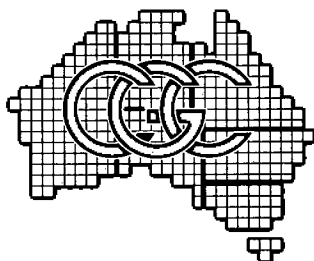




COMMONWEALTH GRANTS COMMISSION

Report on
General Revenue Grant Relativities 1999

Volume I
Main Report



COMMONWEALTH GRANTS COMMISSION

REPORT ON GENERAL REVENUE GRANT RELATIVITIES 1999

VOLUME I MAIN REPORT

CANBERRA

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Volume II Methods, Assessments and Analysis
Volume III Appendixes and Consultants' Reports

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Working Papers

This report is supplemented by the following working papers, copies of which are being made available to major parties to the inquiry. Others are being deposited in the National Library of Australia and State and Territory reference libraries. The names below may change when published.

Volume 1 Relativities and Analysis, and the Standard Budget (ISBN 0642 388814)
Volume 2 Revenue Assessments (ISBN 0642 388873)
Volume 3 Expenditure Assessments: Calculation of Major Factors (ISBN 0642 388865)
Volume 4 Expenditure Assessments: Category Assessments –
 Social and Community Services (ISBN 0642 388849)
Volume 5 Expenditure Assessments: Category Assessments –
 Administrative and Economic Services, and User Charges (ISBN 0642 388741)

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Commonwealth Grants Commission

Chairman C. Richard Rye

The Hon. John Fahey MP
Minister for Finance and Administration
Parliament House
CANBERRA ACT 2600

Dear Minister

As members of the Commonwealth Grants Commission appointed under the *Commonwealth Grants Commission Act 1973*, we respond in this report to terms of reference received in a letter dated 25 January 1995 from Frank Walker, QC MP, the then Minister for Administrative Services, and from you in letters dated 20 January and 21 December 1998.

Yours sincerely

C R Rye, AM, Chairman

R D Barnes, Member

K W Wiltshire, AO, Member

A G Morris, Member

R J Searle, Secretary
25 February 1999

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TERMS OF REFERENCE

The terms of reference for this inquiry were given to the Commission in three parts. Part 1 was provided by the then Minister for Administrative Services in January 1995. Parts 2 and 3 were provided in January and December 1998 by the Minister for Finance and Administration.¹ Consolidated, they are as follows:

1. Pursuant to sections 16, 16A and 16AA of the Commonwealth Grants Commission Act 1973, I hereby refer to the Commission for inquiry into and report upon, by 28 February 1999 at the latest, the question of the per capita relativities which the Commission would regard as appropriate to apply after 1998-99 for the distribution of the combined pool of general revenue grants and health care grants among the States.

The word State(s) in this terms of reference is to be taken as also covering the Northern Territory and the Australian Capital Territory.

2. The Commission's assessment should:

- (a) be based on the application of the principle that the respective general revenue grants and hospital funding grants to which the States are entitled should enable each State to provide the average standard of State-type public services assuming it does so at an average level of operational efficiency and makes the average effort to raise revenue from its own sources;
- (b) take account of:
 - (i) differences in the capacities of the States to raise revenues; and
 - (ii) differences in the amounts required to be spent by the States in providing an average standard of government services.

3. The Commission should prepare two assessments of relative fiscal needs based on:

- (a) a three year review period using the latest available figures for the years 1995-96 to 1997-98 inclusive; and

¹ The full text of the Ministers' letters is at the front of Volume II

- (b) a five year review period, using the latest available figures for the years 1993-94 to 1997-98 inclusive.

The Commission should report on which method is more consistent with the principles of fiscal equalisation.

4. The Commission's assessments should also be based on:

- (a) the latest available figures for the years of the review period, indicating what allowance, if any, should be made to take account of any factors judged to be of a temporary nature; and
- (b) the presumption that those expenditure and revenue functions which have been or which are to be transferred from the Commonwealth to the States and the Territories, or vice-versa, with effect from any time between the beginning of the review period and 30 June 1999, had been transferred prior to 1 July 1993.

5. The Commission should review whether the allowances for special circumstances granted to the ACT continue to be necessary and, if so, make appropriate assessments.

6. As part of the review, the Commission should immediately commence a program of research on particular methods of assessment. The Commission should consult the Commonwealth and States in deciding the priorities for the research program. Findings from this research are to be presented progressively and discussed with the parties. Where appropriate, any outcomes may be introduced into the review assessments in 1999. In particular, the Commission should give high priority to examining the use of Government Financial Statistics (GFS) data in its assessments.

7. The Commission should prepare its assessments on a basis consistent with the Commonwealth's intention that the following components of an Australian Health Care Agreement between the Commonwealth and a State should not affect the distribution of general revenue grants and health care grants:

- (a) payments in relation to mental health;
- (b) payments in relation to the National Health Development Fund; and
- (c) all payments under an adjustments module, including those related to the Critical and Urgent Treatment (CUT) Waiting List Initiative.

8. The Commission should also prepare its assessments on a basis consistent with the Commonwealth's intention that the following payments should not affect the distribution of general revenue grants and health care grants:

- (a) payments to South Australia as part of the Commonwealth's financial assistance package, including compensation for State revenue forgone as a result of the sale of the State Bank of South Australia;

- (b) the National Competition Payments to all States which commenced in July 1997;
- (c) the payment to Western Australia in 1995-96 of compensation for revenue forgone as a result of the sale of Bank West;
- (d) payments to the States to reimburse them for revenue lost as a result of the establishment of a national scheme of companies, securities and futures regulation; and
- (e) payments to the States which are funded from the Natural Heritage Trust of Australia and the Regional Telecommunications Infrastructure Fund.

9. The Commission should prepare its assessments so that the State and Territory contributions to the Commonwealth's deficit reduction strategy as agreed at the 1996 and 1997 Premiers' Conferences, and the varying methods of payment nominated by individual States and Territories, do not affect the distribution of general revenue assistance and health care grants.

