full range of factors which affected the relative costs of providing State services; and
 - the availability of more and better data.
- 37 Many changes were motivated by a desire to increase the transparency of the comparisons and to ensure each State's grants were not directly affected by its own policies (thereby avoiding incentives for States to adopt grant seeking behaviour).

THE INTRODUCTION OF THE GST AND THE RETURN OF REVENUE SHARING

- 38 The next major event to affect the Commission's work was the July 2000 reform of taxation policies and Commonwealth-State arrangements. Among other things, those reforms introduced the GST, reduced income and wholesale sales taxes and abolished some State taxes. The *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (the IGA) which accompanied the reforms said all revenue from the GST would be shared among the States on the basis of equalisation principles and advice from the Commission. The

⁴ Commission Information Paper 2007/12, *Principles, Interpretation and Scope of Horizontal Fiscal Equalisation*, available on the Commission's web site — <http://www.cgc.gov.au>.

States were also given guarantees that for a transitional period their budgetary position would be no worse than it would have been if the reforms had not taken place.

- 39 These reforms substantially increased the level of funds explicitly distributed on the basis of equalisation because the GST revenue replaced the previous financial assistance grants and the revenue from the abolished State taxes. The total funds distributed on the basis of equalisation increased from \$22.9 billion in 1999-2000 to \$30.2 billion in 2000-01 (a 32 per cent increase).
- 40 The GST has also given the States access to a pool of funds which grows automatically with the level of activity in the national economy and more quickly than the previous financial assistance grants — between 2001-02 and 2007-08, the average annual increase in GST revenue was 7.9 per cent⁵ compared with an average annual increase of 3.9 per cent in financial assistance grants between 1993-94 and 1999-2000⁶.
- 41 The reforms changed the context in which the Commission works. They shifted the emphasis in Commonwealth-State arrangements from the amount of assistance made available to its interstate allocation. This has increased the attention given to the Commission's work and related matters such as the continued appropriateness of equalisation as a basis for distributing the GST revenue, the implications of equalisation for the efficient allocation of resources across the country and the desirability of transparent and simple methods.
- 42 The technical aspects of the Commission's processes have not been greatly affected by the reforms because they are designed to produce State shares of assistance which could be applied to any amount of assistance. The main effects have been adjustments to exclude the abolished taxes. The guarantee provisions also required the Commission to assess a second set of shares which assumed the reforms had not been introduced.
- 43 Further historical details of the Commission's work in Commonwealth-State financial relations are in Attachment A and an overview of processes used by the Commonwealth to determine general revenue assistance to the States is in Attachment B. Attachment C contains details of the Commission's other tasks relating to the financing of local government, funding for Cocos (Keeling) Islands, Christmas Island, Norfolk Island and the Jervis Bay Territory and the relative needs of Indigenous Australians in different regions.

⁵ See *Federal Financial Relations 2007-08*, Commonwealth Budget Paper No.3, p9.

⁶ Calculations done by the Commonwealth as part of the guarantee processes indicate that if financial assistance grants had continued, their average annual increase between 2001-02 and 2007-08 would have been 4.1 per cent.

CHAPTER 3

CURRENT EQUALISATION METHODS

INTRODUCTION

- 1 This chapter outlines the methods the Commission currently applies in allocating GST revenue among the States and the factors which drive differences in State financial capacities.

THE AIM OF EQUALISATION

- 2 Equalisation in Australia aims to achieve a situation where, after distributing the GST, each State could, if it chose, provide the same services, charge the same taxes and achieve the same per capita budget result.
- 3 Since the IGA which accompanied the introduction of the GST states the GST revenue is made available to the States to spend according to their own priorities, the only aim of equalisation is to equalise State financial capacities. Other possible aims such as equalising services provided or the outcomes of State services would be contrary to the IGA because they imply constraints on how States spend the GST revenue. In addition, all States have rejected such approaches because they would erode State autonomy.
- 4 Using equalisation to distribute GST revenues to the States implies it relates to their budgets and their financial capacity to deliver services. It is not directly aimed at interpersonal, community or regional equity, except in so far as comparability in State services and their tax prices is an element of interpersonal and community equity.

GUIDING PRINCIPLES FOR IMPLEMENTING EQUALISATION

- 5 During the 2004 Review, the Commission implemented equalisation with the aid of what it called ‘pillars of equalisation’ and a set of guiding principles (see Box 3-1).

Box 3-1 2004 Review equalisation pillars and assessment guidelines

Equalisation pillars. The equalisation principle reflects three pillars of equalisation:

- The financial capacities of States, not their performance or outcomes, are equalised.
- States are equalised to standards that reflect what they all do on average.
- A State's own policies or choices should not directly influence its grant.

Assessment guidelines. The Commission will make an assessment when:

- a conceptual basis for the existence of the disability is established — for example, it has been established that States experience different use and cost imposts when they apply the standard policy; and
- either:
 - there is empirical evidence that differences exist between States in the levels of use and/or unit costs in providing services or in their capacities to raise revenues; or
 - there is incomplete evidence that the identified influence is causing a difference between States, but the 'in-principle' case is strong, and it judges that sufficient evidence exists and that including the assessment improves the equalisation outcome; and
- the assessment is material; and
- the margin of error associated with the assessment is acceptably small.

If the application of the guidelines leads to a decision that an assessment should be made, the Commission will undertake a reality check of the results.

6 Debate in the current 2010 Review indicated they should be clarified and revised to reflect the emphasis in the terms of reference on simplifying the methods. The revised guidelines it proposed in the May 2007 information paper indicate equalisation should:

- *Reflect what States collectively do.* This means the standards to which States are equalised are an average of the range and level of services provided and taxes imposed by all States. The Commission does not aim to give States the capacity to satisfy unmet needs. Nor, for practical reasons, does it attempt to estimate the costs States would incur if they provided services with optimal efficiency. In short, equalisation is based on what States actually do, not what they could or should do.
- *Be policy neutral.* This means each State's share of the GST reflects what States collectively do, but is not directly influenced by its own policies¹. The assessments are based on the premise that each State adopts the average policies in raising taxes and delivering services.
- *Be practical.* This means the assessments must concentrate on the major issues, be based on sound data and methods and be simple and well constructed.
- *Deliver relativities most appropriate to the application year.* This means that, as far as possible, equalisation should reflect State circumstances in the year the funds are used.

¹ However, there may be indirect effects since each State's policies are reflected in the average policy.

IMPLEMENTING EQUALISATION

- 7 Equalising State fiscal capacities requires funds to be distributed in a way that would give each State the same budget outcome per capita if they:
 - provided the average level of State services to their populations;
 - made the average effort to raise taxes from their revenue bases; and
 - operated at the average level of efficiency.
- 8 To provide a basis of comparison, all assessments are made on a per capita basis. They begin with the presumption that, if all things were equal, a State's share of the funds would be equal to its share of the Australian population — that is, an equal per capita allocation of the funds would allow all States to provide the average level of services. However, things are not equal. Revenue bases differ across States so that making the same revenue effort raises different revenues. Population and other features also differ leading to different amounts of services being required and different costs. If all States are to have the same capacity to provide services, the equal per capita allocation must be adjusted to offset those differences.
- 9 So, each State's assistance is the equal per capita amount adjusted for the higher (or lower):
 - revenue raised by applying the average tax rates — the equal per capita amount is reduced (increased) for States where taxing at the average rate would yield above (below) average revenues (implying their per capita tax bases are larger (smaller) than the average);
 - costs of providing the average service — the equal per capita amount is increased (reduced) for States whose inherent features result in above (below) average per capita expenses being incurred to provide the average service; and
 - SPPs it receives from the Commonwealth.
- 10 The Commission calculates these adjustments by examining each tax and service separately and summing the results. (Further details are in Attachment D.)
- 11 For each tax, it:
 - identifies and measures each State's tax base (the value of transactions in the State that would be taxed if the average tax policy applied);
 - applies the average tax rates to it; and
 - compares the resulting assessed revenue with the average per capita revenue for the tax.
- 12 For each service, it:
 - identifies and measures, for each State and Australia, the factors that affect the quantity of services required (such as the number of school students and the number of Indigenous people) and the cost of services (such as diseconomies of small scale, wage levels and population dispersion);
 - adjusts the average per capita expenses for the effects of those factors to estimate each State's costs of providing the average service; and

- compares the result for each State with the average per capita expenses.
- 13 Most importantly, each State's assistance does not reflect its own policies. It is based on the assumption that all States apply the average policies. So, if a State provides below average services, taxes at above average rates or operates with above average efficiency the resulting budgetary benefits are retained by it. (Similarly, the budgetary costs of higher services, lower taxes or lower efficiency are borne by the State). The interstate differences in per capita assistance are due solely to underlying differences in revenue bases and service costs.
- 14 The average revenues, expenses, tax policies and service provision policies used in the assessments are all population weighted averages of each State's policies or experiences. In this way, the policies of the more populous States receive a greater weight.
- 15 The Commission's calculations are, of necessity, backward looking because:
- they require extensive, reliable data on State revenues and expenses, revenue bases, service use and other cost drivers which can only be obtained on an historical basis; and
 - to minimise the effects of data deficiencies and to smooth the effects of short term events, governments require the assessments to be based on data for the most recently completed five years. Those years precede the year when the recommendations are used by between two and six years. (For example, the 2008 Update recommendations were applied in 2008-09, but were based on data for 2002-03 to 2006-07.)
- 16 In the absence of reliable means of adjusting the historically-based results to better reflect the circumstances of the year when assistance is distributed, the Commission assumes they are the best estimate of the future circumstances². This may mean the relativities do not align well with the circumstances of the year when they are applied, but the ongoing use of rolling averages eventually mitigates the bulk of any effects, albeit with a lag.

WHAT CAUSES DIFFERENCES IN STATE RELATIVE FINANCIAL CAPACITIES?

- 17 Table 3-1 indicates that interstate differences in revenue raising capacity and service costs make large and quite different contributions to relative financial capacities. It shows:
- the distribution of the 2007-08 GST and health care grants pool which offsets the differences in fiscal capacity measured in the 2008 Update;
 - the distribution of the same amount that would be made if the fiscal capacities of the States were equal — an equal per capita distribution; and
 - the contribution of differences in revenue raising capacity, costs of providing services and receipts of SPPs to the change in the distribution.

² As discussed in Chapter 4, an exception is that the Commission adjusts the data for the estimated effects of major changes in Commonwealth-State arrangements.

Table 3-1 Sources of differences in State fiscal capacities: 2007-08

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Update distribution ^(a)	15 201.7	11 689.9	9 813.4	4 513.9	4 633.1	1 827.1	962.2	2 352.8	50 994.2
EPC distribution ^(b)	16 699.7	12 636.5	10 171.9	5 114.5	3 834.9	1 194.6	821.2	520.9	50 994.2
	Change ^(c)								
Difference	-1 498.0	- 946.6	- 358.4	- 600.5	798.3	632.5	141.0	1 831.9	3 403.5
Caused by differences in									
Revenue capacity	- 891.5	1 313.6	- 416.0	-1 559.3	906.7	432.9	138.4	75.3	2 866.9
Costs of services	- 614.3	-2 424.4	40.5	971.8	- 71.7	228.7	- 7.3	1 876.7	3 117.7
SPPs received	8.1	164.8	16.3	- 14.3	- 36.4	- 28.9	10.0	- 119.6	199.2

(a) Applying the 2008 Update relativities to the 2007-08 pool and ABS estimates of December 2007 State populations.

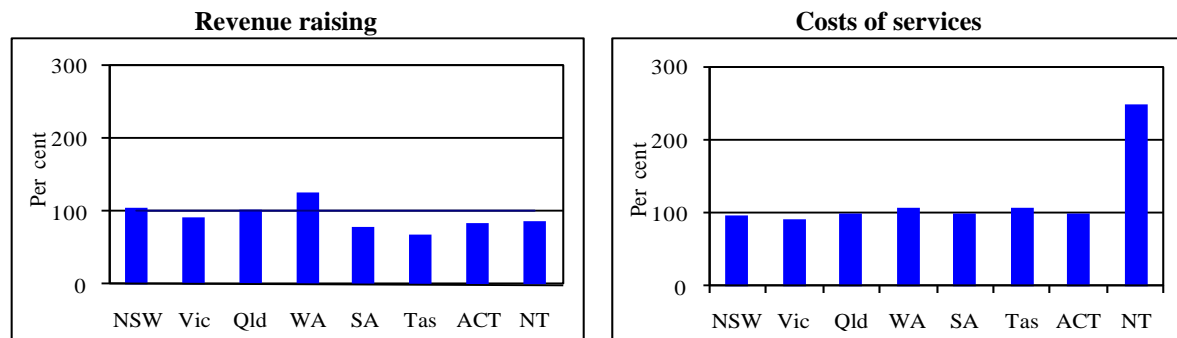
(b) Allocating the 2007-08 pool on an equal per capita basis using ABS estimates of December 2007 State populations.

(c) Total change from equal per capita, calculated as the sum of the positive (or the negative) items in the row.

Source: Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2008 Update*.

- 18 The table shows the total effects of differences in revenue raising capacity and costs of providing services are large, and of similar orders of magnitude, but often move in different directions. Restricting equalisation to compensating for differences in, say, revenue raising capacity would materially change the distribution of the funds. Compared to the equal per capita distribution, the redistribution would be about halved, with New South Wales and Victoria gaining and Western Australia, Tasmania and the Northern Territory losing. The very high costs faced by the Northern Territory and Western Australia in providing services to small, dispersed populations would not be recognised. Nor would the comparatively lower costs of servicing a compact and more densely settled State like Victoria.
- 19 Figure 3-1 shows the State's average relative revenue raising capacities and costs of providing services for 2002-03 to 2006-07. Differences in revenue raising capacity range from 68 to 127 per cent of average while costs of service range from 92 to 108 per cent of average, excluding the Northern Territory's 250 per cent. Differences in revenue capacity have a smaller effect on the distribution since State taxes fund less than 50 per cent of their expenses.

Figure 3-1 Relative revenue raising capacities and costs of providing services, average 2002-03 to 2006-07



Source: Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2008 Update*.

What drives relative revenue raising capacities?

20 Table 3-2 shows the main causes of interstate differences in revenue raising capacities over the years 2002-03 to 2006-07 were:

- mining revenues — mineral resources are unevenly distributed and, in per capita terms, concentrated in Western Australia, Queensland and the Northern Territory;
- taxes on ownership and transfers of real estate — land values and real estate market activity differ markedly with the highest values or levels of activity occurring in New South Wales, Western Australia and Queensland; and
- payroll taxes — the large businesses which pay this tax³ are concentrated in New South Wales, Victoria and Western Australia.

Table 3-2 Major revenue contributors to redistribution from equal per capita: 2002-03 to 2006-07

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total ^(a)
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Mining revenue	666.3	863.7	-511.7	-1 243.7	146.6	65.3	58.7	-45.2	1 800.5
Taxes on ownership and transfers of real estate	-958.2	714.7	-394.5	-209.9	544.3	216.3	21.4	66.0	1 562.6
Payroll tax	-617.5	-193.0	444.7	-26.0	187.6	116.8	49.7	37.7	836.5
Other taxes	17.9	-71.8	45.5	-79.7	28.2	34.5	9.0	16.8	151.7
Total	- 891.5	1 313.6	- 416.0	-1 559.3	906.7	432.9	138.4	75.3	2 866.9

(a) Total change from equal per capita, calculated as the sum of the positive (or the negative) items in the row.
Source: Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2008 Update*.

What drives relative costs of providing services?

21 Table 3-3 shows the main causes of interstate differences in the costs of providing services between 2002-03 and 2006-07 were:

- differences in the proportion of Indigenous people in State populations — Indigenous people use many services more intensively than non-Indigenous people and each service provided to them often costs more. The substantial differences in the proportion of State populations who are Indigenous (ranging from under one per cent in Victoria to almost 32 per cent in the Northern Territory) mean the implications of this effect are high;
- differences in wage levels — wages paid to comparable employees varied from about 4 per cent below the average in Tasmania to 3 per cent above the average in New South Wales. These variations have big effects on the costs of providing State services because they affect over 70 per cent of State expenses;
- diseconomies of small scale — the less populous States have fewer people to spread fixed costs over and there are large differences among the States in the size of their

³ The States have a common policy of exempting small businesses from payroll tax.

population (varying from 6 855 000 in New South Wales to 213 000 in the Northern Territory);

- population dispersion — costs of providing services in remote areas are generally higher and there were noticeable differences among States in the proportion of their populations living in remote areas (varying from 39 per cent in the Northern Territory to 7 per cent in Western Australia and 0.1 per cent in Victoria);
- other population characteristics — differences in age distribution and the proportion of people with low incomes affect the use of many State services while characteristics such as low English fluency increase the costs of services; and
- geographical factors — differences in features such as State size affect the length of roads States must provide and climatic features affect asset lives and maintenance costs.

Table 3-3 Contribution to redistribution of main causes of differences in expenses, average 2002-03 to 2006-07

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total ^(a)
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Indigenous influences ^(b)	394.9	- 852.2	291.9	251.0	- 121.3	6.3	- 39.6	858.7	1 407.9
Wage levels ^(c)	805.3	- 66.7	- 470.2	- 128.7	- 141.1	- 76.1	32.6	44.9	882.8
Diseconomies of small scale	-424.0	-254.7	-117.9	60.6	94.7	175.7	166.9	298.8	796.6
Population dispersion ^(d)	303.7	- 373.0	157.4	213.4	- 15.4	- 44.6	- 38.5	404.3	775.1
Other population influences ^(e)	107.5	- 397.9	252.8	- 23.4	125.3	148.4	- 105.4	107.6	634.2
Physical environment ^(f)	- 94.1	- 429.7	18.6	299.5	37.5	14.3	- 15.5	169.4	539.3
Other influences on expenses	-95.4	-50.2	-92.1	299.4	-51.4	4.7	-7.8	-7.0	303.9
Total	614.3	-2 424.4	40.5	971.8	- 71.7	228.7	- 7.3	1 876.7	3 117.7 ^(g)

(a) Total change from equal per capita, calculated as the sum of the positive (or the negative) items in the row.

(b) Includes the effects of the use of services by Indigenous people and higher costs of servicing them, including the effects of land rights and native title legislation.

(c) Effects of interstate differences in wage levels.

(d) Effects on costs of population dispersion.

(e) Includes the effects of interstate differences in the age profile of the population, cultural and linguistic diversity of the population, income distribution and the use of services by residents of other States.

(f) Includes the effects of climate, natural hazards, water availability, and area and topography as reflected road length.

(g) Total is sum of the row. It is not equal to the sum of the column because some disabilities may offset others.

Source: Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2008 Update*.

CHAPTER 4

RECENT ISSUES IN EQUALISATION

INTRODUCTION

- 1 The States agreed equalisation principles would be used to distribute funds among them as part of the 1976 tax sharing arrangements and again in the IGA that accompanied the introduction of the GST in 2000. Nevertheless, there has been episodic debate on whether equalisation is the most appropriate basis for distributing funds and on how it is best achieved.
- 2 This chapter discusses the major issues raised in the debate. It considers:
 - the relationship between equalisation and efficiency;
 - the relationship between equalisation and simplification and reliability;
 - the relationship between equalisation and contemporaneity; and
 - some technical and practical issues in the implementation of equalisation:
 - the revenues and expenses examined;
 - the treatment of capital transactions;
 - the influences on revenues and expenses measured;
 - the treatment of expenses on economic development;
 - the treatment of specific purpose payments;
 - global revenue assessments; and
 - measuring revenue raising capacity for mining revenue.

EQUALISATION AND EFFICIENCY

- 3 Equalisation in Australia, like that in other federal countries, reflects a recognition that differences in State services and taxes may produce inefficient interstate migration and

interstate disparities in wealth may adversely affect national cohesion¹. However, there are also concerns that equalisation may harm other national objectives, such as economic efficiency and productivity. In a context where such concerns were raised by New South Wales and Victoria, the reference for the 1988 Review asked the Commission to consider whether equalisation had implications for the efficient allocation of resources across Australia. Its 1988 Report concluded that equalisation did affect the allocation of resources but the effects were not serious enough to warrant changes in the way equalisation was implemented.

- 4 Another reference, received in September 1989, asked similar questions. The Commission again concluded that any equalisation system would have implications for efficiency, but a study done for it suggested the effects would be small. It also said it was unlikely that any approach other than equalising the budgetary capacity of the States would better promote equity among individuals in terms of their access to State services and in paying for them.
- 5 The issue was raised again during the 2004 Review and was a major theme in the 2002 Report of the Review of Commonwealth-State Funding done for New South Wales, Victoria and Western Australia². The Commission's 2004 Review Report noted the States had different views on the appropriateness of equalisation as a basis for distributing revenue. While most of the issues were not new and were to be expected, the vigour with which they were put suggested some States had strengthened their view that equalisation needed to be revisited.
- 6 The Commission also said that since State circumstances and approaches to delivering services were constantly changing there would be benefits in reviewing equalisation and its objectives from time to time. It did not do so because it considered it was a matter for governments to initiate a review of the financial architecture of the federation, if they judged it desirable.
- 7 In the context of these debates, efficiency encompasses concepts of allocative or economic efficiency (meaning resources are allocated to regions and tasks up to the point where their marginal benefits are equal to their marginal costs) and technical or service delivery efficiency (meaning the maximum output is obtained from any given level of resources).
- 8 New South Wales, Victoria and some commentators have been concerned that equalisation has the following adverse effects.
 - Equalisation means individuals do not face the true price of the State services they consume which reduces their incentives to relocate to other States and other regions where productivity is higher, which leads to lost output for the nation.
 - Equalisation leads to the public sector in low capacity States being larger than it otherwise might be, because the residents of those States demand more services than they would if they faced their full cost. The grants may also 'stick' to State

¹ The creation of the Commission and the commencement of the special grant process was in part a response to threats by Western Australia to secede from the federation. The introduction of comprehensive equalisation in 1976 was partly influenced by the concerns of the more populous States that they were not receiving their 'fair share' of Commonwealth revenues.

² Garnaut R and Fitzgerald V, *Review of Commonwealth-State Funding, Final Report*, August 2002.

governments, which tend to place greater priority on providing more services than reducing taxes.

- Equalisation may encourage grant seeking behaviour — States may over provide services where they have disabilities (or impose high taxes on small revenue bases) and under provide services where they have cost advantages (or impose low taxes on large revenue bases). This possibility arises because each State's actions affect the average standards to which they are equalised. While no State can vary its priorities to gain a net budgetary benefit, it may be able to increase some service levels at less than full cost³. Studies using Canadian and Australian data also suggest some tax rates in low capacity States are higher, and the revenue bases lower, than they might be without equalisation⁴.
- Equalisation may reduce incentives for a State to promote economic growth because much of the extra State tax revenue generated by successful development is offset by reductions in its share of the GST — its net benefit is its population share of the extra State tax revenue. The balance is, in effect, transferred to the other States through increases in their shares of the GST. Moreover, another major source of revenue from such development, increased company tax, goes to the Australian Government. Similar concerns have been expressed in other countries, including Canada and Germany.
- Equalisation reduces the incentives for a State to improve the efficiency of service delivery because savings are redistributed to other States.
- Resources used in managing the equalisation system could be put to better use.

- 9 In considering these arguments, it is important to be clear about what equalisation does and does not do. Firstly, it equalises the financial capacities of the States, not the level of services provided. Decisions on how those capacities are used (what the funds are used for and where they are spent) are made by each State government, which often do not set out to equalise the standard of their services with those in other States or to equalise services in all regions within their borders⁵. Secondly, equalisation does not remove the effects of location on the costs of private goods and services. Those costs could be expected to have a greater effect on the decisions of individuals about where they live and work than the standard of State services. As a result, any effects of equalisation on the incentives of people to locate in their most productive areas may be much less than implied by the critics. Also, since equalisation is based on the average policy of the States, each State faces the full marginal costs of providing

³ For example, the Northern Territory, which has large needs due to its large Indigenous population, could increase expenses on essential services in remote Indigenous communities by \$1 and recover about 66 cents in increased GST. New South Wales could increase expenses on urban transit services by \$1 and recoup 7 cents through increased GST.

⁴ Smart M, *Raising taxes through equalization*, Canadian Journal of Economics, Vol 40, No 4, November 2007 and Dahlby B and Warren N, *Fiscal incentive effects of the Australian equalization system*, Economic Record, Volume 79, pp 434 – 445.

⁵ Typically, the standard of service provided in each region reflects the need for, and the economic costs of, the service and differs between urban and rural areas.

services in its remote areas; that is, equalisation does not give them incentives to favour service delivery in high cost areas or to high cost users.

- 10 Similarly, equalisation is unlikely to reduce the incentives of States to improve the efficiency of their service delivery processes. Equalisation is based on the presumption that States are equally efficient. If any State makes above average efficiency improvements and reinvests the savings in better services it retains all the benefits.
- 11 Other States have also noted that any real world efficiency effects of equalisation are likely to be much less than those implied by the concerns listed in paragraph 8 because:
 - equalisation may increase efficiency by discouraging inefficient fiscally induced migration (that is, migration caused by differences in the level of State taxes and services) and migration that could generate further inefficiencies by increasing congestion costs in the gaining States;
 - since States decide how they spend the funds, efficiency gains from reducing equalisation depend on the relative efficiency of the public sectors in the gaining and losing States;
 - there is no evidence that equalisation affects State priorities on service delivery and many political and administrative processes mitigate against it; and
 - tax revenue is not the only benefit States or their residents receive from development and there is no evidence that equalisation has prevented States supporting development. However, there is evidence that States compete with each other for development.
- 12 Overall, the size and direction of equalisation's net effect on economic efficiency is an empirical question, albeit a difficult one. Several studies have been done to try to measure the efficiency effects of reducing the level of equalisation achieved.
- 13 Typically, these studies postulate reducing equalisation by distributing the GST to the States where the tax was generated (a 'State of origin' approach), distributing GST on an equal per capita basis or making it less comprehensive. They then model the effects on interstate migration and welfare of State responses to the changes in the revenue available to them.
- 14 Table 4-1 shows the implications for State budgets of replacing the 2005-06 equalisation distribution of GST with distributions based on a 'State of origin' approach and equal per capita payments. The implied redistributions away from Tasmania and the Northern Territory would be about 20 and 50 per cent of their operating expenses. However, the figures are illustrative only. There is no official dissection of GST revenue according to the State where it was generated — it cannot be prepared because of practical issues relating to tax collection processes and the administrative processes of businesses that operate in more than one State.
- 15 Table 4-2 summarises the results of studies that try to estimate the efficiency effects of equalisation. Most indicate equalisation leads to small reductions in national welfare. However, each can be criticised on various grounds, mostly relating to the sensitivity of the outcomes to the assumptions made to allow the inherently complex real world to be modelled.

Table 4-1 Different distributions of GST revenue 2005-06

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	\$b	\$b	\$b	\$b	\$b	\$b	\$b	\$b	\$b
Equalisation distribution	10.4	7.9	7.7	3.8	3.4	1.5	0.7	1.8	37.3
Estimated GST generated (a)	13.2	9.6	6.7	3.4	2.6	0.8	0.7	0.3	37.3
Equal per capita distribution	12.4	9.3	7.3	3.6	2.7	0.9	0.5	0.4	37.3
Differences									
Equalisation less generated	-2.8	-1.7	1.0	0.4	0.8	0.7	0	1.5	
Equalisation less EPC	-2.0	-1.4	0.4	0.2	0.7	0.6	0.2	1.4	

(a) Official figures on GST generated in each State do not exist. Those in the table were estimated by New South Wales in a July 2005 document titled '*GST: The Way Ahead, A New South Wales Government Proposal*'. Their use in the table is for illustrative purposes and does not imply the Commission endorses them.

Table 4-2 Summary of studies on the efficiency effects of equalisation

Studies	Effects modelled	Welfare changes	Relative to GDP ^(a)
		\$m	%
CGC, (1990) (b)	Model concentrated on interstate efficiency gains from removing location specific disabilities.	\$30 million a year in 1988-89 dollars.	0.008
Garnaut and Fitzgerald (2002) (c)	Model aimed at measuring interstate allocative efficiency gains of replacing equalisation distribution with EPC and State of collection allocations.	\$169 million a year by moving to EPC distribution and \$279 million by moving to State of collection.	0.024 to 0.039
Dixon et al (2002) (d)	Similar to the work done for Garnaut and Fitzgerald (2002), but with different assumptions, on labour and leisure choices.	Ranged from \$75 million to \$169 million a year.	0.01 to 0.024
Dixon et al, (2005) (e)	Similar to the work done for Garnaut and Fitzgerald (2002), with further variations in assumptions.	Ranging from -\$65 million to \$135 million under various scenarios.	-0.008 to 0.016

(a) The current year price of GDP when the study was done.

(b) Commonwealth Grants Commission, *Report on Issues in Fiscal equalisation 1990, Volume II*.

(c) Garnaut R and Fitzgerald V, *Review of Commonwealth-State Funding, Final Report*, August 2002.

(d) Dixon PB, Picton MR and Rimmer MT, 2002, 'Efficiency Effects of Inter-governmental Fiscal Transfers in Australia.' *The Australian Economic Review*, Vol 35(3).

(e) Dixon PB, Picton MR and Rimmer MT, 2005, *Efficiency Effects of Changes in Commonwealth Grants to the States: A CGE Analysis*. *Australian Economic Papers Vol 44*.

16 In its 1988 Review Report, the Commission noted that since States were free to decide how they spend the funds received, the most important issue was to ensure equalisation did not affect their decision making processes — that is, to ensure equalisation is policy neutral and does not provide incentives for States to make inefficient decisions. During the 2010 Review, some States have argued that policy neutrality could be improved and potential efficiency costs reduced by means such as:

- confining the expense assessments to the core services which all States provide (education, health and welfare and law and order) because assessments for other services may encourage grant seeking behaviour;

- assessing only those disabilities that reflect interstate differences in service use because allowing for cost differences is more contentious and often based on unreliable data;
 - excluding improvements in State revenue bases that stem from above average economic development policies;
 - discounting the equalisation differentials; and
 - applying safety net arrangements where the shares for South Australia, Tasmania and the Northern Territory are based on equalisation and the other States receive equal per capita shares of the remainder.
- 17 The Commission has noted that reducing the comprehensive coverage of equalisation would reduce the policy neutrality of the assessments and may lead to grant seeking behaviour.

EQUALISATION AND SIMPLIFICATION

- 18 Perhaps the most common criticism of equalisation in Australia and overseas is that it is complex and hard to understand. The Commission's approach has frequently been described as a black box and a process that is understood by only a select few⁶. It is sometimes implied that much of this complexity stems from the assessments of the relative costs of providing services, but critics of Canada's equalisation process, which focuses on revenues only, also say it is complex and non-transparent.
- 19 While simplicity is highly desirable, all States agree that equalisation should be based on what States collectively do and that its results should be fair. There is considerable conflict between those expectations, primarily because what States do, is not simple. For example, they:
- impose a range of taxes, each of which tax fundamentally different things;
 - they provide many services (such as education, health, law and order, roads, transport, industry assistance and administrative services) which often have different client bases;
 - they provide those services in different ways; and
 - the demographic, economic and physical environments of the States differ.
- 20 A task that involves examining such a diverse group of activities and circumstances will inevitably be detailed and involve some complexity. In equalisation, as in many other aspects of life, there is truth in the adage that 'what is fair is not always simple' (and vice versa).
- 21 Finally, it is not always clear what people seek when they ask for 'simple comparisons'. In some cases they seek broad, simplistic comparisons that have few moving parts. In other cases, more transparent comparisons are sought — comparisons that are clear and logical and where the links between State revenues and expenses and the things that affect them can be seen and understood. Simplicity and transparency are not always the same thing.

⁶ See Garnaut R and Fitzgerald V, *Review of Commonwealth-State Funding, Final Report*, August 2002.

- 22 In the 1999 Review, the Commission responded to State calls for greater transparency and accuracy by introducing comparisons which better matched the disabilities with the expenses they affected, made linkages and decision points clearer and removed double-counting. However, that improved transparency increased the level of detail.
- 23 At the start of the 2004 Review, the Commission proposed changes that would continue to base the comparisons on what States do but would also:
- reduce the number of categories, disabilities and adjustments in the expense assessments by making separate assessments only if they had a material effect on grant shares; and
 - use broader measures of revenue bases.
- 24 Notwithstanding the widespread support in principle for simplification and reduced detail, it proved hard to achieve because most States were concerned about the possible implications for their grant shares. They rejected across-the-board approaches to simplification and most argued for more complex and detailed comparisons, if they might benefit them.
- 25 The 2004 Review Report concluded that simplification should be a priority going forward but acknowledged it would be hard to achieve. The 2004 meeting of the Ministerial Council for Commonwealth-State Financial Relations subsequently asked Heads of Treasuries to examine the equalisation methods to see if equalisation could be achieved more simply and reliably.
- 26 The Heads of Treasuries, with assistance from the Chairman of the Commission, examined a wide range of issues. They noted the 2004 Review assessments were very detailed involving some 37 assessments of different State revenues and 359 assessments of influences on State expenses. They also noted many assessments had relatively small effects — 172 of the expense assessments redistributed less than \$5 million each. They concluded the methods were generally robust but simplification would be beneficial, providing it was consistent with the equalisation principle. They recommended that their work be continued by the Commission as part of the broader 2010 review of relativities and that the reference for the review contain guidance on where simplification may be achieved.
- 27 The 2005 Ministerial Council meeting accepted those recommendations. The subsequent terms of reference required the Commission to:
- simplify its methods, provided that it is consistent with the equalisation principle, by:
 - aggregating assessments;
 - applying materiality thresholds;
 - eliminating assessments found unreliable;
 - addressing issues relating to data quality; and
 - reviewing the scope for the use of more general indicators of needs; and
 - report progress to the 2006 and 2007 Ministerial Council meetings.
- 28 Those progress reports stressed the need for simplification and said equalisation could be achieved in a simpler way by applying a ‘clean slate, top down’ approach. Under that

approach, which was broadly accepted by all States, the Commission will disaggregate State revenues and expenses and assess disabilities only if it materially improves equalisation and can be done reliably.

- 29 Some interim assessment guidelines have been developed to help implement the new approach. They indicate the Commission will:
- consider a State service or revenue for separate assessment only if:
 - it is a major service or source of revenue that is distinct from others;
 - it is affected by disabilities that are markedly different from those affecting other services or revenues;
 - satisfactory assessments can be made; and
 - it has a material effect on the GST required by at least one State;if these conditions are not met, the service or revenue would be assessed with other broadly similar ones; and
 - include a disability in the assessments if:
 - there is a presumptive case that it affects State expenses or revenues;
 - a conceptually rigorous method of measuring it can be derived;
 - the data available to measure it are fit for the purpose and of suitable quality; and
 - it has a material effect on the GST required by at least one State.
- 30 While the materiality thresholds to be applied have not yet been finalised, the interim thresholds require: the separate assessment of a service or revenue to change the GST required by any one State by at least \$30 per capita; and a disability to change the GST required by any one State by at least \$10 per capita. (The proposed threshold for disabilities is lower because more than one disability may be assessed for each service).
- 31 Processes involving close consultation with the States are being followed to consider the extent to which State expenses and revenues should be disaggregated into separate services and taxes and the disabilities that should be assessed for each category. The current proposals indicate a substantial reduction in the level of disaggregation — the number of revenue categories could fall from 12 to 7 and expense categories could fall from 39 to 15.

