

**FEDERAL FISCAL RELATIONS IN
AUSTRALIA — 2001**

by

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Abstract

This Paper provides a detailed description of fiscal federal relations in Australian.

The keystone to those relationships is the application by the Commonwealth Grants Commission of the principle of fiscal equalisation — that each State should be able to provide the same standard of services to its population, if it operates at the same level of efficiency and makes the same effort to raise revenues from its own sources.

The Paper pays particular attention to the processes by which this principle is implemented. It illustrates the extent to which expenditure needs as well as revenue capacities are measured and the impacts these assessments have on the per capita distribution of grant revenues between the Australian States.

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FEDERAL FISCAL RELATIONS IN AUSTRALIA

Bob Searle¹

Introduction

The Australian Federation was formed in 1901 when the six British colonies on the Australian continent asked the British Government to pass legislation to form the Commonwealth of Australia. One of those colonies, South Australia, brought the Northern Territory into the Federation with it as a Commonwealth Territory. In 1913, the Australian Capital Territory (ACT) was formed when, as required by the Constitution, the Commonwealth Parliament annexed an area from New South Wales so that the national capital, Canberra, could be constructed.

The Commonwealth gave self government to the Northern Territory in 1978 and to the ACT in 1989. For most practical purposes, the powers and responsibilities of the Territories' Parliaments are now the same as those of the six States.

The States² vary in population from nearly 6.5 million in New South Wales to about 200 000 in the Northern Territory. In 2000-01, their budgets range from over \$31 billion³ in New South Wales to less than \$2 billion in the ACT⁴. In area, Western Australia is the largest at over 2.5 million km² and the ACT the smallest at 2 400 km². Attachment A holds further basic statistics on each of the States.

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² Hereafter, the term State(s) includes the Northern Territory and the Australian Capital Territory unless the context requires otherwise.

³ Australian dollars have been used as the unit of financial data throughout this paper. At the time of writing the paper, the market valued \$1A very close to \$0.50US.

⁴ Budgets are measured by the general government operating expenses according to accrual based Government Finance Statistics.

Because the central government was established by the States, it is the central government (the Commonwealth) that has the clearer list of legislative responsibilities. Attachment B provides an extract of *The Constitution of the Commonwealth of Australia*, detailing the powers of the central government. Commonwealth powers have been amended by referendum only twice — in 1946 when *Section 51 (xxiiiia)* was added to give social security powers to the central government, and in 1967 when the Commonwealth was given power to make laws in respect of the indigenous (Aboriginal) races. This does not mean, however, that the balance of power within the Australian Federation has been stable since it was formed.

When the colonies agreed to federate, they thought they had designed a constitution that would ensure their continued financial independence. Within ten years, however, the Commonwealth was found to have ‘surplus’ funds each year and a system of fixed per capita grants to each State was implemented. *Section 96* of the Constitution has been used ever since to transfer excess central government funds to the States. It states that:

During a period of ten years after the establishment of the Commonwealth and thereafter until the Parliament otherwise provides, the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit.

Although not designed for the purpose, this section of the Constitution has been a major avenue through which the Commonwealth has expanded its influence in the public sector.

All countries that have more than one level of government, whether a Federation or a unitary country, need some way of transferring resources or responsibilities from one level to another. The levels of government never have precisely the revenue capacity to match their expenditure responsibilities. There is always some vertical fiscal imbalance or VFI. In Australia, the VFI is very much in favour of the central government. This is the position countries most frequently experience, but VFI in favour of States or Provinces is not unknown.

An important element of the fiscal transfer system in Australia is that, as well as overcoming the VFI, it has a secondary aim of overcoming a horizontal fiscal imbalance

(HFI). The joint aims within the Australian Federation are to transfer fiscal capacity to the States and municipal government, and to do so in a way that gives each jurisdiction, when added to their own revenue raising capacity, equal capacity to provide services.

Because of its much greater significance in the Australian federal financial system, this paper concentrates on the transfers from the Commonwealth to the States. There are smaller transfers to municipal government which, to a large extent, are also aimed jointly at overcoming both VFI and HFI, and the distribution of much of those funds is on a similar basis to that used in Commonwealth-State arrangements.

Distribution of Responsibilities and Powers in the Australian Federation

Table 1 shows the practical distribution of responsibilities and powers between the three levels of Government in Australia in 1999-2000, based on actual revenue and expenditure patterns. It uses a General Finance Statistics classification based on the United Nations' System of National Accounts.

The most noticeable aspect of Table 1 is that while the sources of revenue are generally specific to one level of government, the expenditure pattern is much more complex. This has arisen largely because of:

- ?? a belief (of at least the Commonwealth) that many revenues are more efficiently collected centrally;
- ?? a conviction by the Commonwealth that it can manage the national economy more readily if it has greater revenue collection authority;

Table 1 Australian Public Sector 1999-2000

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

(a) Australian Bureau of Statistics, *Taxation Revenue Australia, 1999-2000* Catalogue No. 5506.0.

(b) Commonwealth Grants Commission, *2001 Update Report Supplementary Information* p 78.

(c) Australian Bureau of Statistics, *Government Finance Statistics Australia, 1999-2000* Catalogue No. 5512.0.

- ?? an unwillingness of the States and the Commonwealth to share access to the major tax bases; and
- ?? the Commonwealth's use of the tied grants power (section 96 of the Constitution) to influence the standard of most of the services provided by the States (for example, although the Commonwealth has no power in education and health, nearly 60 per cent of outlays in those areas are from its budget).

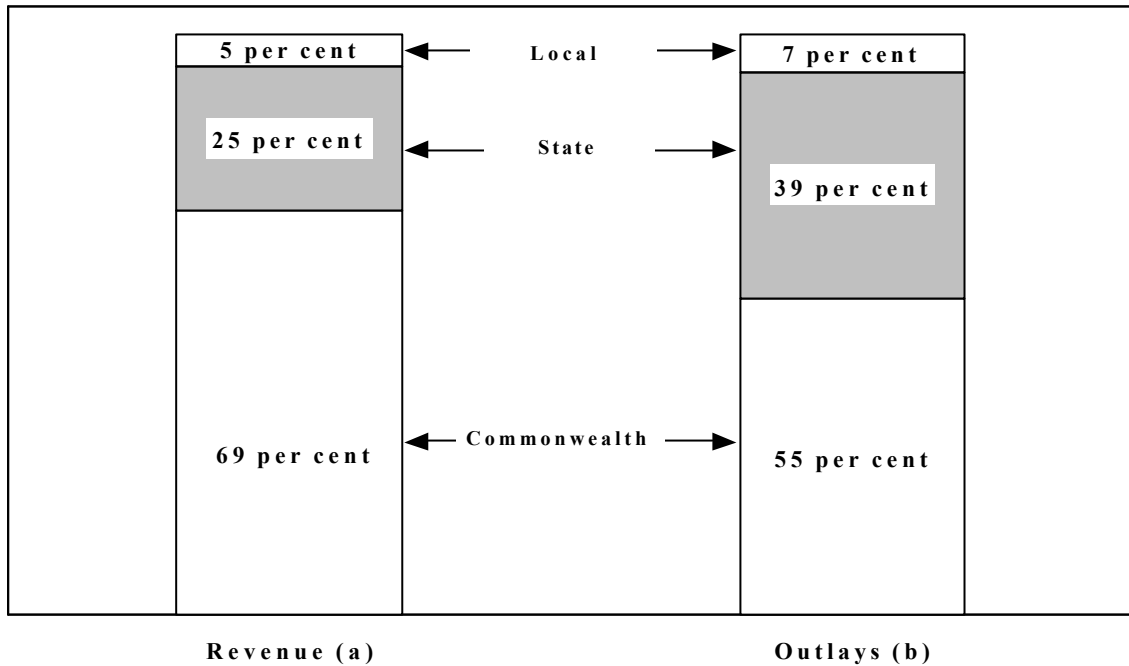
FISCAL IMBALANCES AND OVERCOMING THEM

Vertical Fiscal Imbalance

In 1942, the Commonwealth took over responsibility for the collection of income tax as a war time measure, and has held the power ever since. This has added greatly to Commonwealth surpluses and, as a result, the Australian Federation now has one of the largest vertical fiscal imbalances measured by the international agencies. In its 1999-2000 Budget Papers⁵, the Commonwealth Government summarised the VFI in Australia diagrammatically as follows.

⁵ *Commonwealth Financial Relations with other levels of Government, 1999-2000, Budget Paper No.3, p 15.* Australian Government Publishing Service, Canberra.

Figure 1 General Government Own-source Revenues and Adjusted Own-Purpose Outlays 1999-2000



- (a) Own-source revenue excludes the receipt of payments from other levels of government.
- (b) The ABS measure of general government own-purpose outlays excludes payments to other levels of government and Public Trading Enterprises (PTEs), such as general revenue grants, specific purpose payments (SPPs) and advances and subsidies, and interest payments on borrowings for other governments and PTEs. The adjusted measure adds SPPs ‘through’ the States (other than those for local government purposes) back in to Commonwealth outlays. The adjusted measures for both Commonwealth and State levels of government abstract from all net advances, which is consistent with measures of the underlying deficit.

This shows very clearly that the Commonwealth raises much more revenue than it spends and the States rely very heavily on grants from the Commonwealth to be able to provide the services they have responsibility for. The municipal sector also relies on transfers of funds from higher levels of government (particularly the Commonwealth), but to a lesser extent than the States.

Some attempts have been made in the past to reduce the VFI. The States have given the Commonwealth full responsibility for funding what would otherwise be their functions (such as tertiary education, non-government education and municipal government) and the Commonwealth has given the States access to some tax bases (such as payroll tax). These actions have not satisfied the States, however, and there has been pressure for an

overhaul of the whole tax system. This pressure increased when, in August 1997, the High Court of Australia found that State tobacco franchise fees were constitutionally invalid. This decision also cast doubt on State liquor and petroleum franchise fees and States ceased to collect them. Under safety net arrangements, the Commonwealth increased its excise taxes on these products and returned the revenues raised to the States as revenue replacement payments.

In June 1999, the Commonwealth and the States signed an *Intergovernment Agreement on Principles for the Reform of Commonwealth-State Financial Relations* (IGA) as part of the central government's reforms to the Australian tax system. This involved the introduction of a Commonwealth value added tax, called the Goods and Services Tax (GST), and the abolition of Commonwealth wholesale sales taxes and a number of State taxes, including Financial Institutions Duty. Under the IGA, the Commonwealth returns all the revenue collected from the GST (net of the costs of collection) to the States⁶, but no longer pays them revenue replacement payments or gives them untied financial assistance grants. During a transition period associated with the introduction of the GST, the Commonwealth has guaranteed that the States will be no worse off than under the former financial relations.

