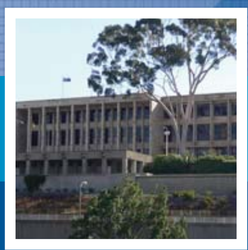
Department of **Treasury and Finance**
Government of **Western Australia**



DISCUSSION PAPER ON

Commonwealth-State Relations

AN ECONOMIC AND FINANCIAL ASSESSMENT OF
HOW WESTERN AUSTRALIA FARES

APRIL 2006

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ISBN 0 7307 4550 3

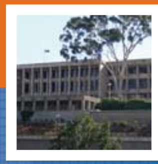
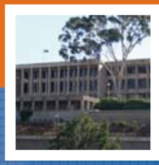


Table of Contents




Foreword

A well functioning federation has the capacity to balance shared, national interest objectives with the tailoring of policies to regional needs and the generation of healthy competition and innovation, producing better outcomes for the community.

Since the inception of the Australian federation, the central government has steadily increased its control over the national purse-strings, to the extent that the States now have a far greater reliance on transfer payments (or grants) than their counterparts in other federations around the world, and the central government a much greater excess of funds than needed for its own purposes.

This has facilitated the central government using fiscal leverage to influence State policies, and funding third parties to deliver services in areas of State responsibility. The central government's use of conditional grants has impacted on resource allocation efficiency, and the way in which grants are allocated between States affects incentives for economic development.

The High Court has generally acted to strengthen the Commonwealth's role in the Federation, by limiting States' access to some taxes and endorsing the Commonwealth's use of its constitutional powers to become involved in areas of State activity.

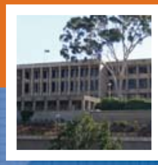
It seems likely that Western Australia is more exposed to adverse community outcomes from current trends because of its remoteness from the seat of central power, its still relatively small population (and hence influence), and needs associated with its unique geographic, economic and demographic features that are potentially less appreciated by the national government.

Despite this disadvantage, on the back of the development of its abundant mineral and energy resources, Western Australia has emerged over the last two decades as an economic power. It now makes a net fiscal contribution to the federation that is substantially larger in per capita terms than the other two net contributors (New South Wales and Victoria).

It is arguable that the deficiencies in the Australian federal system and the impacts on Western Australia in particular are holding back even more successful development of the State's resources, to the detriment of national economic and welfare outcomes, and that increased flexibility and collaboration could help lock in gains for the benefit of future generations.

The purpose of this paper is to increase community awareness of issues in the Australian federal system, provide an objective, practical assessment of how Western Australia fares (incorporating the views of State agencies), and identify potential ways forward, with a view to stimulating further public debate about appropriate reform of Commonwealth-State relations.

Comments from any section of the community are welcome, and can be submitted to the Revenue and Intergovernmental Relations Division of the Department of Treasury and Finance – igr@dtf.wa.gov.au or (08) 9222 9162.



Summary

Federations are generally recognised as the governance system of choice for geographically large nations. Power is dispersed, with regional governments (States in the Australian context) able to tailor services to local needs and test innovative approaches, and a central government (Commonwealth or Australian Government) able to foster national markets and deliver economies of scale for some government functions.

However, a unique feature of the Australian federation is the States' very limited power (relative to the central government) to raise revenue from their own sources, and associated high dependence on grants. The Australian Government is able to use its financial power to exert considerable influence in most areas of State responsibility, and also determines how funding is shared between the States.

Key findings on how Western Australia fares under the current arrangements, what the future may hold if current trends continue and proposals for generating better outcomes for the community both locally and nationally, include the following.

- In general terms, misalignment between central and State government policy objectives and priorities is considered more likely in Western Australia than in most other States, because of Western Australia's remoteness from the central seat of power, and unique features which may not be fully recognised by the central government.

  Misalignment between Australian and State Government policies is more likely in Western Australia.

  – Western Australia's unique characteristics and associated differing needs relate to its vast geographic area, many relatively small, dispersed communities, large indigenous population, resource development and export oriented economy, and economic and social outreach to Indian Ocean rim countries.

  – The Western Australian community is therefore more exposed to the risk of adverse outcomes from the various forms of central government intervention, including conditional grants. Lack of recognition of local needs is also evident in the central government's own-purpose expenditure programs and other national policies.

- All States are exposed by their high dependence on Australian Government grants to discretionary cut-backs in those grants, notwithstanding that they have benefited recently from solid growth during a sustained period of national prosperity, and that the grants provide a degree of stability vis-a-vis own-source revenue volatility.