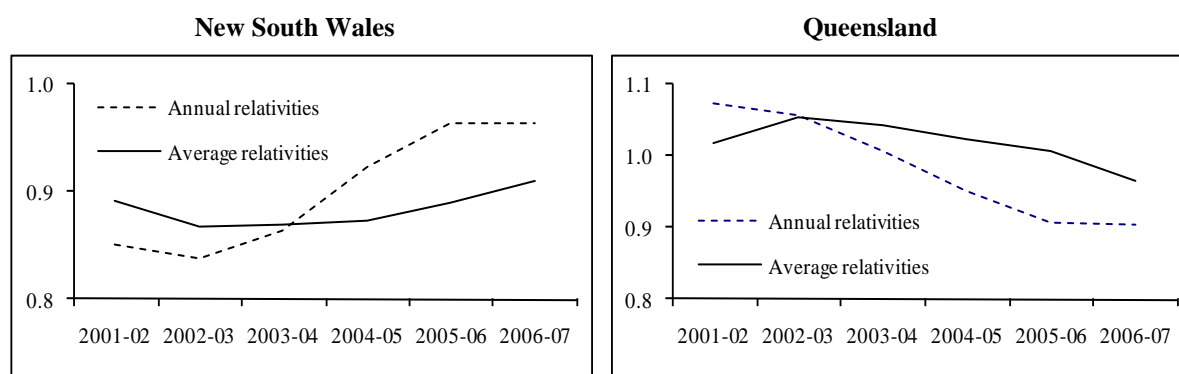
EQUALISATION AND CONTEMPORANEITY

- 32 Reliable measures of State relative financial capacities require reliable data on State revenues, expenses and demographic and economic circumstances, which can be prepared only on a historical basis. This implies the allocation of funds devised by the Commission is backward looking and may not reflect State circumstances in the year it is used.

- 33 The possibility of the allocations being out of date is increased by the averaging processes adopted to improve their stability and reduce the impact of one-off data problems. Up to 1989, State allocations were required to be based on an average of the data for the most recently completed three financial years. Since 1989, references have required the relativities to be based on an average of the data for five financial years; making them between two and six years out of date when the allocations are used.
- 34 To ensure the State shares better reflect the Commonwealth-State arrangements in the year they are applied, the Commission uses a process called ‘backcasting’. Under this process, State revenues and expenses are adjusted to what they would be under the Commonwealth-State arrangements in the year the shares will apply. However, backcasting is only done when the changes in arrangements are large and their effects can be estimated reliably. Changes in State tax or service delivery policies are not backcast because to do so may reduce the policy neutrality and reliability of the results.
- 35 While regular reviews and annual updates keep the State shares as up-to-date as possible, they cannot overcome the lags caused by the use of historical data and the averaging processes.
- 36 When the question of the most appropriate averaging period was last considered in 1999, New South Wales, Victoria, Queensland and Western Australia supported the five year period because it provided more stability in the relativities. South Australia, Tasmania and the Northern Territory argued five years was too long, the relativities were too far out-of-date when they were applied and the volatility in funds distribution may not be reduced.
- 37 The Commission considered that, because equalisation was intended to offset the financial effects of changes in the relative circumstances of the States, volatility in relativities and general revenue assistance was a less relevant issue than volatility in State total revenues. It concluded a three or a five year averaging period could be consistent with equalisation but frequent changes in the length of the review period posed a risk to equalisation. Those conclusions reflected its view that a long period of annual equalisation assessments, with each based on a moving average of the same number of years, would treat all years equally. That, together with the typically cyclical nature of State economies, meant changes in State circumstances should eventually average out and equalisation would be achieved over time.
- 38 In the event, the 1999 Premiers’ Conference decided to retain the five year averaging process.
- 39 In the 2004 Review, South Australia and Tasmania argued again that long term trends in the financial circumstances of some States together with the lags in the process meant equalisation would not be achieved. States whose relative financial capacity was declining over the long term would be continually under-equalised. Conversely, those with long term increases in their relative circumstances were over-equalised.
- 40 Similarly, recent claims by New South Wales and Victoria that their citizens should not be subsidising the high growth States of Queensland and Western Australia reflect concerns about the lags in the process. In effect, they are concerned that the relativities do not fully reflect the current circumstances of the States.

- 41 Figure 4-1 illustrates the significance of the differences in the historical and current circumstances of the States. With the benefit of hindsight, it shows the five year average relativities used to distribute the GST over the period 2001-02 to 2006-07 overestimated the fiscal capacity of New South Wales and underestimated that of Queensland in each year.

Figure 4-1 Comparison of annual and average relativities



Source: Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2008 Update*.

- 42 Several methods of improving the contemporaneity of the State shares have been proposed. They include using State forward estimates of revenues and expenses, using projections of State finances and circumstances, using a two part grant process in which assistance is initially advanced and then reconciled when data are available and using a shorter averaging period.
- 43 Final conclusions on how the relativities might better reflect the circumstances of the year in which they are applied have not been reached. However, the shorter averaging period appears to be the most viable. The other alternatives would increase complexity or reduce the reliability and policy neutrality of the assessments.

ISSUES IN THE IMPLEMENTATION OF EQUALISATION

- 44 On many occasions, the Commission has considered whether it should be seeking full or partial equalisation and how it could:
- best ensure the State relativities are not affected by, and do not affect, the policies of individual States (that is, they are policy neutral); and
 - capture changes in the average policies of the States on financial management, the services provided, how services are provided, and changes in data availability.
- 45 These themes flow through the following sections.

The scope of State revenues and services examined

- 46 Early in the 1981 Review, the Commission proposed that its comparisons cover the revenues and services included in the recurrent budgets of all or most States because:
- States used the assistance being distributed to fund recurrent services; and
 - a comprehensive coverage ensured each State was treated fairly.

- 47 The Commission's proposal included all State revenues and expenditures except:
- expenditure on roads and housing and revenues from motor taxes and housing rents because they were not usually accounted for in State revenue budgets and they were subject to separate Commonwealth-State arrangements;
 - business undertakings that did not regularly make a charge against Consolidated Revenue in all or most States — State railways, metropolitan transport, country water supply, sewerage, irrigation and drainage authorities were included but port, metropolitan water, electricity and gas, banking and forestry authorities were not; and
 - any capital items not usually included in revenue budgets.
- 48 In cases where there were interstate differences in the extent to which the Commonwealth and local governments funded 'State-type' services, the relevant activities of those governments were also included — for example, the suburban transport services provided by the Brisbane City Council were included.
- 49 At that time, and again in later reviews, New South Wales proposed the comparisons be restricted to education, health and law and order services because they were the bulk of State expenses and were provided in all States. It also said a restricted coverage would be simpler and more policy neutral because State policies determined which other services were provided and the amount spent on them.
- 50 Each time, the Commission decided to adopt a comprehensive approach because it had no basis for deciding which services were more important than others. It also considered a partial approach would advantage some States and disadvantage others. For example, expenses on education, health, and law and order account for 55 per cent of State gross expenses in the 2008 Update, but only 39 per cent of the redistribution arising from the expense comparisons⁷.
- 51 However, the scope of equalisation has changed over time following changes in State financial policies and circumstances and the availability of better data. Many changes were made in the 1993 Review. At that time, the Commission decided that, provided comparable financial data were available, the simplicity and transparency of its work would be improved if it covered all recurrent State functions. It considered this would clarify the effect of each function on State shares of general revenue assistance.
- 52 This led to the inclusion of road maintenance expenses, motor taxes, revenues and expenses of housing services and the net impact of all State business undertakings on recurrent budgets.
- 53 Changes in the way States structured their operations, such as the corporatisation and/or privatisation of some services and the introduction of other micro-economic reforms, also affected the scope of the comparisons. These changes culminated in the 2004 Review when

⁷ Restricting expense assessments to education, health, and law and order services would have increased the GST and health care grant revenue of New South Wales, Victoria and Queensland by \$1.9 billion (Victoria would have received \$1.2 billion) and reduced that of the other five States by the same amount (the Northern Territory would have received \$1 billion less and Western Australia \$0.7 billion less).

the Commission decided that since the GST was intended to supplement State budgets, its comparisons should be confined to activities that had a direct impact on State operating accounts. It excluded outlays for the purchase of buildings and capital equipment, the proceeds of borrowings, the business activities of State enterprises, and Commonwealth payments to local government or non-government service providers that pass through the States. However, it included any direct effects of those activities on the operating statements, such as subsidies States provide to enterprises, and the taxes and other contributions trading enterprises make to State budgets.

- 54 ***Including capital transactions.*** Perhaps the most significant change in the scope of the comparisons occurred in the 1999 Review when the Commission decided to include the recurrent effects of capital transactions.
- 55 Prior to 1999, capital transactions were excluded from the comparisons because the Commission considered its task was to distribute funds that supplemented State recurrent revenues and it was the Loan Council's task to distribute capital assistance.
- 56 In the 1999 Review, the Commission reconsidered its approach in the context of changes in Commonwealth-State arrangements and State financial management policies, including:
- the abolition of the Loan Council capital grants program in July 1994 and the creation of new processes for the scrutiny of the government borrowing;
 - the growing use of surpluses on recurrent account to fund capital programs;
 - the growing use of leasing as a means of acquiring capital resources;
 - the increased contracting of the private sector to provide State services;
 - the inclusion of some capital SPPs (such as roads) in general revenue assistance; and
 - the introduction of accrual accounting, which meant the full operating effects of capital were reflected in the recurrent budget.
- 57 Those changes blurred the distinction between capital and recurrent transactions and the Commission considered equalisation would not be achieved unless it included capital transactions or broadened and improved its assessments of the recurrent effects of capital.
- 58 The Commission decided it should not include capital transactions unless directed to. So, it improved its assessments of the recurrent effects of capital by including depreciation expenses. At the time, all States acknowledged the operating effects of capital were relevant to equalisation and most agreed the omission of depreciation detracted from equalisation.

Assessing the implications of capital transactions for State financial capacities

- 59 Assessments of the recurrent effects of capital (manifested in interest earnings, interest expenses and depreciation) on State financial capacities have been contentious and difficult.
- 60 Initially, the Commission considered the Loan Council distribution of loan funds and the absence of evidence of major differences in State policies meant differences in per capita interest expenses would be sufficiently policy neutral indicators of relative needs.

- 61 However, in the 1988 Review it noted State net interest expenses appeared to be heavily affected by State policies and were no longer closely related to Loan Council decisions. To improve the policy neutrality of the assessments, it decided to base them one third on interstate differences in actual per capita expenses, one third on equal per capita and one third on the overall disability factors for all other expenditure. Although an improvement, continued deficiencies led to this assessment being extensively revised in the 1993 Review.
- 62 The 1993 Review assessment estimated the interest expenses the States would incur if they had the facilities needed to provide the average level of services. It took account of:
 - the accumulated capital expenditures each State would have incurred since 1972-73;
 - the funds available to finance that expenditure through capital grants, other capital revenues and accumulated average budget outcomes since 1972-73; and
 - the lower interest rates New South Wales, Victoria and Queensland could achieve because of their larger borrowings.
- 63 In the 1999 Review, the assessment for the newly included depreciation expenses aimed to allow all States to fund the annual depreciation of the capital stock required to provide the average services, after allowing for factors that affect the cost of those assets and their lives. It took account of interstate differences in the quantity of assets required to provide similar services, the cost of those assets and factors that affected their useful lives. The introduction of the depreciation assessment also necessitated changes to the interest expenses assessment to recognise that accumulated depreciation funded some capital expenditure.
- 64 During the 2004 Review, the States generally accepted the conceptual basis of the assessments. However, most wanted them based more solidly on evidence and considered the debt charges assessment could better reflect current circumstances. The methods were revised to simplify the depreciation assessment and use more reliable ways of measuring the allowances.
- 65 In the case of interest expenses, most States said the growing differences in their policies on the use of borrowings to purchase financial assets should not affect the assessments. They agreed the simplest approach was to offset interest earnings against interest expenses. Changes were also made to allow for the effects on State interest expenses of the higher prices and higher capital expenses faced by States with more recent population growth.
- 66 Since the 2004 Review, a reconsideration of the methods has been prompted by changes in State financial circumstances (especially the movement from a position of net debt to one where on average they hold net financial assets) and the 2010 Review's simplification process.
- 67 *The effect of capital related transactions on State relative financial capacities.* Table 4-3 shows how average net interest and depreciation expenses have varied over time. Net interest expenses grew as a proportion of total State expenses until the mid-1990s but fell thereafter as States accumulated net financial assets.
- 68 Table 4-4 shows changes in State interest and depreciation expenses and assessment methods have caused noticeable changes in the distribution of general revenue assistance. The

inclusion of depreciation in the 1999 Review increased the redistribution. It particularly increased the shares of New South Wales and the Northern Territory because of the allowances made for the effects of large cities on asset requirements and costs, the high building costs in remote areas and the debilitating effects of tropical climate on asset lives. However, their shares fell in the 2004 Review when:

- the importance of interest expenses in State budgets declined; and
- the assessment methods were changed because allowances for the effects of large cities and tropical climate on depreciation expenses were not supported by reliable data, and allowances were made for the effects of recent population growth on asset costs and depreciation expenses (increasing the shares of Queensland and Western Australia).

Table 4-3 Average value of capital-related transactions

	Net interest expenses	Depreciation	Net interest as % of State expenses	Depreciation as % of State expenses
	\$pc	\$pc	%	%
1982-83 ^(a)	28.43	na	2.3	
1986-87 ^(b)	67.20	na	3.6	
1990-91 ^(c)	133.43	na	5.4	
1994-95 ^(c)	199.60	249.90 ^(d)	6.3	7.9
1998-99 ^(c)	117.42	157.42	2.9	3.9
2002-03 ^(c)	63.05	186.20	1.3	3.9
2003-04 ^(c)	-111.66	188.50	-2.3	3.9
2006-07 ^(c)	-155.50	224.74	-2.7	3.9

(a) Covers the six States only.

(b) Covers the six States and the Northern Territory.

(c) Covers the six States, the Northern Territory and the ACT.

(d) Estimated by Commission and includes depreciation on urban transit and housing assets. Amounts for subsequent years were from ABS Government Finance Statistics and exclude depreciation for urban transit and housing.

Source: Commonwealth Grants Commission, Reports on 1982, 1985, 1988, 1993, 1999 and 2004 Reviews of State Relativities, and *Relative Fiscal Capacities of the States 2008*.

Table 4-4 Redistribution caused by interest expenses and depreciation assessments

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Redist'n ^(a)
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
1985 Review	-57.2	8.0	-0.2	-16.4	18.1	19.3	0.0	28.4	73.8
1988 Review	-53.7	-12.2	-23.4	-8.3	32.5	7.4	0.0	57.6	97.5
1993 Review	-67.5	-93.6	25.2	66.3	14.5	14.7	-40.7	81.1	201.8
1999 Review	350.4	-143.5	-210.2	35.9	-19.1	-22.7	-55.0	136.2	522.5
2004 Review	-1.0	-108.2	-0.4	87.0	-12.0	3.2	-12.3	43.8	134.0
2008 Update	-39.5	-144.8	7.7	89.0	-7.3	12.3	-7.7	90.4	199.3

(a) The sum of the positive (or the negative) values in the row.

Source: Commonwealth Grants Commission.

The drivers of interstate differences in expenses taken into account

69 When the Commission began the all State reviews it made allowances for factors that affected:

- the use of services, such as student enrolments per capita for education services and the 0 to 17 year old population for child welfare services;
- the cost of providing each unit of the service, including:
 - scale effects — to reflect the effects of diseconomies of small scale;
 - population factors, such as:
 - (i) population age structure and social composition, to measure the effects on the cost of a service arising from interstate differences in the size of groups in State populations, such as people with low English fluency, Indigenous people and people with low income⁸;
 - (ii) population dispersion, to measure the effects on communication, freight and staff costs of interstate differences in population dispersion; and
 - (iii) urbanisation, to measure the effects on service costs arising from congestion, social dysfunction, pollution and the need for planning;
 - environmental factors — to measure the effects on the cost of a common service arising from interstate differences in:
 - (i) geographic and climatic features; and
 - (ii) the level of economic development and availability of private services.

70 The factors taken into account and the methods used to measure them have been debated extensively in every review. Naturally, each State wanted the Commission to recognise extra factors that benefited it, emphasised those that increased its share, and downplayed the others.

71 Those debates and improvements in data led to an expansion in the range of factors recognised and changes in methods to better measure them, to reduce the possibility of double counting, to better link the factors with the expenses they affected, and to reflect changes in circumstances.

72 ***The population characteristics reflected in disabilities.*** Interstate differences in population characteristics have major implications for relative financial capacities because they affect:

- the quantity of services States provide since some services are provided for specific groups of people and some groups use some services more than other groups; and
- the cost of each unit of service provided because some groups of people are more expensive to service than others.

73 The range of characteristics taken into account has been constant. However, the importance of each characteristic differs and it changes over time due to changes in the relative size of population groups across States, the level of expenses States direct to them and the availability of data on how each group affects service use and costs.

⁸ Some of these groups also affect the use of services.

- 74 Population characteristics with large effects on the financial capacities of the States are:
- the proportion of the population who are Indigenous;
 - the proportion of people with low income;
 - where people live, especially the proportion of people living in remote areas;
 - age distribution; and
 - the proportion of the population from culturally and linguistically diverse backgrounds.
- 75 *The proportion of the population who are Indigenous.* This one of the largest influences on relative financial capacities, redistributing almost 2 per cent of funds⁹ relative to an equal per capita distribution. This large redistribution arose because:
- there are large differences between States in the proportion of Indigenous people in their populations (ranging from less than one per cent in Victoria to almost 32 per cent in the Northern Territory compared with the average position of 2.5 per cent);
 - Indigenous people make greater use of many health, welfare, housing, and law and order services (Indigenous use of hospital inpatient and welfare services is more than twice and 3.5 times respectively that of non-Indigenous people); and
 - after allowing for other factors, the costs of providing services to Indigenous people are higher than the costs of providing them to non-Indigenous people (for example, education costs are 10 to 30 per cent higher, community health service costs are 300 per cent higher and housing services are 30 to 80 per cent higher).
- 76 *The proportion of people with low income.* On average, 28 per cent of Australians have low income¹⁰ but the proportion varies from 26 per cent in Western Australia to 34 per cent in Tasmania. These differences redistributed about 1.4 per cent of the funds in 2005-06 because people with low income make greater use of health, welfare and housing services and States on average devote 15 per cent extra resources to students from low income backgrounds.
- 77 *Where people live.* This feature redistributed about 0.8 per cent of the funds in 2005-06. The redistribution arose largely because: people in remote areas use hospital, other health and housing services more than those in other areas; States devote more resources to students living in remote areas; and States subsidise water and electricity costs in arid and remote areas.
- 78 *Age distribution.* Interstate differences in the age distribution of the population redistributed about 0.7 of a per cent of the funds in 2005-06. This effect is smaller than might be expected because the effects often offset each other. For example, States with a higher proportion of older people in their population incur higher health expenses but lower education expenses.
- 79 *Proportion of the population from culturally and linguistically diverse backgrounds.* New South Wales and Victoria have long argued migrants and refugees increase their expenses.

⁹ The pool of GST revenue and health care grants distributed in 2005-06 was \$44 611 million.

¹⁰ The Commission defines low income as households with an annual income of less than \$33 800 or individuals with an annual income of less than \$20 800 in 2006.

During the 1999 and 2004 Reviews, they demonstrated they had above average proportions of migrants and refugees in their population. However, they could not provide, and the Commission could not find, robust data that showed those people had an above average use of services, except for hospital inpatient services. Nor could they demonstrate a materially higher costs, apart from the extra costs arising from low English fluency and some costs linked to refugees. This limited the allowances the Commission could assess.

- 80 The resulting allowances, which mainly reflected the cost imposts of low English fluency, redistributed about 0.2 per cent of funds in 2005-06. On average, costs of providing education and inpatient services to people with low English proficiency were about 10 per cent higher than for others and 50 per cent higher for other health and some welfare services. The proportion of State populations with low English fluency ranged from 0.5 per cent in Tasmania to 4.1 per cent in New South Wales and Victoria and 5.6 per cent in the Northern Territory, compared with an Australian average of 3.1 per cent.
- 81 *Allowing for interstate differences in wages.* The inclusion of allowances for interstate differences in wages has been one of the more contentious issues in recent reviews.
- 82 Arguments for the inclusion of allowances for higher wages were first made by New South Wales in the 1981 Review. The Commission initially rejected the case because it considered wages were heavily influenced by State policies and neutral measures could not be found.
- 83 However, during the 1993 Review, it was convinced there were unavoidable wage differences between the States, but distinguishing the effects of underlying pressures from those of State policies was hard. It concluded the best approach was to use ABS data on private sector wage levels and adjust them to remove the effects of interstate differences in the occupation profile of the workforce. However, to exclude any remaining policy influences and allow for deficiencies in the data it discounted the measured differentials by 50 per cent and restricted them to between 98.5 and 102.0 per cent of the average.
- 84 Those calculations indicated New South Wales, the Northern Territory and the ACT had above average wage levels. Queensland, Tasmania and to a lesser extent South Australia had below average wages. Wages in Victoria and Western Australia were close to the average.
- 85 This allowance and the way it is measured have been debated extensively since 1993. States that opposed it in the 1993 Review continued to do so because they considered:
 - the private sector was an unsuitable benchmark because it was not sufficiently free of State policy influence and many private sector occupations were largely irrelevant to the public sector. Some suggested public sector wage levels should be the benchmark. Others said it should be wages in the private and the Commonwealth government sectors;
 - the non-policy influences on wages would be very small;
 - the wages of teachers, police and nurses should not be assessed because the States could set their wages without being subjected to market pressures and there was a national convergence of wage levels for those professions; and

- the available data were not sufficiently reliable, especially for the smaller States.
- 86 Research during the 1999 Review, including by several external consultants, indicated that:
- economic theory supported the existence of interstate differences in wage levels arising for reasons other than State policies;
 - data confirmed there were differences in wage levels and that almost half of them were explained by State of residence effects; and
 - States had greater policy control over wages for teachers, nurses and police but national benchmarking had not been achieved and the wages were subject to market forces.
- 87 More analysis was done during the 2004 Review and was refereed by an independent expert. It confirmed the theoretical support for the existence of regional variations in wages for similar employees. Quantitative analysis reaffirmed the underlying wage levels for similar employees in the private sector were above average in New South Wales, the ACT and the Northern Territory and below average in Queensland, South Australia and Tasmania. Analysis for the public sector produced broadly similar results. The Commission also did much reality testing, which showed the analysis was consistent with the real world but that adjustments were needed to allow for data uncertainties and specific circumstances in Tasmania and the ACT.
- 88 The quantitative method adopted in 2004 continues to be used but the data were updated in 2007. Further adjustments were made in the 2008 Update to reflect recent above average increases in wage levels in Queensland and Western Australia.
- 89 Not unexpectedly, the States continue to hold diverse views. Some support the analysis. Others argue the data are unreliable and the results are not consistent with the real world.
- 90 Table 4-5 summarises the relative wage levels assessed since the 1993 Review. The relative positions of the States have been consistent despite changes in measurement methods and the coverage and timing of data. The two Territories had the highest relative wages prior to 2001-02 but have fallen since. New South Wales also had above average wages, which peaked in 2001-02. Queensland, South Australia and Tasmania had the lowest relative wages, while Victoria and Western Australia remained close to the average.

Table 4-5 Assessed relative wage levels

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	%	%	%	%	%	%	%	%	%
1993 Review	101.0	100.0	98.5	100.0	98.5	98.5	102.0	102.0	100.0
1999 Review	101.4	99.8	97.7	100.9	98.1	99.2	103.0	102.2	100.0
2004 Review method									
1997-98	101.4	100.9	97.4	98.5	98.5	97.4	102.6	109.3	100.0
2001-02	104.2	99.4	95.9	98.1	96.1	95.9	102.8	103.6	100.0
2005-06	103.2	99.6	97.0	98.2	97.9	96.0	102.6	102.6	100.0
2006-07	103.0	99.5	97.3	98.6	97.8	95.9	102.5	102.5	100.0

Source: Commonwealth Grants Commission, Working Papers of 1993, 1999 and 2004 Reviews and 2007 and 2008 Updates.

- 91 While the interstate wage differentials are comparatively small, they have a large and growing effect on the distribution of funds because wage differentials affect about 70 per cent of State expenses and the spread in relative wages is increasing —wage differentials ranged between 2 per cent above and 1.5 per cent below average in the 1993 Review but grew to 3 per cent above and 4.1 per cent below average in 2006-07. In 1992-93, wage differentials redistributed about 0.9 per cent (about \$150 million) of the available funds compared with an equal per capita distribution but the redistribution grew to 1.7 per cent in 2007-08 (about \$880 million).

Treatment of expenses on economic development

- 92 In the early reviews, the Commission considered all interstate differences in expenditure on functions that were commercial in nature or which had a developmental purpose were due to differences in States policies. It did so to avoid the possibility that its inability to reliably distinguish between the effects of disabilities and State policies on State expenses would adversely affect economic efficiency.
- 93 During the 2004 Review, Western Australia argued all revenue from economic activities in the State, especially large natural resource projects, was included in the Commission's revenue assessments and much of it was in effect transferred to the other States. However, the State expenses required to help establish those projects were not adequately recognised. It argued this asymmetry penalised it and created a disincentive for investment in projects that increase economic activity. It illustrated the argument by reference to developments on the Burrup Peninsula which were forecast to improve national GDP by \$3.6 billion and generate nearly \$600 million in net fiscal benefits for the Australian Government. Western Australia also estimated that, after taking account of its expenditure on multi-use infrastructure and the effects of equalisation it would incur a loss of around \$60 million, while the other States would receive a net fiscal benefit of around \$450 million.
- 94 Western Australia suggested the assessment of revenue capacity should exclude economic activity attributable to State government policy. Alternatively, expense assessments should recognise the disabilities States face in encouraging development, especially when it had a strong national economic benefit.
- 95 The Northern Territory supported Western Australia, as did the Review of Commonwealth-State Funding¹¹. The other States accepted that they assist economic development. However, they argued the practical difficulties of reliably adjusting revenue bases for the effects of economic development policies and of assessing expense needs were too great.
- 96 The Commission accepted that all States assist economic development in a variety of ways. However, it could not identify common policies beyond the broad policy of providing assistance. Nor was it able to identify the underlying influences that create differences between States in costs or clearly establish links between the assistance and State revenues. It concluded interstate differences in assistance were mainly due to differences in State policies.

¹¹ See the *Final Report of the Review of Commonwealth-State Funding*, 2002, p9 and pp150 to 153.

Even if it had been able to develop assessments for particular types of assistance or projects (such as large mining projects), it considered selective or partial assessments would not improve equalisation.

- 97 Consequently, it decided on a majority basis, to continue to assess expenses related to economic development on an equal per capita basis and did not attempt to adjust revenue bases for the effects of economic development policies.
- 98 Western Australia raised the issue again in the 2010 Review. However, it has not yet developed a robust method for identifying and measuring influences on State expenses or adjusting State revenue bases. It appears to have accepted that its concerns may be allayed by an improved assessment of State capital expenditures.

Dealing with specific purpose payments

- 99 State expenses funded by SPPs are generally included in the Commission's estimates of the average expenses on each service¹². The revenue from those SPPs is treated as meeting part of the States' requirements for assistance from the Commonwealth. To do otherwise would imply aspects of State services were omitted from the comparisons and States may not have the financial capacity to deliver the average level of services.
- 100 This approach adjusts each State's general revenue assistance when the interstate distribution of the SPP differs from the Commission's assessment of the relative cost of providing the service. If a State's SPP receipts exceed the Commission's assessments of the cost of providing the service, its general revenue assistance is reduced and vice versa.
- 101 In early reviews, several States and some Commonwealth agencies strongly opposed the Commission's approach on the grounds that it overrode agreements between Commonwealth and State Ministers and complicated negotiations leading to those agreements. They also said it placed equalisation ahead of the objectives governments aimed to achieve through the SPPs.
- 102 In response, the Commission noted that including SPPs in its comparisons did affect the total financial resources available to individual States. However, it did not disturb the conditions of the SPPs¹³ or prevent their objectives being achieved. Moreover, any effect on State resources was diluted because the lags in the equalisation processes meant they occurred progressively over five years ending seven years after the SPP was made.
- 103 More importantly, the Commission considered any trade-offs between equalisation and other policy objectives should be open and transparent, which would be best achieved if terms of reference instructed it to ensure nominated SPPs do not affect the relativities.
- 104 Terms of reference for the 1985 and subsequent reviews have instructed the Commission to ensure nominated SPPs do not affect the relativities. Initially, those directions related to health

¹² It excludes SPPs that do not have a direct impact on State budgets, finance services excluded from its comparisons, or reimburse the costs of services provided to the Australian Government.

¹³ The Garnaut and Fitzgerald Review of Commonwealth-State Funding suggested this may explain why the Government imposed tight conditions on the use of SPP funds, an outcome it saw as inefficient.

care grants but, in the 2004 Review, 14 payments were to be quarantined. While the number of payments subject to quarantining has increased, they are only a small proportion of payments to the States. In 2006-07, less than 2 per cent of SPPs, by value, were quarantined.

- 105 The use of the quarantining approach greatly reduced the intensity of this debate. The reforms of Commonwealth-State financial arrangements, agreed at the November 2008 meeting of the Council of Australian Governments (COAG) and set out in an IGA, should further reduce it.
- 106 Under the November 2008 reforms, most SPPs will be broad banded into five national SPPs (one for each of healthcare, schools, skills and workforce development, disabilities services and affordable housing). The agreements covering each new payment will contain objectives, outcomes, outputs and performance indicators to help clarify the roles of each level of government and provide the States with flexibility in determining how the objectives will be achieved. The interstate distribution of these national SPPs will progressively move to an equal per capita basis over five years, commencing in 2009-10. The IGA says they are to be included in the Commission's comparisons.
- 107 A new group of payments, called national partnership payments, will be introduced to fund specific projects, to facilitate action by States on nationally significant reforms and reward States which deliver on the reform process. The IGA states National Partnership project payments are to be included in the Commission's comparisons and the National Partnership facilitation and reward payments are to be excluded. However, the IGA also gives the Commission discretion, following consultation with the Commonwealth and the States, to treat any National Partnership payment or general revenue assistance differently if it considers that treatment is more appropriate. It also states the Treasurer may direct the Commission on the treatment of individual National Partnership payments, if he considers that appropriate.

Global revenue assessments or tax by tax assessments

- 108 In each review, the Commission has had to decide whether it would assess the relative capacities of the States to raise revenue by using:
- a global approach, in which State revenue bases are measured by a single indicator of the aggregate revenue base, such as State gross product, State household income or State household after tax income plus elements of business income; or
 - a disaggregated tax by tax approach, in which relative revenue raising capacities are derived for each State tax using measures of the value of the activity taxed.
- 109 New South Wales has been a consistent advocate of a global approach. It was supported by Victoria in the 1981 Review and Western Australia in the 2004 Review. The other States have always supported the tax by tax approach — the approach applied in most other federations.
- 110 Arguments advanced in support of a global approach included:
- it is simpler;
 - it is fully policy neutral because is independent of the taxes imposed by States and takes account of the underlying capacity to pay;

- it does not encourage States to reduce taxes in areas of relative advantage or discourage them from devising taxes that more efficiently tap their potential revenue bases; and
- the data used by the tax by tax approach may be policy contaminated and unreliable.

111 The arguments in support of a tax by tax approach included:

- it focuses on measuring the capacity of States to raise revenue from the taxes they impose and takes account of the practical constraints they face in doing so;
- States cannot access their full global capacity because the range of taxes they can impose is constrained by legal issues¹⁴ and interstate tax competition, and they cannot tax the Commonwealth; and
- the measures of global revenue bases do not reflect interstate differences in industry structure (such as the presence of highly profitable mining activity in some States), income distribution, wealth or the extent to which non-residents pay State taxes — all factors which affect State capacities to raise revenue.

112 The Commission's use of the tax by tax approach reflects its belief that it is more consistent with the aim of equalisation (to take account of the capacity of State governments to raise taxes) and it better reflects what States do and the circumstances they face in raising revenue.

113 Table 4-6 shows the two approaches produce different results. It compares relative revenue raising capacities for 2006-07 based on a tax by tax and a global approach where the revenue base is measured using gross State product or gross household disposable income.

Table 4-6 Relative revenue raising capacities, 2006-07: tax by tax and global approaches

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
Tax by tax approach	100.7	87.3	108.3	140.4	78.2	67.6	84.3	90.8	100.0
Global approach based on:									
Gross State product	97.1	95.6	94.6	135.3	88.1	85.4	108.6	136.7	100.0
Gross household disposable income	101.6	102.8	92.3	101.6	93.1	86.2	159.9	102.3	100.0

Source: ABS, *Australian National Accounts, State Accounts*, 2006-07, Catalogue No. 5220.0 and Commonwealth Grants Commission, *Relative Fiscal Capacities of the States* 2008.

Measuring revenue raising capacity for mining revenue

114 There are large variations across the States in their mineral wealth and hence large differences in the States' capacities to raise mining revenue (see Figure 4-2). Those differences together with growth in the importance of mining revenue in State budgets¹⁵ mean differences in resource endowments have a major effect on relative financial capacities¹⁶ and the methods of measuring the capacities to raise mining revenue have been examined in most reviews. The

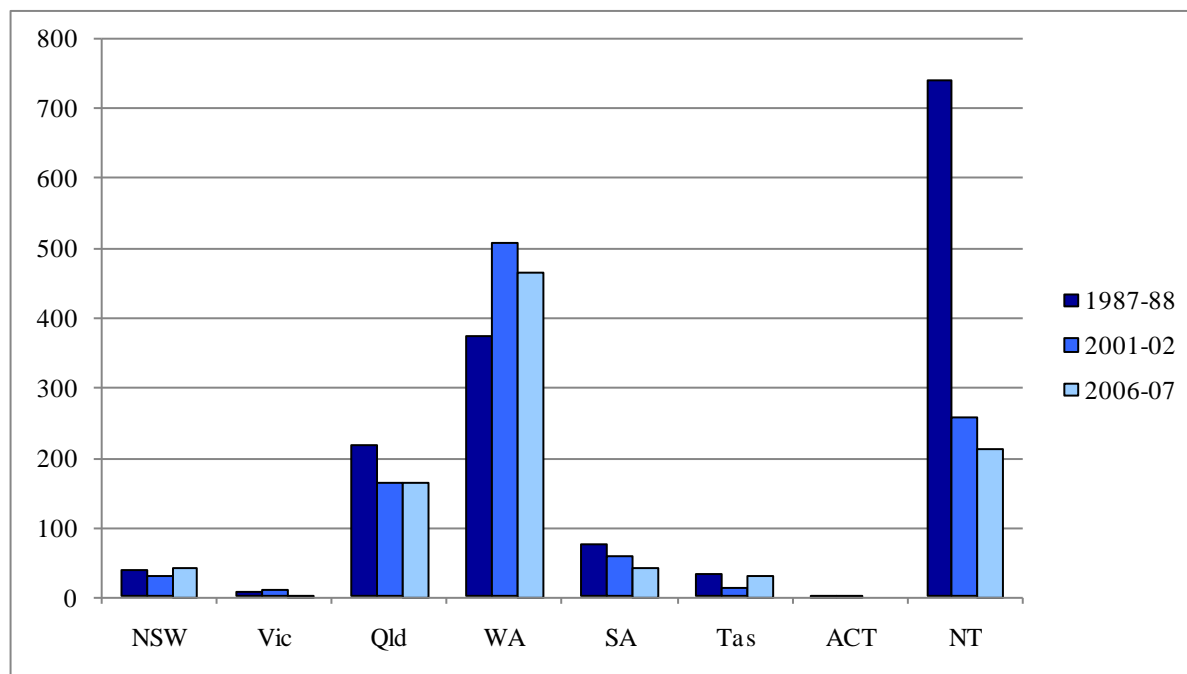
¹⁴ States cannot levy income or sales tax or impose payroll tax on the Commonwealth. The High Court invalidated past attempts by States to expand their tax bases, such as through franchise and pipeline fees.

