

CHAPTER 3

WHY DO STATE FISCAL CAPACITIES DIFFER?

INTRODUCTION

- 1 Fiscal capacities of the States differ because of differences in:
 - what each State could raise from its tax base at Australian average tax rates (its revenue raising capacity or assessed revenue);
 - what each State would need to spend to provide average levels of services for its residents (its assessed cost of providing services or assessed expenses); and
 - the specific purpose payments (SPPs) it receives from the Australian Government.
- 2 States differ in their revenue raising capacities and their assessed costs of providing services because of their different circumstances:
 - different economies and resource endowments;
 - different physical geography; and
 - differences in populations in terms of size, location and socio-demographic characteristics.
- 3 States' SPPs receipts differ because of the different agreements reached between the Australian Government and States on goals and objectives and funding for specific purposes.
- 4 This chapter examines the fiscal capacities of the States and explains why they were different. It also discusses the key drivers of these differences.

FISCAL CAPACITIES OF THE STATES

- 5 Table 3-1 shows the Commission's analysis of each State's fiscal capacity. It shows that Western Australia, Victoria and New South Wales had the strongest capacities, while the Northern Territory and Tasmania had the weakest capacities.

- 6 The fiscal capacity of each State depends on its assessed revenue, assessed expenses and SPP receipts. The relative position of a State as assessed by these three components can vary. The Northern Territory had a below average revenue capacity, and a very high service cost, leaving its overall position weak. By contrast, Victoria also had a below average revenue capacity, but when combined with the lowest service cost of all States, its overall fiscal capacity was the third strongest.

Table 3-1 Fiscal capacities of the States, average for period 2002-03 to 2006-07

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
Assessed revenue	2 479	2 149	2 465	3 031	1 873	1 605	2 008	2 074	2 371
Assessed expenses	5 054	4 708	5 139	5 527	5 082	5 522	5 073	12 825	5 124
SPPs	417	373	415	417	428	457	352	952	412
Fiscal capacity (a)	-2 159	-2 186	-2 259	-2 080	-2 781	-3 460	-2 713	-9 798	-2 341
Relative capacity (b)	182	155	82	261	-440	-1 119	-372	-7 457	0

(a) Fiscal capacity = assessed revenue + SPPs - assessed expenses.

(b) Relative capacity = State capacity - Australian capacity.

Source: Attachment C.

Assessed revenue

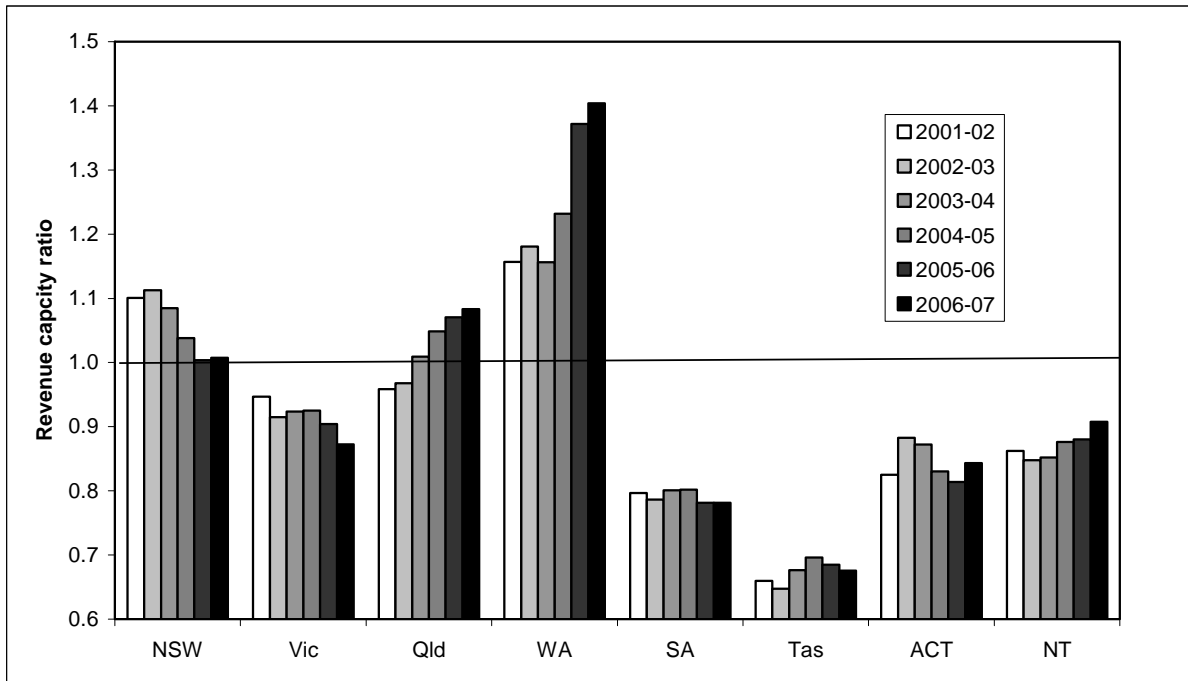
- 7 A State's ability to raise revenue is affected not only by its economic performance but, more importantly, by the specific tax bases through which States raise their revenue. Measuring their capacity to raise tax revenue requires examination of these specific bases. For example, capacity to raise:

- payroll tax depends on employers' payrolls;
- stamp duty on conveyances depends on the value and number of property sales;
- land tax depends on the value of land;
- insurance tax depends on the value of insurance premiums; and
- mining royalties depend on the level of mining activity.

- 8 Over the period 2002-03 to 2006-07, if States had applied average tax rates, Western Australia (\$3 031) and New South Wales (\$2 479) would have raised the most revenue per capita, while Tasmania (\$1 605) and South Australia (\$1 873) would have raised the least. The average amount that was raised over the period was \$2 371.

- 9 Figure 3-1 shows the revenue raising capacity ratios of the States for the years 2001-02 to 2006-07. The revenue capacity ratio of a State measures its ability to raise revenue if it applies average tax rates to its tax bases. It is calculated as its assessed revenue per capita divided by the Australian average revenue per capita.