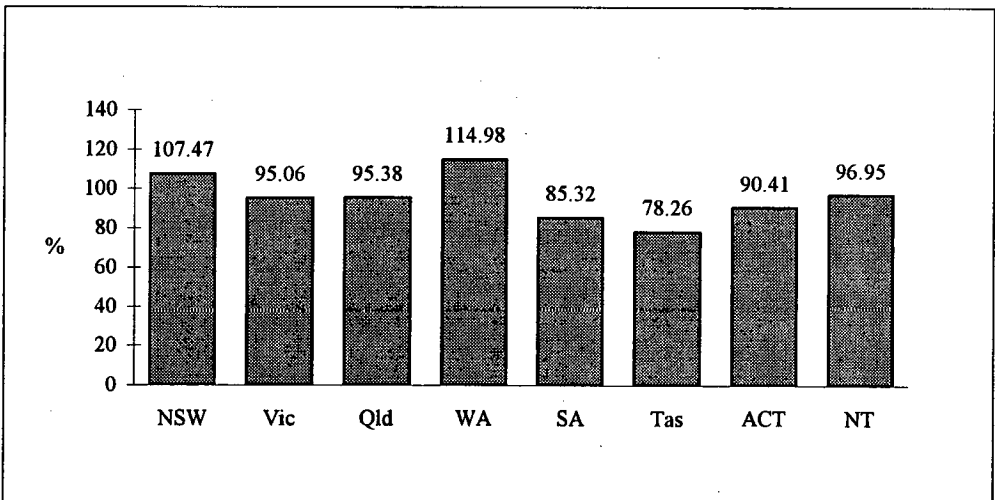
EXECUTIVE SUMMARY

1. The work of the Commonwealth Grants Commission is based on the principle of fiscal equalisation. As applied in Australia, it is that:

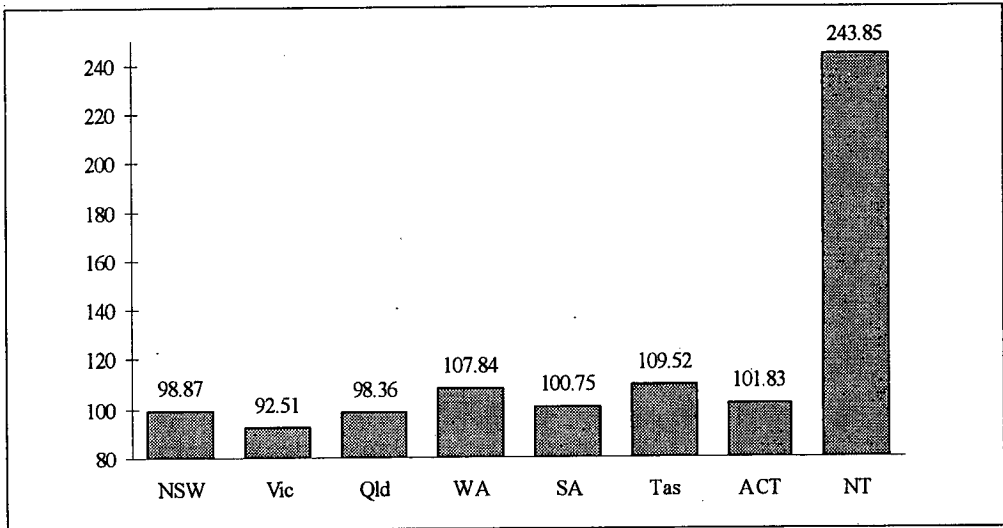
State governments should receive funding from the Commonwealth such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.

2. The application of this principle results in the untied funding from the Commonwealth to the States¹ being distributed unevenly, in per capita terms, because States have different per capita capacities to raise revenue and different per capita expenditure requirements if they are to provide the same level of services. These differences are illustrated in Figure 1 and Figure 2.

Figure 1 STATES' RELATIVE REVENUE RAISING CAPACITIES, 1997-98



¹ In this report, the word State(s) includes the Australian Capital Territory and the Northern Territory unless the context indicates otherwise.

Figure 2 STATES' RELATIVE COSTS OF PROVIDING SERVICES, 1997-98

3. The different financial requirements, expressed as different per capita relativities for each State, are used with population data to share the untied funding. This report provides per capita relativities that could be used for the distribution of untied funding in 1999-2000.

4. Before proceeding with a discussion of the work undertaken during the review, and the findings, we discuss the principle of fiscal equalisation. We note that equalisation is central to the Australian federation because it gives all States the capacity to provide the same level of services while maintaining their flexibility to vary the service levels and standards so as to best meet the needs of their citizens.

THE MAIN FINDINGS

5. The main requirement of the terms of reference was to provide two sets of per capita relativities that could be applied to the distribution of general revenue and health care grants in 1999-2000. Both sets were to enable all States to provide the Australian average standard of State-type services, assuming that they operated at an average level of efficiency and made an average effort to raise revenue from their own sources. One set of relativities was to be based on the latest available data for a five-year period, 1993-94 to 1997-98; and the other on a three-year period, 1995-96 to 1997-98.

Relativities Based on Five-year Period

6. Table 1 provides the relativities based on the five-year period.

Table 1 GENERAL REVENUE AND HEALTH CARE GRANT RELATIVITIES
FIVE-YEAR BASIS

New South Wales	0.90032
Victoria	0.86273
Queensland	1.00775
Western Australia	0.94035
South Australia	1.20764
Tasmania	1.61001
Australian Capital Territory	1.10358
Northern Territory	4.84095
Australia	1.00000

7. Using the 1998-99 pool of grants, Table 2 shows the approximate² effect of the five-year relativities on States' grant shares, and compares them with the distribution decided upon at the Premiers' Conference in April 1998 and implemented in the 1998-99 Budget. The relativities agreed to at the 1998 Premiers' Conference were the equalisation relativities put forward by the Commission in its *Report on General Revenue Grant Relativities 1998 Update*, and were based on a five-year assessment period.