As one of the stated aims of this reform was to give States revenue from a more robust and growing tax base, it should mean a reduction in the extent of VFI. However, because the Australian constitution requires that the Commonwealth levy the GST, the States are even more dependent on the Commonwealth for revenues, particularly as the agreement required them to abolish or reduce some of their own taxes. The first year of the new tax system in Australia is 2000-01 and the VFI will increase markedly as a result. To give the States some greater security on the grants revenues within their budgets, the GST legislation specifies that they have to be involved in any change in the rate of the tax, and the Commonwealth has agreed in the IGA that it has no intention of reducing the specific purpose payments it makes to the States.

⁶ The Commonwealth does not refer to this transfer as a grant to the States, preferring to see the GST collections as being done on behalf of the States. It may even go so far as calling the GST a State tax.

Horizontal Fiscal Imbalance

In addition to the vertical fiscal imbalance, there is also a considerable degree of horizontal fiscal imbalance (HFI) between the Australian States. Independent assessments by the Commonwealth Grants Commission⁷ (the Commission) indicate that States' revenue capacities vary from about 75 per cent of the per capita Australian average to about 114 per cent of that average, largely due to variations in capacities arising from Payroll Tax, Land Revenue, Stamp Duty on Conveyances and Mining Revenue.

With the exception of the Northern Territory, the States' costs of providing the Australian average level of services are all assessed by the CGC to be within 10 per cent of the Australian average. The Northern Territory, however, is measured as having a cost structure nearly 135 per cent higher than that average. The major influences on this aspect of HFI arise from differences in the socio-economic and demographic composition of States' populations, differences in the economies of scale in the provision of services, and differences in the spatial distribution of population within the States' boundaries. In each of these areas, the Northern Territory is greatly different to the other States, giving it a very different cost and demand structure for State services.

HFI within the municipal sector in Australia is even larger than that experienced at the State level, particularly because of the different per capita capacities of local authorities to raise revenue. However, because measurements of these differences are done within each State⁸ and are not calculated on a fully uniform basis, it is not possible to give an accurate measure of the extent to which revenue capacities and costs of services differ between authorities.

⁷ The Commonwealth Grants Commission has responsibility for making recommendations to the Commonwealth Government on how untied financial assistance should be distributed between the States and is the subject of detailed discussion later in the paper.

⁸ There is a Grants Commission established in each of the States and the Northern Territory under State law, to recommend the distribution of Commonwealth assistance to municipal government. They are required to use horizontal fiscal equalisation in their recommendations on the distribution of untied funds provided by the Commonwealth to municipal government authorities.

The Fiscal Transfers

Transfers from the Commonwealth. By far the largest transfer of funds within the Australian Federation is from the Commonwealth to the State and municipal governments.

In 1999-2000, the Commonwealth transferred over \$34 846 million to the State and municipal governments. In addition, the Commonwealth spent another \$414 million on the direct provision or subsidisation of services that would otherwise have been the responsibility of those governments. Table 2 summarises the transfers.

Tied grants to the States are for use within the States' budgets and fund normal activities of the States. Tied grants through the States are for activities for which the States have constitutional authority but which do not influence their budgets; such as the activities of their municipal authorities, the provision of tertiary and primary and secondary schools run by religious and other non-government authorities.

One of the largest specific purpose payments (SPPs) through the States is for local government. In 1999-2000, it was about \$1265 million. This Commonwealth funding is about 11 per cent of municipal revenue and is tied only for the purpose of receipt by the States. It is passed on to local governments, on the recommendations of the State Local Government Grants Commissions as untied funding.

The direct funding of State-type services by the Commonwealth is largely in the areas of vocational education and training, and the provision of services for indigenous Australians. Both are State functions but are now partly funded, with the agreement of the States, through statutory authorities of the Commonwealth.

**Table 2 Commonwealth Transfers to Other Levels of Government
1999-2000(a)**

Transfer	\$m
Untied Funds	
General Revenue Assistance	17 720
Tied Funds - Specific Purpose Payments	
To the States (b)	10 789
	2 125
'Through' the States	4 122
	90
Direct Expenditure of subsidisation of State-type Services	414
Total	35 260

(a) Based on data in *Commonwealth Financial Relations with Other Levels of Government 1999-2000*, Budget Document No. 3, AGPS, Canberra, 1999, and Commonwealth Grants Commission sources.

(b) \$5677 million of this is for Health Care Grants which are distributed from the same pool as the General Revenue Assistance.

Transfers from the States. The States make no payments to the Commonwealth and their payments to municipal government are of little importance in the fiscal transfer system in Australia.

The States are not generous in their assistance to the municipal sector, a situation that may be related to the States' financial capacity and to the revenue bases they have given their municipalities. Apart from the Northern Territory, States do not make untied grants to their local government authorities, although they all provide grants for specific projects or purposes. The different policy in the Northern Territory could be a result of the much younger municipal sector in the Territory, and the stage of development of many of the indigenous communities that have recently been incorporated.

In 1997-98, State grants of \$850 million made up only 7 per cent of total municipal revenue. The percentage contributed by the States varied from about 3 per cent in Tasmania to about 10 per cent in Victoria and Western Australia.

Transfers from the Municipal sector. Except where they are paying for services undertaken on their behalf (under contract), the municipal governments transfer no funds to either the States or the Commonwealth.

Commonwealth Transfers to State Governments

The transfers from the Commonwealth to the State sector are the major element of the fiscal transfer system in Australia and, as such, are the focus of this paper. As indicated in Table 2, the payments are either specific purpose payments (SPPs) or general revenue grants (GRGs), although as noted earlier, the Commonwealth does not use the term GRG in relation to GST transfers.

Under the IGA signed in 1 July 1999, a Ministerial Council for Commonwealth-State Financial Relations was established, comprising the Commonwealth and State Treasurers, to oversight the implementation of the Intergovernment Agreement. The amount of Commonwealth General Revenue Assistance depends on the amount of GST revenue collected, except during the transition period from the old arrangements⁹.

The IGA also specifies that the interstate distribution of the GST will be based on per capita relativities determined by the Commonwealth Grants Commission, and the Ministerial Council also provides a forum for the discussion of those per capita relativities.

This arrangement is intended to provide greater certainty in funding and to make Commonwealth-State relations more harmonious. Previously, the total transfer was decided at an annual Premiers' Conference when the Prime Minister and Treasurer of the Commonwealth met with the Premiers and Treasurers of the States to discuss the economic outlook and organise the fiscal transfer for the coming year. Because it controlled the revenue, the Commonwealth had the upper hand in these discussions and the outcome did not often differ greatly from the 'offer' made to the States a few days before the Conference. For practical purposes, the Commonwealth decided the value of

⁹ The IGA contains a guarantee that States would be no worse off under the new arrangements than had the former arrangements continued. There is a transition period during which States may receive the guaranteed amount rather than the GST share.

the transfer in the context of the budgetary position in which it found itself that year. Because of the powerful position of the Commonwealth, the Premiers' Conference was often seen as a waste of time and simply an opportunity for the States to blame the Commonwealth for any reductions in services or increases in State taxes, and to campaign for tax reform.

The first Ministerial Council meeting to discuss the division of the GST revenue was held on 30 March 2001. As expected, it did not result in any friction between the Commonwealth and the States on the size of the untied funds to be transferred, but it caused another reaction from the States. New South Wales and Victoria, those that receive a much less than equal per capita share of funding under the HFE based relativities determined by the Commission, campaigned for a change to the basis of distribution. The reaction of the Commonwealth and the other States was predictable. There is to be no change to the basis of distribution and the fiscal equalisation, which is covered by the IGS, is to be continued.

One element of contention that will continue relates to the value of the Commonwealth SPPs. Under the new arrangements, the absolute value of GRGs are tied to GST revenue collections. However, the amounts of SPPs remain controlled by the Commonwealth Government. Negotiations on SPPs are held by relevant Ministers and senior bureaucrats over a period of months. Although the negotiating teams involved in the consideration of each SPP presumably have some instructions or guidelines from the Commonwealth Treasury and the Department of Finance and Administration, the total of the SPPs to be transferred seems to many to be no more than the accumulation of the individual outcomes of those negotiations. There is no consolidated report on SPPs from the Commonwealth that details either the conditions of each transfer or the basis on which the distribution has been determined.

It is too soon to judge how much better off the States will be under the new funding arrangements because there is a question of how much the Commonwealth will pay as SPPs in the future. If GST revenue exceeds the Commonwealth's expectations (and the estimated collections for the first year have already been increased by about 10 per cent), it may wish to review the amounts paid as SPPs. From their viewpoint, the States would not welcome any reductions in SPPs and may argue that SPPs are independent of

the new funding arrangements for GRGs. They will claim the clause in the IGA that states that the Commonwealth does not intend to reduce the level of SPPs, but this is a very weak clause and few expect it to have any real power. The Commonwealth will probably be able to act as it wishes.

Specific Purpose Payments. Specific Purpose Payments to the States are used when the Commonwealth wishes to influence State expenditure priorities to satisfy national objectives. These funds must be spent on particular functions and if properly used, they are probably the easiest means by which the Commonwealth could achieve performance equalisation for any particular service provided by the States.

Since 1990-91, the Commonwealth has used over 90 different SPPs to transfer funds to the States. This is not an accurate measure of the number of programs, however, because in some of them, government schools grants for example, there are a number of different sub-programs that are not detailed in the basic, but limited, reference document — *Commonwealth Budget Paper No. 3, Commonwealth Financial Relations with other Levels of Government*. It is more likely that the number of SPPs and sub-programs exceeds 500.

The Specific Purpose Payments through the States are the funds transferred to the States for activities not provided through State budgets. The transfers are made in this way either as an administrative convenience or because the States rather than the Commonwealth have the constitutional authority to perform the function.