Figure 3-1 Revenue capacity ratios, annual data for 2001-02 to 2006-07



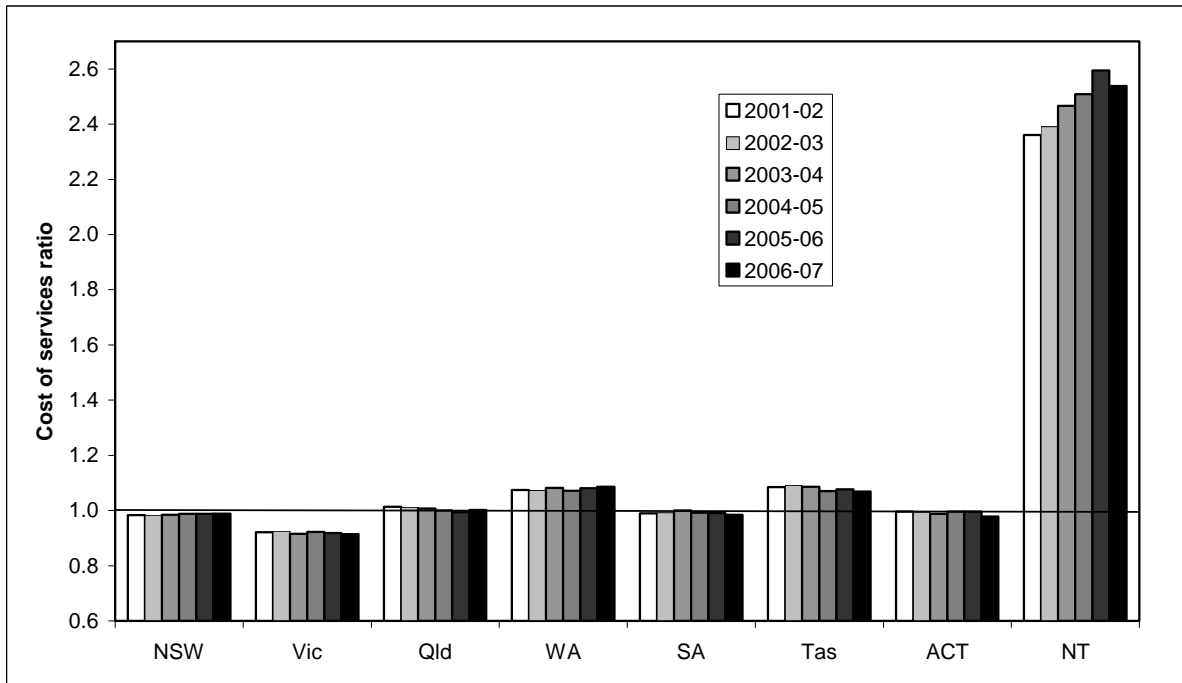
Source: Attachment C.

- 10 Western Australia’s strong capacity derives from the mining boom, affecting its ability to tax its mining industry, and flow on effects to payroll taxes and conveyance duty due to the property boom in that State. New South Wales’ capacity mainly reflects its property market, high land values and high levels of corporate activity, resulting in strong tax bases for property conveyances (but less so in the latter part of the period), land, payroll, financial and insurance taxes.
- 11 Queensland’s relatively high and increasing capacity is due to its sustained property boom and booming mining sector. These two factors, together with growth in the payrolls of medium and large businesses, resulted in Queensland overtaking New South Wales as the State with the second highest revenue raising capacity from 2004-05. At the other end of the scale, Tasmania has weak revenue bases in most areas.
- 12 Property and commodity cycles have big influences on the revenue raising capacity of the States. These cycles affect States at different times. For example, in recent years, especially in 2005-06 and 2006–07, Western Australia had a strong property market while that in New South Wales had cooled. The slowdown in the property market is a major reason why the revenue raising capacity of New South Wales has fallen steadily since 2002-03. States’ relative revenue raising capacity can move rapidly over time and much more than their more stable relative service costs.

Assessed expenses

- 13 State governments provide many services to their residents, each of which can be subject to different use and cost influences. Those influences include the number and type of users who determine the quantity of services needed and the cost drivers which affect the unit costs of particular services.
- 14 In economic terms, the number and type of users of State government services determine the demand for those services. For example, for education services, the number of children is relevant to the number of schools and teachers needed. The demographic and social profile of the population (such as family income level, health status, English language fluency and Indigeneity) may be relevant to student/staff ratios and other inputs needed to achieve a good educational outcome for all students at each school.
- 15 The unit costs of services depends on many things, such as the minimum head office costs (and the population base over which this can be spread), the number, size and location of service points, the dispersion of the service points, costs of travel and communications from regional or head offices, wage levels and locality allowances, costs of providing buildings and equipment and their maintenance, the physical environment in which they are located, and so on.
- 16 Figure 3-2 shows the assessed costs of providing services in each State divided by the Australian averages for the years 2001-02 to 2006-07 (cost of service ratios). It shows that the assessed cost was much higher in the Northern Territory (about 2.5 times the Australian average). Western Australia and Tasmania also had relatively high assessed costs of providing services. Greater proportions of the populations of these States were either high users of services or cost more to service. The Northern Territory had higher than average proportions of Indigenous people, people with low-English proficiency and a widely dispersed population, making the provision of services to them significantly more costly. It also had high diseconomies of small scale and high wage levels. Western Australia has higher than average proportions of Indigenous people and people living in very remote areas. Tasmania had a higher than average proportion of people on low incomes and more people over the age of 65, both having higher use rates for services.
- 17 The assessed costs of Queensland were just above the Australian average while those of New South Wales, Victoria, South Australia and the ACT were below average.
- 18 Victoria's costs were well below average. Victoria is a compact State compared with the other States with a smaller than average proportion of its population living in remote areas. It has the lowest proportion of Indigenous people in its population. Moreover, its proportions of people with low incomes and of school age are below average. This reduced the relative use and the average unit cost of many services. Victoria also had an above average ability to achieve economies of scale in service delivery.

Figure 3-2 Assessed cost of service ratios, annual data for 2001-02 to 2006-07



Source: Attachment C.