Table 2 DISTRIBUTIONS OF GENERAL REVENUE AND HEALTH CARE
GRANTS — FIVE-YEAR BASIS

	1999 Review Distribution	1998 Premiers' Conference Distribution	Difference from 1998 Premiers' Conference Distribution		
	\$m	\$m	\$m	\$pc	%
New South Wales	6718.0	6546.4	171.6	26.93	2.62
Victoria	4719.1	4814.1	-95.0	-20.34	-1.97
Queensland	4118.0	4174.1	-56.1	-16.08	-1.34
Western Australia	2026.5	2116.6	-90.1	-48.96	-4.26
South Australia	2107.0	2131.2	-24.2	-16.22	-1.13
Tasmania	887.7	854.7	32.9	69.95	3.85
Australian Capital Territory	400.8	345.4	55.4	178.59	16.03
Northern Territory	1096.9	1091.5	5.4	28.16	0.50
Total	22074.0	22074.0	265.3	14.09	1.20

(a) Total redistribution between the States.

² Because of rounding and the level of detail in the analysis undertaken in this report, the numbers in tables do not always add to totals.

8. The differences between the 1998 Premiers' Conference distribution and the review distribution are generally small, the total redistribution being just over one per cent of the grants pool. Large changes to the assessments have been made but, in general, many of them cancel out and, in particular, for most States the effects of the changes in data and methods work in the opposite direction from those of updating the years of assessment.

Relativities Based on Three-year Period

9. Table 3 provides the relativities based on a three-year period. Table 4 shows the implications of those relativities.

Table 3 GENERAL REVENUE AND HEALTH CARE GRANT RELATIVITIES
THREE-YEAR BASIS

New South Wales	0.89180
Victoria	0.86704
Queensland	1.00696
Western Australia	0.91503
South Australia	1.23517
Tasmania	1.62399
Australian Capital Territory	1.18581
Northern Territory	4.86197
Australia	1.00000

Table 4 DISTRIBUTIONS OF GENERAL REVENUE AND HEALTH CARE
GRANTS — THREE-YEAR BASIS

	1999 Review Distribution	1998 Premiers' Conference	Difference from 1998 Premiers' Conference Distribution		
	\$m	\$m	\$m	\$pc	%
New South Wales	6656.7	6546.4	110.3	17.30	1.68
Victoria	4744.3	4814.1	-69.8	-14.95	-1.45
Queensland	4116.1	4174.1	-58.0	-16.61	-1.39
Western Australia	1972.6	2116.6	-144.0	-78.26	-6.80
South Australia	2155.8	2131.2	24.6	16.51	1.15
Tasmania	895.7	854.7	40.9	86.96	4.79
Australian Capital Territory	430.8	345.4	85.4	275.36	24.72
Northern Territory	1102.1	1091.5	10.6	54.70	0.97
Total	22074.0	22074.0	271.8 ^(a)	14.43	1.23

(a) Total redistribution between the States.

Five or Three-year Relativities

10. Relativities have been based on five years of assessment since 1991. As well as providing results on the five-year and three-year bases, we were asked to comment on which set of relativities is more consistent with the principle of fiscal equalisation.

11. Adoption of either set of relativities would achieve fiscal equalisation in 1999-2000 and neither can be preferred on that basis. However, if equalisation is sought in the longer run as well as for individual years, it is important that changes to the length of the assessment period be made as infrequently as possible so that each year of assessment has equal weight over time.

12. Thus the advantages, if any, of changing back to a three-year assessment period need to be weighed against the detriment to long term equalisation of changing the period.

Special Circumstances of the Australian Capital Territory

13. The terms of reference also asked us to review the need for allowances for any special circumstances of the ACT, and to make appropriate assessments if necessary. We have concluded that, irrespective of which assessment period is used, the ACT continues to have a legitimate claim for some special allowances because of:

- (i) its status as the national capital and the impact of this on the recurrent expenditure requirements of the Territory Government;
- (ii) transitional allowances in the Police area, because the Territory Government still does not have full policy control over the level of resources devoted to State-type police services in the ACT; and
- (iii) special fiscal needs in the areas of family law expenditure and corporate affairs compensation that arise because of the differences between Commonwealth-ACT financial arrangements and Commonwealth-State financial arrangements generally.

14. The allowances resulting from the ACT's status as the national capital have been included in the assessments of disabilities and influence the per capita relativities as they have in the past.

15. The ACT's special fiscal needs and requirements for transitional funding are discussed in Chapter 7 of Volume II. In summary, we have recommended that the ACT receive \$13.2 million funding in 1999-2000 in addition to that received from the pool.

CHANGES IN THE PUBLIC SECTOR

16. ***Micro-economic Reform and the National Competition Policy.*** There have been some big changes in public sector practices since the last review in 1993, and these have required corresponding changes in the methods used to calculate relativities. From the Commission's perspective, the most important public sector changes have resulted from micro-economic reform (MER), which has affected both the scope and methods of government operations.

17. The National Competition Policy (NCP) arising out of MER has provided States with an agreed schedule of reform for their public sectors. State Governments have agreed to place all their public trading enterprises (PTEs) on an equal competitive footing with the private sector and one another. Governments have also changed the method of providing users of PTE services with assistance towards the cost of those services, and the arrangements and conditions under which the PTEs contribute to the States' budgets.

18. Among the changes in the assessments required by these developments is the introduction of a group of expenditure categories for the States' payments of community service obligations and concessions towards the cost of using PTE services. Another is a change in the approach to the assessments of the States' capacities to raise revenue from contributions by PTEs. With the exception of urban transit services, the detailed analysis of PTE accounts that was undertaken for previous assessments is no longer necessary.

19. ***The introduction of depreciation into the assessments.*** In the past, it was generally agreed that fiscal equalisation in Australia was incomplete because it was not applied to States' full operating costs. The States were left with different capacities to provide services so long as their full operating effects of capital were not being equalised. Micro-economic reform is enabling this inadequacy to be overcome because it requires consideration of the full cost of government services and is leading to the introduction of accrual accounting in the Australian public sector. This is resulting in depreciation expenditure being shown in the States' accounts. At the same time, the distinction between recurrent and capital has become increasingly blurred as State accounts have been consolidated. The assessments now better reflect the total operating impacts of capital on the budgets of the States.

20. ***The cessation of State Business Franchise Fees.*** The States no longer have access to Business Franchise Fees on tobacco, petroleum and alcohol. In 1996-97, these fees raised 14.3 per cent of State revenue but, following a decision by the High Court in August 1997, all Business Franchise Fees were withdrawn. By agreement with the Commonwealth, the State fees were replaced by increased Commonwealth taxes on these products and the States now receive the equivalent funding as a payment from the Commonwealth.