¹⁵ It was 3.9 per cent of own-source revenue in 1987-88 and 7.5 per cent in 2006-07.

¹⁶ Since 2003-04, mining revenue has had the largest effect on the distribution of GST revenue.

issues have covered the revenue to be included, the conceptual approach to measuring the revenue base and data reliability.

Figure 4-2 Relative capacities to raise mining revenue, 1987-88, 2001-02 and 2006-07



Source: Commonwealth Grants Commission calculations.

- 115 *What revenues should be included?* In addition to revenues from royalties and associated charges, some States receive payments from the Commonwealth under arrangements for sharing revenue from offshore oil and petroleum and uranium and others have collected revenue through profits on the rail haulage of coal.
- 116 Revenues from royalties and arrangements with the Commonwealth have been included in all reviews. Profits from the rail haulage of coal were treated as railway revenues when those activities were compared. However, a decision in the 1988 Review to assess freight transport activities on an equal per capita basis (that is, treat all differences in net expenses as being due to State policies), also led to some of Queensland's profits on coal haulage being treated as mining royalties because they were 'a substitute for mining royalties'. The adjustment ceased in 2000-01, when the special contracts which generated the profits expired.
- 117 *How should the revenue base be measured?* The main alternative measures of the revenue base considered were value of production or an estimate of profitability. Prior to the 2004 Review, the Commission used profitability because it considered the capacity of mining companies to pay royalties ultimately shaped the State's royalty policies and profitability took account of interstate differences in the type and quality of minerals and mining costs. Most States accepted this approach, although Queensland argued value of production was a better measure because it was what most States used in imposing royalties.
- 118 There were, however, differences of opinion on:

- how profitability should be estimated — in the absence of independent estimates of profitability, it was initially estimated as value added less wages, payroll tax, workers' compensation insurance costs and average annual capital outlays. It was refined:
 - in the 1982 Review by the introduction of adjustments for expenses on State-type infrastructure in Queensland and Western Australia (because companies in those States made greater contributions than in other States);
 - in the 1993 Review by the introduction of adjustments for exploration costs (because they were an integral part of company costs) and price elasticity effects (because differences between the actual royalties in a State and the average royalties may have affected the level of activity in the State); and
 - the extent of disaggregation by type of mineral — in the 1981, 1982, 1985 and 1988 Reviews, black coal was examined separately because it was taxed more heavily than other minerals. Gold was also examined separately in the 1988 Review because it was often subject to low royalties. However, in the 1993 Review, the Commission ceased those disaggregations to simplify the comparisons.
- 119 In the 2004 Review, the Commission switched to value of production as the measure because data deficiencies meant the estimates of profitability were becoming unreliable, value of production better reflected how the States actually imposed royalties, and it was simpler. However, to reflect the common policy of taxing some minerals more heavily than others, it was necessary to make separate comparisons for: onshore oil and gas; open cut coal; underground coal; and other minerals.
- 120 In every review, comparisons of revenue received under agreements with the Commonwealth have been made separately and on the basis of actual revenues. The revenues received by Western Australia, the Northern Territory and, prior to 1991-92, Victoria were considered an accurate reflection of their revenue capacity because they were determined by the Commonwealth. The other States were treated as having no capacity to raise these revenues.
- 121 *Data issues.* Data issues have had major implications for the mining revenue comparisons, with estimates often being made to overcome data shortages. The most common issue has been the need to estimate data for the most recent year examined in each inquiry because the actual figures were not published until after the Commission was required to report. In other cases, it has been necessary to seek independent advice to overcome interstate differences in the methods used to prepare the data — for example, in the 2004 Review, aspects of mineral production were valued differently across the States.

CHAPTER 5

TRENDS IN EQUALISATION OUTCOMES

INTRODUCTION

- 1 This chapter shows how the State relativities assessed by the Commission have changed over time and explains why. It then uses Commission data to highlight changes in State finances.

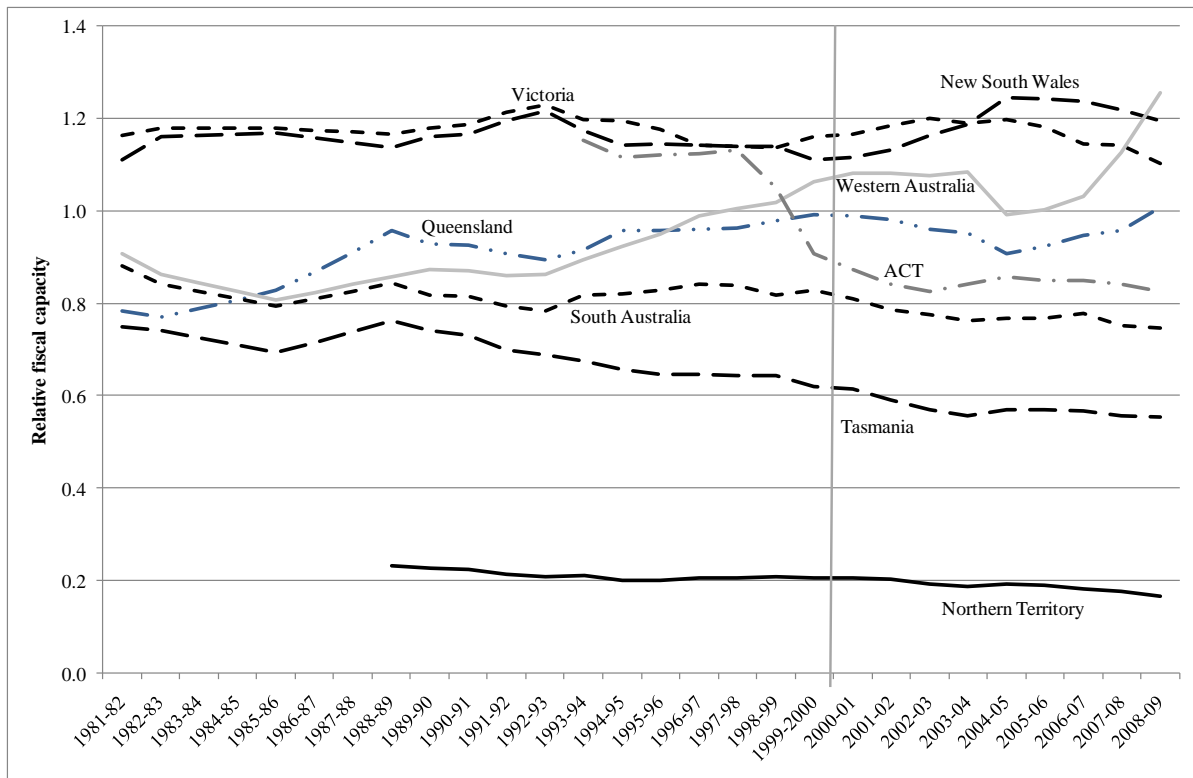
HOW RELATIVITIES HAVE CHANGED OVER TIME

- 2 Figure 5-1 shows the relativities assessed since 1981-82. While the trends in the figure are mostly driven by changes in State circumstances, they are also affected by: the inclusion of the Northern Territory and the ACT in 1988-89 and 1993-94 respectively; the introduction of the GST in 2000-01; and changes in assessment methods in 1993-94, 1999-2000 and 2004-05.
- 3 The introduction of the GST and its accompanying changes in Commonwealth-State financial arrangements affected the measured capacities of the States. The large increase in the funds distributed on an equalisation basis (they rose from \$22 890 million in 1999-2000 to \$30 220 million in 2000-01¹) moved the relativities of all States closer to the average². The abolition of State taxes, especially taxes on financial transactions, reduced the relative revenue raising capacities (and thus the financial capacities) of New South Wales and Victoria³.
- 4 Allowing for changes created by the introduction of the GST, the main trends have been:
 - the strengthening of the fiscal capacity of Western Australia and Queensland reflecting their rapid economic growth, especially in recent years; and
 - the falling relative capacities of Tasmania, the Northern Territory, the ACT and, to a lesser extent, South Australia.

¹ The GST revenue replaced revenue from abolished State taxes and financial assistance grants.

² This arose because while the value of State financial needs was largely unchanged (because State expenses were largely unaffected) they became a smaller proportion of the amount being allocated.

³ Financial transactions tended to be concentrated in New South Wales, Victoria and to a lesser extent the ACT. The abolition of the taxes on them, therefore, removed areas where they had large revenue raising advantages and reduced their overall relative revenue raising capacities.

Figure 5-1 Assessed relativities, 1981-82 to 2008-09

Note: The vertical line between 1999-2000 and 2000-01 designates the introduction of the GST.

Source: Commonwealth Grants Commission analysis.

- 5 The two most populous States have less defined trends. Prior to the 2004 Review, New South Wales benefited from method changes introduced in the reviews (except in 1985) but changes in its circumstances between reviews tended to strengthen its capacity. The 2004 Review method changes increased its assessed capacity, but subsequent changes in circumstances have reduced it. Victoria's relative financial capacity has fallen since 1982-83, especially since 2002-03 largely due to changes in its circumstances.
- 6 Figure 5-2 shows three States have had the highest relative fiscal capacity since 1981-82. Victoria generally had the highest capacity up to 2004-05. New South Wales was the strongest State in 1996-97, 1997-98 and from 2005-06 until 2008-09 when Western Australia passed it.

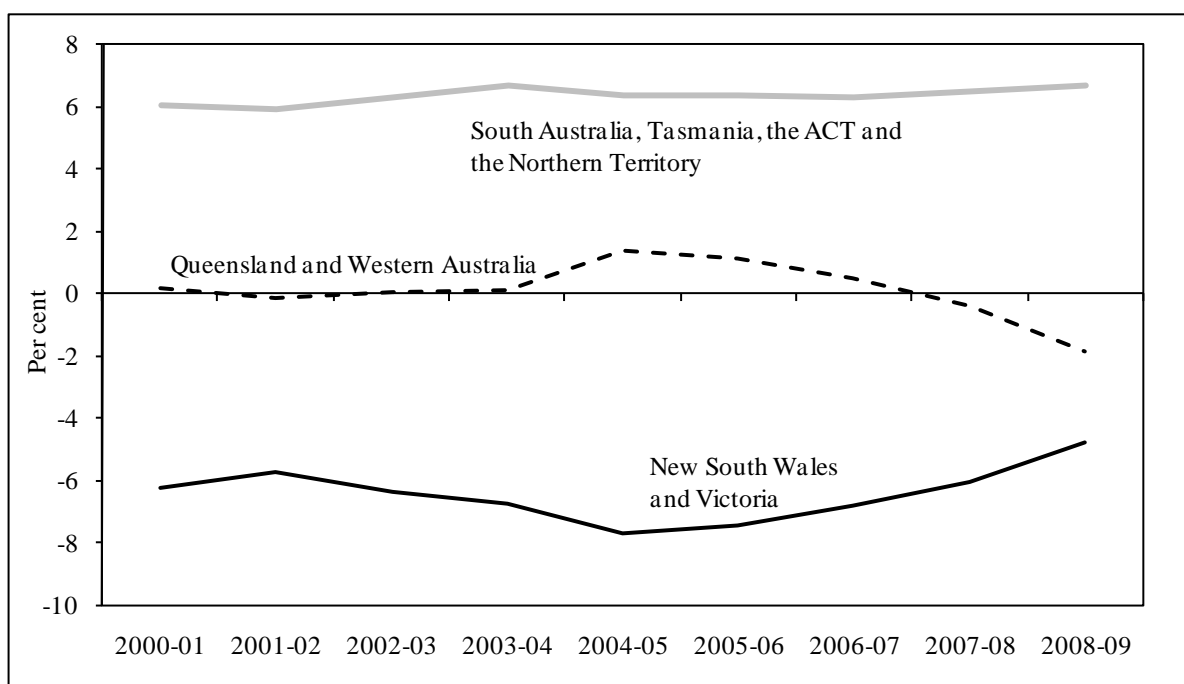
Outcomes in recent years

- 7 Figure 5-2 shows the proportion of the pool distributed away from (or towards) New South Wales and Victoria, Queensland and Western Australia, and the other four States in each year since 2000-01. It shows the redistribution:
 - from New South Wales and Victoria has fallen since 2004-05, reflecting falls in their average relative fiscal capacities which increase their share of the pool;
 - to Queensland and Western Australia has fallen since 2004-05, reflecting increases in their average relative fiscal capacities which reduce their share of the funds; and

- to the four smaller States has remained relatively unchanged.

8 These movements indicate equalisation has worked as it is intended to, despite the use of historical data and five year moving averages. The recent booms in Queensland and Western Australia increased their relative revenue raising capacities and reduced their requirement for assistance. Conversely, slower growth in New South Wales since its peak in 2002-03 has reduced its revenue raising capacity and overall financial capacity leading to an increased share of the pool.

Figure 5-2 Proportion of pool redistributed by State^(a), 2000-01 to 2008-09



(a) The difference between the proportion of the GST and health care grants pool the States receive under the equalisation distribution compared what they would receive under an equal per capita distribution.

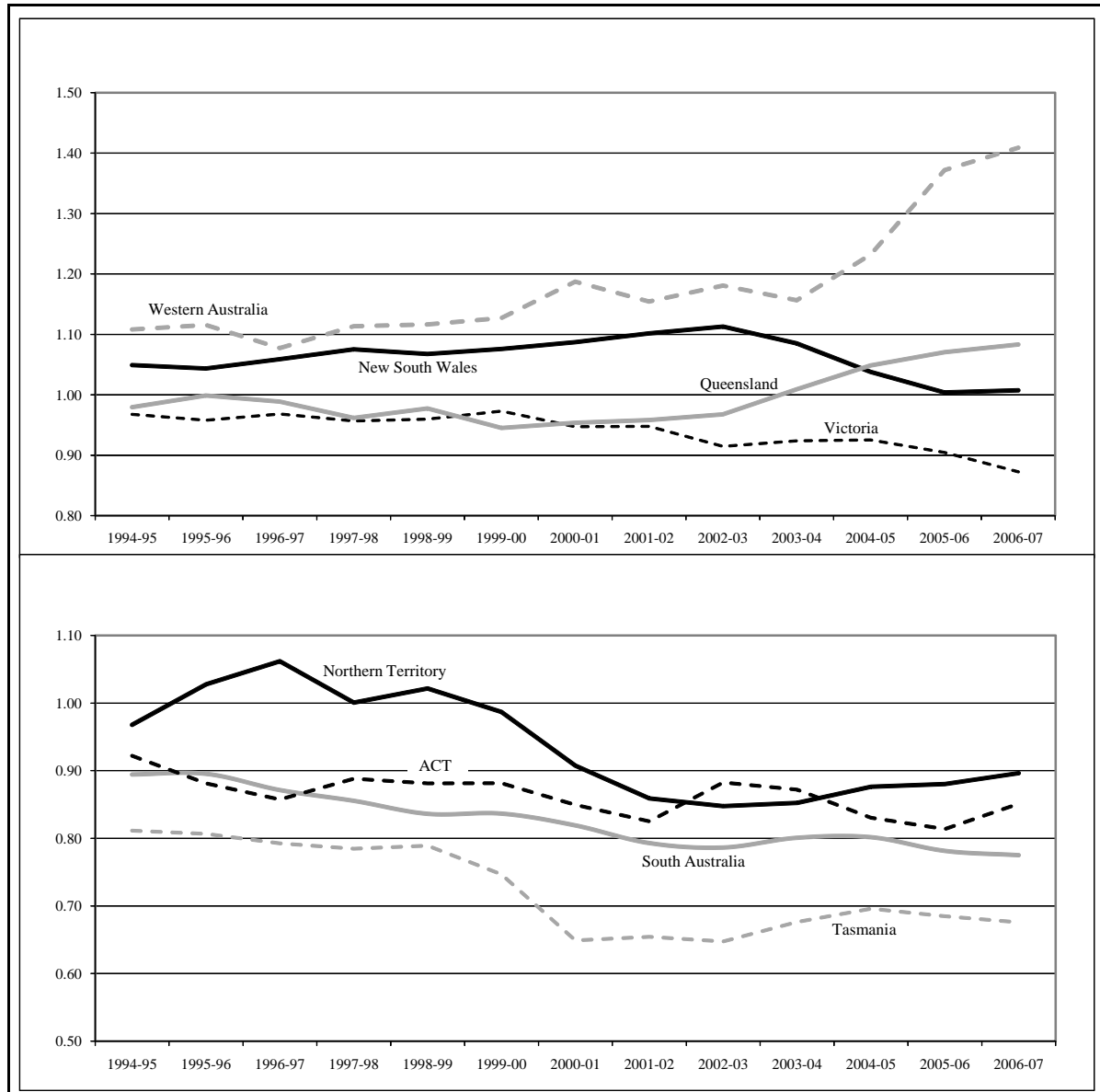
Source: Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2008 Update*.

- 9 **Movements in relative revenue raising capacity.** Figure 5-3 shows the movements in State relative revenue raising capacities assessed by the Commission for each year since 1994-95⁴.
- 10 Changes in State relative revenue raising capacities are heavily driven by relative land values, State real estate market cycles and increased mining activity because those things vary greatly across States and over time. In addition, State reliance on revenue from property transfers and mining has increased over the years.
- 11 The above average revenue raising capacity of New South Wales is largely due to well above average land values and a comparatively strong real estate market for most of the period. The rise in capacity between 1995-96 and 1997-98 was due to a growing real estate market (which increased stamp duty and land tax revenues). The increase from 1999-2000 to 2002-03 was

⁴ These are the capacities calculated for each year using data for that year. The distribution of the 2008-09 pool reflects the average of the capacities for 2002-03 to 2006-07.

also due to a strong real estate market and broad-based growth (which increased relative payrolls). The fall after 2002-03 was mostly due to falls in real estate markets and land values.

Figure 5-3 Relative revenue raising capacities of States — 1994-95 to 2006-07

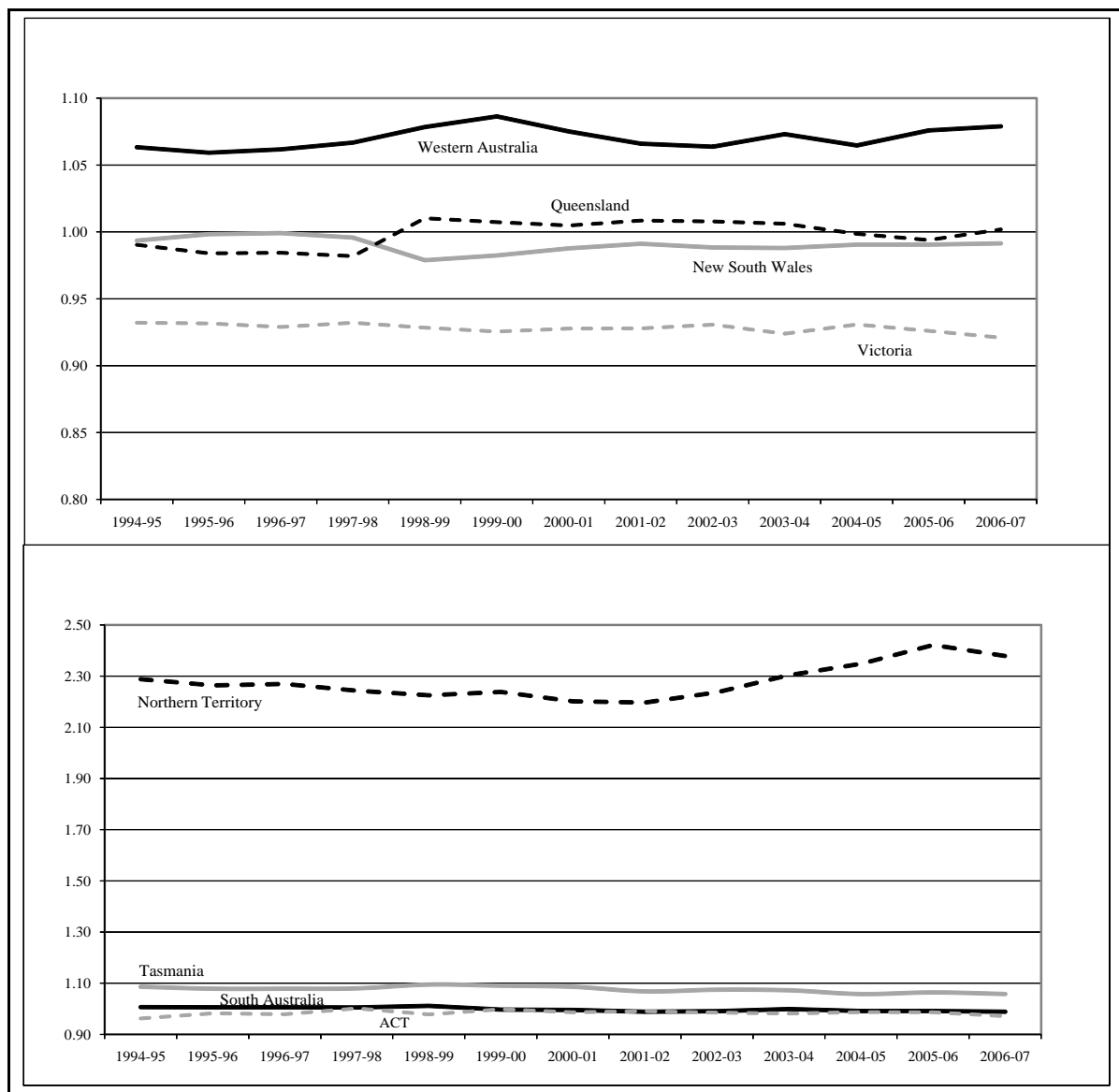


Source: Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2008 Update*.

- 12 Well below average land values and real estate transfers were the major reasons for Victoria's below average capacity and the declines in 2002-03 and 2006-07.
- 13 The declines in Queensland's capacity in 1997-98 and 1999-2000 were linked to below average growth in its real estate market (it grew at half and 40 per cent of the average in 1997-98 and 1999-2000 respectively). The subsequent increases in capacity were due to increased activity in its real estate market and its mining sector.

- 14 Western Australia's high revenue raising capacity and the fluctuations in it stem from its mining sector (its capacity to raise mining revenue is over four times the average) and the flow-on to other sectors. The decline in 1996-97 and the increase since 2003-04 were related to flow-on effects of mining on property markets, employment and payrolls. The per capita value of property transfers in 2005-06 and 2006-07 was well above that of New South Wales at the height of its property boom in the early 2000s.
- 15 The influences on revenue raising capacity in the other States were more diffuse. The declines in Tasmania and the Northern Territory commencing in 1998-99 reflect broad downturns that affected private sector employment, mining activity and property markets.
- 16 *Movements in relative costs of providing services.* Figure 5-4 shows the movements in State relative costs of providing services since 1994-95.

Figure 5-4 Relative costs of providing services — 1994-95 to 2006-07



Source: Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2008 Update*.

- 17 Table 5-1 shows the main features of State populations that affect the use and cost of services. It illustrates some underlying trends in demographic features, such as an increasing Indigenous proportion of the population, a declining low income proportion (as measured by the Commission), a move away from remote areas and a decline in government school attendance.

Table 5-1 Comparison of demographic features

Proportion of population	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	%	%	%	%	%	%	%	%	%
Who are Indigenous (a)									
2006 Census	2.15	0.59	3.50	3.70	1.64	3.43	1.19	30.97	2.46
2001 Census	2.05	0.58	3.47	3.47	1.69	3.68	1.22	28.76	2.36
1996 Census	1.77	0.50	3.14	3.18	1.50	3.23	0.99	28.53	2.11
1991 Census	1.27	0.40	2.51	2.69	1.19	2.03	0.56	26.15	1.64
On low income(b)									
2006 Census	28.87	28.17	27.57	25.92	31.23	33.82	16.62	27.38	28.23
2001 Census	30.53	30.06	33.82	31.56	35.06	39.43	20.10	30.63	31.54
1996 Census	31.72	31.39	33.88	30.44	36.43	38.25	20.84	27.44	32.24
With low English fluency									
2006 Census	4.08	4.14	1.32	1.89	2.24	0.47	1.82	5.58	3.09
2001 Census	3.86	4.01	1.18	1.91	2.18	0.41	1.78	7.24	2.99
1996 Census	3.94	4.33	1.21	2.05	2.32	0.39	1.98	7.41	3.13
Live in urban areas									
2006 Census	69.13	74.21	68.49	74.42	72.77	50.62	99.70	46.11	70.88
2001 Census	69.01	73.89	67.15	71.98	72.25	51.02	99.42	43.63	70.17
1996 Census	66.97	71.24	56.65	63.54	68.50	42.17	99.26	36.01	65.43
Live in remote areas(c)									
2006 Census	1.29	0.11	3.53	6.45	2.56	0.55	0.00	39.32	2.40
2001 Census	1.40	0.12	3.99	6.89	2.76	0.59	0.00	39.74	2.55
1996 Census	1.19	0.43	5.93	10.09	1.88	0.68	0.00	47.13	3.21
Attend gov't schools(d)									
2006-07	10.90	10.40	11.40	11.10	10.30	12.20	10.20	13.80	10.90
2001-02	11.50	11.10	12.40	12.30	11.20	13.10	11.40	14.60	11.70
1997-98	12.10	11.30	12.74	13.40	11.88	13.31	12.70	15.64	12.19

- (a) State Indigenous populations from various editions of ABS publications *Experimental estimates of the Aboriginal and Torres Strait Islander Population* relative to State estimated resident population at 30 June of relevant year.
- (b) Based on data from 2006, 2001 and 1996 Census of people in households with annual family income of less than \$33 799, \$31 200 and \$26 000 respectively or single incomes less than \$20 800, \$20 800 and \$15 600 respectively.
- (c) Figures for 2006 and 2001 based on the State based Accessibility/Remoteness Index of Australia, developed by the National Key Centre for Social Application of GIS for the Commission, and State estimated resident population as at the relevant Census. Figures for 1996 are based on Rural, Remote and Metropolitan Area classifications established by the Department of Human Services and Health and State estimated usual resident population at 30 June 1996.
- (d) Based on data from ABS *Schools Australia* (Cat. 4221.0) as supplemented by data provided by States.

- 18 The figures in the table support the thrust of the Commission's assessments. For example:
- New South Wales has below average proportions of people in those groups who generally increase service costs, such as people who are Indigenous, live in remote areas, have low income (except in 2006) and attend government schools (except in 2006-07). It is also big enough to capture economies of scale in providing services. But its wage and salary levels are above average.
 - Victoria has the lowest relative costs of providing services of all States. Many features are similar to, but more extreme than, those in New South Wales. It has below average proportions of people who are Indigenous, have low incomes, live in remote areas and attend government schools. It also benefits from economies of scale, a compact population settlement pattern and wage levels that are close to the average.
 - Queensland's costs are increased by the above average proportions of its population who are Indigenous, live in remote areas and attend government schools. But, those effects are largely offset by its economies of scale and below average wage levels.
 - Western Australia has above average costs because of above average proportions of Indigenous people, people living in remote areas and government school enrolments. Other contributing factors include the vast area over which its population is spread and its poor water endowments.
 - The demographic features of South Australia largely offset each other — it has below average Indigenous population and attendance at government schools but above average low income, remote area and elderly populations. The main influences on its costs are below average wages which are partly offset by diseconomies of small scale.
 - Tasmania's relatively high costs reflect its diseconomies of small scale and the above average proportions of its population who are Indigenous, have low income, and attend government schools. Those influences are partly offset by low wage levels.
 - The very high relative costs in the Northern Territory are due to the well above average proportions of its population who are Indigenous, have low English fluency, live in remote areas and attend government schools. It also faces large diseconomies of small scale, above average wage levels and its small population is spread over a vast area.
 - The ACT has similarities with Victoria but its costs are increased by diseconomies of small scale, above average wage levels and its role as the national capital. Declining government school attendance contributed to falls in its relative costs since 1997-98.

SOME OBSERVATIONS BASED ON COMMISSION ASSESSMENTS

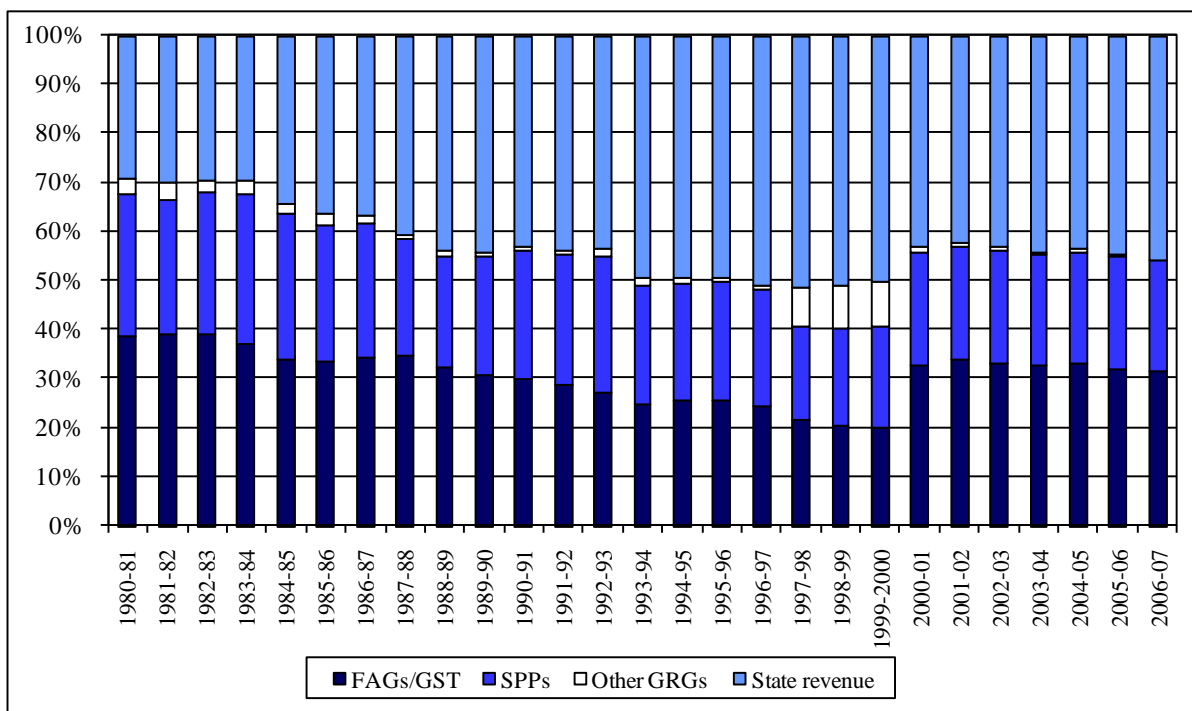
- 19 The Commission's analysis provides insights into many features of State finances, such as:
- their relative financial capacities, which is the basis of the Commission's work;
 - changes in the composition of State revenues and the importance of individual taxes;

- differences between States in their efforts to raise tax revenue; and
- differences between States in the level of services they provide.

Changes in the source of State revenues

- 20 **Changes in the dependence on the Commonwealth.** Figure 5-5 shows the contribution of State taxes, financial assistance grants or GST revenue, other general revenue assistance and specific purpose payments to average State revenue since 1980-81.

Figure 5-5 Average State revenues by source, 1980-81 to 2006-07



Source: Commonwealth Grants Commission analysis of State budgets.

- 21 It shows:

- State tax revenue increased as a proportion of total revenue. It rose from 29 per cent of total revenue in 1980-81 to 50 per cent in 1999-2000⁵. Changes associated with the introduction of the GST (the abolition of some State taxes and Commonwealth payments in lieu of State franchise fees⁶) reduced the State tax proportion to 43 per cent in 2000-01. But strong growth in property markets and mining increased it to 46 per cent in 2006-07.

⁵ It would have been 58 per cent if the revenue replacement payments were treated as State tax revenue — they were classified as other general revenue grants (GRGs).

⁶ The validity of franchise fees was cast into doubt by a 1997 High Court decision on tobacco franchise fees in New South Wales. The Commonwealth introduced arrangements to protect State budgets under which it increased its taxes on those products and introduced provisions to prevent claims for refunds of franchise fees. The extra revenue was given to the States as revenue replacement payments.

- State reliance on financial assistance grants (FAGs) or GST revenue fell. Those revenues were 39 per cent of State revenue in 1980-81 and 32 per cent in 2006-07. This masks a large fall to 20 per cent in 1999-2000 and a rise to 33 per cent after the GST was introduced.
- Specific purpose payments declined from 29 per cent of total revenue in 1980-81 to 23 per cent in 2006-07, partly because some roads grants were transferred from SPPs to financial assistance grants in the late 1990s.

22 Table 5-2 shows that between 1980-81 and 2006-07 State taxes averaged 45 per cent of their total revenue. However, the proportion varies considerably from State to State. On average, New South Wales was the most self sufficient State. Its tax collections were 49 per cent of its total revenue. (Rapid growth in Western Australia made it the most self sufficient State in 2006-07 when its own revenues were 54 per cent of its total revenue.) At the other extreme, taxes in the Northern Territory were only 17 per cent of its total revenue.

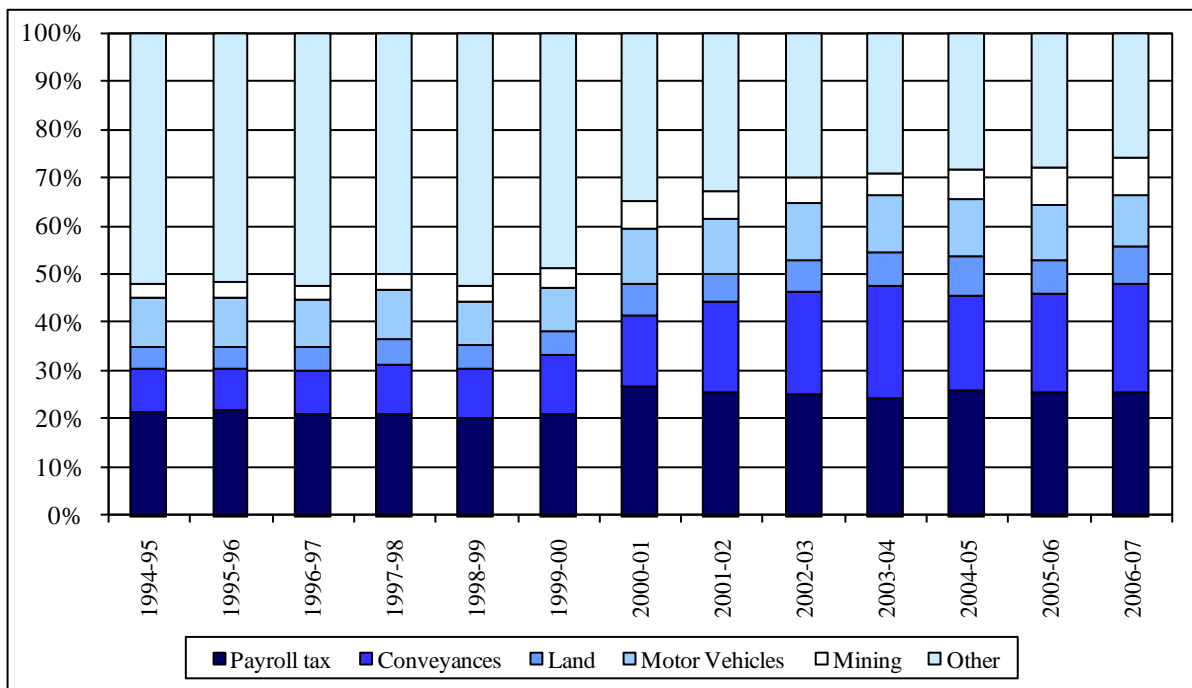
Table 5-2 State own-source revenue as proportion of total revenue, 1980-81 to 2006-07

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	%	%	%	%	%	%	%	%	%
Average proportion	49	48	41	46	39	30	39	17	45

Source: Commonwealth Grants Commission analysis of State budgets.