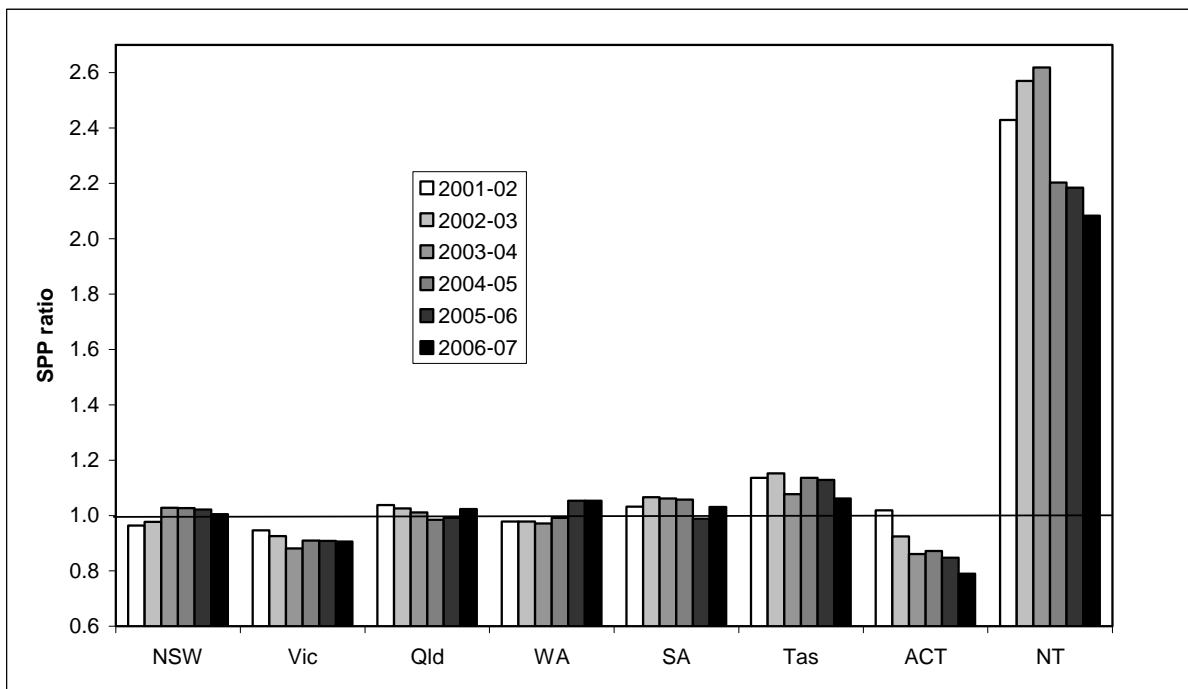
- 19 In summary, States' costs of providing services differ for three reasons:
- differences between the States in terms of scale and proximity to major markets for labour and materials needed to provide services;
 - differences in how people are distributed within the State. Service costs vary with location (if it costs 1 to provide a service in a city, it costs about 1.08 in a town and 1.6 in a remote location), so different patterns of population concentration lead to different average service costs; and
 - differences in the social and demographic characteristics of their populations, and economic conditions such as wage levels.
- 20 The first two reasons each account for about 20 to 25 per cent of the difference in average expenses, and the last for the remainder.

Specific purpose payments (SPPs)

- 21 SPPs from the Australian Government to States are relevant to a State's fiscal capacity because they are an additional source of revenue for the States. The Commission does not include all SPP income when assessing State fiscal capacities — only those that are relevant to the expenses it assesses. Australian health care grants (HCGs) are not treated as SPPs in the Commission's processes because the terms of reference ask the Commission to include most of the HCGs in the pool.

22 Figure 3-3 illustrates the differences between the States in income they received from included SPPs compared with the Australian averages for the years 2001-02 to 2006-07. New South Wales, Queensland, Western Australia and South Australia received about the Australian average per capita share. Victoria and the ACT's shares are noticeably below the average, and the ACT's share is falling further below the average. Tasmania and the Northern Territory received above average shares, with the Northern Territory receiving more than twice the Australian average per capita amount. The shares of both States are moving towards the average.

Figure 3-3 SPP ratios



Source: Attachment D.

23 A comparison of Figure 3-2 and Figure 3-3 suggest that there may be some relationship between State assessed costs of service ratios and SPP ratios. States with higher cost ratios, such as the Northern Territory and Tasmania, have higher SPP ratios. Similarly, States with lower relative costs, notably Victoria, receive a smaller relative share of SPPs. This is not surprising as the processes for determining SPPs may recognise similar types of cost disadvantage (or advantage) to those recognised by the Commission.

24 Over the latter part of the period the SPP ratios have a declining trend in all States except Queensland and Western Australia where they have tended to increase and Victoria where there has been very little change. The strongest decline appears to be for the ACT and the Northern Territory.

REDISTRIBUTION

- 25 The goods and services tax (GST) and HCG pool is distributed among the States to provide each with the same capacity to provide services. It offsets differences in the assessed fiscal capacities of the States. If all States had the same fiscal capacities, the GST and HCG pool would be distributed on an equal per capita basis — according to State population shares. How the actual distribution differs from this is a reflection of States' differences in fiscal capacity.
- 26 Table 3-2 shows the redistribution of the 2007-08 pool that follows by applying relativities in the 2008 Update¹. Table 3-3 shows the amounts redistributed, attributing this specifically to the effects of different revenue raising capacities, costs of providing services and SPP income.

Table 3-2 Redistribution, 2008 Update

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Equalisation distribution (a)	15 201.9	11 693.0	9 812.3	4 519.4	4 627.7	1 826.9	963.9	2 349.3	50 994.2
EPC distribution	16 699.7	12 636.5	10 171.9	5 114.5	3 834.9	1 194.6	821.2	520.9	50 994.2
Difference (b)	-1 497.8	- 943.6	- 359.5	- 595.1	792.8	632.2	142.6	1 828.4	0.0
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
Equalisation distribution (a)	2 194.9	2 231.1	2 325.9	2 130.6	2 909.6	3 687.3	2 830.0	10 874.4	2 411.2
EPC distribution	2 411.2	2 411.2	2 411.2	2 411.2	2 411.2	2 411.2	2 411.2	2 411.2	2 411.2
Difference (b)	- 216.3	- 180.0	- 85.2	- 280.5	498.4	1 276.1	418.8	8 463.2	0.0

(a) Based on the application of the 2008 Update relativities to the GST and HCG pool for 2007-08 and ABS estimates of State populations as at December 2007.

(b) The difference is not the same as the fiscal capacity or relative fiscal capacity numbers shown in other tables and figures in this volume. See Box on page 2 (Chapter 1) for an explanation.

Source: Attachment D of CGC 2008 Update Report.

Table 3-3 Causes of the redistribution from equal per capita, 2008 Update

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total (a)
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
Assessed revenue	- 128.7	250.6	- 98.6	- 732.4	566.5	873.8	410.7	342.1	135.3
Assessed expenses	- 88.7	- 462.0	9.4	458.0	- 44.9	461.1	- 21.0	8 676.9	147.2
SPPs	1.2	31.5	3.9	- 6.7	- 22.9	- 58.4	29.4	- 553.6	9.4
Difference from									
EPC (b)	- 216.3	- 180.0	- 85.2	- 280.5	498.4	1 276.1	418.8	8 463.2	160.6

(a) Total amount redistributed among States (sum of all positives) divided by Australian population.