21. This change resulted in a great deal of discussion during the review, largely because of the detail in the funds replacement arrangements that had been established. We agreed, at the request of the States, to introduce an assessment to ensure that the results of the agreement were upheld.

METHODS OF ASSESSMENT

22. In general, our approach to the assessment of the relativities has been the same as that used for the last six years. The general method used to assess States' revenue capacities has changed very little, as has the method of integrating the States' receipts of specific purpose payments into the measurement of their needs for general revenue funding.

23. In the past, the States have been critical of expenditure assessments because the different functions and causes of expenditure in a category have not always been separately identified in the assessment process. We have overcome this by introducing an assessment framework under which the components of each expenditure category are assessed separately where different disabilities (influences beyond States' control) are applicable. The component assessments are added to get a result for the category as a whole. While this change has added an apparent complexity to the assessments, we believe it was necessary to enhance equity and transparency.

24. In the measurement of disability factors, there have been many changes. Most of these have resulted from the availability of additional data, the detailed 1996 Population Census results being the most important. In particular, the more comprehensive information on the Aboriginal and Torres Strait Islander population has led the Commission to differentiate within the indigenous population to reflect the different requirements for State-type services of people from different socio-economic and regional backgrounds.

THE FUTURE

25. The large expected change in public sector arrangements relevant to equalisation in the future is the proposed introduction of new taxation arrangements, including a goods and services tax from 1 July 2000 and the abolition of a number of State taxes either on that date or thereafter. The report ends with a brief discussion of what is required to keep the relativities up-to-date with the tax changes, and a proposal for updates in both 2000-01 and 2001-02, and a further review in February 2004. So that the assessments in future updates may remain as relevant as possible, we have concluded that more flexibility is needed in allowing for changed circumstances.

ACKNOWLEDGEMENTS

1. We wish to acknowledge the ready co-operation extended to the Commission and its staff, throughout the review, by Commonwealth, State and Territory governments and their officials across a range of departments and agencies. We are grateful particularly for the efforts of the Commonwealth and State Treasuries in organising submissions to the inquiry, participating in conferences, responding to our many requests for information and in helping us reach the decisions required. The Australian Bureau of Statistics has been most helpful in providing the data needed to complete the necessary calculations.

2. Special thanks are due to the staff of the Commission, without whose professionalism and dedication, often going beyond the normal call of duty, it would not have been possible to complete the review.

CHAPTER 1

INTRODUCTION

1. In its *Report on General Revenue Grant Relativities 1994 Update*, the Commission suggested that a possible sequence of events leading to the next review would include it being issued with 'a general reference to conduct research leading to the Review of relativities ... with the requirement to produce a series of discussion papers or reports outlining the Commission's provisional findings on major issues'. This suggestion was accepted by Governments after the 1994 Premiers' Conference and, in consultation with the Commonwealth Treasury and the States, a three-year research program was devised. The first volume of Reports on Research in Progress was distributed for discussion in October 1994. Part 1 of the terms of reference for the 1999 Review was received on 25 January 1995.

Requirements of the Reference

2. As the Commission had suggested, Part 1 of the terms of reference was general in nature. It specified that the Commission should:

- (i) base its assessments on the principle of fiscal equalisation;
- (ii) take account of differences both in States' capacities to raise revenue and in the amounts required to be spent to provide the standard level of services;
- (iii) base its assessments on the latest available data for the years 1993-94 to 1997-98;
- (iv) review whether the allowances for special circumstances granted to the ACT continued to be necessary and, if so, what they should be;
- (v) after consulting with the Commonwealth and State Treasuries, commence a program of research on selected topics; and
- (vi) produce the final report on the inquiry before the end of February 1999.

3. In July 1997, the Commonwealth and the States discussed whether the period on which the relativities were to be based should be reduced to three years. It was agreed to

defer this question until the results of the review were known and, to assist in the eventual decision, Part 2 of the terms of reference, provided in January 1998, asked the Commission:

- (i) to produce relativities on both bases, using 1995-96 to 1997-98 as the period for the relativities based on three years; and
- (ii) to report on which method is more consistent with the principle of fiscal equalisation.

In the letter providing details of these requirements, the Minister advised that 'further terms of reference may be sent in light of changes to funding or other arrangements'.

4. Following the signing by the Commonwealth and the States of the Australian Health Care Agreements, it was considered necessary to provide the Commission with terms of reference on how to treat some elements of the Health Care Grants. At the same time, there was discussion between the parties on whether a number of other payments should influence the Commission's results. Part 3 of the terms of reference, received on 21 December 1998, specified that the distribution of general revenue and health care grants should not be affected by:

- (i) certain specific purpose payments (SPPs); and
- (ii) the States' contributions to the Commonwealth's deficit reduction strategy as agreed at the 1996 and 1997 Premiers' Conferences, and the varying methods the States had chosen to fund those contributions.

These instructions have been implemented in our treatment of SPPs. The details are in Attachment B of Volume II.

The Conduct of the Review

5. The review was carried out through:

- (i) release of Commission research reports in 1994, 1995 and 1996;
- (ii) conferences with the Commonwealth Treasury and the States (the parties to the review) to discuss the research in 1994 and 1995; the general progress of the review in 1997; and the preliminary results of the review in mid 1998;
- (iii) a series of submissions in which the States put written views;
- (iv) visits by the Commission to the States for workplace discussions at central offices of State administrations and workplaces in both metropolitan and country areas; and
- (v) establishment of a working party, including State Treasury representatives, to report to the Commission on issues relating to the operating impacts of capital.

The Structure of the Report

6. This report is in three volumes. In this volume:

- Chapter 2 gives an overview of equalisation in Australia;
- Chapter 3 discusses the assessment methods and the changes we have made to them;
- Chapter 4 sets out our findings in response to the terms of reference;
- Chapter 5 provides an analysis of what causes the States' per capita relativities to differ from one another and what has caused the results of this review to differ from those that the Commission reported on in its *Report on General Revenue Grant Relativities 1998 Update*; and
- Chapter 6 looks at issues relevant to the period before the next review, including the future role of the Commission in recommending the per capita relativities that would be applied to revenue raised from the goods and services tax proposed to be introduced on 1 July 2000, and the other implications of the new tax system.