23 *Changes in the importance of individual State taxes.* Figure 5-6 shows how the contribution of individual taxes to State own-source revenue has changed between 1994-95 and 2006-07.

Figure 5-6 Contribution of major taxes to State own-source revenue — 1994-95 to 2006-07



Source: Commonwealth Grants Commission analysis of State budgets.

- 24 The more important changes are:
- taxes on conveyances of property more than doubled from 10.8 per cent of State revenue in 1994-95 to 22.5 per cent in 2006-07;
 - mining revenue rose by 80 per cent from 4.1 per cent of State revenue in 1994-95 to 7.5 per cent in 2006-07;
 - the abolition of State taxes on financial transactions, reductions in gambling tax rates and the cessation of the revenue replacement payments after the introduction of the GST reduced the importance of other revenues; and
 - payroll tax, the largest State tax, grew about 20 per cent faster than total State revenue. It was 21.2 per cent of State revenue in 1994-95 and 25.2 per cent in 2006-07.

Differences in State policies on revenue raising

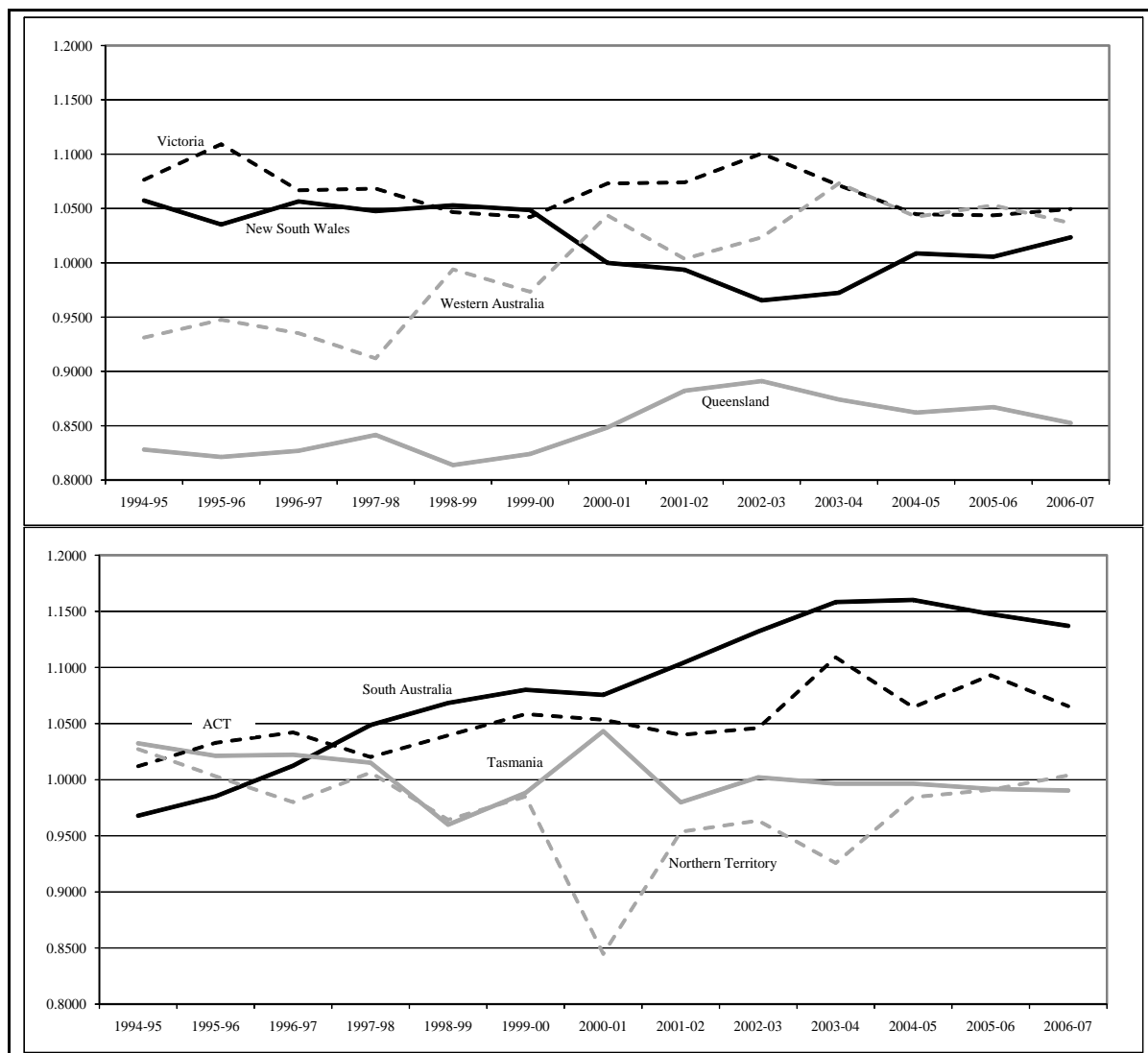
- 25 The Commission's analysis can indicate how each State's actual revenue effort compares with the average effort⁷. A relative effort greater than one indicates a State is taxing at higher rates than the average and/or is achieving greater compliance with the tax.
- 26 Figure 5-7 shows the overall efforts of each State to raise revenue from their taxes and mining activity between 1994-95 and 2006-07. The figure excludes the contributions States sought to obtain from their trading enterprises and other miscellaneous revenues. The extent to which States seek revenue from their trading enterprises has varied noticeably over the years with comparatively large amounts being sought by Victoria in 1998-99, Western Australia in 2000-01 and Queensland in 2001-02.
- 27 Since 1994-95, it has generally been the case that:
- the revenue effort of New South Wales has been above or about average, except in 2002-03 and 2003-04 when the effective rate of tax on land was relatively low;
 - the revenue effort of Victoria has been above average for the whole period;
 - the effort of Queensland has been the lowest of all States;
 - the effort of Western Australia rose to be above average in 2000-01 as a result of increases in several areas including payroll tax and stamp duty on conveyances;
 - the effort of South Australia has been the highest of all States since 1998-99;
 - the effort of Tasmania has been comparatively close to the average;
 - the effort of the Northern Territory has been below average for most of the period due largely to the absence of a land tax and relatively low mining royalties with the noticeable fall in 2000-01 being due to low payroll tax collections; and

⁷ Each State's revenue effort is calculated by comparing its actual revenue (which reflects the application of its own tax rates and conditions to its own revenue base) with the revenue it would collect if it applied the average tax rates and conditions to its own revenue base. This is equivalent to comparing its effective tax rates (defined as actual revenue divided by its revenue base) to the average effective tax rates.

- the ACT's effort has been above average for the whole period. The increased effort in 2003-04 was partly due to increases in aspects of the stamp duty on conveyances. The apparent fall in effort in 2004-05 was primarily due to abnormally low revenue from conveyances.

28 Overall, the revenue efforts of the States have tended to converge. This is consistent with the possibility that increasing integration of State economies and broader economic forces limit their ability to follow very different tax policies.

Figure 5-7 State relative efforts to raise taxes and mining revenues — 1994-95 to 2006-07



Source: Commonwealth Grants Commission analysis.

Differences in State policies on services provided

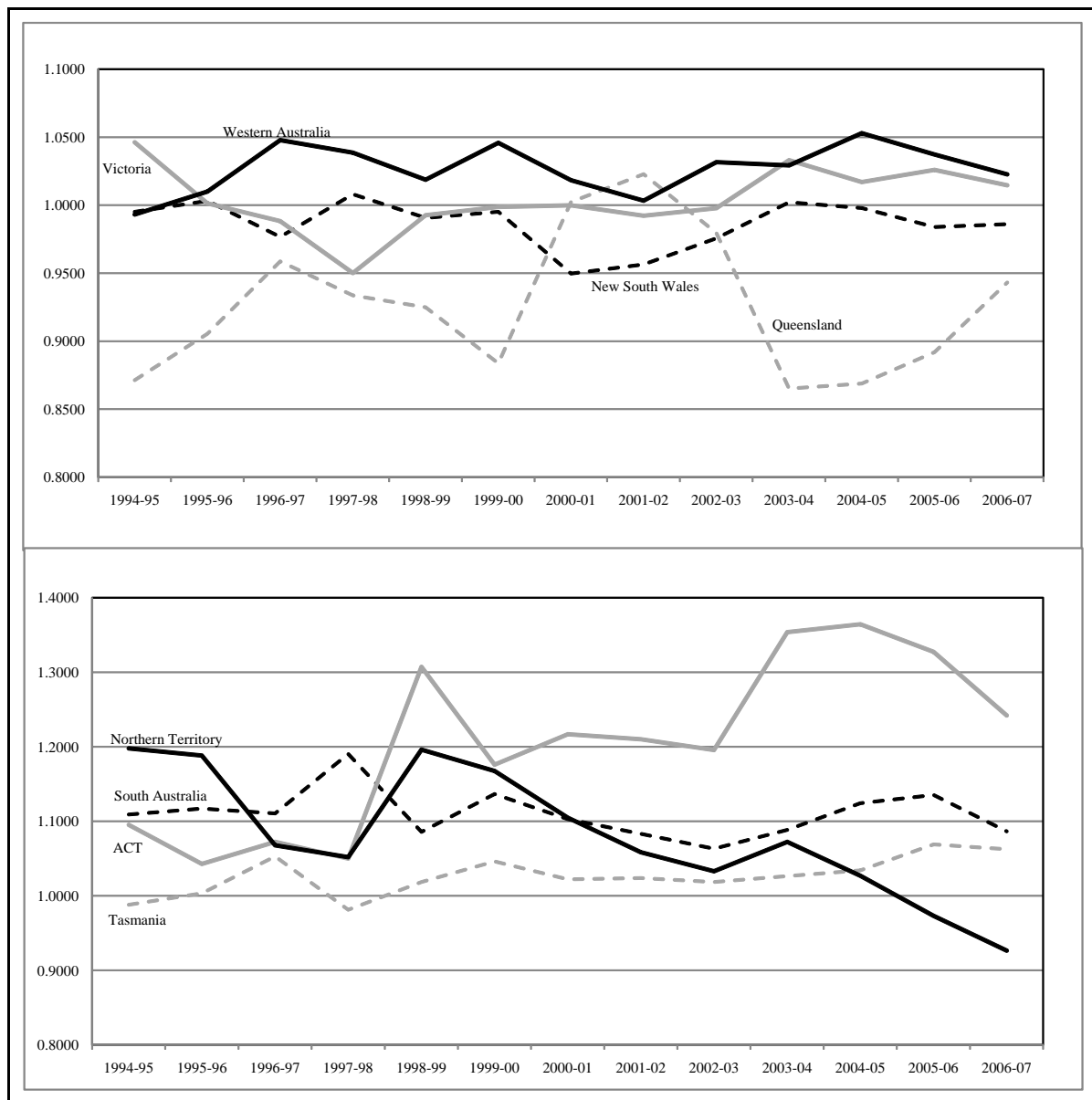
29 Insights into the relative level of services can be also gained by comparing each State's actual expenses with the Commission's estimates of what they would spend if they provided the average level of service. In concept, the difference between the two figures represents the effects of above (or below) average levels of services and/or the effects of above (or below)

average efficiency in the delivery of the service. However, in practice, data issues especially difficulties in the classification of State expenses, mean the comparisons are indicative only.

30 Figure 5-8 shows how State aggregate service levels compare with the average. Service level ratios above 1.0 suggest above average levels of service and/or below average levels of efficiency. The implications from the figure are as follows.

- The overall level of State services has converged, especially since 2003-04.
- New South Wales and Victoria had about average levels of expenses overall, although Victoria has moved above average since 2003-04 due to increased general administrative expenses. The noticeably below average position of New South Wales in 2000-01 and 2001-02 was due to relatively low superannuation expenses.
- Queensland generally had the lowest relative level of expenses (the peak in 2000-01 to 2002-03 was largely due to abnormal superannuation payments) which is consistent with its low relative revenue raising effort. Its expenses in the major areas of education, health and welfare have been consistently below average. The increases since 2004-05 are largely driven by increasing health and welfare expenses and, in 2006-07, superannuation.
- Western Australia, South Australia and Tasmania generally had above average expenses.
- The Northern Territory had well above average expenses prior to 1998-99 but they have trended down since then. They were the lowest of all States in 2006-07 primarily due to substantial relative declines in interest, depreciation, superannuation and general administrative expenses.
- The ACT has had the highest relative expenses of all States since 1998-99. It had above average expenses on health and welfare, education, general administrative services and superannuation. However, its relative expenses have declined since 2004-05, particularly in education, health and welfare services.

Figure 5-8 State relative service levels for all services — 1994-95 to 2006-07



Source: Commonwealth Grants Commission analysis.

CHAPTER 6

AUSTRALIAN ARRANGEMENTS IN AN INTERNATIONAL CONTEXT

INTRODUCTION

- 1 Most countries structured as formal federations and some with other forms of decentralised government redistribute funds among governments to enable each to fulfil its responsibilities. Those arrangements often aim for a distribution of funds that allows the regional governments to provide basic or comparable levels of services and to do so with comparable tax efforts.
- 2 Some literature on fiscal arrangements in federal and decentralised countries indicates the Australian equalisation processes are innovative, pioneering and an example of good practice¹. Such comments generally relate to the comprehensive and objective approach to determining State shares. Other countries have used aspects of Australian arrangements as a starting point for developing theirs.
- 3 Conversely, other commentators consider Australia's aim of full equalisation may be detrimental to national output, its allowances for differences in the costs of services are unnecessary and the use of an independent expert body has led to an overly complex process².
- 4 This chapter examines some of those issues with the help of broad comparisons between Australia, Canada, China, Germany and South Africa. Many other countries could have been chosen. The United States was not chosen because while it is a developed, federal country, it does not have a formal equalisation process, although some equalisation is built into the funding for specific purposes. Nor does the chapter cover the many developing countries that have federal (or multi-layered decentralised) arrangements and which follow equalisation processes in distributing funds (such as Ethiopia and Sierra Leone).

¹ For example, Watts R, *Autonomy or dependence: Intergovernmental financial relations in eleven countries*, Working paper 2005 (5), Institute for Intergovernmental Research, Queen's University.

² For example, Shah A, *A Practitioner's guide to intergovernmental fiscal transfers*, in *Intergovernmental Fiscal Transfers* edited by Boadway R and Shah A, The World Bank, Washington DC, 2007.

THE IMPORTANCE OF THE CONTEXT

- 5 The governmental and intergovernmental arrangements in a country are a product of its history and its social, demographic, economic, geographic and political circumstances. Consequently, arrangements developed by one country may not be appropriate in others. A discussion of intergovernmental arrangements should take account of the context in which they were developed.
- 6 Australian intergovernmental financial arrangements have the following characteristics.
 - Commonwealth dominance over economic policies, income redistribution, social security benefits and revenue collections (it collected 81 per cent of all tax revenue in 2006-07). Among other things, this makes the States reliant on revenue sharing arrangements with the Commonwealth and specific purpose payments for about half their revenue.
 - Comprehensive processes for equalising the capacity of the States to provide services.
 - The extent of revenue sharing reflects Commonwealth budget circumstances and a history of negotiations between the Commonwealth and the States. However, the allocation of the revenues is based on advice from an independent body.
 - Extensive intergovernmental arrangements for co-ordinating Commonwealth-State activities while still retaining an element of interstate competition.
- 7 These arrangements are the result of over a century of evolutionary developments and have been affected by many factors.
 - While Australia is a multi-cultural society (of those who declared their ancestry in the 2006 Census about 25 per cent were born overseas) with regional differences in population characteristics, attitudes, and economic circumstances, it is relatively homogeneous by international standards. For example, it developed from British colonies, has had over 100 years of peaceful democratic governance, English is the only official language, 80 per cent of people live in urban areas of over 10 000, and the average per capita GDP of each State varies from 85 to 137 per cent of the average³.
 - The Constitution allows the Commonwealth and the States to act concurrently in many fields, and provided the basis for the Commonwealth's financial strength by giving it exclusive access to the largest tax at the time of federation. This situation has been perpetuated by the evolution of policies since federation and High Court decisions.
 - The need to fund the war effort led to the centralising of income and corporate taxes in 1942 and the immediate post war years. In 1948, the reimbursement grants to the States moved from a State of collection basis to one based on State population, population density and the number of school children. The Commonwealth declined to return the taxing powers to the States in part because of the benefits for economic and social

³ If average per capita household income is used the range is larger — 86 to 160 per cent of the average.

policies and because there was not a united position among the States. (A resumption of taxing powers would have benefited Victoria, had little effect on New South Wales and led to the other four losing more than they gained⁴).

- The High Court upheld the Commonwealth's right to impose income taxes in peacetime and its power to make grants to the States conditional on them not imposing income taxes.
- Other High Court decisions constrained State revenue raising efforts by preventing them imposing taxes on goods, disallowing a Victorian receipts duty and invalidating State business franchise fees.
- A level of acceptance among the States of the political advantages of not collecting taxes themselves, as illustrated by a statement by a previous Premier of Queensland to the effect that 'the only good tax is a Commonwealth tax'.
- General acceptance in the population of Commonwealth control over policies relating to economic stability, and uniform taxation and social security benefits — possibly reflecting memories of the 1930s depression and World War II, a sense of national identity and an egalitarian philosophy that values uniformity above diversity. The uniform taxation policies, and the High Court decisions relating to them, may have reinforced a popular presumption in favour of similar government services in all States.

How does Australia compare with other countries?

- 8 Table 6-1 provides summary information for 2006 or 2007 which suggests the countries examined have greater variation in their demographic and economic circumstances than Australia.
- 9 **General matters.** Australia and Canada have many similarities. Each is a federation formed from British colonies with the aim of obtaining the benefits of larger size and unity in the areas of commerce and economic development, defence and international affairs. Both are developed high income countries where natural resources play a key role in their economies. They are large countries with uneven settlement patterns and large, inhospitable sparsely settled areas. They have high proportions of their populations in urban areas (about 80 per cent), mostly located in the coastal parts of south-eastern Australia and southern Canada adjacent to the border with the USA. Indigenous people are a small part of the population in both, but tend to be larger proportions of the population in remote areas.

⁴ Jay, WRC, in *Intergovernmental Relations in Australia*, edited by RL Mathews, 1974, p204. The results arise because the distribution arrangements introduced in 1948 moved the allocation of grants away from the place of collection basis and towards States with lower revenue raising capacities.

Table 6-1 Comparison of basic features of selected countries: 2006 or 2007

	Australia	Canada	Germany	South Africa	China
Number of regional governments	6 States, 2 self-governing territories; local governments under State laws	10 provinces, 3 self-governing territories; local governments under provincial laws	16 Lander; local governments under Lander laws	9 regions; local government has status under the constitution	33 provinces, 333 prefectures, thousands of counties and townships
Population – national	21.1 million	33 million	82.3 million	47.9 million	1 314 million
Population in most populous States-	57.6 % in New South Wales and Victoria	62.2 % in Ontario and Quebec	50.1 % in North Rhine-Westphalia, Bavaria and Baden-Wurttemberg	55.6 % in KwaZulu-Natal, Gauteng and Eastern Cape	21.3% in Henan, Shandong and Guangdong
Least populous State	1.0 % in Northern Territory	0.4 % in Prince Edward Island and 0.3 % in the 3 territories	0.8 % in Bremen and 1.3 % in Saarland	2.3 % in Northern Cape	0.2 % in Tibet
Density (persons /sq km) National	2.7	3.3	231	39	137
Densest State (excluding city-states)	22.7 in Victoria	24.3 in Prince Edward Island	529 in North Rhine-Westphalia	576 in Gauteng and 105 in KwaZulu-Natal	
Sparsest State	0.2 in Northern Territory & 0.8 in Western Australia	0.03 in territories & 1.3 in Saskatchewan	73 in Mecklenburg-West Pomerania	3 in Northern Cape & 23 in Free State	
Indigenous proportion National	2.5%	3.6%		Black Africans were 79.0 % of national population, ranging from 97 % in Limpopo to 26.7 % in Western Cape	
Highest regional proportion	32% in Northern Territory	51.1% in territories			
Lowest regional proportion	0.6% in Victoria	1.4% in Quebec			
Official language	English	English & French	German	11 languages in constitution	
Gross state product (\$A pc) National	50 264	47 565	45 958	4 972	2 411
Highest	68 711 in Northern Territory, 68 032 in Western Australia	76 846 in Alberta	79 042 in Hamburg	8 174 in Gauteng	8 650 in Shanghai
Lowest (a)	42 924 in Tasmania	33 500 in Prince Edward Island	31 454 in Mecklenburg-West Pomerania	2 678 in Eastern Cape	868 in Guizhou

(a) Converted to Australian dollars using exchange rates applicable on 22 July 2008 when an Australia dollar was equal to 0.9776 Canadian dollars, 6.6702 Chinese Yuan, 0.6136 Euro, and 7.3883 South African Rand.

- 10 However, there are also major differences.
- Regional and cultural differences within the population are much greater in Canada. Many stem from the distinction between French speaking Canadians (concentrated in Quebec) and English speaking Canadians, leading to two official languages and a separatist sentiment in Quebec. But there are also distinct regional identities in the Atlantic maritime, western and prairie Provinces. While cultural differences and regional associations exist in Australia, they are more muted.
 - Economic circumstances as measured by GDP per capita are broadly similar, but regional differences are greater in Canada reflecting the concentration of natural resources. Average GDP per capita in the Australian States varies from 85 to 137 per cent of the national average. In Canada, it varies from 71 to 161 per cent of the average.
- 11 South Africa also previously consisted of British colonies. It too contains large sparsely settled areas, nearly 60 per cent of its people live in urban areas and natural resources are important to its economy. But the similarities end there. South Africa has been through tumultuous times. Its current governance arrangements and constitution, which date from the mid 1990s⁵, are a response to its previous arrangements. They aim to unite and build a country which was deeply divided on racial and ethnic lines and which contained much inequality.
- 12 Today, South Africa is a multi-lingual, multi-cultural and multi-racial nation with 11 official languages. Though not formally a federation, its provinces have significant roles and a level of autonomy from the central government. There are big regional differences in population composition and economic well being — on average about 10 per cent of the population is white but 60 per cent of them live in the provinces of Gauteng and Western Cape, which contain the cities of Johannesburg, Pretoria and Cape town and have well above average per capita GDP. The World Bank classifies South Africa as an upper middle income economy. However, its national GDP per capita is about 10 per cent of Australia's and there is more variation — average provincial GDP per capita varies from 54 to 164 per cent of the average.
- 13 Germany, like Australia, is a rich developed country with a largely homogeneous population and one official language. However, its population is almost four times that of Australia and is more densely settled, with three of its 16 Lander (states) being city-states, somewhat like the ACT⁶. Like South Africa, its governance arrangements arose from tumult and reflect a desire to prevent the recurrence of earlier circumstances. It has also had to cope with major change arising from the re-unification of east and west Germany. While the average GDP per capita for Germany is of a similar order of magnitude to that in Australia and Canada, there is more variation across the Lander — it ranges from 68 to 172 per cent of the average.
- 14 Finally, China has the largest population of any country in the world and occupies the third largest area (Canada has the second largest). Its history is different from that of the others and has much regional variation in cultural, linguistic and economic circumstances. Economically,

⁵ The constitution was enacted in 1996 following democratic elections in 1994.

⁶ However, each of the German city-states lies within relatively heavily populated regions.

it is the transition from a centrally planned economy to a more market oriented one. While it is experiencing rapid economic growth, it is off a low base. Currently, its national average GDP per capita is about 5 per cent of that in Australia and Canada and there is much greater variation across the provinces — it ranges from 36 to 360 per cent of the average.

- 15 ***The constitution and intergovernmental allocation of powers.*** The constitutions of Australia, Canada, Germany and South Africa are all very different. Reflecting the different environments in which they were drafted, there are differences in the underlying motivations, allocations of powers and ways of setting out the powers of each government. The differences have affected the extent to which judicial interpretation and political and economic events have influenced the development of intergovernmental arrangements. A combination of a constitution and national government legislation and decrees is used in China.
- 16 Each of the federal countries and quasi-federal South Africa has a bicameral national parliament and parliaments in each state. A major distinction is that in Germany and South Africa, the second house consists of regional representatives with extensive powers over legislation that affects the regions. This produces highly integrated and inter-related governance processes which, especially in Germany, constrain the ability of the national and regional governments to act independently and has been criticised as clouding the accountability of each government.
- 17 The constitutions of Canada, Germany and South Africa all have commitments to one or more of human rights, uniformity of living conditions, access to basic services and equalisation. Australia has no similar legislative commitments.
- 18 The Constitution of Australia explicitly lists Commonwealth powers, but says States may legislate concurrently in many of those areas. Residual powers belong to States. It appears to be a decentralist document. However, the High Court has tended to interpret Commonwealth powers broadly which, together with political and cultural developments, has had centralising tendencies.
- 19 Both the written Constitution of Canada and how the country operates appear to be mirror images of Australia. Its Constitution explicitly lists the powers of the federal and provincial governments and a small number of concurrent powers, although it assigned a general ‘peace, order and good government’ power to the federal government which grants it residual power. Its generally centralising flavour extends to allowing the federal government to bring local works under federal jurisdiction by declaring them to be for the ‘general advantage of Canada or for the advantage of two or more provinces’ and to suspend or disallow provincial legislation (though these two powers have seldom been used, especially in the last century). However, Canada’s constitution also allocates the ‘property and civil rights’ power to the provinces, a power the courts have tended to interpret broadly, making it a *de facto* second ‘residual power’. The trend in court decisions, together with the strong regional identities which tend to support provincial autonomy, have produced a much more decentralised federation than in Australia.

- 20 The German Basic Law (constitution), which was drafted in the aftermath of the Second World War, was intended to have a federal character to avoid the re-emergence of a strong central state. It sets out areas of exclusive federal powers, areas of concurrent powers and areas where the federal government may make framework laws. Residual powers belong to the Lander. However, it does not emphasise the division of powers among governments since it lists only the powers of the federation. Rather it reflects a German tradition of ‘mutual connections and interconnections, and overlapping of the centralized and decentralized state units’⁷.
- 21 In general, and apart from areas covered by exclusive federal powers, federal legislation establishes uniform nationwide standards and policy frameworks which the Lander and local governments implement and administer. Meeting the constitutional requirement for uniformity of living conditions across all Germany is interpreted to require uniform policies, principles and standards which the federal government sets under its concurrent and framework powers. In this way, federal legislation has progressively covered most policy areas.
- 22 The South African constitution reflects a negotiated move to a new governing regime which strongly reflects the new order’s human rights and nation building principles. The system has similarities to the interconnected and interlocking German system and many federal features but it also ensures central dominance. Unlike Australia, Canada and Germany, South Africa’s constitution provides for local government as a separate sphere of government. (In the other three countries, local government is a creature of the states.)
- 23 The South African constitution lists a few exclusive provincial and local government powers and many concurrent powers. Residual powers lie with the central government and its laws generally prevail if there are inconsistencies with provincial laws. The central government can also legislate in areas of exclusive provincial powers if necessary for national security, economic unity, to preserve national and minimum standards and to prevent unreasonable provincial action. This has happened only once, but the potential may constrain provincial powers. These provisions, together with a political environment where the African National Congress controls the national parliament, all the provincial governments and most of the large local governments, produce a centralised governing process.
- 24 China is a unitary (non-federal) country characterised by a strong central government but considerable decentralisation of revenue raising and service delivery responsibilities to provincial and municipal governments. A major reform in 1994 resulted in increased revenue raising and increased the central government’s share of the revenue.
- 25 *The distribution of revenue raising powers.* The arrangements are summarised in Table 6-2. In Australia, China, Germany and South Africa, revenue raising powers are highly centralised in the national government. However, in Australia, China and Germany the total revenues from specified taxes or specified proportions of the revenue from several taxes are shared with

⁷ Kramer J, *Federal Republic of Germany in A Global Dialogue on Federalism, Volume 1, Constitutional Origins, Structure, and Change in Federal Countries*, edited by J Kincaid and G Alan Tarr, Forum of Federations, Canada, 2005.

the sub-national governments. In South Africa, the sub-national governments receive ‘equitable shares’ of the nationally collected revenues in the form of grants.

Table 6-2 Overview of allocation of revenue raising powers

	Australia	Canada	China	Germany	South Africa
Taxes levied under national legislation	Personal income, corporate, sales and excise, GST, offshore natural resources	Personal income, corporate, sales and excise, GST, customs duty	Personal income, enterprise income, VAT, duty on imports, securities, tariffs, taxes on banks, insurance companies & railways	Personal income, corporate, VAT, taxes on insurance, tobacco, coffee, alcohol (not beer), mineral oil and electricity.	Personal income, corporate, VAT, general sales, property, customs
Taxes levied under regional (state) powers	Payroll, stamp duty on property transfers, land, gambling motor vehicles, onshore natural resources	Personal income, corporate, sales and excise, GST, property taxes, vehicles, gambling and liquor, natural resources	Property, land use, urban maintenance & construction, vehicle use, income from local state owned enterprises	Property, real estate acquisition, motor vehicles inheritances, beer and gambling	Motor vehicles, gambling, alcohol, hospital fees, tourism. Local government can tax property
Extent of regional autonomy over their taxes	Full power to set bases and rates for all their taxes	Full power to set bases and rates for all their taxes	Can set bases and rates	Tax bases and rates set by national framework laws	Provincial tax bases and rates under national laws. Local government can set its policies
Sharing with regions (national: regional: local (if appropriate) proportions)	All GST revenue to States	None	Personal income (60: 40), enterprise income (60: 40), VAT (75: 25), duty on securities, tariffs (97: 3)	Personal income (42.5: 42.5: 15), corporate (50: 50), VAT shares vary over time in 2007 were 55: 43: 2	No explicit tax sharing but provinces and local government get ‘equitable share’ grants
Proportion of tax revenue collected by national government	81 %	43% (a)	90 %	86 %	95 %
Proportion retained after revenue sharing	68 %	43%	55-60 %	49 %	95 %

(a) This figure covers all own-source revenues, not tax revenues.

- 26 By contrast, revenue raising in Canada is highly decentralised. The Canadian and provincial governments each impose the major taxes — personal income, corporate, sales (including

VAT and GST) and payroll taxes. Each province determines its revenue bases and tax rates. However, to improve economic efficiency and reduce collection and compliance costs, they may participate in tax harmonisation agreements⁸.

- 27 While the Canadian Government has exclusive access to customs duties (a minor source of revenue), its provinces effectively have exclusive access to taxes on property, motor vehicles, gambling and liquor profits and natural resources in their jurisdiction. Constitutionally, the right to collect revenue from offshore resources belongs to the national government. However, it gave the rights to collect revenue from offshore oil and gas in the Atlantic area to the provinces of Newfoundland and Labrador, and Nova Scotia.
- 28 In 2005, 42.5 per cent of total own-source revenue accrued to the Canadian Government, 46.2 per cent to the provinces and 11.2 per cent to local government⁹.
- 29 It is notable that in Australia and Canada, the national governments assumed control of the personal income and corporate taxes during the Second World War and provided the States and provinces with grants to reimburse the lost revenue¹⁰. After the war, the Commonwealth in Australia retained the taxing powers by exercising its power to give grants under conditions it considers appropriate (section 96 of the Constitution). It changed the distribution of the grants away from a point of collection basis to one based on population and made them conditional on the States not reimposing the taxes. The High Court upheld the validity of this action which meant any State that sought to impose taxes would have taxed its residents twice. By contrast, several of Canada's provinces, notably the larger ones (Quebec and to a lesser extent Ontario) sought to reimpose personal and income taxes to reassert their constitutional autonomy and succeeded in doing so, based on support from their electorates.
- 30 *The distribution of expenditure powers.* In each country, the national government is responsible for national functions such as defence, foreign affairs, external trade, currency, immigration, and inter-regional trade, transport and communications. The regional and local governments are responsible for most direct service delivery, in health, school education, public law and order, community services, intra regional transport, power and water.
- 31 The largest differences are in Germany and South Africa. After allowing for national responsibilities, most other responsibilities are allocated on an activity basis. The national governments determine policies and standards while the provincial and local governments administer and implement them. The regional governments have input into those policies, particularly in Germany, through their role in the second house of parliament.

⁸ However the agreements are not universal. In 2006, all provinces except Quebec had an agreement for personal income taxes. Corporate taxes were harmonised in all provinces except Alberta, Ontario and Quebec. Harmonised value-added taxes existed only in Newfoundland and Labrador, Nova Scotia and New Brunswick and Quebec has a provincial value added tax as well as collecting the Canadian GST.

⁹ Figure provided by Canadian Ministry of Finance, July 2008.

¹⁰ A 1930s report by the Rowell Commission in Canada also proposed an intergovernmental system similar to that in Australia (where taxes were imposed centrally and the provinces received general revenue grants from the Canadian Government). But consideration of it was delayed by the war and its proposals were overtaken by the subsequent provincial demands for a return of taxing powers.

- 32 In Australia, national aims and detailed conditions for many State services (especially in health and education) are established through the agreements accompanying the SPPs and intergovernmental councils. This is to a lesser extent true in Canada as well, where broad national criteria (such as comprehensiveness, universality, portability and accessibility) are established as conditions of the Canada Health Transfer, but few conditions are attached to other transfers supporting higher education and other social programs.
- 33 Other noticeable differences occur in social security and income support — in Australia all pensions and unemployment and health benefits for individuals are Commonwealth responsibilities and are uniform across the country. Most social security provisions are also a national responsibility in Germany. However, in Canada, unemployment benefits are funded from national employment insurance which has regionally differentiated eligibility and benefit conditions that cause some discontent among provincial governments. In China pensions, income support and health insurance are local responsibilities and vary greatly between richer and poorer and urban and rural areas (residents of rural areas are largely self-funded¹¹).
- 34 Table 6-3 summarises the central government's share of total expenditure in each country. It shows China has the lowest national share of government expenditure.

Table 6-3 Central government share of total expenditure,

	Share of expenditure
	%
China (2004)	28(a)
Canada (2005)	36(b)
Germany (2002)	41(b)
South Africa (2002)	49(b)
Australia (2006)	64(c)
(a) Fedelino, A and Ter-Minassian, T, <i>Intergovernmental Relations in China</i> , Paper for Stanford Conference on Economic Challenges in Asia, June 2006.	
(b) Shah, A (ed), <i>The Practice of Fiscal federalism: Comparative Perspectives</i> , McGill-Queen's University Press, 2007.	
(c) Data from Australian Bureau of Statistics, <i>Government Finance Statistics</i> .	

HORIZONTAL EQUALISATION AND OTHER FINANCIAL ARRANGEMENTS

- 35 The preceding sections identified some of the historical, political, demographic, geographic and economic circumstances that shaped each country's financial arrangements.
- 36 **Australia.** In 2005-06, the system of revenue sharing and SPPs provided the States and local government with about 50 and about 9¹² per cent respectively of their total revenues.

¹¹ Residents of rural areas are about 60 per cent of the population but account for only 10 per cent of social security expenses.

¹² Productivity Commission Research Report, *Assessing Local Government Revenue Raising Capacity*, p22, April 2008.