(b) The difference is not the same as the fiscal capacity or relative fiscal capacity numbers shown in other tables and figures in this volume. See Box on page 2 (Chapter 1) for an explanation.

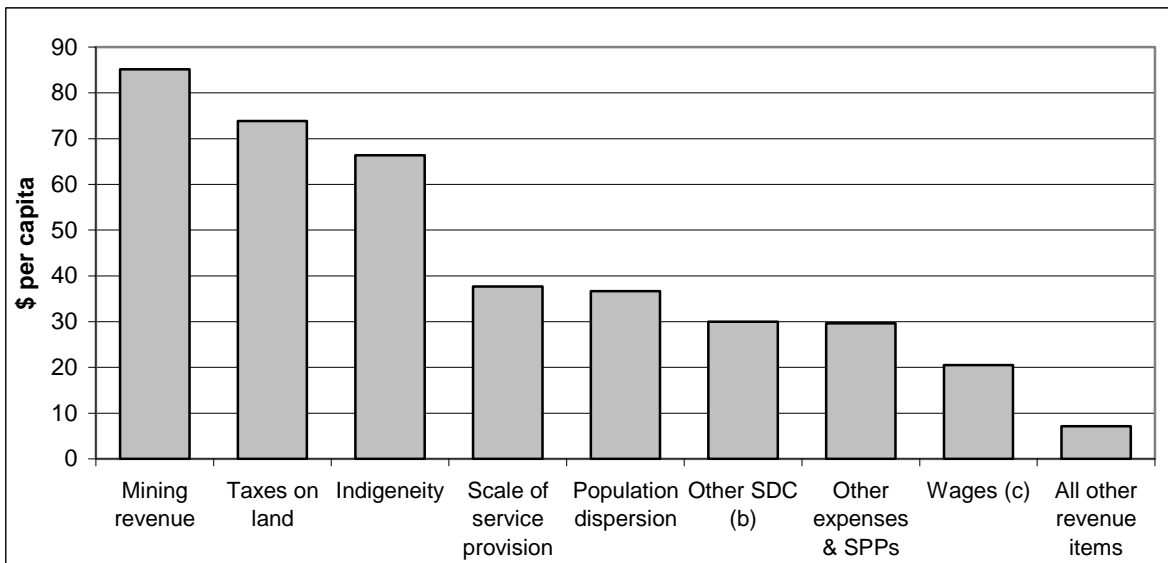
Source: Attachment D of CGC 2008 Update Report.

¹ Commonwealth Grants Commission *Report on State Revenue Sharing Relativities, 2008 Update* (hereafter referred to as CGC 2008 Update Report).

THE KEY DRIVERS OF FISCAL CAPACITIES

- 27 There are a number of key drivers of differences between States in how much revenue they could raise and how costly it is for them to provide the average level of services. It is these drivers that redistribute most of the GST and HCG pool among the States.
- 28 Figure 3-4 shows the drivers of the redistribution in order of their impact. The remainder of the chapter explains how they affect State fiscal capacities.

Figure 3-4 Contribution of major drivers to the redistribution^(a), 2008 Update



- (a) The redistributions shown are the absolute value of all the positives or all the negatives for the States. They cannot be added as redistributions can be positive or negative for a particular State and potentially cancel one another.
- (b) ‘Other SDC’ refers to socio-demographic contributions by drivers other than Indigeneity, such as age, sex, income levels and English fluency.
- (c) Wages refers to the combined impact of the ability to raise revenue from wages and disabilities associated with the level of wages that States may need to pay their employees.

Source: Attachment F.

Mineral wealth

- 29 States raise revenue, in the form of royalties, on minerals that have been mined. The key contributors to mining royalties were coal and minerals such as gold, iron ore, nickel, copper, bauxite and mineral sands.
- 30 Table 3-4 shows the GST and HCG pool redistributed by royalties on minerals. It also shows indicators of the level of State mining activities — the value of production and factor income from mining. Of all revenue categories, mining is the one where States differ most in their capacity to raise revenue. The main influence on the differences between States in mining activity is differences in natural resource endowments.

Table 3-4 Mineral wealth — redistribution and general indicators, 2008 Update

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust (a)
	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc	\$pc
Redistribution	96.20	164.80	-121.30	-586.32	92.15	131.77	172.43	-209.05	85.14
Mining value of production (b)	1 242	174	4 900	13 079	1 515	1 200	0	10 218	2 955
Factor income, mining (b)	886	820	2 483	12 546	1 228	951	10	12 275	2 465

(a) Redistribution amount shown in 'Aust' column is total amount redistributed among States (sum of all positives or all negatives) divided by Australian population.

(b) Five year average 2002-03 to 2006-07.

Source: Attachments B and F.

- 31 Western Australia had high iron ore, bauxite, gold, nickel, oil and gas production, and so had a revenue capacity that was well above average. This strong royalty income resulted in a redistribution of the GST and HCG pool away from Western Australia. Queensland also had a strong mining industry and royalty base, although not as strong as that of Western Australia. Queensland's royalties were derived from large coal, copper, bauxite, oil, and gas mines with significant production. The Northern Territory did not have production on the same level as Western Australia and Queensland, but the per capita value of production was high because of its low population. There was a substantial redistribution of the GST and HCG pool away from the Northern Territory, second only to that for Western Australia. All other States had below average capacity to raise revenue from mining (and below average value of production and factor income), increasing their share of the GST and HCG pool.
- 32 While the redistribution of the GST and HCG pool based on mining revenue broadly tracks factor income, there are some exceptions. The Northern Territory's revenue capacity is lower than suggested by factor income. This is a result of royalties from its offshore activities and uranium going to the Australian Government². Victoria's low revenue capacity was a reflection of the predominance of brown coal mining which generates low royalties and, like the Northern Territory, royalties from offshore oil and gas production (in Bass Strait) go to the Australian Government.

Taxes on land and property transactions

- 33 States are able to impose duty on the transfers of property (including the sale of major State government-owned assets and corporate reconstructions) and tax the ownership of land. (Typically, States restrict tax to commercial and industrial land and non-principal residential land.)
- 34 Table 3-5 shows the effect of the differential ability to raise revenue from land and property transactions on redistribution of the pool. It also shows some general indicators that illustrate the different capacities of the States in this area. The combination of large average revenue from this source and distinct differences between the States in the strength of this tax base makes it the second largest driver of the redistribution of the GST and HCG pool.