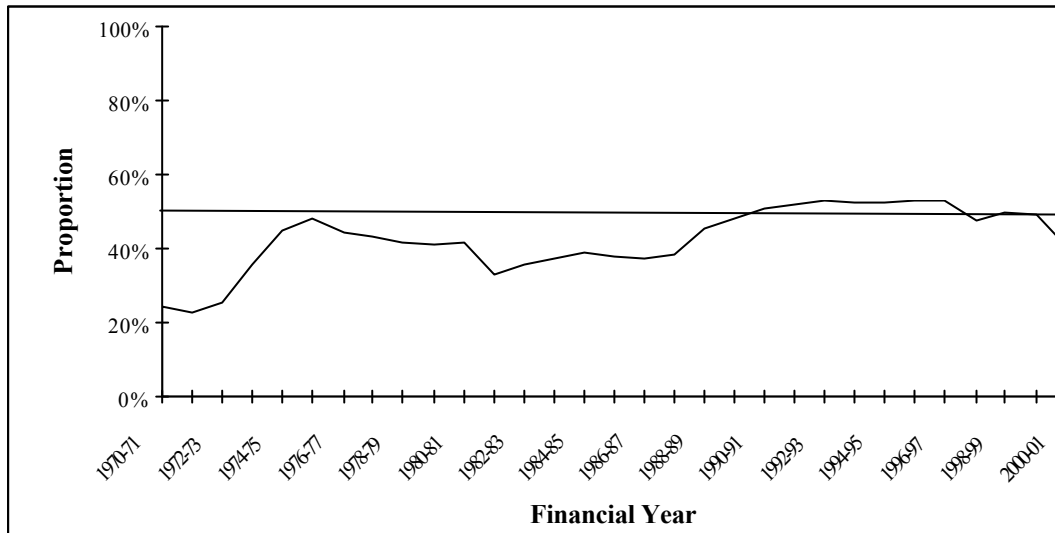
It has been suggested earlier that the involvement of the Commonwealth in making payments for these functions was initiated, at least in part, because of the vertical fiscal imbalance in its favour.

As Figure 2 shows, there has been a trend since the early 1990s for SPPs to make up about half the total grants from the Commonwealth to the States.

The reasons for the two periods of increase in the proportion of SPPs over the last 25 years have been quite different. In 1972, Australia elected a new Commonwealth Labor Government after that party had been in opposition for 27 years, and it quickly expanded both the range and size of SPPs to initiate change and fulfil its social agenda.

The increase in the late 1980s and early 1990s was because the escalation arrangements relating to SPPs at that time were more generous than those relating to GRGs. It can be seen that the new arrangements associate with the introduction of the GST will result in a slight lowering of the SPP proportion.

Figure 2 - SPPs as a Proportion of Commonwealth Grants to the States



It is impossible to comment with any authority about the influence of equity on the distribution of these fiscal transfers from the Commonwealth. It is true, however, that the distribution of many of the major SPPs follows a pattern that is similar to that which the Commonwealth Grants Commission assesses as being appropriate if fiscal equalisation of the State Governments' capacities was the objective. It is also interesting to note that the distributions of some of the larger SPPs (such as those for health and education) have, over time, moved closer to the Commission's assessments.

The central Government can have a greater impact on the equitable provision of a service by State Governments if it uses SPPs rather than GRGs, because the decisions about the minimum level of service are being taken by it rather than the several State governments. What is very difficult to achieve through SPPs, however, is an overall redistribution of fiscal capacity based on equity — it is difficult to use SPPs to adjust for differences in States' revenue raising capacities. This task is usually performed through

the use of untied grants and systems designed to adjust funding for horizontal fiscal imbalances.

General Revenue Grants. As we have seen, untied funds (the GRGs) made up about 50 per cent of the total transfer of funds from the Commonwealth to State Governments in Australia in 1999-2000 and are the largest single avenue through which financial capacity is transferred. The decisions on the size of the transfer are now covered by the IGA and the current rate of GST, 10 per cent, can only be varied by legislation with the unanimous support of the States and Commonwealth.

The distribution of GRGs between the States is based on per capita relativities recommended by the Commonwealth Grants Commission. The basis of these recommendations is the subject of detailed discussion later in this paper.

Commonwealth Transfers to Municipal Government

As stated earlier, the Commonwealth transfers about \$1.265 billion a year to local government, through the States, as untied assistance. There is also a small amount (about \$200 million) passed to local government as tied assistance because it provides services for the Commonwealth on a contract basis.

The untied assistance is passed to the States on condition that they establish a State Grants Commission that acts independently of the government to recommend the distribution to municipal government. The Commonwealth requires the State Local Government Grants Commissions (LGGCs) to distribute the funds in three parts:

about 20 per cent shared between each of the 730 local councils in Australia on an equal per capita basis;

about 30 per cent shared between each Council ‘on the basis of the relative need of each local governing body for roads expenditure and to preserve its roads assets’; and

about 50 per cent on the basis of fiscal equalisation.

One of the conditions attaching to this transfer is that the Commonwealth has to approve the assessment methods of the LGGCs. Until very recently, this has been done by the

Commonwealth Office of Local Government and has not involved the CGC. As part of an inquiry it is currently undertaking, the CGC has examined the methods of the LGGCs and found that none of them apply fiscal equalisation as it does, and pointed out the natural conflicts between the objectives of the EPC and roads elements of the distribution, with the objective of fiscal equalisation. A draft report it distributed for discussion in December 2000 suggested that changes need to be made both to the objectives that the Commonwealth has specified as the reasons for the grants, and the methods used by each of the LGGCs in implementing the Commonwealth's objectives. The CGC's final report on this inquiry is due in June 2001.

THE COMMONWEALTH GRANTS COMMISSION

Background and Method of Operation

The Commonwealth Grants Commission is a small, independent, advisory body that was established in 1933. It was established to reduce disquiet among the States on how federal funding was being distributed, and possibly as an incentive for the people of Western Australia (who had recently voted to succeed from Australia) to remain in the Commonwealth. It has no Constitutional status but is widely seen as an integral element of Australia's federal structure.

Members of the Commission are appointed by the Commonwealth (on either a full-time or a part-time basis) after discussion of prospective candidates with the States. The States in fact have an informal right of veto over nominees. Commissioners are appointed for their expertise and experience and do not represent any jurisdiction or organisation when working on Commission business. Appointees cannot be public sector employees and are usually drawn from academia, retired civil servants or business. Appointments to the Commission can be for up to five years and Members can be reappointed. It is usual to have no more than three or four Members of the Commission.

The Commission is funded by the Commonwealth and has a professional staff of about 35 to 55 depending on workload. To stress its independence from the Commonwealth

Treasury, it is located in the Ministry of Finance and Administrative Services. It has very little contact with the responsible Minister and operates as it sees fit once it has been given terms of reference for an inquiry.

The Commission cannot initiate its own inquiries and operates only on terms of reference from its Minister, usually arrived at after negotiations between the Commonwealth and State Treasuries. In carrying out its inquiries, the Commission treats the States and the Commonwealth as equals in its deliberations. Although it presents its reports to a Commonwealth Minister, the Commission's usual procedure is to release its findings to the States immediately afterwards. Thus, although funded by the Commonwealth, the Commission could be seen to be working for the States — they are much more concerned about its findings than the Commonwealth which leaves the decisions on distribution very largely to the Commission.

All proceedings of the Commission's inquiries are open to the public and it freely discloses the detailed calculations behind its results and findings. Every five years, coinciding with newly available census data, the Commission reviews all aspects of its data and method of calculating the relative shares of general revenue funds to go to each State. In the intervening years, methods are unchanged and annual updates of the calculations incorporate the latest available data.

The principle the Commission follows in arriving at its conclusions (except to the extent that it is told otherwise in the terms of reference) is that of horizontal fiscal equalisation, a principle it first enunciated in 1936. It is:

that each State should be given the capacity to provide the average standard of State-type public services, assuming it:

?? operates at an average level of efficiency; and

?? makes the average effort to raise revenue from its own sources.

The Australian system is thus based on a principle of capacity equalisation within a federation. The States are given the capacity to achieve inter-personal equalisation of

revenue imposts and receipt of services, but are left with the ultimate decisions of what levels of service are to be provided and what revenue efforts are to be made.

The first step in the Commission's application of the fiscal equalisation principle is to decide what range of State-type services and areas of revenue raising should be considered in the equalisation assessments. The Commission last looked at this in detail in 1999 and decided to include all aspects of States' normal recurrent budgetary activities. It:

brought depreciation into the scope of its assessments for the first time (the capital impacts through debt charges had been included previously);

decided that all capital transactions should be excluded;

excluded State spending on functions which are the financial responsibility of the Commonwealth, such as universities, even though they might remain the constitutional responsibility of the States; and

excluded the activities of most government business enterprises (GBE), except for their interactions with the general budget sector — the payment by GBEs of dividends and tax equivalents or to them for community service obligations.

A number of conclusions follow from the implementation of the fiscal equalisation principle, and some aspects of its application are worth noting.

?? The Commission deals with capacity and not performance equalisation. This is because Australia is a federation: the States have sovereign rights in functions they retained when the Constitution was written, and the grants the Commission is concerned with are untied grants. The Commonwealth has no power to direct the States except through SPPs. Capacity equalisation means that:

~~or~~ a State may choose to levy low taxes, and have a reduced standard of public services compared with other States; or

~~✍~~ a State may choose to have high-quality public services in some functions, but this will mean either a lower standard of other services, higher taxes overall, or an increase in its debt; and

~~✍~~ a State that is less careful about the efficiency of its operations will not be able to provide services at average standards unless it has higher than average tax rates or increased debt;

?? the standard to which the Commission works is what has actually happened, what has actually been spent on a function, or raised in taxes — not what any group of experts thinks should have happened;

?? the Commission's recommendations attempt to be policy neutral — as far as possible, the Commission tries to make sure that a State cannot get a larger share of the general revenue funding by changing its priorities or its policies; and

?? central to the Commission's work is the need to measure or estimate 'disabilities'. These are *influences beyond a State's control that require it to spend more (or less) to provide the same service as other States, or mean that it cannot raise as much revenue as (or can raise more than) other States from the same tax rates.*

Thus, as stated earlier, the sources of fiscal imbalance between States are:

?? different per capita capacities for raising own-source revenues; and

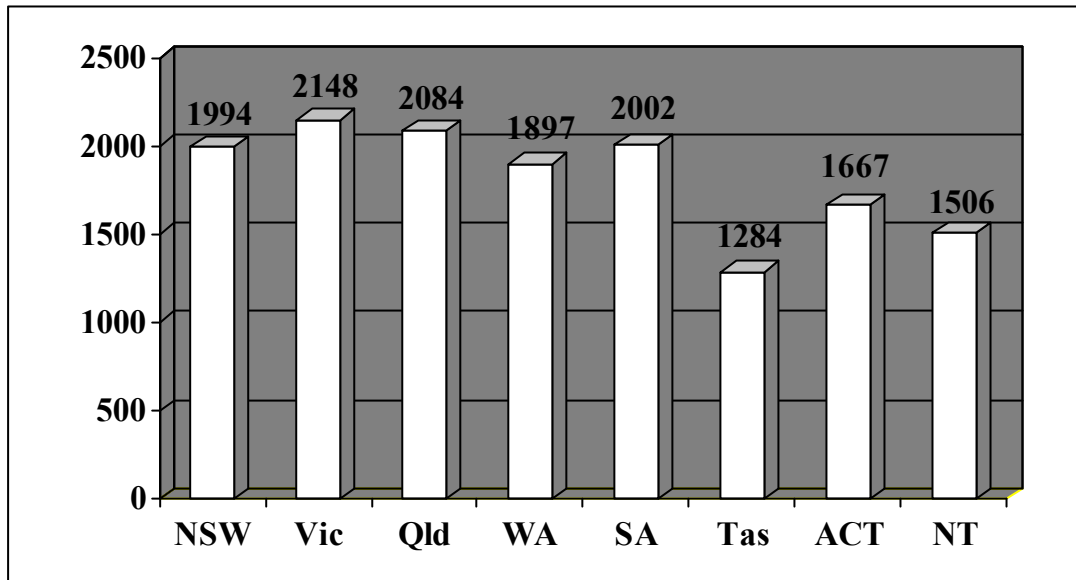
?? different per capita costs in providing equivalent services.