- 37 The GST revenue (net of collection costs) was \$42.6 billion in 2007-08 and made up about 59 per cent of total transfers. The other 41 per cent consisted of a large variety of SPPs. About 35 per cent of the SPPs related to health services and 34 per cent to education.
- 38 The GST revenue is distributed on the advice of the Commission, which applies equalisation principles and has a clear aim of equalising the financial capacity of the States to provide services. Among other things, this reflects a long history of equalisation (the special grants applied equalisation principles to the claimant States), an earlier allocation system for general purpose grants that allowed for some expenditure needs and a view that the pre-1976 distributions were unfair to the larger States.
- 39 The key features of the Australian equalisation system are:
- all States are equalised to the national average fiscal capacity — some are equalised up and some down;
 - it is comprehensive, covering interstate differences in capacity to raise revenue, the costs of providing services and receipts from most Commonwealth SPPs;
 - the capacity to which States are equalised is an average of what they all do — it does not reflect externally determined optimum policies;
 - it aims to be policy neutral in that a State's own policies do not directly affect its grant;
 - the comparisons are made for the most recent five years and averaged; and
 - the State allocations are kept as up to date as data constraints allow, through regular reviews of methods and annual updates of the data in between reviews.
- 40 On average, over the five years 2002-03 to 2006-07 the revenue raising capacities of the States ranged from 68 to 127 per cent of average while costs of service ranged from 92 to 108 per cent of average, excluding the Northern Territory's 250 per cent. These differences were fully offset in the distribution of GST and health care grants for 2008-09.
- 41 The GST and health care grants distributed by the equalisation processes improve the balance between the resources States require to discharge their responsibilities and the resources available to them, and equalise their financial capacities. Recent calculations indicate that 11.6 per cent of the pool (\$6.3 billion) was required to equalise the State financial capacities, with the remaining 88.4 per cent of the pool implicitly distributed on an equal per capita basis.
- 42 *Canada.* The significant revenue raising powers of Canada's provinces result in few untied and specific purpose transfers from the Canadian government. On average, transfers were less than 15 per cent of provincial revenues in 2007¹³.
- 43 The only untied transfers were equalisation payments to some provinces, territorial funding and payments under offshore agreements with Newfoundland and Labrador, and Nova

¹³ Derived from data provided by the Canadian Ministry of Finance in August 2008. The figure varies substantially between provinces.

Scotia¹⁴. However, the existence of only broad, general conditions on the transfers for higher education and other social programs means these too are for all intents and purposes untied.

- 44 Equalisation processes have existed in Canada since 1957 and were formally included in the Canadian Constitution by a 1982 amendment which said:

Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

- 45 Important features of the Canadian equalisation process include:

- it allows only for differences between provinces in their capacity to raise revenue because they are the main source of financial disparities in Canada (the funds available for equalisation are insufficient to overcome differences in revenue capacities, let alone revenue plus expenditure needs) and including expenditure needs would increase the complexity of the process and could intrude unduly into provincial responsibilities;
- provinces whose capacity is above the national average standard are not equalised down;
- as in Australia, each province's revenue raising capacity is measured by comparing the per capita revenue it would raise by applying average tax policies with the national average per capita revenue. The standards to which provinces are equalised have changed several times — the previous ones were based on an average of the five middle capacity provinces, which omitted the three richest and the two poorest ones¹⁵;
- it covers provincial and local government revenues, classified into five groups¹⁶;
- only 50 per cent of revenues from natural resources are included in measuring capacities — the treatment of natural resource revenue is a difficult issue due to their uneven distribution, their volatility (especially during oil price shocks like those of the 1970s and recent years) and concerns about the disincentive effects of equalising them;
- the comparisons are designed to be neutral to the policies of individual provinces, but measurement processes may reduce that neutrality — for example, capacity to raise natural resources is based on the actual revenue raised;
- the comparisons are made for the most recent three years and averaged; and
- equalisation grants are subject to a cap designed to ensure the total resources available to a receiving province do not exceed those of the lowest capacity non-receiving province¹⁷.

¹⁴ The offshore agreements offset the effects on their equalisation grants of the revenues they collect from offshore oil and gas resources.

¹⁵ Some Canadian commentators have suggested the previous exclusion of the strongest provinces was partly intended to constrain the effects of natural resources on the size of the equalisation payments. The current arrangements, which are based on an all province average, take a different approach, limiting the effect of natural resource revenues by excluding half of them.

¹⁶ They are personal income taxes, corporate taxes, consumption taxes, property taxes and natural resource revenues. Revenue from user charges is omitted from the comparisons.

¹⁷ This cap is based on the province's total revenues from natural resources, its assessed revenues from the other taxes and its potential equalisation grant.

- 46 Equalisation reduces but does not eliminate the disparities in the resources available to provinces. The 2008-09 assessments indicate provincial own-source revenue capacities per capita ranged between \$C 4 402 and \$C 12 579, with a national average of \$C 7 089, before equalisation. Following the injection of equalisation grants and payments under the offshore accords, the per capita revenue capacities ranged between \$C 6 734 and \$C 12 579, with a national average of \$C 7 538. The province with the lowest financial capacity was raised from 62 per cent of the pre-equalisation average revenue to 95 per cent of it¹⁸.
- 47 Unlike Australia, where a predetermined pool of funds is allocated on an equalisation basis, the Canadian equalisation program determines both the level and allocation of the payments. Its impact on the Canadian Government's budget, therefore, fluctuates in line with the relative revenue raising capacities of the provinces. For example, the grants totalled \$C 8.1 billion in 1993-94, rose to \$C 10.9 billion in 1999-2000 and 2000-01, fell to \$C 8.7 billion in 2003-04 as conditions converged, but rose to \$C 13.6 billion in 2008-09. They may rise above \$C 15 billion in future years as recent high oil and gas prices enter the three year lagged moving average calculations, increasing the capacities of resource rich provinces¹⁹, the national average revenue capacity and the disparities between provinces. The higher national average provincial capacity may result in the most populous province of Ontario qualifying for equalisation grants in future years. Since the cap on equalisation payments in 2008-09 was set by Ontario (it was the non-receiving province with the lowest capacity in the year) the cap may rise to the financial capacity of the next richest province and increase the equalisation grants of some comparatively resource rich provinces.
- 48 The direct link between the relative revenue raising capacities of the provinces and the total equalisation grants is considered desirable by many commentators in Canada. It makes the trade-offs between equalisation and other government programs obvious, but it can raise budgetary risks for the Canadian Government.
- 49 The Canadian Government also provides general revenue assistance to its three territories (all self-governing) under a territorial funding formula. This formula takes account of both the higher costs of providing services in the territories and their revenue raising capacities. The cost of providing services in the territories has been determined by reference to the amount spent by the national government in each territory in 1993 as adjusted by annual movements in provincial expenditure and population changes²⁰.
- 50 SPPs are the last element of the Canadian financial arrangements. They share the costs of achieving social equity and economic efficiency goals which are the joint responsibility of the Canadian and provincial governments, but which are achieved through provincial government

¹⁸ The post equalisation position ignores the injection of revenue from equalisation and the offshore accords which raises the average level of resources available to the provinces. Relative to the post equalisation average level of resources, the poorest province's capacity is 89 per cent of the average.

¹⁹ Courchene, T, *Fiscalamity! Ontario: From Heartland to Have Not*, Policy Options, June 2008.

²⁰ In the mid-1990s the increases were reduced as part of the government's actions to control budgetary problems and after 2004 a fixed increase of 3.5 per cent was applied.

programs. In 2006-07, the main SPPs were the Canadian health transfer and the Canadian social transfer (supports post secondary education, social assistance and social services, early childhood development and early learning and childcare). These transfers have very broad conditions and for practical purposes are close to general revenue payments. Starting in 2007-08, the cash Canadian social transfers are allocated among provinces on an equal per capita basis. The health transfers are to move to that basis in 2014. In 2006-07, the cash component of these transfers was over twice the size of all general purpose payments²¹.

- 51 Smaller SPPs are also made to help fund services to immigrants and health care reform, infrastructure, labour market training, clean air and climate change initiatives.
- 52 *China*. Reforms in 1994 centralised taxing powers and increased taxation. They also clarified the allocation of expenditure responsibilities, but did not change their decentralised nature.
- 53 The 1994 reforms also introduced a more rules based arrangement for intergovernmental transfers. These transfers take several forms.
 - *Revenue sharing payments*. Revenues from VAT, personal and enterprise taxes and duties on security transactions are shared with the provinces. There are also guarantees to ensure each province gets at least the same nominal revenue from VAT and sales taxes as it did in 1993 plus 30 per cent of the annual increase in revenue collected in the province. Similar guarantees apply to personal and enterprise taxes but the benchmark date is 2001. These guarantees facilitated the acceptance of the 1994 reforms by the eastern provinces. However, they increase the revenue sharing payments (revenue sharing and guarantee payments were 58 per cent of total transfers to the provinces²²), and constrain the central government's ability to make other transfers to reduce regional inequalities.
 - *Specific purpose grants*. There are over two hundred SPPs (including fiscal stimulus packages, infrastructure support, bail-outs for local government social protection plans and partial payments for increased pensions). They include equalisation type payments such as assistance for poor regions and a payment to help western and central regions meet the extra costs of centrally determined increases in civil service wages. SPPs are a growing proportion of total transfers — they were 33 per cent of all transfers in 2003.
 - *Equalisation transfers*. These transfers are designed to equalise resources across the provinces. The total amount is determined by the central government given its budgetary circumstances. They have grown rapidly from 2 billion Yuan in 1995 to 74 billion in 2004, but are still only about 5 per cent of total transfers and fall well short of the amount required to equalise the financial capacities of sub-national governments.

²¹ In addition, to the cash payments, the Canadian Government transferred tax room to the provinces in the 1970s under previous versions of the health and social programs. Including the tax transfers increases the health and social transfers by 70 per cent. They then account for 72 per cent of total transfers.

²² Figures from Shen C, Jin J and Zou H, 2006, *Fiscal decentralisation in China Revisited*, in *Fiscal Decentralization in Asia Revisited*, edited by Sato, M.

- *Other miscellaneous transfers.* These include payments for natural disasters and other emergencies and were 4 per cent of transfers in 2003.
- 54 The equalisation grants allow for differences between provinces in their available revenues and in their expenditure requirements. Differences in revenue capacity are based on actual shared tax revenue, general purpose grants from the central government and standardised collections from the major provincial and local taxes, less remittances to the centre. Revenues from fees for services are omitted from the calculations, which is significant because fees are an important source of revenue for local governments and they vary considerably.
- 55 Expenditure requirements are determined separately for 12 groups of services, including administration, agriculture, culture, education, health care, pensions, social security and welfare and urban maintenance and construction. For many services, the required expenditure is estimated as a national average salary per government employee multiplied by a required number of employees which depends on measures of the use of the service. Estimates of non-salary expenses are made using uniform measures of the drivers of those expenses. The estimation process is detailed and has similarities with those used in Australia.
- 56 Since the available funds are insufficient to meet all the estimated expenditure requirements and equalise revenue capacities, the estimates are scaled back.
- 57 *Germany.* The intergovernmental financial arrangements reflect the requirements in the Basic Law for governments to ‘ensure uniformity of living standards throughout the federal territory’ (Article 106) and establish an equalisation process to ‘ensure a reasonable equalisation of the disparate financial capacities of the Lander, with due regard for the financial capacities and needs of municipalities’ (Article 107).
- 58 Those constitutional requirements, together with the shared tax arrangements have led to a system of financial arrangements involving four main components:
- sharing revenue from joint taxes, which includes some equalisation;
 - explicit equalisation arrangements with funds flowing from richer to poorer Lander;
 - supplementary general revenue assistance (mostly equalisation-type assistance) from the federal government to the Lander; and
 - specific purpose assistance.
- 59 As a first step, the revenue from the joint taxes is shared among the federal, Lander and local governments. The sharing arrangements provide each level of government with funds broadly in line with their responsibilities and reduce disparities among the Lander.
- Personal income tax revenue is shared between all levels of government. Lander and local shares are allocated among them according to the taxpayer’s place of residence.
 - Corporate tax revenue is shared between the federal and Lander governments. The Lander’s share is allocated among them according to the location of the business.

- VAT revenue is shared among all levels of government using proportions determined under federal law. The shares change periodically. During the 1990s, the Lander share increased to provide sufficient funds for the eastern Lander but recently the federal share rose, reflecting its takeover of responsibility for social security provisions.

The Lander's share is allocated among them on an equalising basis:

- 75 per cent of the revenue is allocated on an equal per capita basis; and
- the other 25 per cent is paid to Lander with below average revenue capacity. Revenue raising capacity is measured by reference to actual per capita revenue from personal income, corporate and Lander taxes.

Before 2005, Lander whose revenue raising capacity was less than 92 per cent of the average were raised to that level. The extent of equalisation was reduced in 2005 to improve the incentives for Lander to raise their own taxes²³. In 2007, revenue capacities after distributing the VAT ranged from 91 to 135 per cent of the average, much less than the pre-distribution range of 43 to 168 per cent²⁴.

- 60 Explicit equalisation processes take place after the VAT has been distributed to help create and maintain equal living conditions for the entire population of Germany²⁵. These processes involve equalisation payments between the Lander and supplementary grants from the federal government.

- *The richer Lander contribute to a fund for the poorer ones.* Contributions to, and payments from, the fund depend on relative financial capacity. In this case, financial capacity is measured predominantly in terms of differences in revenue capacity but some adjustments to recognise cost differences are also made.

The measure of revenue capacity differs from that used in distributing the VAT. Since 2005, revenue capacities have been based on: the measure used to allocate VAT; plus per capita VAT revenue; plus 64 per cent of the per capita tax revenues of local governments, as adjusted to what they would be under uniform tax policies.

In principle, the measure of fiscal capacity assumes equality is achieved if Lander have equal per capita revenues. However, to allow for the extra costs of some Lander, their per capita revenues are derived using adjusted populations. Specifically:

- in determining the per capita revenues for joint and Lander taxes, the city states of Berlin, Bremen and Hamburg have their populations weighted by 1.35 to recognise the extra costs incurred because residents of neighbouring Lander use services in the cities but pay taxes to their home Lander; and

²³ Lander with revenue raising capacities below 97 per cent of the average receive funds that offset 95 per cent of the difference between their capacity and the average, and 60 per cent of the difference between 97 per cent and the average.

²⁴ Derived from calculations in Seitz H, *Minimum Standards, Fixed Costs and Taxing Autonomy of Subnational Governments*, Technical University of Dresden, June 2008.

²⁵ Bundesministerium der Finanzen, *The Federal Financial Equalisation System in Germany*.

- the more sparsely settled Lander of Brandenburg, Mecklenburg-West Pomerania and Saxony-Anhalt have their populations weighted by between 102 and 105 per cent in determining capacity for local government taxes, to recognise the higher costs incurred due to population dispersion.

Lander whose financial capacity is below the average receive equalisation funds on a sliding scale depending on how far they are below it. Those above the average finance the payments on a progressive scale depending on how far they are above the average.

After this step, the capacities are between 92 and 136 per cent of the average²⁶.

- *A system of supplementary federal grants.* Lander whose financial capacity after the distribution of VAT and explicit equalisation is below 99.5 per cent of the average receive general purpose supplementary grants. These grants raise their capacity by 77.5 per cent of any post equalisation shortfall below 99.5 per cent of the average. (Prior to 2005, these grants raised capacity to the 99.5 per cent mark.)

After this step, financial capacities range between 95 and 135 per cent of the average.

- 61 Some Lander also receive further supplementary grants for special needs.
 - The nine Lander with populations below 4 million receive allowances for diseconomies of scale in administrative costs. These payments are similar to the allowances for diseconomies of scale assessed by the Commission in the expenditure equalisation process. The need for, and size of, these grants is reviewed every five years.
 - The eastern Lander and Berlin receive payments to help with their high infrastructure/reconstruction expenses and to offset the low financial capacity of their local governments. This payment will be paid on a reducing annual basis until 2019.
 - The eastern Lander receive further payments to compensate for the burdens of structural unemployment. The continued need for these grants is to be reviewed in 2010.
- 62 Finally, the federal government makes a number of specific purpose payments for purposes such as urban transport, regional development, social welfare and school infrastructure. In per capita terms, the payments to the eastern Lander are greater than those to western Lander.
- 63 Revenues from shared taxes were 82 per cent of federal transfers in 2007, supplementary equalisation grants were 1 per cent, special needs grants 6 per cent and SPPs 11 per cent.
- 64 These overall arrangements are criticised in Germany because they result in some financially weaker Lander having greater resources per capita than the richer ones. However, that criticism appears to overlook their greater expenditure needs.
- 65 *South Africa.* The likelihood of imbalances in the resources available to each sphere of government relative to their responsibilities was recognised in the constitution which:

²⁶ The relative capacities used in this step differ from those after the distribution of the VAT because they include local government revenues. Derived from calculations in Seitz H, *Minimum Standards, Fixed Costs and Taxing Autonomy of Subnational Governments*, Technical University of Dresden, June 2008.

- states each province and local government is entitled to an equitable share of nationally raised revenues that is sufficient to allow it to provide basic services and perform the functions allocated to it; and
 - requires an annual division of revenues which sets out the vertical split of revenues among governments and the horizontal split among the provinces and local governments.
- 66 Consequently, the national government makes grants to provincial and local governments. The provincial governments also make grants to their local governments.
- 67 The national government allocates the nationally collected revenues among the three spheres of government after considering advice from the Finance and Fiscal Commission (an independent advisory body established under the constitution), its priorities for medium term expenditure, and after consulting the provinces and local government. The government rejected advice from the Finance and Fiscal Commission that the vertical allocation be based on a formula which reflects the costs of each sphere's responsibilities.
- 68 The first step in the allocation is to set aside a 'top slice' for debt charges and contingencies. The rest is allocated among the three spheres. In 2006-07, the top slice was 11.1 per cent of revenues, and the equitable shares for the national, provincial and local governments were 45.2, 38.1 and 5.6 per cent respectively²⁷. Compared with earlier years, the shares of the national and local governments have increased, reflecting a shift of responsibility for aged and disability benefits to the national government and the introduction of compensation to local government following the abolition of the regional services levy, which was a major source of revenue.
- 69 The equitable payments may be made as general revenue or specific purpose payments. In 2006-07, general revenue payments were 85 per cent of transfers to provinces and 68 per cent of transfers to local government.
- 70 The general revenue funds are allocated among the provinces using relative expenditure needs determined on the basis of horizontal equalisation principles. The low level of provincial revenues makes allowances for differences in revenue raising capacity unnecessary.
- 71 For local government, the allocation of general purpose grants is made on an equalisation basis and takes account of differences in expenditure needs and revenue raising capacity. Prior to the abolition of the regional services levy, 90 per cent of local government expenditures were, on average, funded from their own revenues, but there were substantial variations — some metropolitan municipalities funded up to 98 per cent of their expenditures themselves but some small rural municipalities depended almost entirely on transfers²⁸.

²⁷ Derived from National Treasury, Republic of South Africa, *Budget Review, 2008, Chapter 8, Table 8.1*.
²⁸ Khumalo B and Mokate R, *Republic of South Africa in A Global Dialogue on Federalism, Book 4, The Practice of Fiscal federalism; Comparative Perspectives*, Edited by A Shah, Forum of Federations, 2007.

- 72 The provincial expenditure needs reflect the notional costs of providing basic services (electricity, water, refuse collection and sanitation) to poor households, municipal population and the number of local councillor seats in each municipality.
- 73 *Some basic comparisons.* Table 6-4 dissects the 2006-07 funding for sub-national governments by type of assistance.

Table 6-4 Composition of national assistance to sub-national governments, 2006-07

	Australia (a)	Canada (b)	China (c)	Germany (d)	South Africa (e)
	%	%	%	%	%
States or provinces					
General revenue					
Revenue sharing arrangements	58.3		58.8	82.1	
Non-equalisation transfers		3.7		5.9	73.4
Equalisation transfers		17.0	11.7	1.7	
Specific purpose payments	38.6	77.3	29.5	10.3	13.7
Local government					
General revenue and specific purpose	3.1	2.0			12.9
Total	100.0	100.0	100.0	100.0	100.0

- (a) Figures from Commonwealth of Australia, Budget Paper No. 3, *Federal Financial Relations 2007-08*, Table 1, p5. The total GST revenue is shared to achieve revenue sharing and equalisation aims.
- (b) Figures from Department of Finance, Canada.
- (c) Figures from Shah, A and Shen, C, *Fine Tuning the Intergovernmental Transfer System to Achieve a Harmonious Society and a Level Playing Field for Regional Development in China*, World Bank, 2006. Figures relate to 2004. The equalisation payments include Y74.7 billion in designated equalisation grants, Y 91.9 billion in assistance for increasing wages and Y7.7 billion in assistance for minority regions — official Chinese data classify the last two payments as SPPs. The central government pays its assistance to the provinces who decide how much to pass to other governments.
- (d) Figures from German Ministry of Finance. The equalisation transfers included E 517 million in federal payments to small Lander to compensate for diseconomies of small scale, which perform an expenditure equalisation function — the official German processes treat these payments as outside the equalisation process and as part of other transfers. The national government pays its assistance to the Lander who decide how much is passed to local government.
- (e) Figures from National Treasury of South Africa, *National Budget Review 2008*, Chapter 8, Division of revenue and intergovernmental transfers. All funds are provided to provinces and local government in the form of grants which achieve revenue sharing and equalisation purposes.

- 74 Table 6-5 shows differences in underlying economic capacity (as measured by GDP per capita) and revenue raising capacities (as measured by the equalisation processes).
- 75 The data in Table 6-5 indicate disparities in assessed revenue raising capacities are greater than those for GDP per capita. This is because state taxes do not access all aspects of GDP. The uneven distribution of natural resources in Canada and Australia has a big effect on state revenue raising capacities in those countries.

Table 6-5 Comparison of revenue raising capacities, 2006-07

	Australia	Canada	China	Germany	South Africa
	%	%	%	%	%
Underlying economic capacity					
Maximum as percentage of average	137	161	164	172	360
Minimum as percentage of average	85	71	54	68	36
Assessed revenue capacity for state revenue					
Maximum as percentage of average	127 (a)	177 (b)	Na	168 (c)	(d)
Minimum as percentage of average	68 (a)	62 (b)	Na	41 (c)	(d)

(a) Figures from Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2008 Update*. They are an average of the five years 2002-03 to 2006-07.

(b) Figures from Canadian Ministry of Finance. They are an average of the three years 2004-05 to 2006-07.

(c) Figures derived from data provided by German Ministry of Finance and Prof Dr H Seitz. They are for the 2007 financial year and are based on Lander taxes and their share of personal income and corporate taxes (before distribution of VAT).

(d) State taxes are negligible, so relative capacities are not assessed.

76 Figure 6-1 shows the extent to which the financial capacities of States, Provinces and Lander are equalised in Australia, Canada and Germany — in each case, financial capacity is measured in terms of the definition used in that country. The components of the figure show:

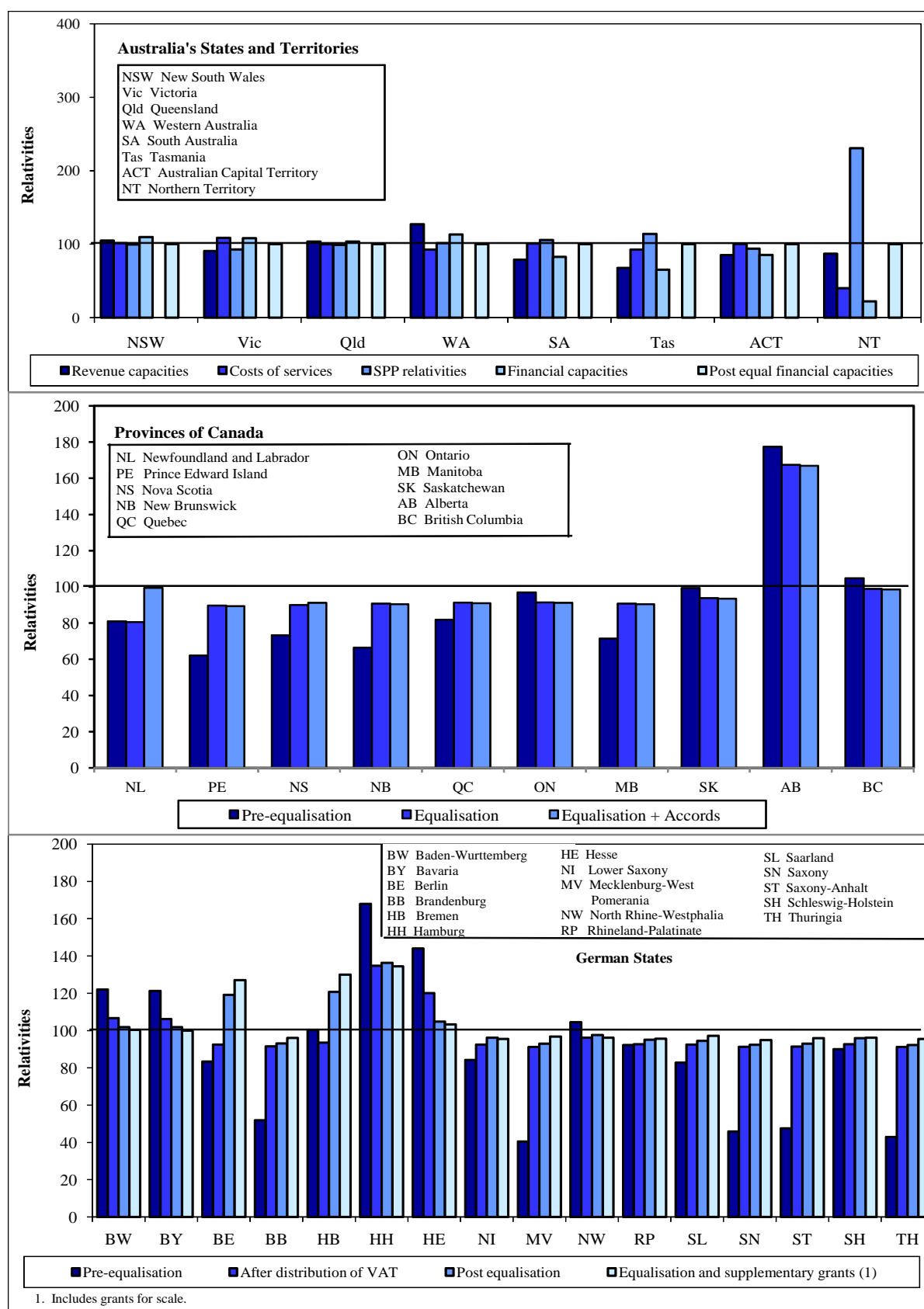
- for Australia, the pre-equalisation differences in revenue capacity, costs of services and receipts from SPPs and post-equalisation relative financial capacities;
- for Canada, the pre-equalisation differences in revenue raising capacity and relative revenue capacities after equalisation transfers and the offshore accords; and
- for Germany, the differences in revenue raising capacity before and after sharing of the VAT, after the explicit equalisation between Lander and after the supplementary federal grants (including those for diseconomies of small scale).

77 It shows that: Australia achieves full equalisation; significant disparities remain after equalisation in Canada; and some disparities remain in Germany. Moreover, it must be noted that differences in the cost of providing services are not taken into account in Canada and are only partly included in Germany.

Concluding comments

78 This brief examination of fiscal arrangements in Australia, Canada, China, Germany and South Africa points to the following conclusions.

- The intergovernmental arrangements in the five countries are quite different. This reflects their varying history, demographic features and national aims.
- Canada, Germany and South Africa all have constitutional commitments to equity of services and/or equalisation but Australia, the country which takes equalisation the furthest, does not. On the other hand, while there are differences between the circumstances of Indigenous and other people, Australia has no other major divisions within its population and it has a strong community attachment to egalitarian ideals.

Figure 6-1 Extent of equalisation achieved — Australia, Canada and Germany

- Provinces in Canada have, and actively seek to retain, a high level of autonomy in policy making and implementation. The Australian States also have autonomy in their area of responsibility but the financial strength of the Commonwealth imposes some constraints. In contrast, the German Lander and the South African provinces have limited policy making autonomy, although they have input to national laws that affect them. While the German Lander have power over policy implementation, South African provinces are subject to greater central controls and some suffer capacity limitations.
- Revenue raising powers are highly centralised by design in South Africa, China and Germany, but each has legislated revenue sharing or grant arrangements. Australia's revenue raising is centralised, but less so than the other three. Taxing powers in Canada are the least centralised with both the Canadian and the provincial governments imposing all major taxes, except customs duty.
- As a direct consequence of the allocation of revenue powers, Canadian provinces are much less reliant on revenue sharing and grant arrangements than comparable governments in the other countries. The Australian States where GST revenue and SPPs on average financed 50 per cent of State expenses were the second least reliant. In China, revenue sharing payments and other grants funded 67 per cent of provincial expenses. They funded almost all provincial expenditure in South Africa.
- Based on GDP per capita, the underlying economic differences across states are smallest in Australia and greatest in China. The differences in measured revenue capacities of states in Australia are also smaller than in Canada (where a concentration of natural resources in Alberta produces a very high capacity) and Germany (where personal incomes, corporate profits and land values are low in the former east German Lander).
- All the countries examined transfer some funds to states in the form of SPPs. The proportion transferred as SPPs is highest in Canada (because there are few untied transfers) but there are few detailed controls over their expenditure. Australia makes considerable use of SPPs. SPPs are relatively unimportant in Germany and South Africa.
- Equalisation is most extensive in Australia.
 - Equalisation in Australia and China covers differences in revenue raising capacity, costs of services and other national payments. In Australia, sufficient funds are available to fully equalise State financial capacities because the total GST revenues are distributed on equalisation principles, but only about 12 per cent of them are required to equalise capacities. By contrast, in China the funds available for equalisation are small relative to the large differences between provinces.
 - Germany goes a long way towards equalising revenue capacities through a combination of equalising revenue sharing, explicit equalisation transfers among Lander and equalising national grants. Aspects of its methods also introduce small allowances for some expenditure effects (diseconomies of small scale, use of services by residents of other Lander and effects of sparse population). It is

- one of few countries where equalisation funds flow between states rather than from the national government to the states.
- Canada has one-sided, revenue equalisation only — provinces with below average revenue capacity receive extra resources but high capacity ones are not equalised downwards.
 - South Africa's process for distributing grants to provinces allows for differences in expenditure need only because provincial taxes are small.
 - Australia's equalisation processes are administered by an independent body, but in the others the national finance department has that role.
- Simplification is a common theme in debates on equalisation in many countries. Canada has reduced the number of revenue categories from 33 to 5 and has adopted simpler measures of some revenue bases. The Commission is working to reduce the number of categories and seek broader measures of revenue bases and expense disabilities. International advisers are encouraging China to do likewise.
 - There are concerns about the incentive effects of equalisation in Australia, Canada and Germany. In Canada, there is concern that equalisation reduces the incentives for provinces to seek resource development because extra revenues would be offset by lower equalisation grants²⁹. Equalisation methods in Canada seek to reduce these effects by excluding half the revenue from natural resources from the determination of revenue capacities and by capping equalisation grants. The concerns also led to agreements between the national government and two provincial governments to quarantine revenue from offshore resources from equalisation. In Germany, concerns that seeking almost full equality of revenue capacities reduced incentives to promote development and created differences in tax collection effort saw the target level of equalisation reduced. It has been suggested that despite an aim of reducing regional inequalities, Chinese development policies may have sought to leave relatively more resources in regions with the stronger growth potential³⁰.
 - There is evidence from studies in Australia, Canada, and Germany that state taxes are higher in the states that receive equalisation benefits. Such evidence is consistent with a hypothesis that equalisation shields them from some effects of tax competition (such as reductions in tax bases through relocation of mobile bases and lower values of immobile ones arising from higher tax rates). The materiality of these dynamic effects and any long term effects on regional development is not known.

²⁹ There is anecdotal evidence that equalisation was a factor in delays in the development of a large nickel deposit in Canada, but there is no similar evidence in Australia.

³⁰ Hoffman, B and Guerra, SC, *Ensuring Inter-regional Equity and Poverty Reduction*, in Martinez-Vazquez and Searle, *Fiscal Equalization, Challenges in the Design of Intergovernmental Transfers*, Springer, 2007.

CHAPTER 7

CONCLUDING COMMENTS

- 1 Australian federal financial arrangements were fundamentally changed in 1976 when the Commonwealth introduced revenue sharing processes for determining and allocating general revenue funds to the States. Initially the total amount available for the States was a predetermined share of personal income tax collections and it was distributed among the States using their previous shares of financial assistance and related grants. However, in 1978, the Commonwealth and State governments decided the Commission would be asked to review the State shares and that the new shares would be based on equalisation principles.
- 2 The relevant legislation defined equalisation in terms of payments that would enable each State to provide services at standards not appreciably different from those of the other States without imposing taxes and charges at levels appreciably different from those of the other States. It also stated that the distribution was to take account of differences between States in their capacities to raise revenue and the costs of providing comparable services.
- 3 Taken together these decisions represented major changes involving
 - the introduction of zero sum, revenue sharing arrangements that aimed to provide the States with the revenues required to discharge their responsibilities and achieve equity among the States — they were intended to address the vertical imbalances between the Commonwealth and the States and the horizontal imbalances among the States;
 - a major expansion in the role of the Commission which required it to examine the financial capacities of all the States, not just those who sought special assistance; and
 - the distribution of funds on the basis of equalisation principles that were defined by governments and took account of State revenue raising capacities and costs of services.
- 4 The Commission produced the first set of new State shares in 1981 but the implied changes were considered too large and it was asked to review them. The second set was produced a year later and was to be phased in over three years subject to guarantees of minimum annual increases in each State's general revenue. The shares have been reviewed at three to six yearly intervals ever since and updated annually since 1989.

- 5 In each review, the Commission made evolutionary changes to its methods for measuring State financial capacities. The changes were aimed at:
 - making the processes more equitable, by ensuring:
 - an individual State's policies did not have a direct effect on its share; and
 - a comprehensive coverage of State revenues and expenses and of the factors that affected them, which in turn ensured the advantages and disadvantages of all States were taken into account;
 - reflecting changes in the economic and demographic circumstances States faced,
 - reflecting changes in State policies and practices;
 - making the comparisons more reliable and increasing the use of objective data; and
 - improving the transparency and simplicity of the comparisons.
- 6 Perhaps the most significant method changes were the inclusion of transactions related to capital (thereby allowing for interstate differences in depreciation and interest expenses), and the inclusion of allowances for interstate differences in underlying wage levels.
- 7 The emphasis on transparency in the comparisons had two dominant effects. The first was an evolution of the equalisation principle which made it clearer that the processes aim to provide each State with the financial capacity to provide the same level of services, with that level of services being the average of the services provided by all States. The second was to identify how the Commission reached and implemented its decisions on the complex links between State revenues and expenses and the factors that drive them. While this improved the transparency of the comparisons it increased the detail and the intensity of calls for simplification.
- 8 At the same time as the Commission's principles, processes and methods were evolving so was the context in which it operated. There has been a strong move by all governments to improve the competitiveness and efficiency of the Australian and State economies which raised questions about the implications of equalisation for the overall efficiency of resource distribution.
- 9 A large contextual change occurred in July 2000 when national taxation arrangements were reformed. As part of the reforms a GST was introduced, wholesale sales taxes and some State taxes were abolished and income tax was reduced. The total revenues of the GST were given to the States in lieu of the previous financial assistance grants and the revenue from abolished States taxes. This change increased the funds allocated among the States on equalisation principles. It, together with a period of high economic growth, provided the States with general revenue funds that grew more rapidly than the previous financial assistance grants. Between 2001-02 and 2007-08, GST and associated guarantee payments increased from \$A30 709 to 42 630 million (a total increase of 39 per cent or an annual average increase of 5.6 per cent), whereas between 1993-94 and 1999-2000, financial assistance and related grants increased from \$A14 356 to 17 709 million (a total increase of 23 per cent or an average of 3.9 per cent a year).

