

# CHAPTER 1

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## INTRODUCTION

### THE PURPOSE OF THIS REPORT

- 1 This report analyses the fiscal capacities the Commission has assessed for each State and Territory (hereafter called States) and how they have changed over time. It has been prepared by staff of the Commission and provides background information and analysis relevant to the *Report on State Revenue Sharing Relativities, 2008 Update*.
- 2 The fiscal capacity of a State is a measure of the difference between:
  - what the State could raise from its tax base at Australian<sup>1</sup> average tax rates (a State's assessed revenue), plus the specific purpose payments (SPPs) it receives from the Australian Government; and
  - what the State would need to spend to provide average levels of services for its residents (a State's assessed expenses).
- 3 Fiscal capacity is a calculation made by the Commission. It is not the same as a State's budget outcome because:
  - adjustments are made to State budget data to ensure comparability between the States and to reflect requirements of the Commission's terms of reference;
  - State budgets report the revenue raised by a State using its actual tax rates, rather than the Australian average tax rates the Commission uses to calculate assessed revenue; and
  - State budgets reflect the State's own service delivery policies, rather than the national average policy. Again, the Commission uses national average policy to determine a State's assessed expense requirements.
- 4 The fiscal capacities calculated by the Commission form the basis on which the goods and services tax (GST) revenue and health care grants (the GST and HCG pool) are distributed

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<sup>1</sup> In this report, Australian average refers to the all-State average. Australian Government and local government activities are not included. For a fuller explanation of terms used by the Commission, see the attachment on Commission terminology.

among the States. That distribution is designed to remove differences in fiscal capacity, with the aim of leaving every State with the same capacity to provide services to its residents.

**The relation between fiscal capacities and the distribution of the GST and HCG pool**

Fiscal capacities provide a relatively simple way to compare the assessment of a State's ability to provide average levels of service to its residents. However, State shares of the GST and HCG pool do not track the year to year changes in their fiscal capacities precisely.

Fiscal capacities are absolute dollar values for a particular year and represent the notional budget outcome if a State provided average levels of service and applied the average effort to raise revenue in that year. By contrast, the GST and HCG pool distribution is based on relativities, and relativities are five year averages of relative needs (the five years covered in the 2008 Update were 2002-03 to 2006-07). Equal weighting is given to the relative needs in each year.

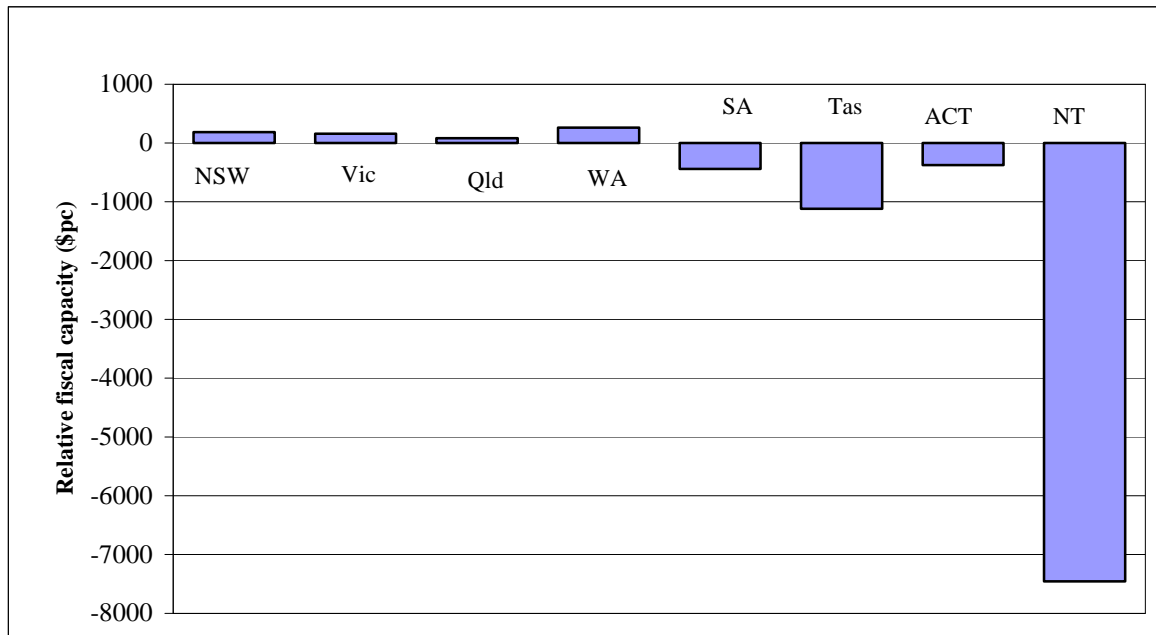
It is possible to average fiscal capacities over five years too, as we have done in parts of this report, but because expenses and revenues generally grow each year, the weighting on each year in the average is different, unlike average relativities.