7. Volume II provides greater detail of the methods used to arrive at our findings and why the results differ from previous assessments.

8. Volume III contains:

- the detailed tables not included in Volume II;
- the report of the working party on the operating impacts of capital; and
- the reports of two consultants on matters relating to the final assessments — the value of commercial and industrial land in the States, and the comparability of road length and road use data between the States.

CHAPTER 2

EQUALISATION IN AUSTRALIA

The Principle of Fiscal Equalisation

1. The work of the Commonwealth Grants Commission is aimed at achieving horizontal fiscal equalisation between the States. Horizontal fiscal equalisation is important in almost all of the world's major federations and is found also in many unitary countries. It is achieved most often by formal equalisation schemes. The concept is seen as part of the fabric of nationhood — that better endowed States or regions contribute to the capacity of those whose resource bases are not as abundant or whose needs are greater, for reasons beyond their own control.

2. The founders of the Australian federal system recognised the need for arrangements to assist particular States and made provision in the Constitution for grants from the Commonwealth to achieve that end. The arrangements were formalised in 1933 with the creation of the Commonwealth Grants Commission and, since then, Australia has developed a comprehensive horizontal fiscal equalisation system.

3. The meaning of horizontal fiscal equalisation as applied in Australia has remained much the same since the very early days of the Commission, though its expression has varied from time to time. For this review, we have adopted the following definition.

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

4. The essence of the principle can be captured by considering some key words in this formulation. **States**, in some sense or other, are the units that are being equalised. Since this is fiscal equalisation, it must operate through State budgets, and relate to their revenues and expenditures.

5. An important concept behind the equalisation calculations is the **standard** (national average per capita) expenditures on each function of government and revenues of each kind, derived from State budgets or other financial information. It is these standards, not the actual expenditures or revenues of each individual State, that are the starting point

for the Commission's assessments. That is, the States are equalised to what, on average, they actually do.

6. Because the system is one of **capacity** equalisation, not performance equalisation, there is no requirement that States follow any particular policies on either side of their budgets. For one thing, States have their own role in the federation; for another, equalisation is applied through untied grants whereas, to the extent that national goals are sought through action by the States, this is done by the Commonwealth making specific purpose payments (SPPs) to them on particular conditions.

7. One of the criticisms sometimes made of the equalisation system is that it leaves States with too much freedom. It has been said, for example, that it is perverse that a State which is a net beneficiary of equalisation may, without penalty, follow a low tax policy. Equalisation does in fact leave a State perfectly free to follow such policies — and it will make little or no difference to its grant. But, unless it is able to be more efficient than other States (see below), it will bear the consequences of a low-tax policy and the resulting lower revenues by way of a lower standard of service provision or (for a time) by higher borrowing. Equally, a State which follows a policy of high spending on one function or another will need to finance that policy itself, either by spending less on other functions, or by raising taxes at higher than standard rates, or by borrowing. In short, the States are not compensated for the policies they individually follow.

8. It is fully consistent with this that there is no requirement within the equalisation system for any audit by a Commonwealth body of the use to which States put their general revenue grants. An equalisation audit would imply that the general revenue grants were no longer untied, but were conditional on meeting some set of criteria.

9. An alternative to the standards based on actual expenditures (or revenues) would be performance standards, based on ideas of what States should be spending on particular functions (or raising from particular revenue sources). It might be thought, for example, that the States should be required to spend a set proportion of their general revenue grants on the welfare of indigenous Australians. But it is not clear how equalisation could be directed towards such particular objectives, or whether, if it could be done, it would make much difference to the calculation of the relative needs of the States. It would also seem that monitoring the output of States across the board and keying their financial support to the achievement of broad national objectives (as distinct from the specific objectives aimed at by particular SPPs) would not be consonant with the sovereignty of States under the Constitution. Moreover, one of the main virtues of a federation is in allowing national goals to be pursued while its component units retain the scope to experiment in taxation and service provision — 'Equality in Diversity', as the title of the Commission's history puts it. Forcing the States into a fiscal straitjacket would not be consistent with this.

10. One further concept to consider in the definition of equalisation is **efficiency**. It is sometimes asserted that Australia's equalisation practices run counter to efficiency in government — or even that they penalise it. This is wrong. Because the States' relative needs are derived from national standard expenditures and revenues, adjusted to take account of influences beyond their control (disabilities), differences in efficiency play no

part in the calculation of relative needs. States that are more efficient than others can use the proceeds of that efficiency as they see fit, while those that are less efficient must (like high-spending States) compensate for the difference by a lower standard of service, higher taxes or increased borrowing. But since standards incorporate the average of States' practices, the States are equalised to whatever levels of efficiency are incorporated in those average practices. It is perhaps this latter fact which has given rise to the concerns (unjustified, in our view) about the interaction between equalisation and efficiency.