- 10 These changes increased the focus on the zero sum nature of the distribution processes and intensified the debate on the continued suitability of equalisation as a basis for allocating the GST among the States. The Commission's 2004 Review Report noted these issues were outside its terms of reference and were properly matters for governments to decide.
- 11 Governments decided against reviewing the application of the equalisation principle. However, they did review aspects of its implementation and the terms of reference for the Commission's 2010 Review of State relativities place an emphasis on simplification provided it is consistent with the equalisation principle.
- 12 There is evidence that the application of equalisation principles achieves the aim of removing differences between States in their financial capacity to provide services. State shares of the GST revenue have moved to offset changes in their relative capacity to raise revenue and in the relative costs of providing services.
- 13 Australia's revenue sharing arrangements reflect its history, political culture and circumstances. They strive for a higher level of equality in State financial capacities than in other countries — they equalise capacities which involves bringing some States up to the average position and others down, and the measure of financial capacity takes account of differences in both the costs of providing services and revenue raising capacity.
- 14 The other countries examined have larger differences among the states.
 - In Canada, financial relations are conducted against a background of large differences in regional identities and a strong desire for provincial financial autonomy, a high level of tax decentralisation and differences between provinces in revenue raising capacity. The introduction of an equalisation process in 1957 was part of the post-war tax decentralisation program. However, constraints arising from the distinct regional identities, decentralised taxing powers and substantial differences in provincial revenue raising capacities, especially given recently high and volatile oil and gas prices, mean full equalisation would not be feasible, even if it was considered desirable.
 - In Germany, historical considerations resulted in the constitution providing for uniform services, while re-unification in 1990 led to large differences in economic circumstances across the nation. For some time, the aim was to raise the revenue raising capacities of the poorer Lander to 99.5 per cent of the national average. Payments are made for some effects on costs of services and for the specific disadvantages of the former east German Lander, but there has not been a systematic attempt to equalise costs of services. Since 2005, the extent of equalisation has been reduced.
 - In South Africa, previous government arrangements left large inequalities between regions and races, which are being addressed under the new, integrated arrangements. Provisions in the new constitution provide for South Africans to have access to adequate housing, health care, social assistance and basic education services. While a very high proportion of tax revenues are collected by the central government, the constitution requires an equitable share of them. The allocation between the central, provincial and

local governments is primarily an annual political decision. The subsequent allocation among provinces is largely based on equalisation principles, but for expenditure responsibilities only. The allocation among local governments reflects equalisation of revenue raising capacity and expenditure requirements.

- In China, the differences in economic circumstances between eastern and western provinces are huge. Historical allocations of revenue among provinces have tended to favour the richer provinces. Part of the reforms introduced in 1994 aimed to provide a more equal distribution of resources through the introduction of equalisation grants. The grants are based on methods similar to those used in Australia and allow for differences in revenue raising capacities and costs of services. The size of the grants has depended on central government budgetary circumstances. While they have grown greatly since 1994, they are too small to have significant equalising effects.
- 15 On a technical level, the comprehensive approach to equalisation in Australia with its consideration of expenditure and revenue needs and the inclusion of other central payments to the states may address some of the issues concerning commentators in Canada and Germany. Some commentators in Canada suggest that while differences in expenditure needs may be smaller than those in revenue raising capacity they, together with other federal programs and the one-sided nature of the equalisation process, imply a rethink of its design is needed¹. The Germans are also concerned about the implications of the poorer Lander appearing to be in a stronger fiscal position after equalisation and the distribution of federal grants than the richer ones. However, an Australian-style equalisation process may be inconsistent with the political situations in those countries.
 - 16 Some issues are common to all the countries examined, despite their different experiences.
 - 17 The need for simplification is a prominent theme in debate in Australia, Canada, and China and to lesser extents in Germany and South Africa. The most recent review of equalisation in Canada recommended simpler processes with fewer, but broader, categories of revenue subject to comparison. Simplification is a major theme of the current 2010 Review in Australia and has been mentioned extensively in reviews of the Chinese processes.
 - 18 In the three developed countries, there is debate about the implications of equalisation for economic efficiency and development, especially in terms of the potential effects on major development initiatives and the tendency for equalisation receiving regions to have higher taxes. Canada and Germany have adapted their processes to mitigate such effects. However, in Australia, governments appear to have concluded that any efficiency costs of equalisation are a price they are prepared to pay for the other benefits it brings.

¹ Some of these issues are raised in Courchene, T, *Fiscalamity! Ontario: From Heartland to Have Not*, Policy Options, June 2008.

ATTACHMENT A

A BRIEF HISTORY OF THE COMMISSION

INTRODUCTION

- 1 This attachment supplements the material in Chapter 2. A detailed account of the Commission's history up to 1993 is in its publication *Equality in Diversity*¹.
- 2 The Commission was established under the *Commonwealth Grants Commission Act 1933* and given the role of advising on applications by the States for special assistance. That role was broadened in 1978 following changes in Commonwealth-State financial arrangements, which introduced arrangements for sharing a predetermined pool of funds among the States. It has also had roles relating to the finances of local government, Australia's non-self-governing territories, Norfolk Island and the funding of services for Indigenous Australians.

THE COMMISSION AND SPECIAL GRANTS

The principle for determining special grants

- 3 The Commission's First Report said special grants should enable the claimant States 'with reasonable effort, to put their finances in about as good order as that of the other States'. Its Third Report in 1936 (page 75) described the principle more precisely as:

Special grants are justified when a State through financial stress from any cause is unable to efficiently discharge its functions as a member of the federation and should be determined by the amount of help found necessary to make it possible for that State by reasonable effort to function at a standard not appreciably below that of other States.
- 4 It implemented the principle by comparing the budgetary circumstances of the claimant States (as summarised in their deficits) with those of what it called the standard States. Other things being equal, a grant was recommended that reduced a claimant State's per capita deficit to the average deficit of the standard States. To ensure like was compared with like, the Commission adjusted the State deficits to remove the effects of differences in accounting policies, the

¹ Commonwealth Grants Commission, *Equality in Diversity. History of the Commonwealth Grants Commission (second edition)*, Australian Government Publishing Services, Canberra, 1995.

severity of taxes and the standard of education, health and public order services. Up to 1945, it also included penalties for claimancy of up to 10 per cent of standard revenues and expenses.

- 5 The interpretation of the principle gradually broadened from a minimum financial need concept to one of equalising the financial capacities of the States. This is illustrated by the progressive move from financial needs with penalties for claimancy, to financial needs without penalties, to raising claimant States to a balanced budget outcome and, finally, raising them to the average budgetary outcome of the standard States.
- 6 The methods used to apply the principle also evolved to ensure a State's grant was not affected by its own decisions and to make methods more robust and more firmly based on data. The changes led to more of the State budgets being examined. There was also a change to directly estimating the effects on revenues and expenses of underlying features of State populations and economies (often called needs) instead of working backwards by adjusting actual expenses and revenues to remove differences due to policies on service standards and tax rates.

Which States were claimants?

- 7 Special grants were initially available to Western Australia, South Australia and Tasmania. From time to time, States ceased applying for special grants in return for extra financial assistance grants and changes in Commonwealth-State arrangements in 1971-72 enabled Queensland to make claims. States that made claims in each year are listed in Table A-1.

Table A-1 Claimant States

Years	Claimant States
1934-35 to 1959-60	Western Australia, South Australia, Tasmania
1960-61 to 1967-68	Western Australia, Tasmania
1968-69 to 1969-70	Tasmania
1970-71	South Australia, Tasmania
1971-72 to 1973-74	Queensland, South Australia, Tasmania
1974-75	Queensland, South Australia
1975-76 to 1980-81	Queensland

Source: Mathews RL and Jay WRC, *Federal Finance*, Nelson, Melbourne, 1972, Tables 23, 32 and 42 and various issues of Budget Paper No.7, Payments to or for the States, the Northern Territory and Local Government, AGPS.

Which States were used as the standard?

- 8 New South Wales, Victoria and Queensland were the standard from 1934-35 to 1958-59 (but in 1935-36 New South Wales was omitted because its financial experiences were unrepresentative). New South Wales and Victoria were the standard States from 1959-60.

How significant were special grants?

- 9 Special grants were essentially 'top-up' grants aimed at reducing disparities in the financial circumstances of the States. Their significance depended on what other arrangements existed

between the Commonwealth and the States and whether parts of them fulfilled a similar role. The main features of Commonwealth-State arrangements are summarised in Attachment B.

- 10 Table A-2 summarises the changes in special grants and other Commonwealth payments to the States. Special grants were relatively important initially when the States raised most revenue themselves. Their importance declined with the introduction of tax reimbursement grants in 1942-43 and generally continued to do so² as those grants (and their successors) grew.

Table A-2 Average annual composition of Commonwealth payments^(a) to the States

	General revenue payments	Special grants	Specific purpose payments ^(b)	Total	Special grants as % of total
	\$m	\$m	\$m	\$m	%
1934-35 to 1941-42	0.0	4.5	25.0	29.5	15.3
1942-43 to 1945-46	68.7	5.2	22.6	96.5	5.4
1946-47 to 1958-59	470.4	51.4	144.7	666.9	7.8
1959-60 to 1964-65	594.7	22.3	194.1	811.1	2.7
1965-66 to 1971-72	1 090.0	29.2	423.8	1 543.0	1.9
1972-73 to 1982-83(c)	4 342.7	26.4	3 872.0	8 241.1	0.3

(a) The amounts are the average annual payments during each period.

(b) Includes payments of interest on debt and sinking fund payments under the Financial Agreement.

(c) Excludes general capital grants and payments direct to local government.

Source: Mathews RL and Jay WRC, *Federal Finance*, Nelson, Melbourne, 1972, Tables 23, 30, 33, 40 and 46 and Commonwealth Budget Paper No.3.

- 11 Over time, the interstate distribution of general revenue funds attracted growing criticism for its perceived inequities. The combination of financial assistance grants (with the interstate allocation based on history and intergovernmental negotiations), supplementary grants and special grants was said to produce a distribution that favoured the less populous States³. At the 1970 Premiers' Conference, the Commonwealth suggested the Commission be asked to review the distribution of general revenue grants. However, the suggestion was not taken up.

REVENUE SHARING ARRANGEMENTS — 1981 TO 2010

The 1981, 1982, 1985 and 1988 Reviews

- 12 In 1976, the Government introduced revenue sharing arrangements under which an agreed proportion of personal income tax revenue was to be allocated among the States by reference to their adjusted populations. Adjusted population was defined as a State's estimated population at 31 December of each year multiplied by a per capita relativity factor, which was

² The cessation of penalties for claimancy and increased allowances for the higher costs in claimant States after 1945 increased the grants.

³ See, for example, Mathews RL and Jay WRC, *Federal Finance*, Nelson, Melbourne, 1972.

initially based on per capita receipts of financial assistance grants in 1975-76. The relativities were to be reviewed by an independent body before the end of 1980-81.

- 13 ***The 1981 Review.*** The Commonwealth considered the Commission should review the relativities but the less populous States were concerned conflicts may arise if the same body reviewed the relativities and considered claims for special grants. Nevertheless, the July 1977 Premiers' Conference agreed the review would be done by the Commission supplemented by three associate members (one nominated by New South Wales and two by the other States).
- 14 Terms of reference received in 1978 asked for advice on 'whether any change is desirable in the per capita relativities between the States of their tax sharing relativities'. The *States (Personal Income Tax Sharing) Amendment Act 1978*, required the inquiry to be made:
 - (i) on the basis of the principle that the respective payments to which the States are entitled ... should enable each State to provide, without imposing taxes and charges at levels appreciably different from the levels of the taxes and charges imposed by other States, government services at standards not appreciably different from the standards of government services provided by the other States;
 - (ii) taking account of:
 - differences in the capacities of the States to raise revenues; and
 - differences in the amounts required to be expended by the States in providing comparable government services.
- 15 Prior to this inquiry, the Commission's assessments of special grants did not affect the assistance paid to the other States. However, in the tax sharing review it had to assess the relative financial position of all States as the first step in deriving their shares of the tax revenue. A change in the share of any one State would affect the shares of all States.
- 16 The basic methods developed in the claimancy inquiries remained applicable. With the new role, the main issues to be decided, and the Commission's decisions, were:
 - what standard should be used? The Commission decided it should be a population weighted average of the experiences of all six States.
 - which taxes, charges and services should be subject to comparison? The Commission decided it should examine recurrent taxes (except motor taxes), recurrent services (but not expenditure relating to roads, housing and depreciation) and the State business enterprises which affected State budgets (mostly transport and water enterprises).
 - how would it convert the assessed needs for each State into per capita relativities? It did so by relating each State's assessed deficit per capita to the Victorian assessed deficit, where each State's assessed deficit was defined as:
 - its assessed expenditure (defined as standard expenditure plus the State's expenditure needs);
 - less its assessed revenues (defined as standard revenue plus the State's revenue needs);
 - less its above or below standard per capita receipts from specific purpose grants;
 - less the standard budget outcome (the difference between the standard expenditure and revenue, including Commonwealth grants).

- 17 The Commission found the shares of New South Wales, Victoria and Queensland were too small and those of the less populous States too large. Table A-3 compares the State shares of the tax sharing grants (plus Queensland's special grant) for the period 1977-78 to 1979-80 with those assessed by the Commission. The findings would have reduced South Australia's grant by about 10 per cent and those of Western Australia and Tasmania by about 20 per cent.

Table A-3 Existing and assessed State shares of tax sharing grants^(a), 1977-78 to 1979-80

	NSW	Vic	Qld	WA	SA	Tas	Six States
	%	%	%	%	%	%	%
Existing shares of grants	30.52	22.59	18.29	12.09	11.60	4.90	100.00
Assessed shares of grants	32.43	23.54	19.91	9.71	10.45	3.95	100.00
Share of population	36.02	27.40	15.59	8.81	9.22	2.97	100.00

(a) The figures are the average of 1977-78 to 1979-80 and include tax sharing grants and special grants.

Source: Commonwealth Grants Commission, *Report on State Tax Sharing Entitlements 1981*, Main Report, Table 8-10.

- 18 The report was supported by New South Wales, Victoria and Queensland but strongly opposed by the others, with the Premier of Western Australia calling the findings 'distorted, ludicrous and absurd'. The Prime Minister noted the issue was State shares, not the total Commonwealth grants, and while the Commonwealth was willing to assist the discussions, it was more a matter for co-operation among the States.
- 19 In the event, the Commonwealth agreed to increase the total grant for 1981-82 by \$60 million to be distributed to the three States whose share would have increased. The Premiers' Conference agreed the Commission should be asked to review its findings.
- 20 ***The 1982 Review.*** This time, the Commission was asked whether any change was desirable in the State factors contained in its 1981 Report and if so what changes. In preparing its advice it was to have regard to:
- the equalisation principle applied in the 1981 Report;
 - the new grants to the States and the Northern Territory for health⁴; and
 - the continuation of previous specific purpose payments to South Australia and Tasmania under their hospital cost sharing agreements.
- 21 The Commission was asked to present two sets of relativities for distributing the tax sharing grants based on different treatments of the new health care grants.
- 22 The review was conducted by the members who did the 1981 Review. They used principles and methods similar to those used in the 1981 Review, although the comparisons for most

⁴ The Commonwealth had decided that in 1981-82 it would replace the previous specific purpose grants for health (including hospital cost sharing grants) with payments that were for general purposes but which would be identified as Commonwealth contributions towards health costs in the States and the Northern Territory. However, the hospital cost sharing grants for South Australia and Tasmania were to continue because their health care agreements did not expire until 30 June 1985.

taxes, charges and services were refined and they included data for 1980-81 (including some new population estimates from the 1981 Census).

- 23 Table A-4 compares the State shares of tax sharing grants for 1981-82 derived by applying the relativities from the 1982 Review, the 1981 Review and the actual distribution of those grants in 1980-81 to State populations at December 1981.

Table A-4 Comparison of existing and assessed State shares of grants^(a), 1981-82

	NSW	Vic	Qld	WA	SA	Tas	Six States
	%	%	%	%	%	%	%
Existing shares of grants (a)	31.71	22.86	17.43	12.11	11.20	4.70	100.00
1981 Review – assessed shares (b)	33.11	23.41	19.41	10.18	10.11	3.77	100.00
1982 Review - assessed shares (b)	32.21	23.26	19.54	10.63	10.55	3.82	100.00

(a) The per capita relativities are applied to State populations at December 1981 available in late 1981.

(b) The per capita relativities are applied to May 1982 ABS estimates of State populations at December 1981.

Source: Commonwealth Grants Commission, *Report on State Tax Sharing and Health Grants 1982*, Tables 7-7 and 7-9.

- 24 Part of the change between the existing 1981-82 share and the shares assessed in the 1981 and 1982 Reviews was due to changes in the estimated populations, which increased Queensland's share of the Australian population and reduced those of New South Wales and Victoria.
- 25 Compared with the 1981 Review, the 1982 Review reduced the shares of New South Wales and Victoria and increased them for the other four States.
- 26 Not unexpectedly, the 1982 Report met criticism from every State except Queensland — the States whose share was reduced by the 1981 Report (Western Australia, South Australia and Tasmania) remained critical and they were joined by New South Wales and Victoria whose benefits from the 1981 Report were reduced.
- 27 The Commonwealth proposed the relativities be phased in over three years. It also agreed to a guarantee under which each State would receive a 2 per cent real terms increase in its grant in 1982-83 and 1 per cent increases in 1983-84 and 1984-85. That guarantee was funded from the total amount of tax revenue to be made available to the States in each year.
- 28 The three less populous States received payments under the guarantee in each year. New South Wales and Victoria also received them in several years. The application of the guarantee prevented any noticeable movement towards the new relativities.
- 29 *The 1985 Review.* The 1976 tax sharing policy agreements between the Commonwealth and the States envisaged the relativities would be reviewed every three to five years. The Commission's 1981 Report noted the requirement to base the relativities on an average of the results for the three past years produced results that were out of date almost as soon as they were implemented. Moreover, the three or five years between reviews meant the relativities used in the year immediately prior to a new review would be based on data that were up to

nine years old. It suggested an alternative approach based on annual reviews but with no special grants. That suggestion was not taken up at the time.

- 30 Terms of reference for a third review were received in February 1984 and required a report by March 1985. They asked for relativities appropriate for distributing tax sharing grants after 1984-85 with the comparisons to use the same equalisation principle as the first two reviews and to be based on data for the three years 1981-82 to 1983-84. They also asked for four sets of relativities — one for the six States, one for the six States and the Northern Territory, one that included relative health needs and one that excluded them.
- 31 For the first time, the terms of reference:
- limited equalisation by directing that payments received by Tasmania following the cessation of the Gordon-below-Franklin dam be excluded from the assessments; and
 - sought advice on a specific issue of method — whether it was appropriate to apply the equalisation principle to services in the nature of business undertakings.
- 32 The Commission's report found:
- the option which included health needs was the only one that gave full effect to the equalisation principle;
 - it would be premature to include the Northern Territory in the tax sharing arrangements until the financial arrangements between it and the Commonwealth were consistent with those between the Commonwealth and the States; and
 - it was appropriate to continue to apply equalisation to business undertakings that regularly impose costs on the revenue budgets of most States.
- 33 Table A-5 compares the 1984-85 actual distribution of tax sharing grants (plus guarantee payments) with the distribution that would have resulted from the application of the relativities (including health needs) assessed in the 1982 and 1985 Reviews. It shows that compared with:
- the actual shares, those of New South Wales, Victoria, and South Australia would rise and those of Queensland, Western Australia and Tasmania would fall; and
 - the 1982 Review relativities, Queensland's share would fall substantially, New South Wales would fall marginally and the other States would rise.

Table A-5 Comparison of actual and assessed State shares of tax sharing grants^(a), 1984-85

	NSW	Vic	Qld	WA	SA	Tas	Six States
	%	%	%	%	%	%	%
Actual shares of grants	29.75	22.24	20.88	11.54	11.01	4.58	100.00
1982 Review - assessed shares	30.50	22.60	21.44	10.58	10.89	3.99	100.00
1985 Review - assessed shares	30.48	22.81	20.02	11.36	11.19	4.14	100.00

(a) Including the guarantee payments actually paid in 1983-84. The amount actually paid under the guarantee provisions has been distributed in accordance with the 1982 and 1985 relativities.

Source: Commonwealth Grants Commission, *Report on State Tax Sharing and Health Grants 1985*, Main Report, Table I-4.

- 34 The changes between the 1982 and 1985 relativities were due to:
- changes in the circumstances of the States;
 - changes in the distribution of specific purpose payments over the years;
 - changes in State shares of the six State population;
 - inclusion of data from the 1981 Census that were unavailable for the 1982 Review; and
 - changes in methods for assessing the States' relative ability to raise pay-roll tax, land revenue and some stamp duties and their relative costs of services for education and law and order services. The changes in assessment methods reduced the shares of Queensland (up to 70 per cent of the reduction in its share between the two reviews was due to method changes) and Tasmania, and increased the shares of all other States.
- 35 Against the background of a Commonwealth announcement that the large increase in its total tax collections in 1984-85 would not be reflected in the payments to the States in 1985-86, Queensland and Tasmania expressed concern with the Commission's conclusions. Western Australia was also dissatisfied but said it had fared better than it expected. The other States sought implementation of the findings, although New South Wales and Victoria said they did not go far enough. The Premier of New South Wales asked, 'Why should the people of New South Wales be paying taxes to subsidise the people of Queensland and Tasmania?'⁵
- 36 The 1985 Premiers' Conference decided:
- the tax sharing grants would be replaced by financial assistance grants that would grow at a pre-determined rate;
 - the Commission's 1985 relativities would be used to distribute the grants in each of the years 1985-86 to 1987-88, except that South Australia and Tasmania would receive special revenue assistance to smooth their adjustment to their reduced shares;
 - the health grants would continue to be distributed separately but would be included in the financial assistance grant processes from 1988-89; and
 - the Commission would do another review to determine the relativities for 1988-89.
- 37 *The 1988 Review.* The terms of reference were sent to the Commission in March 1986. They were similar to those for the 1985 Review. New features were:
- the relativities would be applied to the total of financial assistance grants, identified health grants, Medicare Compensation grants and special revenue assistance given to Queensland, South Australia and Tasmania; and
 - the Commission was to report on whether the application of the equalisation principle had significant implications for the efficient allocation of resources across Australia.
- 38 Table A-6 compares the actual shares of general revenue and identified health grants in 1987-88 with those that would arise from the assessed relativities for the six States and the

⁵ *The Canberra Times*, 3 April 1985.

Northern Territory with the Medicare Compensation grants continuing as specific purpose payments.

Table A-6 Comparison of actual and assessed shares of general revenue and identified health grants^(a), 1987-88

	NSW	Vic	Qld	WA	SA	Tas	NT	Total
	%	%	%	%	%	%	%	%
Actual shares of grants	30.18	22.01	17.79	11.20	10.30	3.77	4.75	100.00
1988 Review - assessed shares	30.22	22.32	18.10	11.01	10.20	3.71	4.44	100.00

(a) General revenue grants include the financial assistance grants, the special revenue assistance received by some States and a negative special grant for the Northern Territory.

Source: Commonwealth Grants Commission, *Report on General Revenue Grant Relativities 1988*, Main Report, Table 3-1.

- 39 The relativities would have increased the shares of New South Wales (albeit only slightly), Victoria and Queensland and reduced them for the other States and the Northern Territory.
- 40 Those changes were due to:
- changes in State shares of the total population — Queensland, Western Australia and the Northern Territory had above average population growth;
 - changes between the years used to derive the 1985 Review relativities (1981-81 and 1983-84) and those used in this Review (1984-85 to 1986-87) in:
 - State shares of specific purpose payments; and
 - State economic and demographic circumstances; and
 - changes in assessment methods.
- 41 Major changes in assessment methods included:
- including the Northern Territory in the standard to which all States were equalised;
 - introducing adjustments to State expenses and revenues aimed at making the relativities better reflect the circumstances of the years when they would be applied — adjustments were made when the arrangements for specific purpose payments in 1987-88 differed from those in 1984-85 to 1986-87;
 - ensuring differences between States in operating policies for business undertakings did not affect the relativities — this included a decision that all interstate differences in net expenses for freight transport services were due to policy differences;
 - allowing for interstate differences in the extent to which State-type services were provided by private, local government and other non-State service providers; and
 - treating part of Queensland Rail's profits from the haulage of coal as mining royalties.
- 42 The requirement to consider the implications of equalisation for the efficient allocation of resources reflected concerns of New South Wales and Victoria. Among other things, they argued the allowances for the effects of location on the costs of services (such as the allowances for the higher costs of services in remote areas) drove a wedge between the

economic costs of services and the tax prices faced by individuals and so distorted the allocation of resources. The Commonwealth broadly supported them. The other States and the Northern Territory opposed their arguments.

- 43 On these issues, the Commission concluded:
- equalisation did have consequences for the efficient allocation of resources but they were not serious enough to warrant changes in the way equalisation was implemented;
 - the essential requirement was that equalisation should not distort the decisions State governments make in allocating their resources;
 - equalisation should not play a role in enhancing efficiency in the public sector; and
 - its recommendations should be based on the equalisation principle as specified in its terms of reference — it was the task of governments to resolve any conflicts between equalisation and efficiency and specify the scope of fiscal equalisation accordingly.
- 44 Comment on the report was overwhelmed by State concerns about the Commonwealth's proposal to reduce the total amount of financial assistance grants by \$650 million. The Premiers' Conference decided the reduced total amount would be distributed according to the relativities for the six States and the Northern Territory with the identified health grants and the Medicare Compensation payments included in the pool. To ease the adjustment to the reduced pool and the new relativities, special revenue assistance was to be provided to ensure each State and the Northern Territory received at least the same nominal amount of general revenue assistance and hospital grants as in 1987-88.
- 45 It was also decided that the three yearly reviews would be replaced by annual updates on the basis of three year moving averages and five yearly major reviews of methods. Updates were to use the methods determined in the latest review.

The 1993 and 1999 Reviews and the annual updates

- 46 *The 1989 to 1992 Updates.* These annual updates were done by applying the methods of the 1988 Review to the most recent data. The major change over the period was an increase in the number of years whose data was reflected in the relativities. The 1989 update was based on three years of data⁶. In the 1990 Update, the Commission was asked for relativities based on the three most recent years (1986-87 to 1988-89) and the five most recent years (1984-85 to 1988-89). The 1990 Premiers' Conference decided the five year relativities would be used.
- 47 Another noticeable development in the terms of reference was the growing list of specific purpose payments the Commission was directed to ensure had no effect on the relativities.

⁶ After the 1989 Update the Commission was asked to report on the continued desirability of annual updates. The Commonwealth and all States except Victoria and Western Australia supported annual updates. Most accepted the three year averaging as a reasonable compromise between up-to-dateness and stability in the relativities and, failing that, favoured a longer rather than a shorter averaging period. The Commission recommended the continuation of annual updates based on three year averages.

- 48 Table A-7 compares the shares of the six States and the Northern Territory assessed in the 1988 Review and each update. To isolate the implications of the changes in the relativities, the shares are based on 1988-89 State populations, except where stated otherwise.

Table A-7 Comparison of actual and assessed shares of general revenue and health grants, 1988-89

	NSW	Vic	Qld	WA	SA	Tas	NT	Total
	%	%	%	%	%	%	%	%
Actual shares of grants in 1988-89	30.63	22.25	17.62	11.09	10.24	3.67	4.50	100.00
1988 Review	30.49	22.22	18.05	11.37	10.24	3.56	4.08	100.00
1989 Update	29.84	22.00	18.60	11.17	10.56	3.66	4.17	100.00
1990 Update								
three year shares	29.14	21.61	19.12	11.08	10.93	3.84	4.29	100.00
five year shares	29.77	21.82	18.66	11.22	10.61	3.71	4.22	100.00
1991 Update	29.04	21.39	19.05	11.33	10.89	3.88	4.42	100.00
1992 Update ^(a) – 1988-89 populations	28.59	21.14	19.36	11.35	11.06	3.95	4.55	100.00
1992 Update – 1991-92 populations	28.51	21.17	19.57	11.41	10.91	3.93	4.50	100.00

(a) These shares are based on relativities that used the same methods as previous updates. The Commission was also asked to produce relativities based on the assumption that Victoria was not able to collect revenue from Bass Strait oil and gas production. Those relativities, which were adopted by the 1992 Premiers' Conference, increased Victoria's share by 0.7 per cent and reduced all other States accordingly.

Source: Commonwealth Grants Commission, Reports on General Revenue Grant Relativities 1989, 1990, 1991 and 1992 Updates.

- 49 The table shows:
- the updates produced a steady reduction in the shares of New South Wales and Victoria, and increased the other States and the Northern Territory, except for Western Australia which initially fell but then rose to about the same level as in the 1988 Review;
 - the move to five year averages in the 1990 Update increased the shares of New South Wales, Victoria and Western Australia and reduced the others. However, the shares of New South Wales and Victoria were still below those of the 1989 Update;
 - changes in the distribution of population among the States between 1988-89 and 1991-92 further reduced the share of New South Wales (its share of the population fell), and increased the shares of Queensland and Western Australia (whose population share rose). For the others, population changes partly offset the changes in relativities.
- 50 The changes in State shares during the updates were generally caused by an increase in the extent to which State expenses were funded from their own tax revenues and changes in the relative revenue raising capacities of the States — the revenue raising capacity of New South Wales, Victoria and Western Australia generally rose and those of other States, especially Queensland, fell. Payroll tax, stamp duty on conveyances, land tax and mining revenue caused the largest changes. There were also changes in the relative costs of providing services — for

example, above average reductions in enrolments in government schools reduced Victoria's shares. Much of the increase in the Northern Territory's share arose because increasing levels of State expenditure magnified the effects of its very high relative costs.

- 51 Each update report was criticised by New South Wales, Victoria and other States whose shares fell. However, the relativities were always adopted. The Northern Territory was given special assistance in 1989 and 1990 to ease its adjustment to the lower relativities, with that assistance being funded from the total pool of assistance. In 1992, the Commonwealth agreed to increase the total by \$166 million over and above the formula increase — \$150 million was distributed among all States on the basis of their 1992 Update relativities and \$16 million was distributed to New South Wales and Victoria on a per capita basis.
- 52 *The 1993 Review and the preceding Report on Issues in Equalisation.* In September 1989, the Commission received a reference asking it to examine 'issues associated with the methodology' used in the 1988 Review. The Government said the responses on those issues would be considered in framing the reference for the 1993 Review. The issues included the range of revenue sources and expenditure functions covered by the assessments, the treatment of specific purpose payments, the appropriateness of assessing location specific costs and the likely effects on the application of the equalisation principle of taking account of economic efficiency and administrative simplicity. It was also asked to examine some technical issues including how it measured the revenue base for mining revenue from black coal, the effects of population dispersion on the costs of services and the relative costs to States of debt charges.
- 53 The October 1990 Report responded to each issue but noted that, as a whole, the reference related to the general issue of 'the extent to which fiscal equalisation should be used in the future as the basis for distributing general revenue assistance among the States'. It said it could help answer that question, but generally it was a matter 'for decision by governments'.
- 54 The Commission concluded any system of equalisation would have implications for efficiency but it was unlikely that any approach other than one of equalising the budgetary capacity of the States would better promote equity among individuals in terms of their access to State services and in paying for them. A study done for it indicated that reducing equalisation by removing location specific allowances would increase Australian net output by about \$30 million a year. The Commission noted the study was based on many debatable assumptions and therefore was not a sound basis for reaching conclusions on the efficiency effects of equalisation.
- 55 Since no State denied that location affected the costs of providing services, the Commission concluded it was appropriate to continue allowing for those effects, so long as the methods used to measure them ensured a State's actions did not directly affect its allowance.
- 56 On the other issues, the Commission concluded:
- if equalisation was the only aim of the system for distributing general revenue grants, it would be desirable for the assessments to cover all State revenues and services, except those fully funded by the Commonwealth. But, practical issues prevented it including capital transactions. Economic efficiency issues meant differences in per capita

expenditure on functions with a developmental objective or a commercial character should be viewed as arising solely from differences in State policies; and

- including specific purpose payments in its comparisons was necessary to equalise the capacity of the States to provide services (excluding them would only equalise the part of services funded from State revenues). Doing so did not prevent the aims of the SPP being achieved, but it did adjust the distribution of the general revenue grants if the distribution of the SPP differed from that of the needs assessed by the Commission.

- 57 The terms of reference for the 1993 Review were received in January 1991 and asked for two sets of relativities (one to share the general revenue and health grants among the six States and the Northern Territory and the other to share them among the six States, the Northern Territory and the ACT). Each was to be based on the equalisation principle and data for the five years 1987-88 to 1991-92. A subsequent part of the reference sought an extra set of relativities which ensured the policy intent of the 1993 Medicare Agreements was not diluted.
- 58 In this Review, the Commission made many changes in its methods, including ones which:
- included roads and housing expenses and motor tax revenue;
 - allowed interstate differences in wage levels and office rents to affect the relativities; and
 - changed the method of measuring interstate differences in costs of providing urban transport services to reduce the possibility that the relativities would be affected by differences in State policies on the standard of services and operating efficiency.
- 59 There was also a difference of opinion between the Commission and the Commonwealth, New South Wales, Victoria and some private organisations over whether the value of assets involved in corporate reconstructions were part of the revenue base for stamp duty on conveyances. The Commission considered they were but the others considered they were not.
- 60 Table A-8 compares the actual shares of general revenue and health care grants in 1992-93 with those that would arise if the relativities derived in the 1993 Review were applied. The ACT has been included in all the figures. It also shows the effects of adjusting the relativities to avoid reducing the policy effects of the 1993 Medicare Agreements.
- 61 The new equalisation relativities increased the shares of New South Wales, Victoria and Tasmania. The Medicare adjusted relativities increased the shares of New South Wales, Queensland, Tasmania and the Northern Territory relative to the equalisation shares.
- 62 New South Wales and Victoria criticised the relativities for subsidising the less populous States at their expense. New South Wales also said they should be applied immediately. Queensland was concerned that they were based on population data that were nearly seven years old — the Commission had not been able to include detailed data from the 1991 Census.

Table A-8 Comparison of actual shares for 1992-93 with those from the 1993 Review

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	%	%	%	%	%	%	%	%	%
Actual distribution 1992-93	27.71	21.24	19.15	10.83	10.51	3.84	1.89	4.83	100.00
1993 Review distributions									
Equalisation basis	28.63	21.38	18.83	10.65	10.40	3.91	1.69	4.51	100.00
Medicare adjusted	29.02	21.25	18.88	10.55	10.10	3.93	1.54	4.74	100.00
Distribution agreed at 1993 Premiers' Conference ^(a)	29.06	21.66	18.58	10.33	9.88	3.87	1.99	4.64	100.00

(a) Includes effects of Medicare adjustments (including guarantee payments funded from inside and outside the pool) and special revenue assistance to the Northern Territory and the ACT. It is based on December 1992 populations.
Source: Commonwealth Grants Commission, *Report on General Revenue Grant Relativities 1993* and Commonwealth of Australia, *Commonwealth Financial Relations with other Levels of Government 1993-94*, Table 16.