Redistributions of the GST and HCG pool shown in this report may also differ from those shown in the *Report on State Revenue Sharing Relativities 2008 Update*. In some parts of the latter report, the 2008-09 GST and HCG pool is used to illustrate the redistributions. The *Relative Fiscal Capacities of the States 2008* (this volume) uses only the 2007-08 GST and HCG pool to illustrate redistributions.

**RELATIVE FISCAL CAPACITIES**

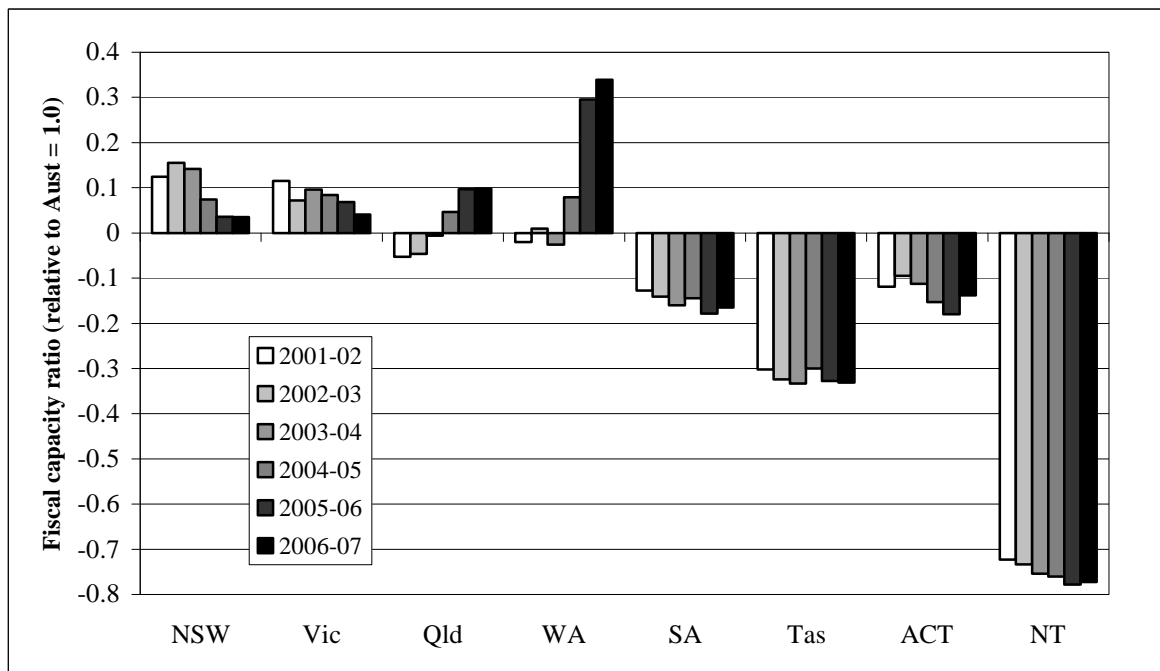
- 5 Figure 1-1 compares each State's fiscal capacity to the average capacity of all States. It is an average of data for 2002-03 to 2006-07. It shows that New South Wales, Victoria, Queensland and Western Australia have capacities above the Australian average, and South Australia, Tasmania, the ACT and the Northern Territory have capacities below the Australian average. Western Australia has the strongest capacity and the Northern Territory has the weakest capacity.
- 6 States with below average fiscal capacities need an above average share of the GST and HCG pool to give them the Australian average capacity to deliver services. States with above average fiscal capacities require a below average share.
- 7 The fiscal capacities of the States vary over time. Figure 1-2 shows:
  - an overall trend of a falling relative fiscal capacity of New South Wales between 2001-02 and 2006-07 with Victoria showing a similar, but less pronounced, trend;
  - the strengthening relative capacities of Queensland and Western Australia, with the relative fiscal capacity for the latter increasing sharply in 2005-06 and even more sharply in 2006-07, exceeding that of New South Wales and Victoria for both years; and
  - a general decline in the financial capacity of South Australia, Tasmania, the ACT and the Northern Territory.