The Purpose of Equalisation

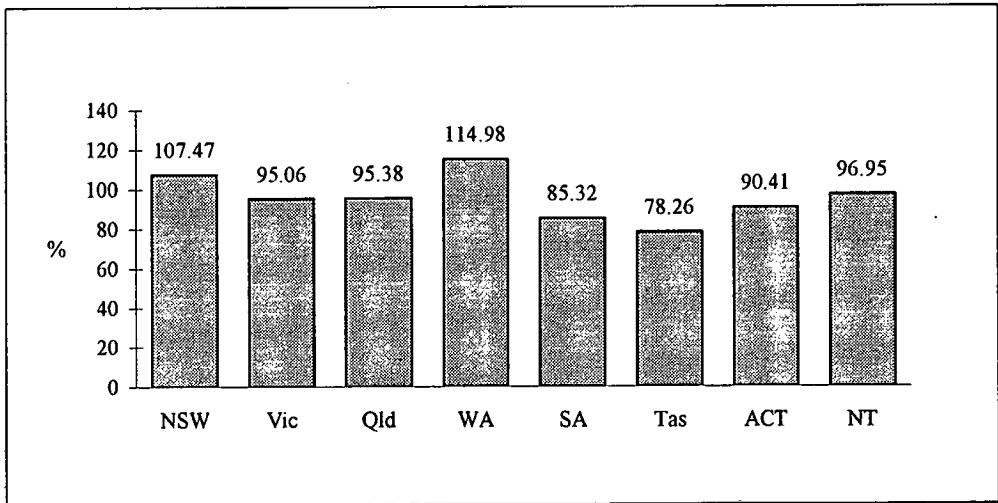
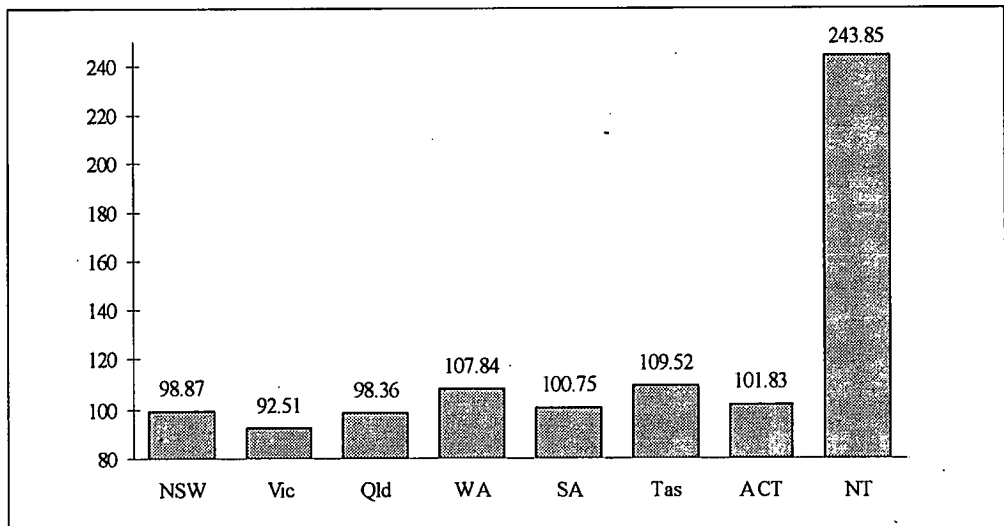
11. At its simplest, equalisation might be thought of as having to do just with State budgets, as aimed at putting all States onto a level fiscal playing field. However, to many, including many experts in public finance or administration, any idea of equity between the States has no real meaning. Equity, it is said, is only relevant to individuals. Indeed, a criticism levelled against the Australian system of horizontal fiscal equalisation is that it does not attempt to achieve interpersonal equity — an idea usually expressed as 'equal treatment of equals'.

12. It would be a full answer to such critics, at least in principle, if it could be justly asserted that equalisation is aimed at ensuring that the people of all States receive equitable treatment. This would imply a wider view of equalisation than considered so far. A big problem in applying such a view would be that, in a federation like Australia where powers are shared between different levels of government, there are strict limits to how far a purely horizontal equalisation system can contribute to the objective of interpersonal equity. It is the Commonwealth, rather than the States, which controls the more relevant influences, notably the personal income tax and the social security systems.

13. Nevertheless, it would be wrong to suppose that Australia's horizontal equalisation system makes no contribution to interpersonal equity. Perhaps this is best seen in the negative sense. It is hard to see how equity could be achieved if people in one State could receive the same standard of State services as those in another State only if they paid higher State taxes and charges. While indicators of State economies, such as average household income, are relatively homogeneous in Australia (notably more so, for example, than in the United States or Canada), there are still important differences between State governments in both their capacities to raise revenue and the costs they face in providing services. It is these differences — nothing more, and nothing less — which the equalisation system seeks to overcome.

14. Figure 2-1 shows the relative revenue raising capacities of the States in 1997-98. Western Australia heads the list, at 14.98 per cent above the national average, while the other States with above average capacities are New South Wales and the Northern Territory. By contrast, Tasmania (particularly) and South Australia have revenue raising capacities well below average.

15. On the other side of the budget, the States' relative costs of providing standard services — shown in Figure 2-2 — are not, with one exception, so diverse.

Figure 2-1 STATES' RELATIVE REVENUE RAISING CAPACITIES, 1997-98**Figure 2-2** STATES' RELATIVE COSTS OF PROVIDING SERVICES, 1997-98

16. Leaving the Northern Territory aside, the range from lowest cost of service provision (Victoria) to highest (Tasmania) is about half that on the revenue side, though it still amounts to about 17 percentage points. The costs of providing government services in the Northern Territory, with its population of less than 200 000 scattered over 1.3 million

square kilometres, are of course very high — nearly two and a half times the national average. The Territory could not survive, in any recognisable form, and one or two other States would be in deep financial crisis, if Australia's fiscal equalisation system did not extend (as those of many other countries do not) to the equalisation of State expenditures as well as revenues.

17. The differences summarised above mean that, without differential grants, the States' capacities to provide services would vary greatly from one another. Equalisation implies that the people of the various States are entitled to comparable levels of service if they make comparable efforts to finance them. Horizontal fiscal equalisation thus serves an important equity objective. It also says something about the value that Australians place on nationhood; it has been described as 'the glue that holds the federation together'.

18. It should be stressed that the equalisation system has nothing to do with resolving Australia's very large vertical fiscal imbalance, which arises because the Commonwealth collects most of the public revenues, while the States continue to carry very large expenditure responsibilities. In consequence, the States rely heavily for their financial viability (in aggregate, to the extent of over 40 per cent of their total budget revenue) on grants from the Commonwealth, in their various forms. (This proportion will rise to over 55 per cent if, as planned, the introduction of a goods and services tax is accompanied by the abolition of some State taxes.) The Commission makes an input only to the distribution of untied Commonwealth grants to the States, not to their quantum. That is an issue to be resolved at the annual Premiers' Conferences.

19. However, equalisation does need to be seen in the context of the vertical fiscal imbalance. Given the present distribution of taxation powers, the States naturally tend to see the large transfers (or most of them) as a right, representing their due share of national resources. For the same reason (among others), one of their chief complaints in the ongoing debate with the Commonwealth over federal financial arrangements is about the high proportion of such transfers, usually about half since the early 1970s, they receive as SPPs. While, from the Commonwealth's perspective, these are seen as contributing to national objectives, the States do not necessarily give such objectives the same priority and, in general, would prefer greater freedom to express their own priorities. A higher proportion of general revenue grants would allow this.