– Under the GST arrangements, this has been experienced in unilateral changes to the calculation of the guaranteed minimum funding for the States and the abolition of National Competition Policy payments, with the risk now switching more to specific purpose payments (and to the imposition of more conditions on States' spending generally).

Long term projections of GST benefits show no gains compared to the original estimates.

- In relation to differences of view over whether there is a GST windfall that should oblige States to abolish certain taxes listed for review under the GST agreement (which, under some coercion from the Commonwealth, most States have now committed to do), the latest projections of Western Australia's net benefits from the GST are actually no greater, after 2007-08, than was originally expected when the agreement was signed.

  – Although the GST has grown faster than originally expected over the first five years, slower growth in the GST is projected going forward, and estimates of State revenues foregone have increased.

- Historically, Western Australia fared well under the Grants Commission arrangements for distributing Australian Government general purpose assistance (now the GST) to the States, until the current comprehensive system of 'equalisation' (which also required increases in grants to poorer States to be funded by the other States) was introduced in the early 1980s.

Western Australia is particularly exposed to disincentives for economic development.

  – Western Australia has since been particularly exposed to characteristics of the new system that act as disincentives to economic development and tend to entrench lower service standards in rural and remote areas. This paper finds that improvements to the current system are possible, but that more fundamental reform also warrants further consideration.

- In relation to specific purpose payments (SPPs), Western Australia currently receives slightly less than its population share in total, which could be considered inadequate in light of the generally above average cost of delivering services in the State. However, by and large, this is corrected through adjustments to GST shares.

  – Western Australia will actively support the inclusion of new programs such as Auslink and the National Water Initiative in the Grants Commission's processes, particularly in light of the current low share of funding for Western Australia.

  – Nonetheless, Western Australia is likely to be more exposed than most States to adverse service delivery and other community outcomes from the conditions imposed on SPPs, including certain conditions ('input controls') that dictate how the States are required to spend their own source and general purpose grants as well as the SPP funding.


- Although Western Australia is currently (and likely only very temporarily) receiving slightly more than its population share of the GST, it now cross-subsidises other States substantially more in per capita terms than either New South Wales or Victoria, after all Australian Government revenues and outlays are entered into the equation.

Western Australia provides the largest per capita subsidy to the federation.

  – To an extent, this is a natural outcome of Western Australia's rapid economic development over the past two decades, and the broader 'equalisation' that occurs at the community level through the Australian Government's uniform tax and welfare system (and is consistent with fairness in the functioning of a federation).

  – However, it is also likely to reflect lack of full recognition of Western Australia's needs in areas such as infrastructure support for major projects, services and infrastructure for Aboriginal communities, and services and infrastructure in rural and remote regions generally (including telecommunications and local government responsibilities).

  – Sharing of revenues by the Australian Government from potential new LNG projects using gas produced from petroleum fields off the State's coast would help contain the growth in Western Australia's subsidy, while providing substantially more incentive for the State to promote and facilitate such projects for the benefit of the nation.

Sharing of revenues from new LNG projects, and fiscal benefits and costs of important State initiatives, would be in the national interest.

  – More generally, a fairer sharing of the costs and benefits of State initiatives that generate national benefits (including large fiscal gains for the Australian Government) would help ensure that these initiatives were given sufficient priority by the States.

- In the absence of any short term practical means for reducing the States' financial dependence on the Australian Government (and even if these means were available), the paper identifies much improved collaboration between the central and State governments as a key to drawing out the benefits of Australia's federal system.

  – A particular challenge and priority for Western Australia is raising the profile of the State's special needs among national government decision makers.

Improved collaboration and raising awareness of Western Australia's needs is a key.

  – Western Australia also has a common interest with other States in pursuing coordinated initiatives with the Australian Government (particularly through the Council of Australian Governments) that will generate national welfare and economic benefits.

Federalism

Introduction

Federalism is a system of government in which power is divided between one central government and several regional governments (e.g. State or provincial governments). The alternative to a federalist system is a unitary or centralist system, where only a national level of government exists.

According to the Forum of Federations, although only 25 of the world's 193 countries have federal political systems, the citizens of these countries make up about 40 per cent of the world's population (www.forumfed.org). They include the United States, Canada and Germany and, according to the Productivity Commission, account for about half of global GDP.

Large countries tend to adopt federalist systems.

Geographically large countries tend to adopt federalist systems as a practical way of addressing challenges caused by vast distances. Prominent historian Lord Acton once said, 'in any country of significant size, popular government could only be preserved through a federal structure. Otherwise the result would be elite rule by a single city, such as London or Paris'.