**Figure 1-1 Relative fiscal capacities<sup>(a)</sup> of the States, five year average 2002-03 to 2006-07**



(a) Relative fiscal capacity = State fiscal capacity minus Australian average fiscal capacity.  
Source: Attachment C.

**Figure 1-2 Fiscal capacity ratios<sup>(a)</sup> of the States, annual data for 2001-02 to 2006-07**



(a) The fiscal capacity ratio = Australian per capita fiscal capacity/State per capita fiscal capacity. The vertical axis shows variance from the Australian ratio (by subtracting 1.0).  
Source: Attachment C.

8 These changes have occurred mainly because of changes in State circumstances. For example, the weakening of the property markets in New South Wales and Victoria and a decline in payroll tax capacity have been the main causes of their falling capacities, while buoyant

property markets and the mining boom strengthened the fiscal capacities of Queensland and Western Australia. The position of the Northern Territory has deteriorated because Australian service standards as measured by average net expenses have grown rapidly over the period, (by 25 per cent) amplifying the effect of the Northern Territory's high assessed costs. This is despite increases in its revenue raising capacity in recent years.

## WHAT IS IN THE REPORT?

- 9 To estimate fiscal capacities, the Commission starts with a comprehensive and comparable set of State budgets. Chapter 2 uses these budgets to present an average State budget, and to illustrate how State practices differ from this average and change over time.
- 10 The average State budget provides a current picture of 'what States do' in terms of the relative importance of different services they provide and of the way those services are financed. Attachment A presents a summary of these averages and individual State expenses and revenues, arranged using a common framework of services and revenues — referred to by the Commission as the 'adjusted budget'. The purpose of the adjusted budget is to present each State's budget in a comparable way, using a common classification framework.
- 11 Actual State budgets differ from the average State budget because States follow different *policies* and because their *circumstances* are different. In this context:
  - policy is controlled by the State in question, for example, what tax rate is charged; and
  - circumstances are conditions not under the control of the State, for example, the proportion of aged people in its population.
- 12 The fiscal capacity of each State as measured by the Commission is intended to show differences from the Australian average due to differences in circumstances, not policy. Differences between States in policies are not relevant to the measures of 'capacity'. However, the average of their policies is used to provide the Australian benchmark.
- 13 Many different circumstances can affect a State's capacity to raise revenues or to provide services. Their economies are different, their resource endowments are different, their physical geography is different and their populations are different in terms of size, location and socio-demographic characteristics.
- 14 Chapter 3 outlines what drives differences between States in their fiscal capacities. Chapter 4 discusses the fiscal capacity of each State individually. These are supported by Attachment B, which provides a summary of economic and demographic indicators that influence a State's fiscal capacity.
- 15 Chapter 5 shows how State holdings of physical assets and net financial worth and operating statement outcomes have varied over time.
- 16 **Attachments.** The overall measure of the fiscal capacities of each State can be disaggregated into a range of measures. These measures can tell us:

- what States could raise from their tax bases if they were to impose the Australian average tax rate, both in total and from individual taxes; and
  - what it would cost States to provide the Australian average level of services, in total and by individual service or functional group.
- 17 When expressed relative to the Australian average, they also provide information on:
- the relative revenue raising capacity of each State and its tax effort, in total and by individual tax; and
  - the relative cost of providing services in each State and the level<sup>2</sup> at which services are actually provided.
- 18 A State may have a strong capacity to raise revenue from mining or land but not from payroll or vehicle taxes. Service provision in one State may be relatively more expensive than in another. It may cost more to provide urban transit services in one State and relatively less to provide national park services. It is the mix of these relative capacities and costs which determine the overall capacity of each State. Attachments C to E provide detailed tabulations of such information.
- 19 Attachment F illustrates how Commission assessments of different revenue capacities and service costs influence the allocation from the GST and HCG pool required by States. It contains details of the redistribution of the pool from equal per capita (EPC) resulting from the assessment of each revenue, expense, user charge and SPP category and each disability factor.
- 20 Attachment G contains details of State taxation policies.

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<sup>2</sup> Level of service ratios, which express a State's actual expenses as a ratio of the amount the Commission estimates it would need to spend to deliver average levels of service (a State's assessed expenses), may not be comparable across States. Their comparability and accuracy depend on the comparability of the detailed data for each State's actual expenses for each service. However, States sometimes classify similar expenses differently. Those classification problems have a lesser effect on the assessed expenses prepared by the Commission because they depend on the average expenses of all States rather than the expenses of individual States.