² Note: Some off-shore oil and gas production is subject to petroleum resource rent tax rather than royalties to the Australian Government.

- 35 On average, over the years 2002-03 to 2006-07, New South Wales had by far the greatest capacity to raise revenue from land taxes, translating into the large redistribution away from it shown in Table 3-5. High property values (both residential, and commercial and industrial) in New South Wales combined with an above average proportion of renters were the driver of its strong revenue capacity. New South Wales had the third highest per capita capacity to raise revenue from conveyances. High property values as well as high overall value of conveyance transactions, especially in 2002-03, provided the above average capacity for conveyance duty.
- 36 Victoria had higher than average property values but had turnover that was 12 per cent below average, resulting in an overall land-related tax base per capita that was below average. It also had a lower than average proportion of renters, weakening its land tax base. Its strong capacity to raise revenue from its high valued industrial and commercial land because of its strong manufacturing base only partially offset its lower than average capacity in other areas.

Table 3-5 Taxes on land and property transactions — redistribution and general indicators^(a), 2008 Update

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust (b)
Redistribution, \$pc	- 138.34	136.36	- 93.52	- 98.93	342.23	436.42	62.78	305.44	73.88
Median house prices (c), \$'000	520	370	301	308	263	248	361	285	na
Value of housing finance commitments, \$pc	7 321	6 146	7 524	8 213	5 642	3 876	5 761	5 127	6 903
Value of commercial and industrial land, \$pc	10 577	9 964	7 348	8 520	5 718	3 000	6 510	9 028	8 961
Value of non-principal residential land (d), \$pc	19 570	13 179	14 129	14 209	7 916	3 905	14 134	4 449	14 897
Proportion of private renters, %	22.8	19.7	25.5	20.9	17.1	16.6	19.8	22.2	21.7

(a) Five year averages 2002-03 to 2006-07 except median house price which is June quarter data for each year averaged.

(b) Redistribution amount shown in 'Aust' column is total amount redistributed among States (sum of all positives or all negatives) divided by Australian population.

(c) For capital cities only. Source: Real Estate Institute of Australia, *Real Estate Market Facts*.

(d) CGC Working Papers, Volume 2, 2008 Update.

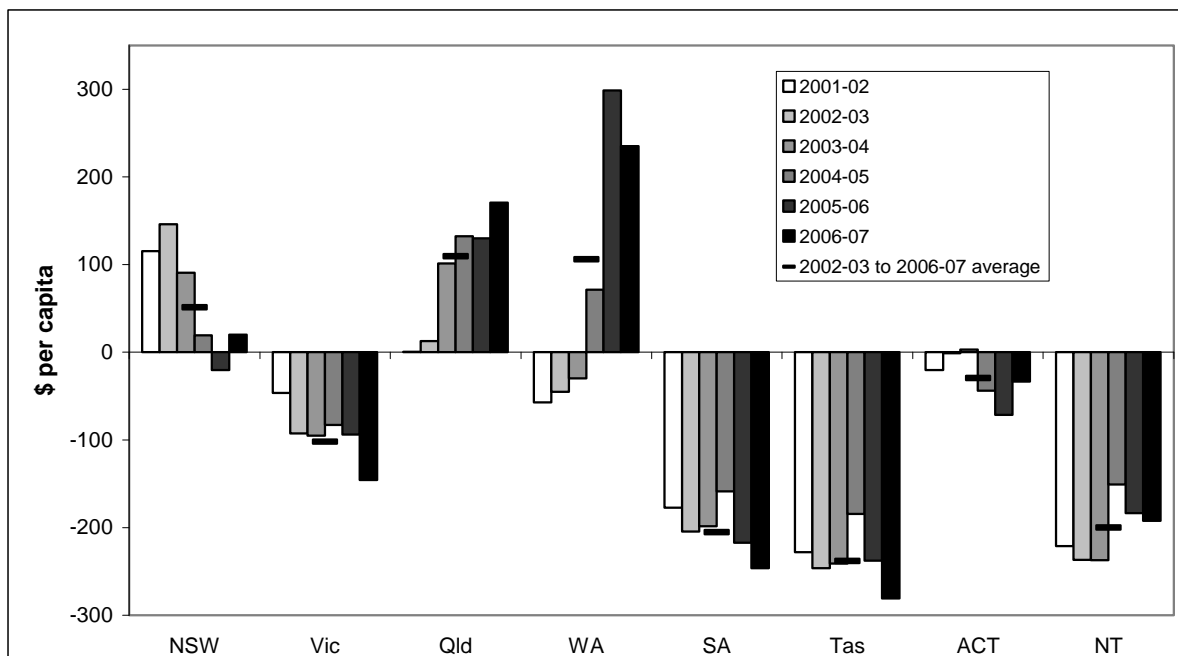
Source: Attachments B and F, unless noted otherwise.

- 37 High turnover of properties gave Queensland the second strongest average capacity, just behind New South Wales, to raise revenue from property sales. However, it had below average per capita value of commercial and industrial land and residential land, and median price for houses in Brisbane that were also below average, indicating a below average capacity for land tax. The combined effect of the two taxes was an above average revenue capacity for Queensland.
- 38 Western Australia has seen a property boom in recent years, and a correspondingly sharp rise in conveyances. In the five years to 2006-07, Western Australia still had below average commercial and industrial land values and residential land values but its above average value of

conveyances more than offset this, giving it above average revenue capacity overall for land and property taxes.

- 39 South Australia, Tasmania, the ACT and the Northern Territory had below average property values, turnover, or both, resulting in below average capacities to raise revenue from land-related taxes over the five years ended 2006-07. The Northern Territory had above average values of commercial and industrial land but this was not sufficient to give it an above average land tax capacity.
- 40 The property market is very volatile and moves at different rates and often in different directions across the States. The result is that the five year average revenue capacities discussed above mask some substantially different trends across States over the years. For example, New South Wales' capacity to raise revenue from property sales trailed off from 2003-04, and its revenue from property sales flattened. By contrast, increasing property prices and turnover in Queensland and Western Australia, fed by solid ongoing economic growth, increased their capacity to raise revenue. Tasmania's property market, which lagged the booms of the other States, also partially caught up in recent years, but it shows signs of slowing again and its small commercial and industrial property sector limited its revenue capacity.
- 41 Conveyances represent the main source of revenue for the States and differences in capacity are shown in Figure 3-5, which graphs each State's revenue raising capacity from conveyances for each year 2001-02 to 2006-07 relative to the average.