- 63 In the event, because new Medicare Agreements became effective in 1993, the Premiers' Conference decided to adopt the Medicare adjusted relativities including the ACT, but with an adjustment to exclude all assets transferred under corporate reconstructions from the State revenue bases (which had a small benefit for New South Wales). It also agreed to provide:
- special assistance to the ACT and the Northern Territory to be funded from the pool;
 - extra special needs funding to the ACT to be funded by the Commonwealth; and
 - Medicare Guarantee payments to New South Wales and Victoria to be funded half from the pool and half by the Commonwealth.
- 64 *The 1994 to 1998 Updates.* The 1993 Premiers' Conference was expected to concurrently consider the 1993 Review Report and a report by Heads of Treasuries on the equalisation principle and methods. However, the Heads of Treasuries Report was not completed in time.
- 65 In the meantime, the Commission was to update the relativities using data for 1988-89 to 1992-93 and the 1993 Review methods except that assets transferred under corporate reconstructions were to be excluded from State revenue bases.
- 66 The Heads of Treasuries Report was considered at the 1994 Premiers' Conference. It said equalisation was justified on equity grounds and while the principle was simple, its implementation was detailed and complex. It examined some of the implications of equalisation for efficiency, canvassed options for change and noted change could be achieved by different distributional arrangements or changes in Commission methods. The report made no specific recommendations on future directions, partly because changes would have large distributional effects and there were often substantial differences of views between New South Wales and Victoria and the other States. The Premiers' Conference noted the report.
- 67 The references for the 1995 to 1998 updates were similar to those for the 1994 Update.
- 68 Table A-9 compares the shares of general revenue and health grants agreed at the 1993 Premiers' Conference with the shares implied by the relativities assessed in each update. To focus on the effects of the updates, all shares are calculated using December 1993 populations.

- 69 The 1994 Update was affected by: corrections to calculations in the 1993 Review (which reduced the share of Queensland); the use of data from the 1991 Census (which increased the shares of New South Wales and Victoria and reduced them for Queensland, Western Australia and South Australia); and other data revisions (more recent data on relative wage levels increased the share of New South Wales and Tasmania and reduced it for Victoria).

Table A-9 Comparison of actual 1993-94 shares with those from the 1994 to 1998 Updates

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	%	%	%	%	%	%	%	%	%
Actual distribution 1993-94 ^(a)	29.02	21.25	18.88	10.55	10.10	3.93	1.54	4.74	100.00
1994 Update	29.75	21.09	18.50	10.28	10.06	4.04	1.52	4.76	100.00
1995 Update	29.71	21.43	18.49	9.98	9.94	4.11	1.51	4.81	100.00
1996 Update	29.75	22.08	18.47	9.59	9.81	4.12	1.51	4.66	100.00
1997 Update	29.86	22.14	18.39	9.45	9.84	4.13	1.50	4.68	100.00
1998 Update	29.86	22.21	18.13	9.33	10.10	4.14	1.61	4.61	100.00
1998 Update and 1998 population	29.66	21.81	18.91	9.59	9.65	3.87	1.56	4.95	100.00

(a) Excludes effects of Medicare guarantee payments and special revenue assistance to the Northern Territory and the ACT. It is based on December 1993 populations.

Source: Commonwealth Grants Commission, Reports on General Revenue Grant Relativities, 1994 to 1998 Updates.

- 70 The 1995 to 1998 Updates saw a decline in the shares of Queensland, Western Australia and the Northern Territory, mostly because of increases in their relative capacity to raise revenue.
- 71 The last line in the table shows substantial changes in the shares of the pool were caused by the population drift away from New South Wales, Victoria, South Australia and Tasmania and towards Queensland and Western Australia. Population movements tended to partly, and in some cases fully, offset the effects of the changes in relativities.
- 72 The recommended relativities were accepted each year. However, it was also often decided that part of the pool would be used to fund special revenue assistance to some States to reduce the effect on their budgets of the changes in relativities. The ACT and the Northern Territory received this special revenue assistance in most years and Queensland received it in 1994.
- 73 *The 1999 Review.* The terms of reference received in January 1995 asked the Commission to review the relativities used for distributing the combined general revenue and health grants among the six States and two Territories. Alternative relativities based on three and five years of data were sought. The Commission was asked to begin a program of research immediately and present its findings progressively but not implement them before the 1999 Report.
- 74 The reference said parts of the payments to the States under the new health care agreements were not to affect the relativities. However, it did not continue the 1993 Review approach of

trying to align the Commission's assessments of the relative costs of health services with the terms of those agreements.

- 75 As was usual in reviews, the availability of new and different information facilitated changes in methods that improved the measurement of relative financial capacities. They included improvements in the measures of relative road maintenance expenses, differences in wage levels and the effects of population dispersion, diseconomies of small scale and Aboriginality.
- 76 The most significant change was the expansion of the scope of the comparisons to include depreciation expenses. With this change, the scope of equalisation became almost complete, because it now covered virtually all State recurrent revenues and expenses.
- 77 Table A-10 compares the State shares of the general revenue and health care grant pool applied in 1998-99 with those implied by the five year relativities assessed in the review.

Table A-10 Comparison of actual shares for 1998-99 with those from the 1999 Review

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	%	%	%	%	%	%	%	%	%
Actual 1998-99 distribution ^(a)	29.66	21.81	18.91	9.59	9.65	3.87	1.56	4.94	100.00
1999 Review	30.43	21.38	18.66	9.18	9.55	4.02	1.82	4.97	100.00

(a) Covers the pool of financial assistance and unquarantined health care grants. It excludes special revenue assistance and national competition payments. The two distributions in the table are based on December 1998 populations.

Source: Commonwealth Grants Commission, *Report on General Revenue Grant Relativities 1999*.

- 78 The main reasons for the changes in the State shares were:
- the inclusion of depreciation expenses — this substantially increased the shares of New South Wales and the Northern Territory, substantially reduced the share of Queensland and had smaller negative effects on all other States;
 - the introduction of detailed data from the 1996 Census — this reduced the shares of Queensland, Western Australia and the Northern Territory, partly because the growth in their Indigenous population was below the average;
 - changes in the relative revenue raising capacities of the States — the capacities of New South Wales and Western Australia rose noticeably and those of Victoria, Queensland and South Australia fell, all largely because of movements in real estate markets; and
 - changes in the method of measuring diseconomies of scale substantially increased the shares of New South Wales, Victoria, Queensland and the ACT, left Tasmania largely unchanged and reduced the shares of the others, especially the Northern Territory.
- 79 In responding to the request for advice on the length of the review period, the Commission noted relativities produced using a three and a five year period were out of date when they were used, but less so for a three year period. A five year period would better smooth the relativities and even out the effects of data errors. It concluded equalisation would be achieved with either period but frequent changes in the length of the review period would be inappropriate.

- 80 Reaction to the review report was consistent with its effects on State shares. New South Wales and Victoria repeated their concerns about the extent of their ‘subsidies’ to other States. Towards the end of the review, New South Wales placed newspaper advertisements drawing attention to the extent of the redistribution towards other States.
- 81 The 1999 Premiers’ Conference adopted the recommended five year relativities.

The introduction of the Goods and Services Tax

- 82 On 1 July 2000, the Commonwealth introduced a package of tax reforms, which included:
- the introduction of a goods and services tax (GST);
 - reductions in income tax rates and the abolition of the wholesale sales tax and a number of State taxes (mainly taxes on banking and financial transactions);
 - an undertaking in the accompanying *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (the IGA) that all revenue from the GST would be paid to the States, which could spend it in accordance with their own priorities, but the financial assistance grants and payments in lieu of State business franchise fees⁷ would cease and the States would abolish a number of their taxes (some immediately, some on 1 July 2001 and others over the next few years), reduce gambling tax and take on extra responsibilities (mainly grants to first home owners);
 - a guarantee to the States that in the transitional years their budgetary positions would be no worse than if the reforms had not been introduced;
 - specific purpose payments would continue; and
 - subject to the transitional arrangements, the GST revenue would be distributed among the States in accordance with equalisation principles and advice from the Commission.
- 83 These reforms had no implications for the conceptual basis of the Commission’s work. However, they did change the context of that work. Firstly, they meant equalisation would be applied to a larger amount — in 1999-2000, \$22.9 billion was distributed on an equalisation basis but that grew by 31.7 per cent to \$30.2 billion in 2000-01. Secondly, the total amount to be distributed among the States was to be based solely on total GST collections. This implied the end of the bargaining at the annual Premiers’ Conference during which States sought to mitigate budgetary issues (including the potential effects of a reduction in their share of general revenue assistance) by increases in the total amount distributed among them. It increased the focus on the recommended shares.

⁷ An August 1997 High Court ruling cast doubt on the validity of the State business franchise fees on tobacco, alcohol and petroleum, which raised about \$5.2 billion in 1996-97. At the request of the States, the Commonwealth introduced safety net arrangements. It increased its taxes on those products and passed the revenue to the States in an agreed way that maintained their budgetary positions.

The 2000 to 2003 Updates

- 84 Terms of reference seeking an update of the 1999 Review relativities were received in December 1999. They asked for two sets of relativities:
- one for distributing the combined pool of GST revenue and health care grants; and
 - one for distributing a combined pool of financial assistance and health care grants that would have been payable if the previous arrangements had continued.
- 85 The reference required the relativities to be based on data for 1994-95 to 1998-99 and the 1999 Review methods and principles, unless provisions of the IGA necessitated changes.
- 86 Provisions of the IGA that had to be taken into account covered the abolition of taxes and the expansion of expenditure. The Commission adjusted the data for each year included in its assessments to exclude the revenues from the abolished taxes — it assumed they had already been abolished and made no comparisons for them. It also included imputed expenses for the new responsibilities and assessed factors that caused differences in State per capita expenses.
- 87 The requirements for the 2001, 2002 and 2003 Updates were similar. Each update was based on a rolling average of the data for the most recent five years, and the list of SPPs to be excluded from the equalisation process grew each year. In the 2001 Update, the Commission was asked to consider the implications of the States' movement to accrual accounting and how it should deal with large one-off payments for unfunded superannuation liabilities.
- 88 Table A-11 compares the State shares of the pool implied by the Commission's assessed relativities in each update⁸ with the 1999-2000 shares of financial assistance and health care grants (including the payments in lieu of business franchise fees). To isolate the effects of the changes in relativities, the shares are based on December 1999 State populations.

Table A-11 Comparison of actual shares for 1999-2000 of general revenue and health care grants with those from the 2000 to 2003 Updates

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	%	%	%	%	%	%	%	%	%
Actual distribution 1999-2000 ^(a)	30.90	21.64	18.71	9.76	9.20	3.76	1.74	4.28	100.00
2000 Update	30.72	21.62	18.88	9.69	9.29	3.72	1.81	4.25	100.00
2001 Update	31.11	21.74	18.60	9.61	9.27	3.70	1.87	4.11	100.00
2002 Update	30.63	21.56	18.76	9.62	9.39	3.83	1.88	4.34	100.00
2003 Update	30.12	21.61	18.90	9.55	9.53	3.94	1.86	4.48	100.00
2003 Update and 2003 population	29.66	21.83	19.37	9.66	9.34	3.67	1.56	4.91	100.00

(a) Includes special revenue assistance to the Northern Territory and the ACT, and based on December 1999 populations. Source: Commonwealth Grants Commission, Reports on State Revenue Sharing Relativities 2000 to 2003 Updates.

⁸ This does not represent the funds actually received because in most years additional money was paid under the guarantee provisions of the IGA.

- 89 The main trends in State shares of the pool over these updates were:
- a strengthening of the relative financial position of New South Wales, which reduced the share of the pool required to give it the same financial capacity as the other States. This reflected a trend across all States to fund more of their expenses from their own tax revenues (which magnified the effects of New South Wales' above average capacity to raise revenue), increases in its capacity to raise revenue (especially from real estate transfers) and a reduction in its costs of providing services, stemming largely from the lower levels of debt in all States;
 - a strengthening of Western Australia's financial position, mainly due to its increasing capacity to raise mining revenue, including the North-West Shelf project; and
 - a weakening of the relative position of South Australia, Tasmania and the Northern Territory. In South Australia and Tasmania, the changes were generally driven by falling capacities to raise their own revenue. In the Northern Territory, rising State expenses magnified the effects of its high relative costs of providing services.
- 90 The abolition of State taxes, including the payments in lieu of State franchise fees, affected the shares by removing the revenues and the related above or below average revenue bases from the comparisons. The effects depended on how those revenue bases were spread across the States. For example, the abolition of financial institutions duty and bank accounts debits duty increased New South Wales' share because its revenue raising advantages arising from an above average level of financial transactions were no longer taken into account.
- 91 The update reports met with predictable comments.
- New South Wales and Victoria invariably criticised them. They drew attention to the year to year changes in revenue from the pool and the implications of reductions in that revenue for State services. They said their revenue per capita from the pool was less than the national average per capita amount and claimed they were 'subsidising' the other States. New South Wales also argued there was a large and growing gap between its estimates of the GST paid in New South Wales and its revenue from the pool.
 - The other States expressed various levels of support for the conclusions.
 - The Commonwealth noted the issue was one for the States to resolve among themselves but said the assessed relativities would be implemented unless the States could unanimously agree on an alternative allocation.
- 92 The annual meetings of the Ministerial Council for Commonwealth-State Financial Relations⁹ accepted the GST relativities recommended by the Commission would be used to allocate the GST and health care grant pool. Under the IGA, the other relativities recommended by the Commission (the financial assistance grant relativities) were used to calculate the guaranteed minimum amounts for the States. In each year 2000-01 to 2003-04, the only amounts paid to

⁹ The Ministerial Council consisted of the Australian and State treasurers. It was created to oversee the operation of the IGA and took over many of the responsibilities of the annual Premiers' Conferences.

the States in addition to the GST and health care grants pool were the amounts required to implement the guarantee provisions of the IGA — called budget balancing assistance. They were paid to all States in 2000-01 and 2001-02, to all States except Queensland and the Northern Territory in 2002-03, and to New South Wales only in 2003-04.

The 2004 Review

- 93 *The terms of reference and their interpretation.* A reference was received in December 1999 asking for a report by February 2004 on the appropriate relativities for distributing the GST and health care grants pool after 2003-04. Unlike previous references, it did not require the Commission to base the relativities on the equalisation principle or direct it on the data to be used. A supplement to the reference received in November 2003 directed the Commission to ensure certain SPPs, including parts of the health care grants, did not affect the relativities.
- 94 The omission of the equalisation principle from the reference appeared to reflect strong differences of opinion between New South Wales and Victoria and the other States on the continued appropriateness of using it as the basis for distributing general revenue assistance.
- 95 Early in the review, New South Wales and Victoria argued the existing level of redistribution was becoming unsustainable and the equalisation principles should be reviewed. For example, Victoria said the introduction of the GST and the IGA changed the environment in which the Commission operated. It noted ‘States had traded own-source revenues for revenues collected under Commonwealth legislation, but which have no impact on the Commonwealth budget.’ It said the Commission’s approach was not appropriate in an environment where governments were focussing on competitiveness, value for money and more effective and efficient services.
- 96 Victoria said the current approach stifled the evolution of competitive and dynamic State governments and did not adequately take account of changes in public administration. It considered equalisation should be based on outcomes rather than inputs and, if it continued to focus on inputs, it should use standards that reflect best practice in service delivery.
- 97 In a discussion paper¹⁰, the Commission noted the IGA agreed and signed by all States in June 1999 specified the GST revenue was to be distributed on the basis of equalisation principles. It also noted the wording of the reference, the history of previous reviews and the context in which the reference was prepared indicated it was asked to review the methods used in applying the equalisation principle. It concluded the relativities should be based on the equalisation principle set out in its 1999 Review Report. It said questions about the appropriateness of equalisation as the basis for distributing funds and whether other concepts of equalisation could be adopted were outside the scope of the reference. If governments wanted it to review the equalisation principle a separate reference should be provided.
- 98 Issues raised by the States, which it considered were within the scope of the reference were:

¹⁰ Commonwealth Grants Commission, Discussion Paper CGC 2001/7, *Interpretation of the Terms of Reference for the 2004 Review, and Issues of Concepts and Methods*, August 2001.

- whether equalisation should be based on a desired level of service delivery efficiency rather than an average of existing efficiency levels;
 - whether there should be a clearer delineation between factors governments could control (and which should not affect the allocation of funds) and those they cannot control (and which should be taken into account);
 - whether equalisation should better reflect the role of States in developing their economies and revenue bases; and
 - whether equalisation could be achieved by simpler and more transparent approaches that reduced the need for the Commission to exercise its judgment.
- 99 Most States accepted the Commission's conclusions. New South Wales and Victoria accepted the IGA said the GST would be allocated on the basis of equalisation principles, but they did not accept the Commission's interpretation was the only or the most appropriate one.
- 100 *A separate, broader, State-funded review.* In November 2001, the Governments of New South Wales, Victoria and Western Australia announced they had initiated a review of the methods of allocating general and specific purpose payments to the States. The review was to assess the current system in terms of economic efficiency, equity, simplicity and transparency.
- 101 The review proceeded by means of a December 2001 background paper and call for submissions, a public forum in March 2002, discussions with interested people, an interim report in April 2002 and a final report in August 2002¹¹. However, the only governments which made submissions were those of New South Wales, Victoria and Western Australia.
- 102 The final report of the review reached the following conclusions.
- The current system of allocating general and specific purpose payments affects national economic performance in many ways:
 - it affects the distribution of people, economic activity and development;
 - it involves significant overhead costs and game playing;
 - the methods for distributing the GST reward cost disabilities and inefficiency and distort the size and shape of the public sector in the States; and
 - the methods for distributing the GST distribute benefits of development without sharing the costs and dull incentives for growth promoting policies.
 - A study commissioned by the review indicated the economic costs of the current system were between \$150 and \$280 million a year. The review suspected the effects on development and growth policies may be more fundamental problems.
 - The concept of equity must relate to outcomes for individuals and households, not to equalising the financial capacity of State governments.

¹¹ Garnaut R and Fitzgerald V, Review of Commonwealth-State Funding, Final Report, August 2002.

- The current system is not simple or transparent. It noted the allocation of general grants overrode the allocation of SPPs and there was no requirement for States to spend funds in accordance with the Commission's assessments.

103 The review proposed an alternative system in which:

- the distribution of the GST would give each State a flat amount to cover the minimum overhead costs of government, with the rest allocated on an equal per capita basis; and
- a co-operative model would be used for SPPs in the areas of health, aged care, education and training. Payments in those areas would be broadbanded into two programs with the States having authority over service delivery and without Commonwealth micro-management and input controls. The Commonwealth would have primary control of a third program for Indigenous community development. SPPs outside those three areas would be discontinued and the funds rolled into the two State-controlled programs. SPPs relating to cross-border activities such as national roads would be unchanged.

104 The review claimed its new system would make Australia the most egalitarian of the world's federations, with more certain delivery to all Australians of the services that are most important to equity and equality of opportunity, and at far lower cost to State and national development.

105 There was limited reaction to the report. Queensland had the estimate of the economic costs of the current system redone using different assumptions. This produced a range of results, some of which suggested reducing equalisation may reduce economic welfare¹².

106 *The results of the Commission's 2004 Review.* Table A-12 compares the 2003-04 shares of the GST and health care grants pool with those implied by the 2004 Review recommendations.

Table A-12 Comparison of actual shares for 2003-04 with those from the 2004 Review

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	%	%	%	%	%	%	%	%	%
Actual distribution 2003-04 ^(a)	30.02	21.60	19.51	9.54	9.29	3.80	1.87	4.36	100.00
2004 Review	29.21	21.47	20.19	10.14	9.22	3.70	1.84	4.23	100.00

(a) Covers the pool of GST revenue and health care grants. It excludes all budget balancing assistance and national competition payments. The two distributions in the table are based on December 2003 populations.

Source: Commonwealth Grants Commission, *Report on General Revenue Grant Relativities 2004*.

107 The results of the 2004 Review increased the shares of Queensland and Western Australia and reduced those of all other States. The Commission said this arose for the following reasons.

- Some methods had changed. It made changes to strengthen the conceptual approach, make the assessments more policy neutral and firmly based on objective, quantifiable evidence, and have them reflect the current policies of the States on revenue collection

¹² Picton M and Dixon P, *Issues involving modelling by CoPs of the efficiency effects of Commonwealth-State Funding*, Report to Queensland Treasury, March 2003.

and service delivery. This reflected the concern of most States, especially the larger ones, about the level of judgment in the assessments.

There were major changes to the depreciation and debt charges assessments aimed at making them more rigorous, with greater reliance on evidence and conceptual clarity. The new assessments reduced the differences between the States because the Commission concluded interstate differences in construction costs and the influences of climate and urban complexity were previously overstated. The new method increased the assessed costs of providing services in Queensland (and to a lesser extent Western Australia) and reduced them in New South Wales and the Northern Territory.

The increased emphasis on hard data led to changes which reduced Western Australia's measured relative capacity to raise mining revenue. Reductions in the assessment of diseconomies of small scale reduced the shares of the less populous States.

- The assessments were more up to date because they included a more recent year and the results of the 2001 Census. This meant the strong real estate market in New South Wales increased its relative capacity to raise revenue. Reductions in the proportions of people in groups that use State services more intensively or are relatively expensive to service (those with low income, low fluency in English, who live in remote areas or are Indigenous) in Victoria, South Australia and the ACT reduced their shares of the pool.

108 The report received hostile responses from New South Wales and Victoria.

- They intensified their attacks on equalisation and focussed on the difference between their estimates of the GST paid in their State and the amount returned under the Commission's calculations — 'New South Wales will be subsidising other states to the tune of \$2.9 billion and \$780 million of that total will go to Queensland, a wealthy state with a smaller population without the problems faced by New South Wales'¹³. The Victorian Treasurer said he 'wouldn't have a problem if special financial assistance was going to 'needy states' such as Tasmania or the Northern Territory — but not Queensland and the ACT'¹⁴.
- For the first time since the Commission's early years, the commentary became personal with the Premier of New South Wales attacking the members of the Commission as 'a select priesthood of obscure and mediocre economists'¹⁵.
- New South Wales and Victoria undertook public advertising and electronic petitions aimed at winning public support for the Commonwealth to vary the Commission's recommendations. The Commonwealth also conducted an advertising campaign to highlight its increased support for the States.

109 Despite the public commentary, the relativities recommended in the 2004 Review Report were used to distribute the GST and health care grants pool in 2004-05.

¹³ See *The Sydney Morning Herald* of 4 March 2004.

¹⁴ See *The Age* of 4 March 2004.

¹⁵ See *The Sydney Morning Herald* of 4 March 2004.

- 110 The Commission's report acknowledged its review had been conducted in a context where some States were strengthening their view that the equalisation principles should be revisited and that they did not accept its view that doing so was beyond the terms of reference. It also said it was supportive of a far-reaching review of equalisation and its underlying purposes.
- 111 Regardless of whether governments established a review of the principles of equalisation, the Commission recommended that work be done to consider whether:
- the present comprehensive examination of all State operating revenues and expenses was appropriate and necessary;
 - equalisation could be achieved more simply; and
 - key data used in the comparisons were robust and comparable.
- 112 *Review of horizontal fiscal equalisation methodology.* At the March 2004 Ministerial Council meeting a majority of States and Territories and the Australian Government agreed Heads of Treasuries would review the Commission's methodology. That review was to cover the issues listed in the previous paragraph but it was not to examine the underlying principles of horizontal fiscal equalisation.
- 113 This review was overseen by a steering committee consisting of the heads of the Australian, Victorian and Tasmanian treasuries and the Chairman of the Commission. A secretariat of Australian Government Treasury and Commission officers supported the steering committee, which consulted regularly with the States and commissioned independent advice from the Australian Bureau of Statistics and external consultants.
- 114 Heads of Treasuries concluded the Commission's approach could benefit from a programme of simplification, providing that to do so was consistent with the equalisation principle. They examined many options for simplification and concluded four deserved further examination.
- 115 Heads of Treasuries concluded the most appropriate way forward was for the Commission to be given terms of reference for a broad review of methodology. They also suggested the reference provide the Commission with guidance on where simplification may be achieved.
- 116 The Ministerial Council meeting in March 2005 accepted those recommendations and terms of reference were subsequently forwarded to the Commission. They required it to simplify its methods, provided that to do so was consistent with the equalisation principle, by:
- aggregating assessments;
 - applying materiality thresholds;
 - eliminating assessments found unreliable because of unsatisfactory data or methods;
 - addressing issues relating to data quality; and
 - reviewing the scope for the use of more general indicators of State needs.
- 117 The Commission was to report progress to the 2006 and 2007 Ministerial Council meetings.

- 118 Those reports indicated the Commission had established and was beginning to implement an approach to achieve equalisation in a simpler way. Under this approach, which was broadly accepted by all States, the Commission proposed starting with a clean slate and disaggregating State revenues and expenses only if it materially improved equalisation and could be done reliably. To help that process, the Commission proposed new guidelines, including materiality thresholds and reliability criteria, to help it make decisions on assessment methods¹⁶.
- 119 The Commission also introduced a protocol aimed at increasing data quality and established a work program for it and the States to review the reliability of the major data series it used. In some cases, this review led to changes in the data used in the 2006, 2007 and 2008 Updates.
- 120 *The 2005, 2006, 2007 and 2008 annual updates.* While this review has been progressing, the Commission has also been asked to undertake annual updates of the relativities using the 2004 Review methods and the data for the most recent five years.
- 121 Table A-13 compares the State shares of the GST and health care grants pool implied by the relativities assessed in each update with the 2004-05 shares. To isolate the effects of the changes in relativities, the shares are based on State populations in December 2004.

Table A-13 Comparison of actual shares for 2004-05 of GST and health care grants with those from the 2005 to 2008 Updates

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	%	%	%	%	%	%	%	%	%
Actual distribution 2004-05 ^(a)	29.05	21.40	20.48	10.17	9.16	3.74	4.20	1.81	100.00
2005 Update	29.08	21.64	20.26	10.11	9.15	3.72	4.20	1.83	100.00
2006 Update	29.24	22.14	19.87	9.91	9.04	3.72	4.26	1.84	100.00
2007 Update	29.82	22.27	19.52	9.34	9.18	3.70	4.30	1.86	100.00
2008 Update	30.49	22.88	18.73	8.71	9.19	3.67	4.45	1.88	100.00
2008 Update and 2008 population	29.69	22.93	19.37	8.89	9.04	3.56	4.63	1.88	100.00

(a) Includes GST and health care grants only. It is based on December 2004 populations.

Source: Commonwealth Grants Commission, Reports on State Revenue Sharing Relativities 2005 to 2008 Updates.

- 122 Over these updates, the main trends in State shares of the pool were:
- increasing shares for New South Wales and Victoria. In the 2005 Update, above average wage increases in New South Wales increased its costs of providing services by more than its revenue raising capacity, but in later years, its relative revenue capacity fell. In the case of Victoria, its relative revenue raising capacity fell in each update;
 - reducing shares for Queensland and Western Australia. Strengthening economies increased the relative revenue raising capacity of Queensland in each update and in Western Australia in each update after the 2005 one. Their shares were also reduced by

¹⁶ See Commonwealth Grants Commission, *Progress Report to Ministerial Council for Commonwealth-State Financial Relations 2007*, Attachment A.

falls in their relative costs of providing services in most years (the exception was the 2007 Update when wage increases in Queensland were above average);

- an initial decline then an increase in the share for South Australia. In the 2005 Update, its share fell because reductions in its relative costs more than offset the effects of a declining relative capacity to raise revenue. In the 2006 Update, revisions to ABS data on wages increased its relative revenue capacity. Falls in its relative revenue raising capacity were the main reason for its increasing shares in the 2007 and 2008 Updates;
- a decline in Tasmania's share. Its relative costs fell in all years mainly because of below average increases in wage levels and declining effects of diseconomies of small scale. In the 2007 and 2008 Updates, increases in its relative capacity to raise revenue due to above average increases in activity in its real estate market also reduced its share; and
- increases in the shares for the ACT and the Northern Territory. In the ACT, this was due to a reduced revenue capacity, but in the Northern Territory, it was because increases in State expenses magnified the effects of its above average cost structure.

- 123 The last row in Table A-13 shows changes in State shares of the total population left the Northern Territory's share of the GST and health care grants unchanged, reduced the shares of New South Wales, South Australia and Tasmania and increased those of the other States.

ADMINISTRATIVE ARRANGEMENTS FOR THE COMMISSION

- 124 Throughout its 75 years, the Commission has received its terms of reference and reported to a variety of Australian Government ministers. They are listed below.

Responsible Minister	From
Prime Minister	May 1933
Special Minister of State	December 1972
Minister for Administrative Services	December 1975
Treasurer	March 1983
Special Minister of State	July 1983
Minister for Administrative Services	July 1987
Minister for the Arts and Administrative Services	March 1993
Minister for Administrative Services	June 1994
Minister for Finance and Administration	October 1997
Minister for Finance and Deregulation	December 2007
Treasurer	January 2008

- 125 In each case, the administrative arrangements preserved the Commission's status as an independent statutory authority of the Australian Government. They clarified reporting arrangements and provided the means for the Commission to obtain the resources necessary to discharge its responsibilities. A list of the members and secretaries of the Commission is in Attachment E.

ATTACHMENT B

A BRIEF HISTORY OF GENERAL REVENUE ASSISTANCE ARRANGEMENTS

Year	Details
1901-02	75 per cent of customs and excise revenue and 'surplus revenue' paid to States.
1910-11	Per capita payments to all States introduced. Special grants were also paid to Western Australia (from 1910-11) and Tasmania (from 1912-13).
1927-28	Per capita grants replaced by 1927 Financial Agreement under which the Commonwealth met the interest and sinking fund payments on State debt.
1929-30	Special grants payments to South Australia commence.
1942-43	Commonwealth took over income tax. States were given 'tax reimbursement grants' based on their average income tax collections in 1939-40 and 1940-41. A uniform entertainments tax was also established and the five States which previously levied it were reimbursed on the basis of their 1941-42 collections.
1946-47	Total tax reimbursement grants were set at \$80 million. Each State's grant in subsequent years was based on its share of the base amount increased by the percentage increase in the Australian population and half the percentage increase in Australian average wages per person employed.
1947-48	Total tax reimbursement grant increased to \$90 million and distributed using the existing proportions.
1948-49 to 1957-58	The <i>States Grants (Tax Reimbursement) Act 1946</i> said the distribution of the grants would progressively move from the State of collection basis applied in 1947-48 to one based on each State's share of the Australian population adjusted for density and the number of children aged 5 – 15 years of age by 1957-58.
1949-50 to 1958-59	Ad-hoc supplementary grants were also paid to all States after 1949-50.

Attachment B A brief history of general revenue assistance arrangements

Year	Details
1959-60	Tax reimbursement, supplementary grants and special grants were replaced by increased Financial Assistance Grants (FAGs). The shares of FAGs received by New South Wales, Victoria, Queensland and South Australia were their shares of total grants paid in 1958-59 rounded up to the nearest whole number. But New South Wales and South Australia were each given an extra \$2 million.
1960-61 to 1964-65	Each State's FAG was its 1959-60 grant indexed by movements in its population, Australian average wages and a betterment factor of 10 per cent of the increase in average wages.
1965-66	The betterment factor was increased to 1.2 per cent of grants. Victoria's grant was also increased by \$1.2 million. Queensland's base grants were to be increased by \$2 million each year due to its large area and small population.
1966-67	Special assistance of \$5 million was provided and distributed among all States and was added to the base for determining FAGs in future years.
1968-69 and 1969-70	Western Australia was paid \$15.5 million in each year in lieu of special grants. That amount was to be included in its base for calculating future FAGs.
1970-71	Total FAGs were increased by \$40 million (3.5 per cent of 1969-70 FAGs). New South Wales and Victoria were also to receive an extra \$2 per capita for five years, but it was not included in the base for calculating future FAGs. The \$2 million annual addition to Queensland's base was continued because its share was too low, but the \$15.5 million addition to Western Australia's grant was to be phased out at \$3 million a year due to its increasing financial capacity. The Commonwealth agreed to take over debt charges on \$200 million of State debt in 1970-71 rising to \$1000 million in 1974-75.
1971-72	The betterment factor was increased to 1.8 per cent per annum. Payroll tax was transferred to the States but FAGs were reduced by about 90 per cent of the estimated collections.
1972-73	Total FAGs increased by \$112 million (about 7.5 per cent of 1971-72 FAGs). Per capita additional grants to New South Wales and Victoria were increased to \$3.50 and included in the base for future FAGs.
1973-74	The annual \$3 million reduction in Western Australia's grant was discontinued — it continued to receive \$6.5 of the initial \$15.5 million. Tasmania's grant was increased by \$15 million to allow it to cease applying for special grants.
1974-75	FAGs for South Australia and Tasmania were adjusted for Commonwealth takeover of their railways. South Australia's FAGs were increased by \$25 million to allow it to cease applying for special grants.
1975-76	Total FAGs increased by \$220 million (about 9 per cent of 1974-75 FAGs), Western Australia's FAGs increased by \$5 million.

Attachment B A brief history of general revenue assistance arrangements

Year	Details
1976-77	FAGs replaced by personal income tax sharing arrangements. The States in total were to receive 33.6 per cent of net personal income tax collections in the year to be distributed among them using their 1975-76 FAG proportions. States were guaranteed that for the first four years they would not receive less than what they would have under the previous FAG process.
1977-78	Total entitlements were fixed at \$4336.1 million and future entitlements were to be 39.87 per cent of net personal income tax collections in the preceding year.
1979-80	First general revenue assistance grants paid to Northern Territory.
1981-82	Total tax sharing grants were the 1980-81 amount increased by 9 per cent. They were distributed using the relativities established in 1976-77, except that \$27 million was used to ensure the revenues of Victoria, South Australia and Tasmania increased by at least 8 per cent. An extra \$60 million was allocated among New South Wales, Victoria and Queensland to compensate for deferring the 1981 Review relativities. Another \$105.1 million was allocated among all States and the Northern Territory in lieu of terminated SPPs and functions taken over by them.
1982-83	Total tax sharing grants were set at 20.72 per cent of the previous year's total tax revenue. This was divided into two pools: (i) a 'basic' tax sharing pool (20.323 per cent of total Commonwealth tax revenue), distributed using State populations and relativities that phased in the 1982 Review relativities over the three years 1982-83 to 1984-85; (ii) a 'supplementary' pool (0.397 per cent of revenue) which guaranteed each State's grant would rise by 2 per cent (<i>real</i>) in 1982-83 and 1 per cent (<i>real</i>) in the next two years.
1983-84 and 1984-85	Total tax sharing grants in 1983-84 and 1984-85 were 21.21 and 20.88 per cent respectively of total net Commonwealth tax collections in the previous year.
1985-86 to 1990-91	Tax sharing grants were replaced by FAGs. The 1985-86 amount was that for 1984-85 increased by the change in the CPI. In 1986-87 and 1987-88, FAGs were increased by the CPI movements plus 2 per cent. They were distributed using the 1985 Review relativities. Special revenue assistance was also paid: (i) to South Australia and Tasmania in 1985-86 and 1986-87 to smooth their adjustment to the new relativities; (ii) to Queensland in 1985-86 to adjust for introduction of Medicare; (iii) in 1986-87, 1987-88 and 1988-89 as compensation for the termination of the Isolated Patients' Travel and Accommodation Assistance Scheme and a program of aid for disabled people.