Revenue Assessments

There are substantial differences between States in the per capita revenue they collect from their own taxes and charges (ranging, in 1999-2000, from \$1284 per capita in

Tasmania to \$2148 per capita in Victoria). This is illustrated by Figure 3 which also shows the Australian per capita average, or standard, revenue collected by the States to be \$2012.

Figure 3 - Total Own-Source Revenue Per Capita – 1999-2000



The differences in revenue collections are caused by:

- ?? differences in the range of taxes levied;
- ?? differences in the rates of tax charged; and
- ?? differences in the capacity of States to raise revenue (ie revenue disabilities caused by differences in the economic and demographic positions of States which are beyond their control and which affect the size of their revenue bases).

The first two groups of differences reflect policy choice by the State governments. Only the last one reflects non-policy influences that the Commission takes account of in its calculations. To accept the first two as reasons for variation in the per capita relativities would be to allow the States to influence their own levels of funding. This would destroy effort neutrality and be a serious inefficiency in the grant design system.

The revenue assessments aim to measure the differences in the States' capacities to raise revenue. They do this by comparing the revenue each State would raise from its own

sources if it made the same revenue effort as all the other States – what the Commission terms standardised revenue. It is what they would collect if they each imposed taxes at the average rates and collected their taxes with the average level of efficiency. The measured differences in capacity thus arise only because of differences in the size and structure of the States' revenue bases.

The task of estimating States' standardised revenues is similar to the Representative Tax System operated in many countries. It involves:

- ?? deciding how to group revenue sources for assessment purposes;
- ?? identifying and measuring the revenue base for each group of taxes; and
- ?? measuring the standard revenue effort for each group of taxes.

Grouping Revenue Sources. After re-examining the scope and structure of its standard budget in 1999, the Commission concluded that 15 categories are needed to best measure the differences between States in their ability to raise revenue¹⁰. The classification, and the contribution of each category to total standard revenue, is shown in Attachment C.

It can readily be seen that many of the States' revenue sources, even in this grouped presentation, are only very small contributors to total own-source revenue. This is indicative of the problems of inefficiency and splintering the States see in their tax bases and, together with the level of VFI, formed the basis for their case for tax reform.

Measuring the Revenue Base. Once the assessment categories are decided, the Commission defines the revenue base for each one. Revenue bases are usually the legislative base for the tax and are measured as the number or value of activities or assets subject to tax in the majority of States. For example, the revenue base for the taxes on motor vehicles is the number of vehicles (weighted by type); for stamp duty on conveyances, it is the value of land and other assets sold.

¹⁰ This standard budget used in the 2000 Update calculations also reflects the changes in State taxes as a result of the IGA. The Commission has 'backcast' these for the purpose of calculating the per capita relativities to apply to the GST pool. Thus revenues exclude franchise fees.

If no State, or virtually no State, taxes a part of the assumed revenue base, it is excluded from the measure of the revenue base. For example, all States impose a land tax on property but most exempt residential properties, so these are excluded from the revenue base in all States. Similarly, all States exempt small businesses from payroll tax and the Commission excludes the wages paid by such businesses from its assessments by adjusting data from which the revenue base is measured.

In some instances, there are so many differences between States in how they impose a tax that it is impossible to get a common measure. In these cases, the Commission looks for a measure that is related to the particular tax but, if one is not available, it uses a broad measure of economic activity such as household income, total private expenditure or industry profitability. Mining revenue, where Western Australia has a much different policy to the others and where a measure of profitability is used, is an important example of where the Commission finds it necessary to apply this procedure.

When measuring revenue bases, it is also necessary to consider whether the level of activity in a State is influenced by the rate of tax imposed on it — that is, whether there are price or supply elasticity effects. For example, some States use taxation policy as a deliberate means of influencing economic development by encouraging mineral extraction. Their revenue bases for mining, a measure of profitability, should be measured as if they operated at standard tax rates and, where necessary, the observed revenue base of a State is adjusted for such elasticities.

Measuring the Standard Revenue Effort. Revenue effort is influenced by many things, including the rate of tax, the exemptions and concessions, and the enforcement effort. The Commission summarises the effects of all these things into the standard effective rate of tax or standard revenue effort. This is calculated as total revenue collected by all the States, divided by the total of their estimated revenue bases.

Where there is a common policy among the States to apply progressive rates of tax (for example, in Payroll Tax), the assessments also take account of the differences between States in the value distribution of the taxable transactions. In effect, this is done by dividing the revenue base of each State into common value ranges, and performing separate assessments in each of those ranges.

Estimating Standardised Revenues. Estimating standardised revenue is achieved by multiplying each State's revenue base by the standard effective rate of tax. As the process can be described very easily by example, the following discussion of the Payroll Tax assessment is used to illustrate the Commission's revenue assessment method.

The Payroll Tax Assessment. States' payroll taxes are collected from employers on the basis of the value of the wages and salaries paid. The tax is in the range of 5 to 7 per cent of payrolls, depending on the jurisdiction and the value of the payroll. All States exempt small employers from the tax but there are differences between them in the definition of a small employer (in one State it is annual payrolls below \$456 000, but in another it is payrolls below \$850 000).

The revenue base is defined by the Commission as the estimated value of payrolls subject to tax: that is, the payrolls of public sector trading enterprises and private employers, except for small businesses where the payrolls are below the national average exemption level.

The starting point for the measurement of this revenue base is data from the Australian Bureau of Statistics on aggregate compensation received by employees resident in each State. As such, the data include payrolls that are not taxed. The Commission therefore adjusts them for each State to exclude:

- (i) payrolls attributable to the general government sector; and
- (ii) the estimated gross payrolls of private sector businesses with less than 20 employees in Australia (this corresponds to payrolls of about \$650 000).

The adjustments are also based on data obtained from the Australian Bureau of Statistics.

Because the payroll tax rates applied by the States are progressive, it is necessary to take account of differences between States in the distribution of payrolls by size bands. This is done by dissecting the aggregate revenue base for each State into value groups, using details of payrolls and tax paid that are provided by the States from their tax collection records. The States' aggregate payroll tax assessments then become the accumulation

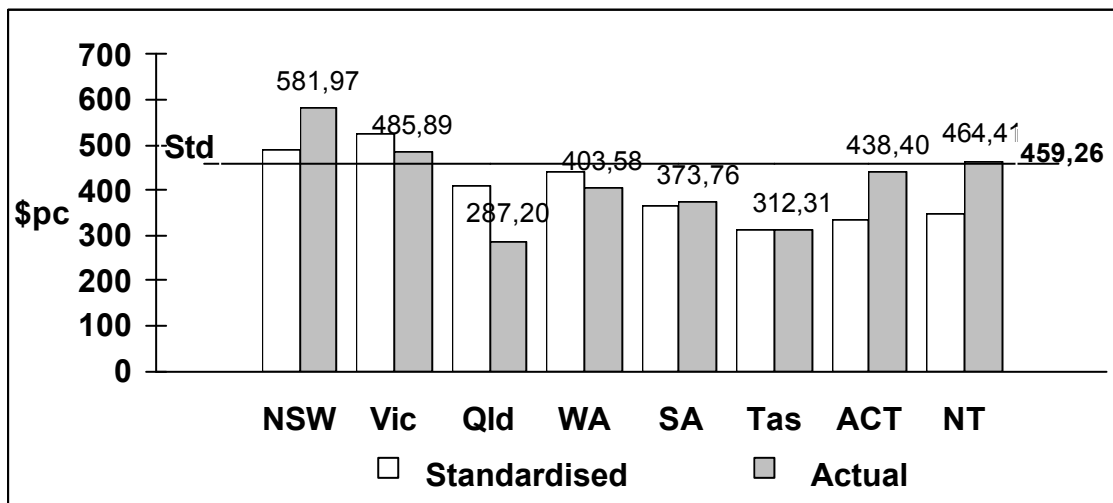
of the separate assessments made for each value range, by applying the average rate of tax in each value range to the States' values of payrolls in each of those value ranges.

Figure 4 summarises the payroll taxation assessments for 1999-2000. It shows that New South Wales and Victoria had above average revenue raising capacity and that the other States had below average capacity.

The above average capacities in New South Wales and Victoria arose because:

- (i) the wages, salaries and supplements per head of population in those States exceeded the Australian average;
- (ii) the proportion of total wages, salaries and supplements attributable to private sector employers with more than 20 employees in those States exceeded the Australian average proportion; and
- (iii) New South Wales had an above average proportion of large payrolls.

Figure 4 - Payroll Tax Assessments - 1999-2000



Comparisons between the actual and standardised revenue for each State indicate how their revenue efforts differed from the average. The actual revenues of New South

Wales, Victoria, the Australian Capital Territory and the Northern Territory clearly exceeded their standardised revenues because:

- (i) these States applied the highest rates of tax; and
- (ii) the low tax effort in Queensland brought the standard down and therefore reduced all States' standardised capacities.

The actual revenue of Queensland was well below its standardised revenues because it applied the lowest rates of payroll tax and had the highest exemption level. The rates of tax in Western Australia were also below average.

Total Revenue Assessments. Taking all 15 revenue assessments together, Figure 5 compares the revenue each State actually collected in 1998-99 with the Commission's assessments of what it would have collected under standard conditions. As discussed earlier, it is the standardised levels of expenditure that are used in the final determination of the States' relative levels of untied funding.