Figure 3-5 Revenue raising capacity for conveyances, 2001-02 to 2006-07



Source: Attachment D

Indigenous influences

- 42 Indigenous influences relate to the higher use of services by Indigenous people, the higher costs of providing services to them and the effects of land rights and native title legislation. Indigenous influences are the largest single determinant of differences in assessed service delivery cost.
- 43 Table 3-6 contains the per capita redistribution caused by Indigenous influences as well as the proportion of Indigenous people in each State's population.

Table 3-6 Indigenous influences — redistribution and Indigenous population, 2008 Update

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust (a)
Redistribution, \$pc	- 56.95	- 162.06	68.93	118.16	- 76.07	12.30	- 115.82	3 965.59	66.40
Indigenous pop, % (2001 Census)	2.13	0.60	3.57	3.60	1.74	3.77	1.26	29.87	2.44
Indigenous pop, % (2006 Census)	2.17	0.60	3.58	3.78	1.66	3.45	1.21	31.60	2.50

(a) Redistribution amount shown in 'Aust' column is total amount redistributed among States (sum of all positives or all negatives) divided by Australian population.

Source: Attachments B and F.

- 44 Higher proportions of Indigenous people in populations, especially in remote areas, increase the costs of providing services. Indigenous people have needs that increase their use of many health, welfare and law and order services.
- 45 Indigenous people use public hospitals more than non-Indigenous people. For example, separations per 1 000 population of Indigenous persons in 2005-06 were almost three times the separation rate for other persons. They also tend to have more secondary conditions that lead to longer stays in hospital. Indigenous children cost more to educate because English is often not their first language. Indigenous children under the age of 17 are more likely to need welfare services while services to remote communities (which have higher proportions of Indigenous people) are more expensive. Maintenance on public housing provided to Indigenous people is also more expensive than for non-Indigenous people. In 2005-06, the direct cost including administration and maintenance per State owned and managed Indigenous housing dwelling (excluding capital costs and payroll tax) was \$6 354, or 24 per cent higher than the equivalent cost per State public housing dwelling of \$5 145³.
- 46 The Northern Territory faced particularly high use rates and costs in providing services due to its large Indigenous population. Queensland, Western Australia and Tasmania also faced higher costs in providing services because of their above average proportions of Indigenous people.

³ Source: Housing Assistance Act 1996: *Annual Report 2005-06* and Commonwealth State Housing Agreement *National Data Reports: State Owned and Managed Indigenous Housing, 2005-06*.

Other socio-demographic composition influences

- 47 There are socio-demographic composition influences, in addition to Indigeneity, that impact on the cost of providing services. Different services are provided to people of different ages, sex and income levels, while people from different economic, cultural and linguistic backgrounds can be more costly to service. There are also some cases where States' costs are increased because they provide services to residents of other States.
- 48 Table 3-7 contains the per capita redistribution attributable to these socio-demographic composition influences as well as some general indicators that illustrate the interstate differences in socio-demographic composition.
- 49 Differences in socio-demographic composition have the largest effect on education and health services. States bear a significant proportion of the costs of running government primary and secondary schools. The greater the proportions of school age children, the more school services cost. Also, the larger the proportion of students attending government schools, the more school services will cost because State governments contribute much more per student to government schools. Very young people and older people use health services (particularly hospitals) more than other people and the services they use often cost more.

Table 3-7 Other socio-demographic composition influences — redistribution and general indicators, 2008 Update

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust (a)
Redistribution, \$pc	- 15.55	- 75.91	59.95	- 11.02	78.78	299.59	- 309.27	498.00	29.99
Proportion of students at government schools, %	67.39	65.45	69.35	67.31	66.21	73.91	60.05	78.58	67.37
65 years and over pop, % (2001 Census)	13.13	13.07	11.71	11.07	14.66	13.84	8.53	3.78	12.62
65 years and over pop, % (2006 Census)	14.01	13.85	12.55	12.21	15.62	15.17	9.82	4.71	13.49
Low income pop, % (2001 Census)	30.45	30.04	33.70	31.45	35.03	39.33	20.07	29.61	31.45
Low income pop, % (2006 Census)	28.87	28.17	27.57	25.92	31.23	33.82	16.62	27.38	28.23

(a) Redistribution amount shown in 'Aust' column is total amount redistributed among States (sum of all positives or all negatives) divided by Australian population.

Source: Attachments B and F.

- 50 Queensland, Western Australia, Tasmania and the Northern Territory had above average proportions of children of school age, and thus a greater per capita requirement for schools. These four States also had high proportions of children in government primary and secondary schools, which are more expensive for States to fund than non-government schools.
- 51 South Australia and Tasmania had the highest proportions of people aged 65 years or over. On average, people in this age group use and cost more in terms of health care. South Australia and

Tasmania had greater than average proportions of people with low incomes who also tend to use some services more than average, including health and housing.

Scale of service provision

- 52 Scale of service provision covers disabilities that States face because of diseconomies of scale in administration and in the provision of services from many small centres.
- 53 The costs of providing these base structures were inevitably greater in per capita terms for the less populous States. Accordingly, Western Australia, South Australia, Tasmania, the ACT and the Northern Territory faced greater costs per capita than the other three States.
- 54 Table 3-8 contains the per capita redistribution attributable to scale of service provision as well as information on the population of each State.

Table 3-8 Scale of service provision — redistribution and percentage of population in each State, 2008 Update

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust (a)
Redistribution, \$pc	- 61.22	- 48.60	- 27.94	28.57	59.53	354.62	489.84	1 383.00	37.67
Percentage of Australian population (b)	32.75	24.78	19.95	10.03	7.52	2.34	1.61	1.02	100.00

(a) Redistribution amount shown in 'Aust' column is the total amount redistributed among States (sum of all positives or all negatives) divided by Australian population.

(b) Population as at December 2007 and is from 2007-08 *Mid Year Economic and Fiscal Outlook*.

Source: Attachments B and F.

- 55 Administrative scale factors were assessed to recognise the per capita differences in the costs of operating the minimum administrative structures⁴ required to provide State services.
- 56 The other aspect of scale recognised by the Commission is service delivery scale, which recognises the per capita differences in the costs of providing small service outlets in sparsely populated areas. The costs of providing such outlets varied from service to service. However, the costs were generally greater in per capita terms for States which had a larger proportion of their populations living outside the capital city. Queensland, Western Australia, South Australia and the Northern Territory had the highest proportion in remote areas and Tasmania had the highest proportion outside the capital city. These States faced higher costs per capita than New South Wales, Victoria and the ACT.