Attachment B A brief history of general revenue assistance arrangements

Year	Details
1988-89	The Northern Territory was included in the FAG processes in the same way as the States. It also received special revenue assistance to smooth its adjustment.
1991-92 to 1993-94	The total of FAGs was maintained in real terms. In 1993-94, FAGs were increased by small amounts previously paid for local roads maintained by States. The ACT was included in the FAG arrangements from 1993-94. In 1992-93, Victoria received special revenue assistance in lieu of royalties from Bass Strait oil production. From 1993-94, special revenue assistance was paid to several States for various reasons, including to ease adjustments to Commission relativities, as part of the Medicare arrangements and to recognise special needs.
1994-95	FAGs were to be maintained in real per capita terms.
1995-96	FAGs were increased by amounts previously paid as Road Grants.
1996-97	States were to make contributions to the Commonwealth's deficit reduction strategy in 1996-97, 1997-98 and 1998-99.
1997-98, 1998-99 and 1999-2000	The Commonwealth made revenue replacement payments to offset the loss of State tax revenues following a High Court decision that invalidated business franchise fees. States also received National Competition Payments for implementing micro-economic reforms in each year.
2000-01 onwards	GST introduced with the total proceeds distributed to the States in lieu of FAGs, revenue replacement payments and revenues from abolished State taxes. GST distributed using Commission relativities. States were guaranteed that revenue in each year would not be less than under the previous arrangements. The ACT received payments for its special needs.

Source: *Payments to or for the States, Northern Territory and Local Government Authorities* (Budget Paper No. 7) for 19974-75 to 1986-87; *Commonwealth Financial Relations with Other Levels of Government* (Budget Paper No. 4 or No.3) for 1987-88 to 1996-97; *Federal Financial Relations* (Budget Paper No. 3) for 1997-98 to 2007-08.

ATTACHMENT C

OTHER COMMISSION TASKS

- 1 Over the years, the Commission had other smaller tasks relating to:
 - the financial arrangements for local government, including;
 - assessing the financial assistance required by local governing bodies in 1974, 1975 and 1976 to allow them to function with reasonable effort at standards comparable with those of other local governing bodies;
 - advising on the interstate allocation of general revenue assistance for local government;
 - evaluating the operation of the *Local Government (Financial Assistance Act) 1995*; and
 - advising on the interstate allocation of local roads grants;
 - estimating the Commonwealth expenditure required to allow residents of the Cocos (Keeling) Islands and/or Christmas Island to receive government services comparable with those in other remote centres of Australia;
 - evaluating the financial and administrative arrangements, government services and financial capacity of Norfolk Island in 1997 and the assistance required to enable State and local services to be provided at comparable Australian standards in 2007;
 - advising on the State and local services provided in the Jervis Bay Territory and the cost of providing them at Australian levels; and
 - advising on the relative needs of Indigenous Australians in different regions for health, housing, infrastructure, education and employment services funded by the Commonwealth and how well the allocation of funds reflected relative needs.
- 2 The tasks of assessing the financial assistance required by individual local governing bodies between 1974 and 1976 and the 2001 Indigenous Funding Inquiry required expansions of the Commission. Four additional members were appointed for the local government funding inquiries and three for the Indigenous Funding Inquiry.

THE COMMISSION AND LOCAL GOVERNMENT

- 3 ***Grants for individual local governing bodies.*** The *Commonwealth Grants Commission Act 1933* was amended in 1972 to give the Commission the power to inquire into applications by regional organisations of local government bodies for financial assistance.
- 4 The Commission reported in 1974 and 1975 on grants for individual local governing bodies. Those grants reflected the relative fiscal needs of the local governing bodies. They were intended to allow each local governing body to provide standard services as long as it adopted a standard severity of taxation — this aim was similar to that of the special grants.
- 5 In the first report, the Commission recommended the payment of a total of \$56.345 million to 806 councils — zero grants were assessed for another 70 councils. In the second report, it recommended payment of \$79.908 million to 844 councils and zero grants for 41.
- 6 ***Changes in government policy.*** The assessment of zero grants for councils with above average financial capacities attracted strong criticism and led to a request for advice on possible means of assessing base grants which ensured all councils would receive a grant.
- 7 The Commission's report suggested a two part system in which general revenue grants would be provided to all councils in a way that provided a large measure of equalisation. Councils with large revenue raising or expenditure disabilities could apply for extra equalisation grants. The government took no action on this report because its policy was one of equalisation.
- 8 However, the policy of the new government elected in 1975 was to provide a fixed percentage of personal income tax collections for distribution to local government, partly on the basis of population and partly on the basis of equalisation — each council would receive a grant. The Commission was to distribute the total among the States and each State was to establish its own State grants commission to distribute the funds to local authorities in the State.
- 9 ***Interstate allocations of local government assistance.*** In March 1976, the Commission was asked for advice on the distribution of the total among the States and how each State's share might be divided into per capita and equalisation components.
- 10 Its advice on the interstate distribution was derived by updating and summing the equalisation-based assessments for individual councils. It also recommended that to avoid giving grants that substantially exceeded those justified by equalisation, a maximum of 30 per cent of each State's allocation should be distributed on a per capita basis. The 1976 Premiers' Conference accepted the recommended interstate distribution but decided that in distributing the funds within each State a minimum of 30 per cent should be distributed on a per capita basis.
- 11 In late 1976, the Commission was asked to review the interstate distribution and to report in time for its advice to be used in distributing funds for 1977-78. The inquiry applied equalisation principles whereby the fiscal capacities of individual local governments were equalised to a broadly comparable standard, irrespective of State boundaries.
- 12 The State shares recommended in the 1976 inquiry and the revised shares are shown in Table C-1. The revised shares were accepted by the 1977 Premiers' Conference.

Table C-1 State shares of local government assistance, 1976 and 1977

	NSW	Vic	Qld	WA	SA	Tas	Total
	%	%	%	%	%	%	%
1976 Report shares	36.6345	25.2845	17.3016	9.4015	8.5178	2.8601	100.0000
1977 Report shares	36.4977	25.4513	16.8606	9.3897	8.6010	3.1997	100.0000

(a) The shares did not allow for unincorporated areas in the States.

Source: Commonwealth Grants Commission, *Special Report 1977 on Financial Assistance for Local Government*.

- 13 Those shares were used until 1985-86. Over that period:
 - a 1978 reference asked the Commission for advice on processes for determining the interstate allocation of the local government assistance — it recommended governments consider an equal per capita distribution because of its simplicity and predictability; and
 - a Committee of Inquiry into Local Government Finances¹ recommended the interstate distribution of the grants be reviewed before determining grants for 1986-87 and, ideally, in conjunction with the Commission's review of general revenue assistance to the States. Failing such a review, the Committee suggested equal per capita allocation.
- 14 The government decided to adjust the State shares for 1986-87 to include the Northern Territory and then move the distribution to an equal per capita basis over three years starting in 1987-88.
- 15 In 1990, the Commission was again asked to review the shares of the States and the Northern Territory and to derive a similar share for the ACT. The assessments were to be made with a view to equalising the fiscal capacities of the local government sectors as a whole in each State.
- 16 The Commission's report provided two sets of State shares, each based on the equalisation principle applied in its reviews of State relativities:
 - one set was based on the functions performed by local government in each State — the Commission noted interstate differences in local government functions meant this distribution would double count financial needs for States where some local government functions are performed by State governments; and
 - a set which complemented the allocation of funds for State purposes. This allocation would, in principle, equalise the financial capacities of the combined State and local government sectors in each State. However, the Commission recommended the shares not be used in 1991-92 because of concerns about the adequacy of the data and methods used to derive relative costs of providing some services, such as roads.
- 17 The complementary shares would have reduced the grants to New South Wales and Victoria from 61 to 25 per cent of the amount available — a reduction of \$253 million in 1990-91 dollars. Despite the Commission's advice that the relativities not be used, reactions from New

¹ It was known as the 'Self Inquiry' (after its chairman Professor Peter Self). It reported in October 1985.

South Wales and Victoria were quick and highly critical. They said the calculated shares were unfair to their residents and the equalisation process would complicate the distribution.

- 18 In May 1992, the Commonwealth decided the interstate allocation of general revenue grants for local government would continue to be made on an equal per capita basis.
- 19 *The 2001 Inquiry*. The Commission had no further involvement with local government until 2000, when it was asked to review the operation of the *Local Government (Financial Assistance) Act 1995*. Specifically, it was asked whether: the Commonwealth's aims as set out in the Act were being achieved; the national principles (which were developed to help the State grants commissions achieve a consistent approach to distributing the assistance) were appropriate; and State grants commissions were consistently applying the national principles. It was explicitly directed not to consider the adequacy of the total amount of assistance made available or its interstate distribution.
- 20 The Commission concluded the Commonwealth's aim of:
 - providing every local governing body with some assistance was achieved because the national principles ensured each authority received a minimum grant and all authorities with road responsibilities received a share of the identified local road grants;
 - certainty of funding was achieved because the Act provided for automatic annual escalation of the total amount of funds made available to local government;
 - an equitable level of services, which was described in terms of horizontal equalisation but given the limited funding available was really about providing more assistance to disadvantaged local authorities, was broadly being achieved. However, there were conflicts with the requirement for minimum grants and changes were required in the methods used by some State grants commissions to better implement equalisation; and
 - improving the efficiency and effectiveness of local authorities and improving services provided to Indigenous people was inconsistent with the untied nature of the funds because each attempted to impose conditions on their use.
- 21 The Commission said the operation of the Act would be improved if the total assistance was divided into three pools — one that provided for per capita assistance to all local authorities; one that provided assistance for maintaining local roads; and a relative needs pool that improved equity by giving more assistance to disadvantaged authorities.
- 22 The report was referred to the House of Representatives Standing Committee on Economics, Finance and Public Administration for consideration as part of its 2002-03 inquiry into cost shifting onto local government². Among other things, the Committee recommended a new, simpler national model, based on equalisation principles, be designed for distributing general revenue grants to local authorities. The Government decided to retain the existing processes.

² Report of the House of Representatives Standing Committee on Economics, Finance and Public Administration titled *Rates and taxes: A Fair Share for responsible Local Government*, October 2003.

- 23 *The review of the interstate distribution of local road grants.* The Commission's next local government-related task was given to it in October 2005, when it was asked for advice on an interstate distribution of the local roads grants based on relative needs.
- 24 The Commission's 2006 Report concluded:
- the existing interstate distribution did not reflect current local road expenditure needs — it was affected by the pre-1991-92 distribution of funding;
 - a lack of data that were reliable and comparable across States prevented the use of a preferred approach that would derive State shares by reference to the relative length of each type of road, relative use of those roads and different costs of road maintenance;
 - an approach that applied the average expenditure per capita in urban, rural and remote areas to each State's population in those areas provided a better distribution than the current one. This approach reflected the different maintenance requirements in each area, but assumed urban, rural and remote areas were similar in all States and so the same per capita expenditure would provide the same maintenance service; and
 - a further review should be undertaken when improved national data become available.
- 25 The existing and recommended interim shares of local road funds are compared in Table C-2.

Table C-2 Existing and recommended State shares of local road maintenance expenditure

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	%	%	%	%	%	%	%	%	%
Current shares	28.3	20.1	18.3	14.9	7.8	5.2	3.1	2.3	100.0
Recommended shares— based on data 2002-03 to 2004-05	31.3	22.0	20.2	11.3	8.9	3.3	1.2	1.8	100.0

Source: Commonwealth Grants Commission, *Report on the review of the interstate distribution of local road grants, 2006*.

- 26 The government did not accept the recommendation that the interim shares be applied because without reliable information it could not be confident that any systemic change in the existing distribution would be equitable. It also decided not to seek a further review of the shares due to the poor prospects of obtaining the necessary rigorous standardised data from all States.

THE COMMISSION AND THE NON-SELF-GOVERNING TERRITORIES

- 27 Amendments to the Commonwealth Grants Commission Act in 1984, 1992 and 1995 progressively extended the potential coverage of Commission activities to the Cocos (Keeling) Islands, Christmas Island, the Jervis Bay Territory, Norfolk Island and other external territories. By 1995, its activities could cover all Australian States and Territories.

The Indian Ocean Territories — Christmas Island and the Cocos (Keeling) Islands

- 28 **Cocos (Keeling) Islands.** The Cocos (Keeling) Islands are located in the Indian Ocean about 2770 kilometres northwest of Perth. They consist of 27 low-lying coral islands but only two (Home and West Islands) are inhabited. The population at the 2006 Census was 571.
- 29 In the processes leading to the 1984 Act of Self Determination by the Cocos Malay people, the Australian Government said that, if the people chose integration with Australia, it would have an obligation to raise the Cocos Malay services and standard of living to Australian levels, that it would do so in no more than 10 years and it would ask the Commission to monitor progress.
- 30 The Commission subsequently prepared three reports on the Cocos (Keeling) Islands in 1986, 1989 and 1993. The 1986 report outlined the standards and processes the Commission would use in monitoring progress. It concluded a variation of the equalisation principle should be applied. In particular, services should be provided at standards not appreciably different from the standard of services provided by governments to remote communities in other parts of Australia and at a cost to the community that is reasonable after taking account of the economic and other circumstances of the Cocos Malay community.
- 31 Akin to the view on services, the Commission considered the standard of living available to the Cocos Malay community should be comparable to that enjoyed by other remote Australian communities after taking account of the differences between the communities in their economic and other circumstances.
- 32 The report of the second inquiry identified a wide range of issues relating to the legal, social and economic framework of the Islands, employment and incomes, government works and services, taxation and the finances of the local council that required action if the commitments to the Cocos Malay community were to be achieved. These issues extended well beyond the fiscal equalisation matters covered by the Commission's State and local government inquiries.
- 33 The Commission's recommendations were in the main reflected in a 1991 Memorandum of Understanding Relating to the Achievement of Mainland Equivalent Living Standards and Levels of Services on the Cocos (Keeling) Islands, signed by the Prime Minister and the community leaders. The memorandum provided for the Commission to monitor progress.
- 34 The 1993 Report concluded the Commonwealth had gone far towards fulfilling its commitment to raise the standard of services to mainland levels but a few areas, such as freight handling and water supply, required further improvement. On the standard of living, it noted it was below Australian standards and the gap may have widened since 1989. It recommended future policies focus on improving employment opportunities and containing costs of living. However, it also said that in the long term the Commonwealth's ability to influence the standard of living was limited and improvements would depend heavily on community efforts.
- 35 The thrust of those findings were accepted by the Australian Government and the community.
- 36 **Christmas Island.** Christmas Island is located in the Indian Ocean 2600 kilometres from Perth and 900 kilometres from the Cocos (Keeling) Islands. In 2006, its population was 1347.

- 37 In 1995, the Commission was asked to advise on financial arrangements, the standards and methods of service delivery and the community contribution to service costs for Christmas Island. The reference implied a wide ranging inquiry like the 1989 Cocos inquiry and reflected the government's policy of aligning conditions and standards on Christmas Island with those of comparable communities in the rest of Australia and of providing residents with rights, opportunities and responsibilities equal to those of their fellow Australians. These policy objectives had similarities with the equalisation principle.
- 38 In reaching its conclusions, the Commission adopted standards that reflected the experiences of remote communities in all States and mainland Territories. However, the emphasis was on Western Australia because its agencies were used to provide many services.
- 39 It concluded that some services were provided at a standard below that on the mainland (notably in aspects of education, welfare, housing, legal services and economic development), but the community was making a reasonable revenue contribution. It made suggestions on how service delivery might be more efficient and more appropriate to circumstances on the Island.
- 40 *The 1999 Report on the Indian Ocean Territories.* The Commission received a reference in May 1999 asking what communities were comparable in terms of service requirements with the Indian Ocean Territories and what it would cost in 2000-01 to provide government services, grants and infrastructure in the Territories similar to those in the comparable communities, after taking account of their relative capacities to contribute to the costs.
- 41 The Commission's report reached the following conclusions.
- No communities were strictly comparable with the Territories. However, small, remote communities with similar demographic features and service needs provided a guide.
 - The level of Commonwealth-type services was at the comparable community standard.
 - Extra spending was needed on some State-type services to bring them to comparable community standards. These were in the areas of vocational education and training; health (carer and patient support, and specialist services); welfare services; assistance for industry; and grants for cultural and recreation services.
 - More needed to be spent on depreciation and repairs and maintenance of assets on Cocos and while depreciation on Christmas Island had been overestimated, more needed to be spent on repairs and maintenance.
 - Funding received by the two shires aligned with that in comparable communities.
 - Over the five years commencing 2000-01, some infrastructure projects (such as marine freight handling facilities and water supply projects) were required in the Territories. The total cost was estimated at about \$89 million in 1998-99 dollars but it could be funded from unspent appropriations of past years and depreciation provisions.
 - Commonwealth and State taxes and most service charges were at comparable community levels, except that: wholesale sales taxes and excise and customs duties

were not applied; there were no water consumption charges on Christmas Island; and housing rents on Cocos were too low.

- Extra annual net expenditure of \$2.1 million in 1998-99 dollars (less than 6 per cent of annual expenses) was needed to bring service standards to comparable community levels.

42 The Department of Transport and Regional Services addressed those recommendations in subsequent budgets.

43 *The 2007 Report on the Indian Ocean Territories.* A further inquiry into the costs of providing State-type services in the Indian Ocean Territories was sought in April 2007. It was essentially an update of the 1999 inquiry, but did not cover infrastructure requirements.

44 The report concluded that, with marginal adjustments, services in the Territories were broadly consistent with those in Western Australia and current funding levels were sufficient. It also noted the current costs of delivering services in the Territories were high, even compared to remote communities in Western Australia, but that was expected given their remoteness and small size.

45 The report was used in budget considerations for 2008-09.

Norfolk Island

46 *The 1997 Report on Norfolk Island.* Norfolk Island is located in the South Pacific Ocean, some 1500 kilometres off the east Australian coast. The *Norfolk Island Act 1979* gives the Norfolk Island Government self-governing powers similar to those in the ACT and Northern Territory plus responsibility for functions (such as social security, immigration and customs) which are reserved to the Commonwealth elsewhere. The population of Norfolk is 2000.

47 Following a recommendation by the Commonwealth Parliament Joint Standing Committee on the National Capital and External Territories³, the Commission was asked in October 1996 to inquire into Norfolk Island's financial and administrative arrangements, government services and economic capacity, including its capacity to meet current and future service and infrastructure requirements and the contribution of the community towards those services.

48 After an extensive and consultative inquiry, the Commission reached the following conclusions.

- Some services on Norfolk were provided at standards below those in similar communities in the States and some infrastructure was in poor condition. It estimated that providing mainland standards of services would require a 20 per cent increase in Norfolk Island Government revenues.

³ Report of the Joint Standing Committee on the National Capital and External Territories, *Delivering the Goods*, February 1995.

- Total revenue collections could be increased by at least 60 per cent before the Island's population would be contributing more than people on the mainland. Thus, there was no financial reason why Island residents could not receive services at mainland levels.
- The Island's administrative capacity and efficiency was also below standard. While the Commission made suggestions on how improvements might be made, it was not sure that a community of less than 1800 could be expected to have the administrative capacity to provide the range of government services for which Norfolk was responsible.
- If the Norfolk Island Government did nothing to improve its administrative capacity and infrastructure, there was a risk the Island economy, revenue capacity and levels of services would all deteriorate.

49 *The 2006 Review of the financial capacity of Norfolk Island.* In the context of an Australian Government announcement that it was considering alternative governance models for Norfolk Island, the Commission was asked for advice on:

- the financial assistance needed from the Australian Government to enable State and local government-type services to be provided on Norfolk Island at comparable Australian levels (and existing debts to be serviced), if comparable Australian revenue raising efforts were made, and if services were delivered at the average level of efficiency; and
- how much local government funding might be provided, consistent with local government funding arrangements applying in the rest of Australia.

50 Since that advice was only part of a range of information sought by the Government, the Commission was not asked for advice on the costs of Commonwealth services or Norfolk's capacity to raise Commonwealth taxes.

51 After allowing for the special circumstances of Norfolk, including its remoteness, its reliance on tourism, its low wage levels and its diseconomies of small scale, the Commission concluded the Australian Government would need to provide \$9.1 million to enable comparable State and local services to be delivered on the Island, with comparable revenue efforts and with services delivered at average efficiency.

52 The Commission noted its estimate was based on the range of State and local government services provided and taxes imposed in comparable communities, not on those actually provided or imposed on Norfolk. Moreover, it was based on the existing governance arrangements and did not allow for any effects that may arise if Australian Government taxes or services were introduced. Those things could materially change the estimated amount required.

53 There was much local opposition to the possibility of changes in the governance arrangements for Norfolk and the Australian Government decided not to pursue them.

Jervis Bay Territory

- 54 The Jervis Bay Territory is a non self-governing territory of the Commonwealth and administered by the Commonwealth Minister for Transport and Regional Services who applies ACT laws and local ordinances. The ACT Government delivers most State-type services in the Territory, which is located about 200 kilometres south of Sydney and has a population of less than 600.
- 55 In a context where the Commonwealth was considering whether State and local government-type responsibilities should be discharged by New South Wales, the Commission was asked for:
- information on the State and local government-type services provided to Territory residents and the revenues collected from them;
 - an estimate of the funds New South Wales would have required in 1999-2000 to provide State and local government-type services at Australian standards; and
 - an estimate of capital expenditure required to ensure assets were at Australian standards.
- 56 In its 2002 Report on this inquiry, the Commission:
- decided Australian standards would be interpreted as the standards applying in the ACT or in those parts of New South Wales surrounding Jervis Bay;
 - concluded residents of the Territory generally received similar government services to elsewhere (legal aid and some welfare services were not provided and some court, police and regulatory services were below standard levels), infrastructure was generally equivalent to that in similar sized communities in surrounding areas of New South Wales and all State and local government taxes were payable;
 - estimated the funds required by New South Wales if it had discharged State and local government-type responsibilities in 1999-2000 were \$8.3 million if the assets were transferred to the State or \$7.0 million if assets were not transferred and the Commonwealth met depreciation expenses; and
 - no extra expenses were required to ensure the assets were at Australian standards.
- 57 There have been no policy decisions relating to changes in responsibilities for service provision in the Jervis Bay Territory since the Commission presented its report.

THE COMMISSION AND FUNDING SERVICES FOR INDIGENOUS AUSTRALIANS

- 58 In September 1998, the Minister for Aboriginal and Torres Strait Islander Affairs committed the Government to ‘working with the indigenous community and ATSIC to develop appropriate regional models and to devolve, where possible, decision-making and management

to the local level'⁴. He also said the Government intended to ask the Commission to develop measures of relative disadvantage that could be used to target resources more effectively towards those groups within the Indigenous⁵ population who are in the greatest need.

- 59 This commitment required an amendment to the Commonwealth Grants Commission Act to give the Commission the power to undertake the inquiry. The necessary amendment was passed by Parliament in September 1999.
- 60 In November 1999, the Commission received terms of reference asking it to develop methods of calculating the relative needs of Indigenous Australians in different regions for health, housing, infrastructure, education, training and employment services. It was also asked, to the extent possible, to calculate indexes of need and compare them with the actual distribution of expenditure on those functions, taking account of the expenditure by the States and Territories.
- 61 Like all other Commission inquiries, this inquiry was conducted in an open and consultative fashion. Most contributors to the inquiry thought it should estimate the total level of resources required to provide Indigenous people with services comparable to those received by non-Indigenous people. They considered addressing that large gap was more important than redistributing existing funding between groups of Indigenous people.
- 62 The Commission's inquiry reached the conclusions listed below.
- Indigenous people experience entrenched levels of disadvantage compared to non-Indigenous people in all regions, and across all functions examined in the inquiry.
 - Data difficulties constrained the ability to construct indicators of relative need, but some could be prepared using 1996 Census data. They consistently indicated the highest needs per person (or per household) were in remote regions. A data driven index of Indigenous socio-economic disadvantage calculated for the Commission by the ABS indicated almost 80 per cent of the most disadvantaged Indigenous people live in very remote areas, but some urban areas also had large numbers of highly disadvantaged people.
 - While measures of relative need can be useful as a guide to resource allocation, a formula based approach cannot be used in isolation. Judgment is an essential part of allocation.
 - All available evidence indicated mainstream services do not meet the needs of Indigenous people to the same extent as they meet the needs of non-Indigenous people.
 - Barriers to access prevent Commonwealth mainstream programs from adequately meeting the needs of Indigenous people. The barriers include the way programs are designed, funded and presented, and the cost to users. There are extra barriers in remote areas due to the lack of services and long distances necessary to access those that do exist.

⁴ *Beyond Welfare*, Statement by Senator John Herron, Minister for Aboriginal and Torres Strait Islander Affairs, Darwin, 23 September 1998.

⁵ The term 'Indigenous' is used to refer to Aboriginal peoples and Torres Strait Islanders.

- Since most service provision is under State control, the Commonwealth has limited influence on the extent to which the distribution of mainstream programs reflects the relative needs of Indigenous people in different regions.
- The failure of mainstream programs to effectively address needs of Indigenous people means that Indigenous-specific programs are expected to do more than they were designed for and, as a consequence, focus less on the disadvantaged.
- There was progress in aligning needs and funds for health, housing and infrastructure.
- Important principles and key areas for action that should guide efforts to promote a better alignment of funding with needs include:
 - full and effective participation of Indigenous people in decisions affecting funding distribution and service delivery;
 - a focus on outcomes;
 - ensuring a long term perspective;
 - ensuring genuine collaborative processes involving government and non-government funders and service deliverers;
 - recognising the importance of effective access to mainstream programs, and clear actions to identify and address barriers to access;
 - improving the collection and availability of data to support informed decision making, monitoring of achievements and program evaluation; and
 - recognising the importance of capacity building in Indigenous communities.
- Achieving equitable access to mainstream services is the highest priority.
- Financial data on the provision of services to Indigenous people on a regional basis are very poor. There are practically no data on what mainstream funds are spent in each region of each State, or on any specific group of people in any State.
- If data are to contribute in a more comprehensive way to decisions about regional funds allocations, the Commonwealth, the States and other service providers will need to make much greater effort to improve their comparability, reliability and availability.

63 The Government said the Commission's report provided 'a valuable basis for further development of evidence based policy in Indigenous affairs.' It accepted many of the Commission's findings and built a set of principles for equitable provision of services to Indigenous people from those suggested by the Commission. The Government also decided to report again on the geographic distribution of resources and need in 2005-06. That report was deferred because data from the 2006 Census would not have been available and it would not have been able to take account of some major policy initiatives.

ATTACHMENT D

COMMISSION METHODS

- 1 This attachment provides an outline of the methods the Commission uses to assess the relativities recommended for use in distributing the GST revenue among the States.
- 2 To improve the acceptance and transparency of the outcomes, the methods involve the aggregation of detailed comparisons for each State tax and each service. This approach enables the States to be assured that the Commission has taken account of the facts that many factors affect State revenues and the use and costs of State services, and that the types of factors and their effects vary markedly from tax to tax and service to service.
- 3 The current approach to implementing equalisation involves:
 - establishing the average or standard range and level of services and revenues; and
 - identifying and measuring the differences between the States in:
 - their revenue bases, and hence the revenue they could raise if they made the average tax effort — the relative revenue raising capacity; and
 - the use and costs of the average services — the relative costs of services.
- 4 *Establishing the standards on which States are equalised.* The assessments begin with the derivation of the average per capita revenue from each State tax and the average per capita expenses incurred on each service they provide. These financial averages reflect the average State policies on service levels, operating efficiency and tax effort.
- 5 As discussed in Chapter 4, the figures cover all taxes and services included in the operating statements of the States and are prepared on an accrual basis. They are derived from the ABS Government Finance Statistics for the States, which classifies the transactions on a head-of-tax or service basis. The average revenue or expense for each category is derived by dividing the Australian total of State revenues or expenses by the Australian population. Thus, the comparisons are not based on the actual revenues or expenses of any single State.
- 6 *Measuring the revenue States could raise if they made the average revenue effort.* This is done by applying the average tax rates to each State's tax bases, which are generally measured

using the value of transactions that would be taxed if the average tax policy applied. For example, the tax base for stamp duty on conveyances is the value of property sold.

- 7 A State has an above average revenue raising capacity (or a revenue raising advantage) if the per capita value of its tax base exceeds the average (or national) value.
- 8 ***Measuring what it costs each State to provide the average standard of services.*** This is done by measuring the effects on per capita costs of features of the State's economic, geographic and demographic characteristics (called disabilities¹). There are two types of disabilities — those that affect service use and service costs.
 - *Use disabilities* reflect differences between States in the use of services arising from factors such as population characteristics and the availability of private services. Use disabilities are assessed by identifying:
 - the users of the service — for example, schools are provided for students and industry assistance for agricultural, mining and other businesses; and
 - whether, across Australia, some groups of people use the service more or less than others — for example, hospital services are used more intensively by some age groups and by Indigenous people and some welfare services are used more intensively by people on low incomes.

States have a disability if the groups to which services are directed, or which make most use of a service, are a larger proportion of their population than they are of the national population. Conversely, States have an advantage (negative disability) if the size of the group is smaller than the national average.

- *Cost disabilities* affect the cost per unit of service provided to some groups of people or regions. For example, communication factors can increase the costs of providing many services to people from non-English speaking backgrounds and providing services in remote areas usually costs more. States with relatively more people in high cost groups or living in high cost regions are assessed to have disabilities.

The prices of inputs used in providing State services may also vary for reasons beyond the control of individual States. For example, wage rates and office rents differ across the States and some States incur diseconomies of small scale. However, higher costs arising from a State's decision to provide a higher level of service do not constitute a disability².

¹ Disabilities are defined as circumstances beyond the control of individual States that require a State to spend more (or allow it to spend less) per capita than other States to provide the average level of service. For taxes, disabilities are the circumstances beyond a State's control that cause its per capita tax base to differ from the average.

² The classification of disabilities as use and cost disabilities is useful, but it is not clear cut because some influences could be included in both. For example, Indigenous people use many services more intensively than non-Indigenous people (leading to above average service use in States where Indigenous people are an above-average proportion of the population). However, the cost of a service provided to an Indigenous person is also often higher than that of a service provided to a non-Indigenous person.

- 9 What it would cost each State to provide the average standard for each service is estimated by adjusting the average per capita expenses on the service by the effects of the State's disabilities³. As this approach recognises only the average cost and the factors beyond the control of individual States, it means the State shares are neutral to each State's own policies.
- 10 *Some special cases.* The Commission may assess the revenue capacity or costs of providing services in all States to be equal to the average if it considers:
 - all differences in revenues or expenses are due to differences in State policies — no State has a disability; or
 - there are disabilities but they cannot be adequately measured or they are not material.
- 11 *Bringing the assessments together.* A State's allocation from the GST pool (its equalising requirement) is calculated as the amount needed to ensure it has the average per capita recurrent budget outcome after taking account of the costs it would incur in providing the average services, the revenues it would raise by making the average revenue effort and its actual receipts of specific purpose payments from the Australian Government⁴.
- 12 Each State's relativity is then derived by expressing its per capita equalising requirement as a ratio of the national average per capita amount distributed in the year.
- 13 To provide some stability in the recommended relativities, comparisons are made using data for each of the five most recent years and the results averaged.
- 14 A relativity below one indicates a State requires less than an equal per capita share of the GST pool; a relativity above one indicates it requires more than an equal per capita share.

³ The effect of a State's disabilities is measured by comparing its position to the average position — for example, the proportion of a State's population in the school age groups is compared to the average proportion. This is equivalent to its relative costs of providing services — the estimated per capita cost of providing the average service in the State relative to the average per capita cost.

⁴ This is equivalent to an equal per capita share, adjusted for:

- the effect of its above or below average costs of providing services — expense needs;
- the effect of its above or below average revenue raising capacities — revenue needs; and
- its above or below average per capita revenue from SPPs — SPP needs.

ATTACHMENT E

MEMBERS AND SECRETARIES OF THE COMMISSION

- 1 This attachment lists chairpersons, members and secretaries of the Commission since its creation in 1933. Appointees to the Commission are designated as Members and may work on tasks as assigned by the Chairperson. In some cases, Members were appointed primarily for specific purposes, as happened in the early 1970s when some appointments were primarily for inquiries into local government finances and in 1999 when some appointments were primarily for the Indigenous Funding Inquiry. The list identifies the Members appointed for those purposes separately from the others, who worked on matters relating to financial arrangements for the States, the Australian Capital Territory and the Northern Territory and inquiries relating to other territories.

CHAIRPERSONS

Name	From	To
Eggleston, The Hon Sir Frederick	July 1933	November 1941
Mills, Professor R C OBE	November 1941	November 1945
Fitzgerald, Alexander OBE	November 1945	September 1960
Phillips, Sir Philip CMG, MM	October 1960	September 1966
Melville, Sir Leslie KBE	October 1966	September 1974
Else-Mitchell, The Hon Mr Justice R CMG	October 1974	June 1989
Rye, C R AM	July 1989	June 1999
Morris, A G	July 1999	Current

MEMBERS

Name	From	To
Giblin, Professor L F DSO, MC	July 1933	July 1936
Sandford, Sir Wallace	July 1933	July 1936
Creasey, G L CBE	July 1936	December 1938
Wood, Professor G L	July 1936	June 1953
Pearce, The Rt Hon Sir George KCVO	January 1939	December 1944
Kenneally, The Hon J J	January 1945	September 1954
Prest, Professor W OBE	October 1953	September 1965
Reid, Sir Alexander CMG, ISO	October 1954	November 1965
Melville, Sir Leslie KBE	October 1965	September 1966
	January 1979	June 1981
	January 1982	September 1982
Goodes, H J CBE	November 1965	September 1971
Lane, W R CBE	December 1966	April 1993
	December 1993	December 1994
Goodsell, Sir John CMG	October 1971	December 1972
Mathews, Professor R L CBE	December 1972	January 1990
Nimmo, J F CBE	January 1974	December 1974
Crawford, Sir John AC, CBE	January 1979	July 1979
Donovan, J B	January 1979	June 1981
	January 1982	September 1982
Eyers, E S OBE	October 1979	June 1981
	January 1982	September 1982
Daniel R CBE	July 1986	January 1988
Barnes, R D	July 1989	August 1999
Argy, F AM, OBE	September 1991	September 1996
Wiltshire, Professor K W AO	March 1995	March 2004
Morris, A G	August 1997	June 1999
Early, L J PSM	August 1999	August 2004
Rolfe, H A	November 1999	November 2004
Williams, Professor R A FASSA	April 2002	current
Appleyard, G P	June 2004	current
Owens, H J	August 2004	March 2006
Westacott, J	July 2006	current
Smith, G J	August 2006	current

MEMBERS APPOINTED PRIMARILY FOR THE LOCAL GOVERNMENT INQUIRIES, 1973-77

Walls, A N AM	September 1973	August 1976
Whalan, L E	September 1973	March 1977
Sheehan, W J	February 1974	June 1975
Moye, D V	January 1975	May 1977
Collins, P G AM	September 1975	May 1977
Heron, W J	September 1975	March 1979

MEMBERS APPOINTED FOR THE INDIGENOUS FUNDING INQUIRY, 1999-2001

Rees, G	December 1999	June 2001
Reid, N B	December 1999	June 2001
Baban, T G	June 2000	June 2001
Harben, S G	June 2000	June 2001

SECRETARIES OF THE COMMISSION

Name	From	To
Richardson, M	July 1933	May 1948
Forster, G A (acting)	May 1948	June 1949
McKenzie, K J	June 1949	January 1963
Callinan, A	January 1963	February 1969
Sweeney, T A (acting)	February 1969	October 1972
Moye, D V	October 1972	March 1974
Glasson, A A	March 1974	July 1993
Searle, R J	July 1993	March 2003
Nicholas, M A (acting)	March 2003	January 2005
Spasojevic, J	January 2005	Current

ACRONYMS

ABS	Australian Bureau of Statistics
AIHW	Australian Institute of Health and Welfare
COAG	Council of Australian Governments
FAG	Financial Assistance Grant
GDP	Gross Domestic Product
GST	Goods and Services Tax
IGA	Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations
SPP	Specific Purpose Payment
VAT	Value Added Tax