Some Limits to Equalisation

20. In practice, there are considerable limits — inherent or imposed — on the extent to which equalisation is actually applied in Australia. This part of the chapter looks at some of them.

21. *The scope of equalisation.* One constraint upon equalisation is that it has until now been confined to recurrent transactions (even though there were links with capital in the assessment of the differential needs of the States to meet debt charges). This restriction, reflected in previous terms of reference for Commission inquiries, was mainly because the distribution of capital raising between the States was regarded as the responsibility of the Loan Council, and the distribution of capital SPPs was a matter for the relevant portfolios. Over the years, however, the role of the Loan Council has become less

prescriptive and capital payments to the States have declined in importance. At the same time, the distinction between the recurrent and capital aspects of State budgets has become more and more blurred as States have consolidated their accounts. A number of developments have contributed to this.

- (i) Capital outlays on social infrastructure (assets that do not offer a financial return — schools, welfare centres and the like) are now usually financed from taxation and other recurrent receipts.
- (ii) New devices affecting the recurrent budget (including various kinds of leasing arrangements) have been adopted for the financing of capital assets, both equipment and buildings.
- (iii) Governments have introduced accrual accounting, so that (among other things) the operating effects of capital are better reflected in the recurrent budget.

22. In the light of all this, we believe that equalisation would be improved if we were to widen its scope by fully assessing the recurrent effects of capital on State budgets (assessing both depreciation and interest on debt). Chapter 3 provides the details.

23. ***Quarantining.*** Successive terms of reference for reviews and updates have imposed limits on equalisation by requiring that the Commission's calculations not be affected by the distribution of certain SPPs. For the most part, these payments have been small, and the effect of their 'quarantining' from the equalisation processes correspondingly small. However, in the terms of reference for the 1993 Review, the Commission was required to produce, as well as an 'equalisation' set of relativities, one which excluded factors addressed by the then new Medicare agreements between the Commonwealth and the States. The adoption of these latter relativities has had important effects (exceeding \$100 million) on the distribution of grants in 1993-94 and each of the more recent years.

24. In the present review, the quarantining associated with the Australian Health Care Agreements (which replaced the Medicare agreements in 1998) is much less than the health quarantining previously required. However, the list of other items to be quarantined has been augmented by the inclusion of payments to the States funded from the Natural Heritage Trust of Australia and the Regional Telecommunications Infrastructure Fund. These payments are potentially quite large, and their quarantining is a further lessening of the priority given to equalisation. There can be no objection, of course, to governments putting other national objectives ahead of equalisation, but it is not always clear what objectives a particular instance of quarantining is meant to serve.

25. ***Assessment period.*** Any comprehensive assessment of States' needs for financial assistance in a future year must be based on past experience, which in itself imposes a constraint on equalisation. One question is the appropriate length of that past experience — the **assessment period** (formerly called the review period). At the Premiers' Conference in 1990, governments considered a report by the Commission which recommended that reviews and updates of relativities continue to be based on calculations for the three most recent full years. However, the Conference decided to adopt a five-year assessment period, preferring the increased stability in grant shares which the change was

expected to bring, rather than the more up-to-date calculations inherent in the shorter period. In retrospect, it is not clear that much stability has been gained. The terms of reference for this review require the Commission to produce relativities on both bases, and to comment on which method is more appropriate to the principle of fiscal equalisation. This is discussed in Chapter 4.

26. **Practical limits.** Australia's equalisation system is heavily based on identifying and measuring **disabilities**. These are influences beyond a State's control that cause its per capita expenditures or revenues to differ from nation-wide averages. They give rise to differing 'needs' of the States for financial assistance. The equalisation system may be seen, in concept, as directed at meeting such needs, the measurement of disabilities being the method of doing so.

27. An example of needs arises from the differential proportions of the elderly in States' populations. These are likely to require differential expenditures per head of total population if, to take one example, standard health services are to be provided. So the needs arising from the age structure of the population are met by an age-structure element of the disability calculations in the health assessments.

28. There are in fact a myriad of influences on State government revenues and expenditures that are outside their control, and thus potentially relevant to the estimation of disabilities. Many are quite insignificant. Sometimes, it is put to the Commission that a particular influence should be allowed for, but no or insufficient evidence of its effects can be found. Thus, States have at times claimed a disability where there was no indication that it was leading to any additional expenditure. On the principle of basing equalisation on what States do, not what they 'ought' to do, the Commission could not accept such a claim.

29. Clearly, there are practical limits to the extent to which equalisation can be applied. Compromises are often necessary between an all-out application of equalisation on the one hand and materiality, simplicity and transparency on the other. The underlying simplicity of the equalisation principle can be obscured by unnecessary complication in its application, and indeed such complication may bring the whole process into disrepute.

30. This is not to say that the Commission will shrink from assessing a disability if there is not a perfect set of data available to measure it. Despite the fact that the Australian statistical system is very highly regarded around the world, State activities and the influences on their budgets are so wide-ranging that the information available to assess disabilities is often incomplete or fragmentary, broad-brush or impressionistic, or indicative rather than precisely relevant. The Commission collects whatever further information it can in visits to service providers in each State, in metropolitan, rural and remote areas. In combining statistics, less precise information and anecdotal evidence, supplemented as necessary with the knowledge and experience that individual Commissioners bring to the task, there is frequently a big role for judgement.

31. Most States agree that the Commission must exercise its judgement. However it has occasionally been proposed that it should be sharply limited, or even avoided, so that disabilities would be assessed only where complete and accurate data were available. We do not accept that to eschew judgement would improve the equalisation process. To restrict the estimation of disabilities in such a way would not do justice to those

States that rely on equalisation for their financial viability; and sometimes (for example, in assessing the costs of urbanisation or those arising from large concentrations of people), to refrain from judgement would not serve the legitimate interests of the larger States. In any case, as a practical matter, to put equalisation into effect requires judgement at every step, beginning with decisions about the scope and structure of the standard budget (the consistent framework into which the States' transactions are put). Our approach has been to apply judgement, as necessary, to the data we have been able to find or collect for ourselves, provided that we can be confident that the inclusion of the disability thus estimated will result in a closer approximation to equalisation. It seems to us that this is the appropriate test to apply.