Population dispersion

- 57 Providing many services to geographically dispersed populations has been found to be more costly than providing services in compact, closely settled areas. This is because the costs of travel, freight, communications, and encouraging service providers to live in these regions generally increase with distance from major population centres or with remoteness.

⁴ The minimum structures comprised that part of head offices of State departments which provided the fixed component of corporate services, policy and planning functions and some whole of State services (such as those provided by Treasuries and museums).

58 Table 3-9 contains the per capita redistribution due to population dispersion as well as some general indicators of the level of population dispersion in each State.

Table 3-9 Population dispersion — redistribution and general indicators, 2008 Update

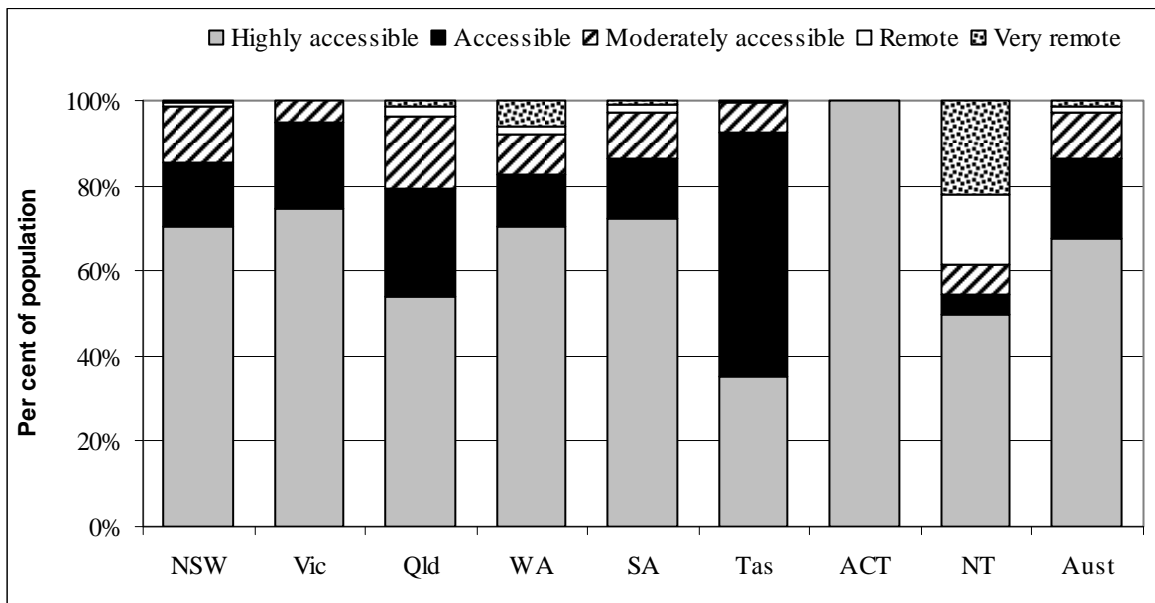
	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust (a)
Redistribution, \$pc	- 44.27	- 72.18	38.07	102.53	- 9.73	- 90.68	- 114.22	1 898.25	37.15
State area, '000 sq km	800.64	227.42	1 730.65	2 529.88	983.48	68.40	2.43	1 349.13	7 692.02
Population density 2007 estimate, persons per sq km	8.56	22.72	2.39	0.82	1.60	7.19	138.50	0.16	2.71
Proportion in highly accessible areas, % 2001 Census	70.72	74.30	54.59	71.60	72.83	35.32	99.80	49.40	68.22
Proportion in highly accessible areas, % 2006 Census	70.62	74.48	54.19	70.37	72.47	35.28	99.82	49.67	67.79

(a) Redistribution amount shown in 'Aust' column is total amount redistributed among States (sum of all positives or all negatives) divided by Australian population.

Source: Attachments B and F.

59 Figure 3-6 illustrates the differences in population dispersion for each State.

Figure 3-6 Population by accessibility, 2006 Census



Source: Attachment B.

60 States with larger proportions of their population in remote or very remote areas were assessed as having higher expenses. Schools and police services, in particular, need to be provided where people live and are therefore more costly to provide when the population is spread out over a large area. Additionally, services to Indigenous communities are more expensive because those communities are generally dispersed and are often in remote areas.

61 Queensland, Western Australia, and the Northern Territory are physically the three largest States. Along with South Australia, they had the lowest population densities. Additionally, Queensland, Western Australia, and the Northern Territory had an above average proportion of their population in remote or very remote regions.

Wages

62 The relative level of wages in a State has two opposing effects on fiscal capacity. States with high total amounts of wages paid are able to raise more revenue through payroll taxes. As employers, however, States with high wage rates for comparable employees face higher costs in delivering services (measured through the Commission’s assessment of wages input costs).

63 Table 3-10 shows the redistributive effect of wages on the revenue raising capacity and service costs and the net impact. If considered individually, the payroll tax effect would rank as the third largest on both the revenue side and the service delivery side. However, because the effects of wages on the revenue and cost sides of a State’s fiscal capacity are usually opposite in direction, their net effect is much smaller.

64 The indicators in Table 3-10 only tell part of the story and do not reflect, with the exception of the 'relative wages for comparable employees' indicator, differences in skill levels and employment demographics between the States.

Table 3-10 Wages and payroll tax — redistribution and general indicators^(a), 2008 Update

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust (b)
Redistribution									
Payroll tax, \$pc	-89.16	-36.83	105.40	-9.53	114.34	235.68	150.29	168.17	39.28
Wages Input costs, \$pc	116.27	-12.72	-111.45	-60.69	-88.72	-153.58	95.59	207.83	41.74
Total redistribution, \$pc	27.11	-49.55	-6.05	-70.22	25.62	82.10	245.88	376.00	20.53
Net compensation of employees, \$pc									
Private sector wages, \$pc	14 584	14 133	12 030	13 441	11 322	8 958	11 005	10 728	13 383
Average weekly earnings, \$	832.22	792.40	743.20	791.58	706.62	696.36	938.74	786.24	790.24
Relative wages for comparable employees (c)	1.035	0.995	0.967	0.983	0.973	0.959	1.026	1.029	1.000
Proportions of businesses with over 200 employees, %	0.72	0.73	0.69	0.71	0.63	0.60	0.44	0.45	0.70

(a) All indicators are averages of 2002-03 to 2006-07 except for proportion of businesses with over 200 employees which is 2004 data.
 (b) Redistribution amount shown in 'Aust' column is total amount redistributed among States (sum of all positives or all negatives) divided by Australian population.
 (c) Ratio of wages and salaries in each State relative to the Australian average for 2005-06, based on econometric analysis of the ABS’s 2006 Survey of Education and Training confidentialised unit record file data. See 2008 Update working papers for details.