Figure 5 - Total Own-Source Revenue Per Capita, Actual and Standardised - 1999-2000

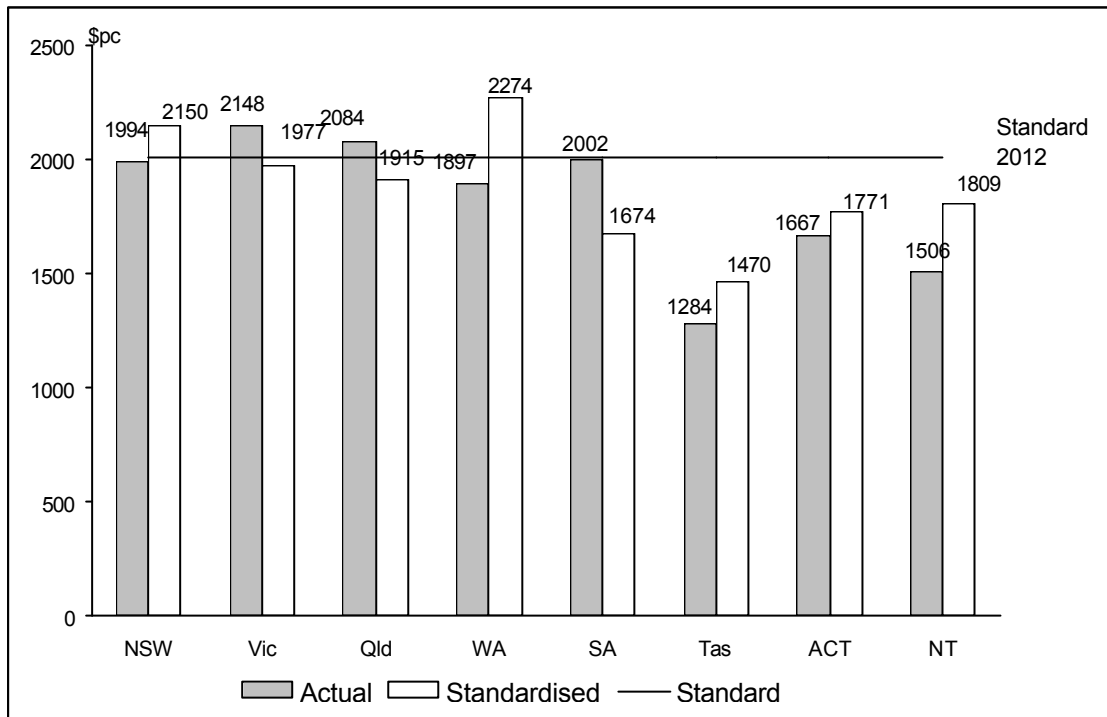
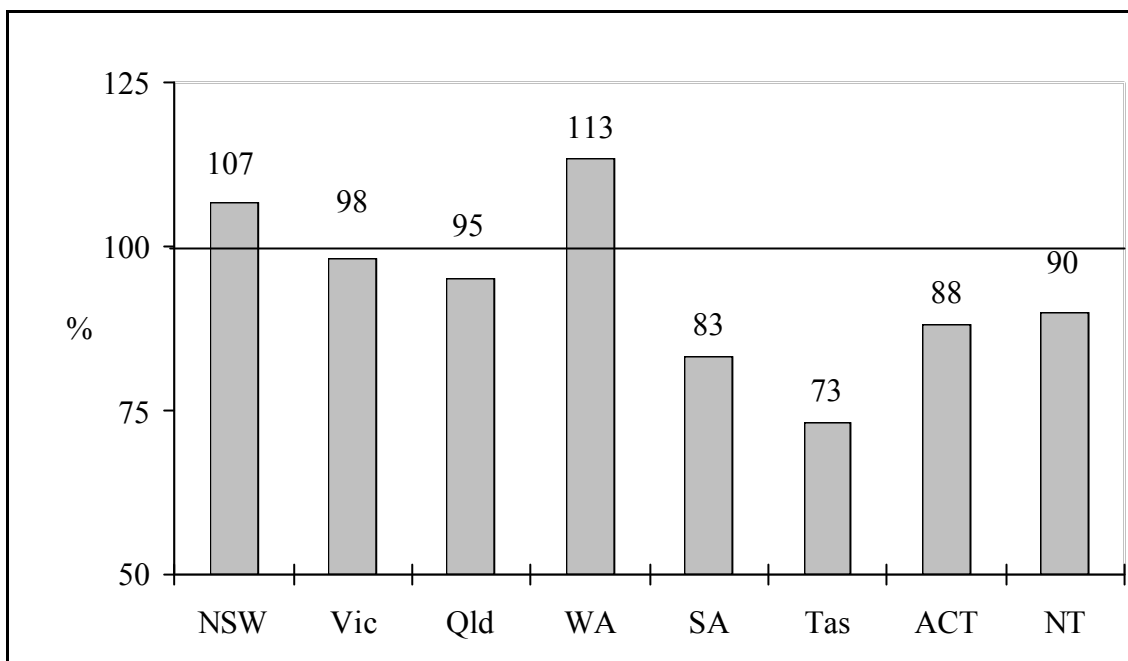


Figure 6 shows the Commission's assessments of States' overall relative revenue raising capacities, by expressing the standardised revenue assessments as a percentage of the average. Tasmania, the poorest State, has a capacity 27 per cent below average. Western Australia, with its vast mineral resources, is assessed by the Commission as being 14 per cent above average in revenue raising ability.

Figure 6 - Relative Revenue Raising Capacity Ratios – 1999-2000

Expenditure Assessments

The Commission undertakes expenditure assessments in each of the 43 categories into which it classifies State recurrent expenditure. It is this that makes it different to all other equalisation systems in the world. Only a handful of other nations include assessments of expenditure needs in their untied grant determination processes, and then it is done by general indicators rather than a quantified assessment of needs in each functional area.

The functions used by the Commission are shown in Attachment D. As indicated earlier, the assessments are based on the calculation of disabilities (which can be either negative or positive), and are defined as:

influences beyond the States' control that result in them having to outlay different per capita levels of expenditure to achieve the same objective.

The expenditure approach is somewhat different to that used for the revenue assessments. They take a much more direct approach at identifying and quantifying what causes the differences the States face.

Disability Factors. Disabilities generally reflect differences in the social, physical and economic structure of the States. For discussion purposes, we find it useful, in considering expenditure disabilities, to distinguish between demand influences and cost influences. In practise, this distinction is not always clear but some examples might assist the explanation.

The most frequently used disability factor that relates to demand is based on differences in the **socio-demographic composition** of the States' populations. This takes into account differences in the characteristics of State populations (such as age-sex, Aboriginality and income levels) on demand for and unit costs of services. For example, differences in the age distributions of population affect the demand for a number of services. Persons of school-age require education services; many elderly persons require nursing home services; and males in the late teens or early twenties are more likely than others to generate police services.

Similarly, differences between States in the proportion of persons of Aboriginal background affects the relative demand for and cost of providing health services. (The proportion of persons of Aboriginal descent is particularly high in the Northern Territory.) The numbers of migrants from different language groups affects the costs of services through the need for interpreter services; or through more complex problems because they seek services later (health services in particular). The effects of such demographic characteristics on costs are complex and the information available to measure them is often sparse.

Another demand influence is the **cross-border factor**. This measures the net effects on a State's costs of:

- ?? use by its inhabitants of services provided by other States; and
- ?? use of its services by the inhabitants of other States.

The major instance of cross-border use of services in Australia is the flow of people into the Australian Capital Territory (ACT) from the surrounding State of New South Wales. The ACT services most used by the residents of New South Wales are hospitals, education, police, court facilities and social welfare provision. Without an adjustment

to the assessment for this movement, the ACT would receive insufficient funds to provide the standard level of services, and New South Wales would receive too much.

Looking now at some influences on the unit cost of services, the location of the population in the vast areas of Australia is an obvious cause of cost differences. Other things being equal, a more dispersed population costs more to service than a more concentrated one. The costs of telephone communication are greater over longer distances; travel in connection with the provision of services is more expensive; the average cost of freighting goods or transferring staff is greater; and the cost of compensating staff for working in remote and harsh locations may be greater. Population dispersion factors aim to measure and allow for differences in the influence of these types of costs.

Beyond a certain point of population concentration, however, urbanisation adds to costs. A large enough urban area will require the provision of a public transport service (nearly always at a net cost in Australia), and the larger the city the greater need for railways (nearly always more demanding on the budget than road transport).

Another cost differential arises from differences in economies of scale. The Commission measures these at two levels.

- ?? **Administrative scale** relates to the additional expenditure of the States not able to take advantage of the economies of scale available to the more populous States. It concerns mainly policy development and administrative tasks carried out in central and regional offices, or specialised services (such as the legislature) provided centrally for the whole of a State's population.
- ?? **Service delivery scale** refers to the differential costs of providing services at the point of service delivery (a school or a police station) arising from lower efficiency, because of population sparsity, in the use of staff and other resources at service outlets.

The last example to be discussed is input costs. The Commission has taken the view that the costs of some basic inputs into State government service provision are not within, or fully within, the States' control. A very important example is wages.

Salaries and related costs are a high proportion of total expenditure on State-government functions. The wage levels which a State pays its employees is determined more by the general economic climate in the State, or by the centralised wage-setting system that operated in Australia until very recently, than by any action or inaction of the State Government.

The statistics clearly show, for example, that the level of private-sector wages in New South Wales (Sydney in particular) are higher than elsewhere in Australia. It would be surprising indeed if there were no flow-on effects into the State public sector. Obviously, however, States have some influence on the level of wages they pay, and the Commission has therefore approached the estimation of wage cost disability factors very cautiously.

Measuring and combining disabilities. The Commission measures all State disabilities from their position relative to the Australian average. For example, a State would have a disability in providing services to the aged if the proportion of its population over 60 years was greater than the Australian average.

In combining disabilities, the Commission first estimates the proportion of the expenditure to which the particular disability applies and weights the disability factor accordingly. Some disabilities are combined by multiplication because they interact with others (particularly input costs), but many are independent of each other and are therefore added.

The Government Schools, Secondary Education Assessment. Government Schools, Secondary Education is a useful example through which to explain the process for an expenditure category. Table 3 shows that the Commission assessed ten disability factors and combined their effects into an overall 'category disability'. It shows that Queensland had a disadvantage of over 10 per cent over the Australian average because of its high social-demographic composition factor, but it had an advantage of 34 per cent through lower than average costs associated with vandalism and security. After

weighting the disabilities by the proportion of expenditure affected by each of them — the component weight — and adding the weighted disabilities, Queensland's overall cost of providing the Australian average level of service was 8.57 per cent above average.