32. *Equalisation and efficiency.* Another compromise that may be required is between equalisation and efficiency. Efficiency here has its usual meaning of achieving objectives with the maximum economy in the use of resources (allocative efficiency). The Commission takes the view that it should not ignore developments in public sector policies and practices, particularly where they are indicative of a high priority being given to an aspect of public administration. One such development in recent years has been the increased emphasis on efficiency in government service provision, notably (but not solely) through the implementation of Micro-economic Reform and the National Competition Policy. Relevant areas of the expenditure assessments include public trading enterprises and industry assistance.

33. The quest for efficiency in government service provision may have wide-ranging implications for the equalisation assessments. The use of new technologies (such as video conferencing), for example, may change service delivery patterns as well as enhance efficiency. This may require new or revised disabilities in the future.

34. Changes made in this review to reflect such efficiency considerations are discussed in the following chapter.

35. There is another kind of efficiency — grant design efficiency — to do with the assessment process. The Commission has always been concerned that its assessments be as policy neutral (that is, as efficient) as possible, so that States have minimum incentive to change their policies in the hope of gaining a greater share of general revenue grants. It would surely undermine confidence in the equalisation system if States were able to manipulate it to their own advantage.

36. While good assessment design can minimise this possibility, it cannot eliminate it. In principle, States — particularly the larger States — could seek a greater grant share by changing their budget priorities and thus the financial standards to which disabilities are applied. A Heads of Treasuries Working Party concluded in 1994 that 'in most cases, however, the incentive [for such wasteful grant-seeking] is minor and unlikely to affect government decision making'.

Equalisation in Practice

37. Even allowing for the limitations of equalisation, big differences are evident within Australia in the standard of public services, both between regions and between

different kinds of service. In the course of this review, for example, we have observed the lack, or the run-down state, of facilities in Aboriginal communities, particularly in the tropical north and the central deserts, and the stresses being felt by teachers and welfare workers in providing services in poorer metropolitan areas in some of our major cities. To some, the continued existence of such problems might suggest that equalisation is not achieving its objectives — or that it should be changed to become more prescriptive.

38. It is sometimes difficult to tell whether what is being observed reflects differences in standards of living, rather than in government service provision. For example, that government schools in poorer areas may lack some of the facilities to be observed in their counterparts in wealthy areas is likely to be the result, at least partly, of different levels of parental and community support. Equalisation, in relating to budget capacities, not standards of living, may have little to do with differences such as these (though to the extent that it is standard State policy to provide additional resources to schools in poorer areas, that would be reflected in the assessments).

39. Since equalisation is based on what States, in the aggregate, actually do, it cannot compensate for any general shortcoming of governments in addressing particular social problems. The States have the power to decide how to allocate their resources, between both regions and functions; and the distribution of general revenue grants cannot overcome any perceived deficiencies in that allocation. Any influence the Commonwealth may wish to exert has to be exercised either directly or, if through the States, by the use of SPPs.

40. The same point may be relevant in addressing secular economic decline in a State. It was said to us in this review that Tasmania suffers from such a decline, and that the Commission should give it special consideration on that account. Assuming that Tasmania's economic performance is indeed in long-term decline, the equalisation system can compensate it retrospectively so far as the decline has given rise to relative reductions in its income bases and relatively greater calls on State resources to provide welfare payments and other outlays. Lags in the system may create a problem; a State in perpetual decline would never 'catch up'. In any case, it is far from clear that attempts to reverse such a decline (as opposed to coping with some of its symptoms) could, or indeed should, be financed through the equalisation system. Other forms of Commonwealth-State co-operation would be needed.

41. It would of course be a mistake to suppose that governments are omnipotent, or that it would be reasonable to expect them to be able readily to overcome any community deficiencies. There are limits to what governments can achieve and, within that, limits to what equalisation can achieve.

42. Because it relates to general revenue grants, equalisation has to do with inputs, not outputs. This is another way of saying what was said earlier — that the system is one of capacity equalisation, not performance equalisation. Governments are given the financial resources (the inputs) to enable them to provide a standard level of services (the outputs) with a standard effort in revenue raising. But they are not obliged actually to do so. They may decide to run a 'lean and mean' public sector, in the belief that a lower standard of services will be compensated for in the minds of their electorates by lower State

taxes. Also, differences in efficiency may remain, and they too may result in different standards of services between States.

43. It may also be that the starting points are not the same. Equalisation of all States has been in effect only since 1981, and the two self-governing Territories were included more recently still. Because capital needs have not been assessed (other than through debt servicing and, in this review, depreciation allowances), differences in the capital inheritance of State governments may be having some effect on their recurrent expenditure needs. As well, New South Wales has asserted that its costs are influenced by the age of some of its infrastructure (gaols which date back well into the nineteenth century, for example). However, it is not clear to us how — or even whether it would be appropriate — to allow for such influences, and we have not attempted to do so.

44. The question of starting points may be of particular relevance to the Northern Territory, which was not included in the equalisation system on the same footing as the States until 1988-89, ten years after it obtained self-government. It may be that the standards of services, and perhaps more particularly of capital infrastructure, bequeathed to the Territory by the Commonwealth were below those to be found in the States at the time. If the requisite capital assets were not in place, or were inadequate, the provision of recurrent services is likely to have been impaired. Arguably, the Commission may not have been able, in its subsequent recommendations, to compensate fully for any such deficiencies. The inclusion in this review of a depreciation assessment will help, over time.

45. Finally, it should be noted that Australia is not unique in most of the respects discussed above. Almost every country with more than one level of government — whether federated or not — has a system of grants between those levels to meet the almost inevitable vertical fiscal imbalance. Usually, grants flow from the higher to the lower levels of government, reflecting the financial power of the centre. In most countries, grant distribution has at least some elements of horizontal equalisation, though in none, so far as we are aware, is equalisation as comprehensive as here.

46. In recent years, there has been increasing international interest in both the institutional framework for, and the methods used in, Australia's horizontal equalisation system. A number of countries, notably China and South Africa, have set up equalisation systems which draw heavily on Australia's experience.