Source: Attachments B and F, and ABS catalogue 8165.0, *Counts of Australian Businesses, including Entries and Exits June 2003 to June 2006*.

- 65 The tax on payrolls is dependent on both the size and level of compensation paid to employees of each employer. All States exempt small businesses from payroll tax so States with a higher proportion of small businesses would have a lower capacity to raise payroll tax. Conversely, States with higher numbers of medium and large businesses are able to raise more payroll tax.
- 66 New South Wales and Victoria had above average abilities to raise revenue from payroll tax. These two States and the ACT had average or above average compensation of employees per capita. However, employees in the ACT (and the Northern Territory) were more likely to be employed in the general government sector, which was not part of the revenue base. New South Wales and Victoria also had an above average proportion of large businesses resulting in a larger tax base.
- 67 While compensation of employees per capita has grown at above average rates in both Queensland and Tasmania in the last few years, it still remains below the Australian average. Both States also had a higher proportion of small businesses that were exempt from payroll tax under the provisions of all States. The situation was similar in South Australia, except that compensation of employees has been growing at below average rates.
- 68 On the other side of the equation, higher estimated wage rates for comparable employees⁵ contributed to higher costs of providing services in New South Wales, the ACT and the Northern Territory. These higher wage rates were due to influences outside the control of governments. The cost of living was high in all three States, particularly the respective capital cities, as reflected in high housing costs (New South Wales and the ACT) or the costs of isolation⁶. On the basis of the Commission's calculations, the wages cost disability in New South Wales negated its payroll revenue advantages and resulted in a redistribution to that State. The reverse occurred in Queensland — its assessed wage cost advantages almost exactly offset its lower payroll tax capacity. Victoria had an above average payroll tax capacity (partly because of the concentration of large businesses) and a wage costs advantage, resulting in a redistribution of the GST and HCG pool away from that State. There was also a redistribution away from Western Australia. In this case, the increase in its share of the pool attributable to its below average payroll tax capacity was smaller than the reduction in pool share arising from its wage costs advantages in service delivery. In South Australia and Tasmania, payroll tax disadvantage was larger than their cost advantages from lower wages for State government employees, leaving them with net positive redistributions of GST and HCG pool.
- 69 High wages costs in the ACT and Northern Territory plus their lower revenue capacity from payroll tax bases led to a large per capita redistribution of the GST and HCG pool to the two Territories.

⁵ See Volume 4 of the working papers for how wages for comparable employees were measured.

⁶ To attract employees to the remote capital, many employers offer attractive salary packages. Some of the extra benefits include: more holidays, paid airfares to other capital cities for the employee or their family and subsidised accommodation. These extra benefits made it more expensive to employ people in the Northern Territory.

Wages input costs

It has been claimed that the Commission's assessments should include a properly costed allowance for differences in wages used to deliver State services.

The assessments do include this, and have done so since 1993.

For the current update, wages input costs were assessed to move some \$883m between the States. The States with the largest impacts on their redistributions were New South Wales (+\$805m) and Queensland (-\$470m). Reflecting changes in relative wages over time, the allowance for New South Wales and the Northern Territory has declined in recent years while those for other States have been stable or increased.

These allowances are very significant. For example in the case of New South Wales, this allowance more than offsets the impact on the State's GST and HCG pool share of its above average ability to raise payroll tax.

Estimation of these differential costs for wages is done by comparing private sector wages for individuals with similar skills and in similar industries across the States. Performing the measurement in this way removes the effect of State government wage policy which has an impact on the actual wages paid to State public servants.

FISCAL CAPACITY, SERVICE DELIVERY EFFICIENCY AND ACTUAL SERVICES

- 70 Current measures of fiscal capacity are based on the average efficiency of service delivery across the States. Divergences from that, for individual States, are not reflected in their individual capacities, or in the consequent distribution of the GST and HCG pool.
- 71 Changes in the service delivery efficiency of individual States can influence assessed fiscal capacities over time if those changes affect the average of what States spend, the only indicator of service delivery consistently available across States and expense categories. If changing efficiencies are not accompanied by changing expenses, those efficiency gains have no impact on assessed capacities or States' revenue from the GST and HCG pool.
- 72 When a State makes an efficiency improvement, it initially enjoys the full financial or service quality/quantum benefit. If the State takes some of that efficiency in lower expenses, it will lower the average expenses of all States and so affect assessed fiscal capacities. In some cases, the impact on the distribution of the GST and HCG pool will see a part (usually a very small part) of the financial benefit offset. In others, it will reinforce the financial benefit. In no case will the GST and HCG redistribution leave a State worse off. The upshot is that States always have an incentive to improve efficiency with or without equalisation. The box below explains the efficiency effect in more detail.

Service delivery efficiency and equalisation

It is sometimes asserted that the Commission's equalisation practices run counter to efficiency in government — or even that they penalise it. This is wrong.

The States' relative needs are derived from average expenses and revenues, adjusted to take account of influences beyond their control. Differences in efficiency play no part in the calculation of GST and HCG shares. Since average expenses incorporate the average of States' practices, States are equalised to the levels of efficiency incorporated in those average practices. States that are more efficient than the average can use the proceeds of that efficiency as they see fit, while those that are less efficient than the average must compensate for the difference with lower quality services, higher taxes or increased borrowing.

This can be illustrated by a simple example. Suppose Victoria was able to improve the efficiency of its hospitals to such an extent that it reduced its actual expenses by 10 per cent. Its cost of providing inpatient services in 2006-07 was \$5.334 billion, so its improved efficiency would have generated budget savings of \$533 million.

What impact would a \$533 million reduction have on Victoria's assessed share of GST and HCG pool?

A reduction in inpatient services average expenses of \$533 million in 2006-07 would produce a total redistribution of \$1.9 million for all States (including a \$1.3 million increase to Victoria's share). This effect on the distribution of the GST and HCG pool is immaterial and would have no practical effect on the incentives of any State to apply efficient service delivery processes.