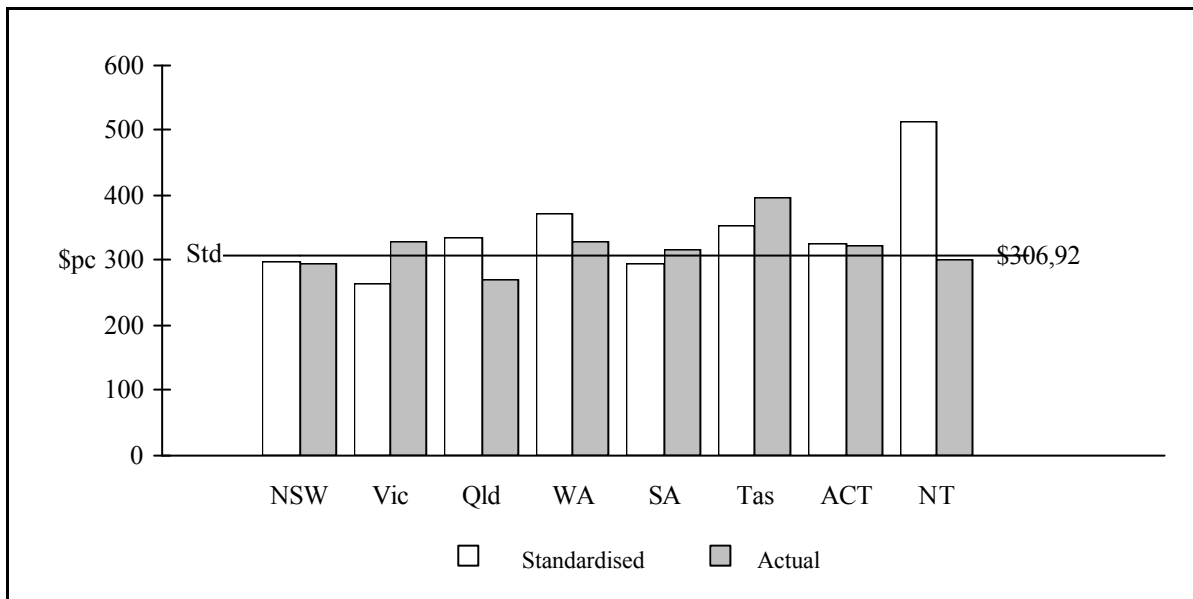
In simple terms, and again using Queensland as the example, the Commission calculates its standardised expenditure as the Australian average per capita standard, multiplied by 1.08570, multiplied by the Queensland population.

Table 3 - Government Secondary Education Disability Factors – 1999-2000

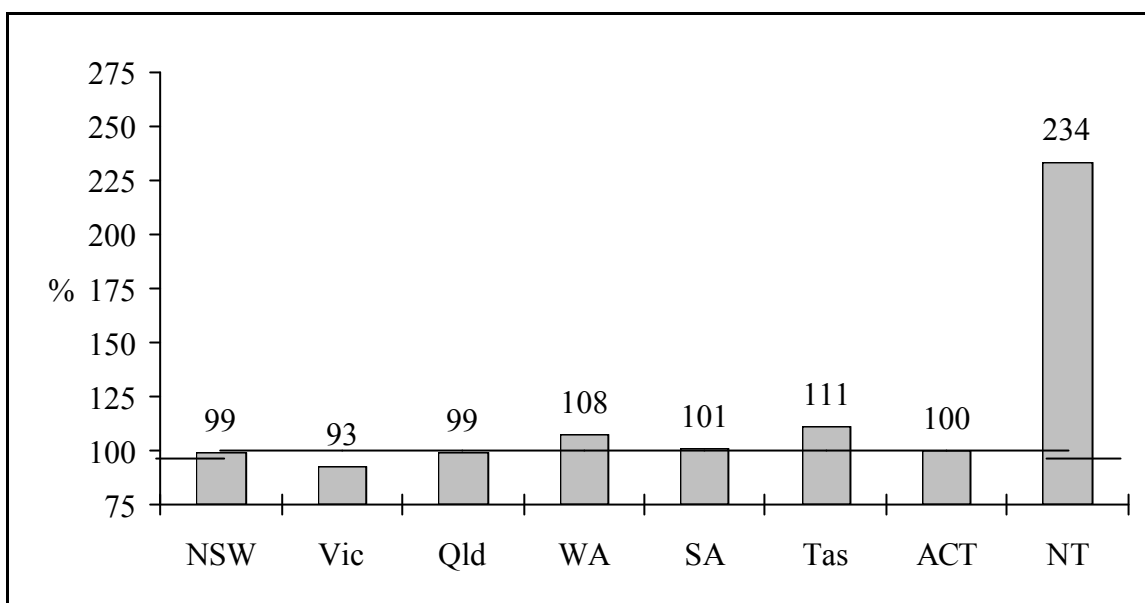
Factors	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
SCALE AFFECTED EXPENDITURE (component weight = 0.78%)								
Administrative scale	0.586743	0.668812	0.780304	1.208601	1.391171	3.491858	5.132463	8.761363
Input costs	1.015777	0.996259	0.979643	1.010858	0.979122	0.980694	1.022189	1.007066
Component factor	0.596	0.66631	0.764419	1.221724	1.362127	3.424446	5.246347	8.823267
Cont. to category factor	0.004668	0.005219	0.005987	0.009569	0.010669	0.026821	0.041091	0.069106
SCHOOLS (component weight = 97.98%)								
Dispersion	0.994252	0.990093	1.010361	1.022916	0.992867	0.995819	0.983188	1.114476
Input costs	1.014144	0.996476	0.981856	1.010024	0.981326	0.982526	1.019314	1.006768
Service delivery scale	0.99406	0.992454	1.002996	1.006218	1.007992	1.040106	0.960583	1.10444
Socio-demographic composition	0.967334	0.881353	1.108669	1.169204	0.984033	1.114196	0.997942	1.220571
Grade cost	1.001585	1.002483	0.996453	0.995592	0.999018	1.003426	1.009146	1.000371
Cross border	0.998254	1	1	1	1	1	1.031622	1
Component factor	0.969502	0.865097	1.099422	1.209871	0.965351	1.137669	1.00046	1.512052
Cont. to category factor	0.948838	0.846659	1.075989	1.184084	0.944776	1.113421	0.979137	1.479825
ISOLATION (component weight = 0.2%)								
Isolation	0.043153	0.062041	0.119353	2.339621	0.294369	3.646341	1.11538	57.55709
Component factor	0.043153	0.062041	0.119353	2.339621	0.294369	3.646341	1.11538	57.55709
Cont. to category factor	8.63E-05	0.000124	0.000239	0.004679	0.000589	0.007293	0.002231	0.115114
VANDALISM (component weight = 1%)								
Vandalism and security	1.15734	1.284051	0.661745	0.799249	0.834124	0.448186	0.701153	0.351869
Component factor	1.15734	1.284051	0.661745	0.799249	0.834124	0.448186	0.701153	0.351869
Cont. to category factor	0.011538	0.012801	0.006597	0.007968	0.008315	0.004468	0.00699	0.003508
NATIONAL CAPITAL (component weight = 0.04%)								
National capital	0.00000	0.00000	0.00000	0.00000	0.00000	0.00000	61.0566	0
Component factor	0.00000	0.00000	0.00000	0.00000	0.00000	0.00000	61.0566	0
Cont. to category factor	0.00000	0.00000	0.00000	0.00000	0.00000	0.00000	0.024565	0
CATEGORY FACTOR	0.96513	0.864802	1.088812	1.2063	0.964348	1.152003	1.054013	1.667553

Putting this assessment into the standard presentation gives us Figure 7 where Queensland's overall disability is represented by the amount of standardised expenditure above the standard line of \$306.92 per capita. The large disability faced by the Northern Territory is also very obvious.

Figure 7 Government Secondary Education – Assessments, 1999-2000



Total Expenditure Assessments. Taking the combined assessments for all 43 expenditure functions, the Commission's assessments of States' relative costs of providing services is shown in Figure 8. Apart from the Northern Territory, with its small population scattered over a large area (200 000 people in 1.35 million km²), the Commission does not believe there to be great differences between the States. Victoria has the lowest cost at about 7 per cent below the national average. In Tasmania, costs are about 11 per cent above average.

Figure 8 - Relative Cost of Service Provision Ratios – 1999-2000

Equity and the Treatment of Specific Purpose Payments

The issue that now remains unanswered is how the Commonwealth's distribution of specific purpose payments (SPPs) between the States is taken into account by the Commission.

The necessity for the Commission to consider how to treat SPPs within its processes comes direct from the principle of fiscal equalisation. The Commission is asked to work on the basis that each State should be given the capacity to provide the average level of services. The question then is:

should the average level of services that is being considered include those funded by specific purpose payments?

The Commission believes that it cannot fulfil its objective of equalising States' capacities to provide services unless, in many cases, it includes those services funded by SPPs in its measurement of average levels of service, because the SPPs are contributing to States' capacities to fund services. It therefore takes the variation in the receipt of SPPs paid to the States into account in arriving at its overall measure of States' needs

for general revenue funding. It terms this procedure for treating SPPs the ‘inclusion approach’.

The levels of standard expenditure therefore includes the expenditure funded from the SPPs, and the SPPs are deducted from the Commission’s assessment of what each State needs to spend to provide the standard level of services – its total expenditure requirement. Results based on the use of this ‘inclusion approach’ thus adjust a State’s level of untied financial assistance to take account of differences in the States’ receipts of SPPs that cannot be justified by the Commission as resulting from differences in relative need.

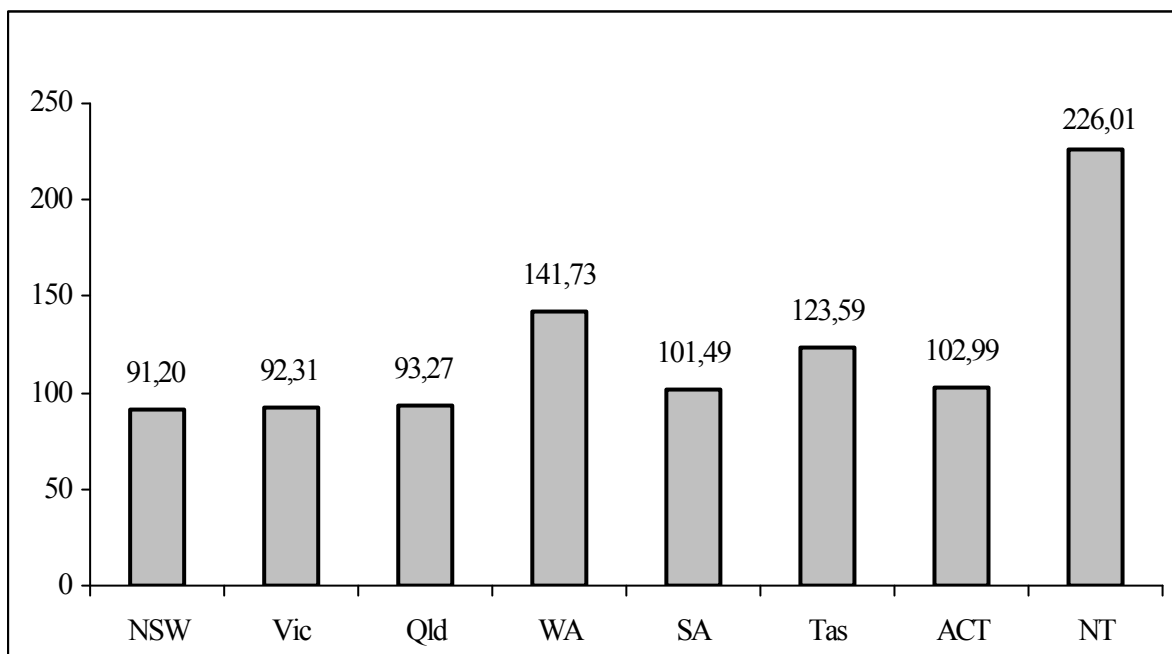
With one exception, the relative levels of the States’ receipts of SPPs is not dramatic. It is shown in Figure 9. The exception in the Northern Territory results from that State’s high demand and costs of services, but it is not quite as high as the Commission’s assessments of the Territory’s expenditure needs shown in Figure 8. The level of receipt in Western Australia is influenced by that State being the sole recipient of an SPP to cover a royalty equivalent to on-shore petroleum production, which is easier to levy if combined with the Commonwealth’s off-shore levy.

This treatment of SPPs fits into the model the Commission uses to determine the per capita relativities because each State’s need for united grants is measured, in per capita terms, as:

$$\begin{array}{r}
 \text{its Standardised Expenditure} \\
 \textit{plus} \quad \text{the Standard Budget Result} \\
 \textit{less} \quad \text{its Standardised Revenue} \\
 \textit{less} \quad \text{its receipt of SPPs treated by the inclusion method}
 \end{array}$$

The standard budget result is simply the difference between total per capita expenditure and total per capita revenue included in the standard budget. There is no requirement for the Australian States to operate on a balanced budget and the Commission’s standard budget therefore never balances. The assumption within the current assessment model is that the States have the same per capita capacity to operate at a surplus or deficit.

Figure 9 States' Relative Receipt of Specific Purpose Payments Treated by Inclusion, 1999-2000



The inclusion approach is one of three ways in which SPPs are treated by the Commission. The three approaches and the decision framework used to decide when each is used, are provided in Attachment E.

Combining the assessments. The final outcome of the Commission's considerations is a set of per capita relativities which are its recommendations concerning the relative levels of per capita grant to which each State is entitled. The per capita relativities recommended in the Commission's 2001 Update Report¹¹ were:

¹¹ Per capita relativities for distribution of the pool of GST revenue and health grants based on calculations over the five year period 1995-96 to 1999-2000.

State	Relativity
New South Wales	0.92186
Victoria	0.87625
Queensland	1.00470
Western Australia	0.96275
South Australia	1.18043
Tasmania	1.50109
Australian Capital Territory	1.14778
Northern Territory	4.02230
Australia	1.00000

The application of these relativities in the grant distribution process (adjusted for the distribution of Hospital Funding Grants) is such that, compared to the Australian average of about \$1437 per capita, New South Wales will receive only \$1295 per capita and the Northern Territory will receive \$6773 per capita.

Some Difficulties

The degree of equalisation. Australia has lived for a long time with a very detailed and complete equalisation system. It has suited the nation's purposes well but is coming under increasing pressure as the general ideal of equality of opportunity that was part of the 'Aussie image' decreases over time. The more populous States of New South Wales and Victoria are applying increasingly greater political pressure to the system and challenging the extent to which their citizens are 'subsidising' those of the other States.

To date, these pressures have been withstood by the other States and equalisation continues to be applied, but it is possible that this will change in the future as other States, most likely Western Australia and Queensland, join the group in complaint. If there is a move away from the complete application of equalisation, however, Australia will at least know what it is moving from and will be in a better position to make judgements about the extent to which any such move is justified.

The use of the inclusion approach to SPPs. Not all States and not all Commonwealth Government Departments responsible for SPPs agree with the application of the inclusion approach and the issue is frequently raised for discussion. It is one of the most controversial aspects of the Commission's work. Few doubt that it is necessary to achieve fiscal equalisation, but that is not the only objective of government, and how should other objectives be weighed against fiscal equalisation?.

The most common criticism of the Commission's use of the inclusion approach is that it overrides the distribution of the specific purpose payment — a distribution arrived at after sometimes long and difficult negotiations before agreement is reached and signed by Commonwealth and State Ministers or senior officials on behalf of their governments.

In one sense, the Commission agrees with this criticism in that the financial distribution is over-ridden, but this occurs up to seven years after the event because the Commission (as instructed in its terms of reference) uses the previous completed five years on which to base its assessments. It is important to note, however, that the policy objectives are not influenced by the over-riding of the financial distribution. SPPs are usually distributed with a prospective view in mind, while GRGs are based on the analysis of retrospective data and (largely) on the assumption that nothing has changed. These points often appear to be overlooked by the critics.

The Commission also notes that relativities based on the inclusion approach neither redistribute the actual levels of SPPs received in past years nor influence the distribution of such payments in future years; the process only adjusts the distribution of general revenue grants in a future year to reflect the requirements of fiscal equalisation based on the analysis of a past period.

Data requirements. There is some criticism of the Commission on the grounds that its processes are too resource intensive and its data requirements too demanding. Work done by the Commission, however, indicates that very few SPPs have as small a ratio of administrative cost to amount distributed as the untied grant distribution system.

Generally on the issue of data requirements, it is true that the Commission has been the cause of a great expansion in management data relating to the public sector in Australia.

This is not a bad thing, however, as the ‘new’ data are used in making budgetary and other decisions and have greatly improved the basis of policy advice being given to the elected representatives.

The Involvement of Politics

To a very large degree, the existence and operations of the Commonwealth Grants Commission have minimised the involvement of politicians, both Commonwealth and State, in the grant distribution system. The Premiers and Treasurers of New South Wales and Victoria have become a little more politically active on the issue of whether equalisation should apply, but no politicians are involved in debate with the Commission. There is no attempt to put political pressure on the Members and no contact between politicians and the Members when the results of the Commission’s deliberations are announced.

In this way, Australia has been able to allow the elected representatives to concern themselves with the issues of VFI, and has handed the more technical issue of overcoming HFI to a specialist body.

The Involvement of the States

Because of the importance of the Commission’s work to the States, they are directly involved in all its procedures. This has been the case since the Commission’s establishment in the 1930s and is seen as integral to the Australian system. The extent of this contact, and the openness of the Commission’s work to examination by the States, contribute greatly to the acceptance of the results (technically if not politically, the Commission’s work is still highly regarded).

The involvement of the States in selecting Commissioners was outlined earlier. For the five-yearly reviews of the data and methods used to make the assessments, the States:

- ?? assist the Commonwealth in developing the terms of reference for the inquiry;

- ?? assist the Commission in designing the events and timetable for the inquiry;
- ?? assist in deciding the scope and structure of the standard budget, and the specification of other data collections;
- ?? provide the data requested, both financial and non-financial;
- ?? arrange for the Commission to visit State workplaces to get first-hand experience of disabilities and talk to service providers;
- ?? make written submissions to the Commission on all aspects of the inquiry;
- ?? attend conferences with the Commission and the other States to discuss the issues; and
- ?? examine the Commission's preliminary findings and meet with it and the other States to discuss them.

For its part, the Commission makes all submissions public, holds all its discussions in public and makes sure that any information given to one State is given to all the others. It makes at least summaries of all its work available to the States for examination as soon as the results of the inquiry are known, and makes further details, and even the minutes of its meetings, available on request once an inquiry has been completed.

The States have the results of an inquiry, and many of the calculations behind those results, for up to six weeks before the Report is discussed at a meeting of the Ministerial Council for Commonwealth-State Financial Relations. During that period, they act as very efficient 'auditors' of the Commission's work and are supplied with any alternative calculations they require.

CONCLUSION

The Australian system of fiscal transfers has many good aspects to it but also has some problems. The work of the Commonwealth Grants Commission is the most developed approach to fiscal equalisation in the world, and is being studied with interest by a

number of countries wanting to establish or reform their intergovernment fiscal transfer systems.

Some parts of the Australian system however — like the level of vertical fiscal imbalance, deciding the absolute level of the intergovernment transfer and the mix of tied and untied grants within that transfer — are not ideal.

The important thing to note is that it was designed for Australia and works fairly well in Australia. While it might be of interest to other nations, it is always necessary to design a system that suits the political and cultural environment of the nation to which it is to be applied.

For those from other countries that study the Australian system, the things of most interest seem to be:

- ?? the size of the VFI and the support for this by many in the Commonwealth Government;
- ?? the apparent lack of control over the size of the total transfer from the Commonwealth to the States, and its allocation between SPPs and GRGs;
- ?? the independence of the Commonwealth Grants Commission, and that its Members are not political appointments and do not represent any authority other than themselves;
- ?? the comprehensiveness of Australia's horizontal equalisation system;
- ?? the Commission's approach to expenditure assessments;
- ?? the interface between the distribution of general revenue grants and the distribution of SPPs; and
- ?? the openness of the Commission's processes and the involvement of the States as both a source of debate and information, and as 'auditors' of the assessments of relative needs for funding.

Attachment A

Basic Data on States and Territories

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Area and Population								
Area (km ²)	801 600	227 600	1 727 200	2 525 500	984 000	67 800	2 400	1 346 200
Coastline (km)	1900	1 800	7 400	12 500	3 700	3 200		6 200
Population (1998-99)	6 367 287	4 682 951	3 480 317	1 844 559	1 489 570	471 363	308 484	191 353
Population per km ²	7.94	20.58	2.02	0.73	1.51	6.95	128.54	0.14
Population Characteristics								
Net interstate migration (%, 1999)	-0.23	0.09	0.50	0.10	-0.19	-0.78	-0.39	-0.49
Capital city population (% 1999)	63.0	72.5	45.6	73.3	73.2	41.3	100.0	45.7
Population under 15 (% 1999)	20.5	20.0	21.2	21.2	19.6	21.2	20.8	26.1
Population over 64 (% 1999)	12.8	12.7	11.4	10.6	14.4	13.5	8.2	3.4
Persons with low fluency in English (% 1996)	3.94	4.33	1.21	2.05	2.32	0.39	1.98	7.41
Indigenous population (1996)	109 925	22 598	104 817	56 205	22 051	15 322	3 058	51 876
Standardised death rate per '000 population (1998)	6.0	5.8	6.1	5.8	6.0	6.3	5.4	8.9
Perinatal death rate per '000 live births (1993)	8.5	7.5	8.1	7.3	7.6	9.5	7.2	19.3
Aged 15-69 with post- school qualifications (% of all aged 15-69)	43.7	38.1	36.9	42.1	38.2	36.7	48.9	37.1
Income characteristics								
Gross State Product per capita (\$'000, 1998-99)	33.3	32.3	27.5	34.2	27.2	23.6	39.0	33.8
Household disposable income per capita (\$'000, 1998-99)	29.2	27.9	24.8	27.0	25.1	22.9	38.2	27.2
Housing affordability								
Proportion of income devoted to Home Loan Repayments (June 1999)	28.4	22.9	22.8	21.0	19.6	19.1	14.3	15.0
Mean weekly capital city rent (June 1999)	216	200	169	156	163	150	174	254

The Constitution of the Commonwealth of Australia - An Extract**Part V.- Powers of the Parliament**

51. The Parliament shall, subject to this Constitution, have power to make laws for the peace, order, and good government of the Commonwealth with respect to:-

- (i) trade and commerce with other countries, and among the States:
- (ii) taxation; but so as not discriminate between States or parts of States:
- (iii) bounties on the production or export of goods, but so that such bounties shall be uniform throughout the Commonwealth:
- (iv) borrowing money on the public credit of the Commonwealth:
- (v) postal, telegraphic, telephonic, and other like services:
- (vi) the naval and military defence of the Commonwealth and of the several States, and the control of the forces to execute and maintain the laws of the Commonwealth:
- (vii) lighthouses, lightships, beacons and buoys:
- (viii) astronomical and meteorological observations:
- (ix) quarantine:
- (x) fisheries in Australian waters beyond territorial limits:
- (xi) census and statistics:
- (xii) currency, coinage, and legal tender:
- (xiii) banking, other than State banking; also State banking extending beyond the limits of the State concerned, the incorporate of banks, and the issue of paper money:
- (xiv) insurance, other than State insurance; also State insurance extending beyond the limits of the State concerned:
- (xv) weights and measures:

- (xvi) bills of exchange and promissory notes:
- (xvii) bankruptcy and insolvency:
- (xviii) copyrights, patents of inventions and designs, and trade marks:
- (xix) naturalisation and aliens:
- (xx) foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth:
- (xxi) Marriage:
- (xxii) Divorce and matrimonial causes; and in relation thereto, parental rights, and the custody and guardianship of infants:
- (xxiii) invalid and old-age pensions:
- (xxiiiA) the provision of maternity allowances, widows' pensions, child endowment, unemployment, pharmaceutical, sickness and hospital benefits, medical and dental service (but not so as to authorise any form of civil conscription), benefits to students and family allowances: [inserted by No. 81, 1946, s. 2]
- (xxiv) the service and execution throughout the Commonwealth of the civil and criminal process and the judgments of the courts of the States:
- (xxv) the recognition throughout the Commonwealth of the laws, the public Acts and records, and the judicial proceedings of the States.
- (xxvi) the people of any race, ~~other than the aboriginal race in any State~~, for whom it is deemed necessary to make special laws: [altered by No. 55, 1967, s. 2]
- (xxvii) immigration and emigration:
- (xxviii) the influx of criminals:
- (xxix) external affairs:
- (xxx) the relations of the Commonwealth with the islands of the Pacific:
- (xxxi) the acquisition of property on just terms from any State or person for any purpose in respect of which the Parliament has power to make laws:

- (xxxii) the control of railways with respect to transport for the naval and military purposes of the Commonwealth:
- (xxxiii) the acquisition, with the consent of a State, or any railways of the State on terms arranged between the Commonwealth and the State:
- (xxxiv) railway construction and extension in any State with the consent of that State:
- (xxxv) conciliation and arbitration for the prevention and settlement of industrial disputes extending beyond the limits of any one State:
- (xxxvi) matters in respect of which this Constitution makes provision until the Parliament otherwise provides:
- (xxxvii) matters referred to the Parliament of the Commonwealth by the Parliament of Parliaments of any State or States, but so that the law shall extend only to States by whose Parliaments the matter is referred, or which afterwards adopt the law:
- (xxxviii) the exercise within the Commonwealth, at the request or with the concurrence of the parliaments of all the States directly concerned, of any power which can at the establishment of this Constitution be exercised only the Parliament of the United Kingdom or by the Federal Council of Australasia:
- (xxxix) matters incidental to the execution of any power vested by this Constitution in the Parliament or either House thereof, or in the Government of the Commonwealth, or in the Federal Judicature, or in any department of officer of the Commonwealth.

Attachment C

Commonwealth Grants Commission Standard Budget 1999-2000 - Revenue

Revenue Classification Category	\$pc	Per cent
Taxation		
Payroll Taxation	459.26	18.54
Land Revenue	102.4	4.13
Stamp Duty on Conveyances	267.1	10.78
Financial Transaction Taxes	104.23	4.21
Stamp Duties on Shares and Securities	3.93	0.16
Gambling Taxation	168.04	6.78
Insurance Taxation	60.23	2.43
Heavy Vehicle Registration Fees and Taxes	25.4	1.03
Other Vehicle Registration Fees and Taxes	123.91	5.00
Stamp Duty on Vehicle Registration/Transfers	70.64	2.85
Drivers' Licence Fees	13.15	0.53
Other Taxation	13.67	0.55
Interest Earnings	136.37	5.51
Mining Revenue	69.89	2.82
Contributions By Trading Enterprises	394.24	15.92
Sub-total Taxation	2012.46	81.24
User Charges		
Vocational Education and Training	32.74	1.32
Hospital Patient Fees	48.36	1.95
	81.31	3.28
Law and Order Fees and Fines	40.72	1.64
Property Titles	33.91	1.37
Public Safety and Emergency Services	49.15	1.98
National Parks and Wildlife Services	3.64	0.15
Aboriginal Community Services	0.00	0.00
Primary Industry	19.54	0.79
Roads	34.09	1.38
Regulatory and Other Services	20.52	0.83
Other User Charges	100.60	4.06
Sub-total User charges	464.59	18.76
Total Revenue (a)	2477.05	100.00

- (a) Total own source revenue differs from the amount shown in Commonwealth Grants Commission *Report on State Revenue Sharing Relativities 2000/1 Update, Supplementary Information p 43* because user charges have been included.

Attachment D

Commonwealth Grants Commission Standard Budget 1999-2000 - Expenditure

Expenditure Classification Category	\$pc	Per cent
Pre-school Education	20.95	0.45
Government Schools Education	656.96	14.05
Government Secondary Education	193.13	4.13
Non-government Secondary Education	171.29	3.66
Vocational Education and Training	0.91	0.02
Transport of Rural School Children	29.51	0.63
Hospitals	601.16	12.86
Nursing Homes	10.73	0.23
Mental Health	79.30	1.70
Community Health	212.40	4.54
Public Health	44.14	0.94
Police	183.85	3.93
Administration of Justice	77.28	1.65
Corrective Services	63.02	1.35
Public Safety and Emergency Services	61.04	1.31
Housing	89.33	1.91
less Housing User Charges	-81.31	-1.74
First Home Owners Scheme	40.92	0.88
Family and Child Welfare	69.31	1.48
Aged and Disabled Welfare	138.31	2.96
Other Welfare	29.39	0.63
Concessions and Other Payments - Electricity and Gas	50.97	1.09
Concessions and Other Payments - Water Supply and Sewerage	30.10	0.64
Concessions and Other Payments - Freight	33.60	0.72
Concessions and Other Payments - Non-urban Passenger Transport	25.79	0.55
Concessions and Other Payments - Other Trading Enterprises	19.08	0.41
Concessions and Other Payments - Other	12.41	0.27
Culture and Recreation	65.12	1.39
National Parks and Wildlife Services	32.54	0.70

Aboriginal Community Services	7.53	0.16
Superannuation	590.76	12.63
GST Administration Costs	123.77	2.65
Other General Public Services	24.96	0.53
Primary Industry	83.20	1.78
Mining, Fuel and Energy	20.05	0.43
Tourism	19.66	0.42
Manufacturing and Other Industry	20.76	0.44
Subsidies – Petroleum Products	27.93	0.60
Subsidies - Alcohol Products	6.18	0.13
Urban Transit	81.06	1.73
Roads	130.56	2.79
Debt Charges nec	182.32	3.90
Depreciation	333.43	7.13
Regulatory and Other Services	62.52	1.34
Total Expenditure(a)	4675.90	100.00

- (a) Total expenditure differs from the amount shown in Commonwealth Grants Commission *Report on State Revenue Sharing Relativities 2001 Update, Supplementary Information p 43* because user charges have not been offset.

Attachment E

The Treatment of Specific Purpose Payments

The inclusion approach discussed in the paper is one of three ways in which SPPs are treated by the Commonwealth Grants Commission. In summary, the three approaches can be explained as follows:

- (i) The **inclusion method**, where expenditures financed from the SPP and from State sources are both included in the standards used in the expenditure assessments. The SPP itself is treated as part of the Commonwealth revenue payments available to finance part of the total financial assistance requirement of each State.
- (ii) The **exclusion method**, where the payment and expenditure funded from it are removed from the revenue and expenditure standards used in the assessments.

- (iii) The **absorption method**, where expenditures financed from the SPP and from State sources are included in the expenditure standards. The SPP is treated as though it were part of the general revenue pool distributed among the States.

The treatment given each SPP is arrived at separately after the Commission has asked itself the questions illustrated in Figure E-1.

Figure E-1 TREATMENT OF SPECIFIC PURPOSE PAYMENTS