Advantages of Federalist Systems

There are benefits of both federalist and centralist systems of government, as illustrated in the following diagram.

ADVANTAGES	
Federalism/Subsidiarity	**Centralism**
Competitive pressures on regional taxes, services and regulation	Conducive to efficient national markets
Capacity to test and demonstrate innovative approaches	Simplicity and cost-effectiveness of uniform taxes and regulations
Policies can be tailored to local circumstances	Policies can reflect the national interest
More government representation for the community	
Limits abuse of power	

A well functioning federation will include a role for the central government in meeting national interest objectives, including where regional governments potentially overlook cross border 'externalities' (e.g. non-standard gauge railways inhibiting interstate trade, or non-standard trade qualifications inhibiting population mobility), or where there are economies of scale.


The Australian Federation

The Australian federation was established in 1901. It consists of three tiers - the national government, eight State and Territory governments (established or continued under the Australian Constitution), and hundreds of local government authorities (established under State legislation).

At federation, the Australian and State governments were allocated separate powers and responsibilities. Section 51 of the Australian Constitution sets out the specific responsibilities of the Australian Government.[1] Powers not listed in this section are residual State government powers (see also Appendix 1).

Over time, this 'division of powers' between Australian and State governments has become less visible in practice. In particular, the Australian Government now has policy roles in areas of traditional State government responsibility, including health and education.

In part this reflects expansive interpretations by the High Court of the Australian Government's Constitutional responsibility for foreign affairs and corporations. Other explanations behind the gradual shift towards a more centralist system (particularly concerning revenue powers), and an assessment of its impacts, are included later in this paper.

Nevertheless, there are many good examples of the benefits of both 'competitive federalism' (particularly competition between the States) and 'collaborative federalism' (particularly collaboration between the Commonwealth and the States collectively) at work in Australia.

Since Federation, Australia has become more centralist, but the advantages of a federalist system are still visible.

- States cannot afford to have tax rates that are too far out of line with each other (e.g. payroll taxes). Indeed, Western Australia has established interstate tax competitiveness as one of its key fiscal targets.
  - At the same time, centralised administration of taxes like company tax and the GST has delivered the benefits of economies of scale, and simplicity and lower compliance costs for national businesses.
- Federalism has allowed individual State governments to 'experiment' with new ideas and ways of doing things. Where successful, these have been adopted by other governments as 'best practice'.
  - In 1999 the Western Australian Government established a health call centre and health advice line called HealthDirect. The centre is operated by registered nurses who are able to provide callers with an initial assessment of symptoms, advice on how urgent the problem is, self care advice and information on where to go for medical care.

1 Most of these responsibilities or powers are not exclusive to the Australian Government. However, the Constitution also provides that Federal laws will take precedence over State laws in these areas.

  - Western Australia's initiative was monitored by other jurisdictions, with a number since establishing or considering their own services (Western Australia delivers the Northern Territory's service under a Memorandum of Understanding). In February 2006, the Council of Australian Governments (COAG) agreed to establish a National Health Call Centre Network, which is intended to incorporate the State centres.

- National Competition Policy (NCP) is generally recognised as a constructive outcome of the 'cooperative federalism' period in the 1990s.

- Following the February 2006 COAG meeting, all jurisdictions have committed to a wide ranging 'national reform agenda' encompassing improvements to human capital (particularly through better health and education), a new NCP reform agenda (encompassing energy, transport and infrastructure regulation and planning) and a program to reduce the regulatory burden imposed by the three levels of government.

- There are also many examples of policy differences in the Australian federation that reflect local circumstances, community preferences and democratic principles.

  – Daylight saving 'summer time' applies in a number of States, but has been consistently voted against in Western Australia, Queensland and the Northern Territory.

  – Unlike other States, Western Australia prohibits electronic gaming machines in hotels and clubs. Apart from reflecting local community preferences, this helps facilitate evaluation of the economic, fiscal and social consequences of this form of gambling.

  – Deregulated retail trading hours were rejected in Western Australia in the February 2005 referendum.

A well functioning federal system is likely more important for regions that differ most and are furthest from the national capital.

A federation that practices genuine, balanced devolution of power is likely to be more important from the perspective of less-populous regions that are relatively remote from the seat of central power, and which most differ in terms of geography, economic structure and population composition. Such regions include Western Australia.

Although 'globalisation' has changed the nature of externalities and scale economies in Australia over the last century, it has not reduced the need for a federation that recognises diversity. For example, the economic rise of China and India is clearly an opportunity for Western Australia and the nation, but potentially a threat for States more dependent on manufacturing industries.

Vertical Fiscal Imbalance

Introduction

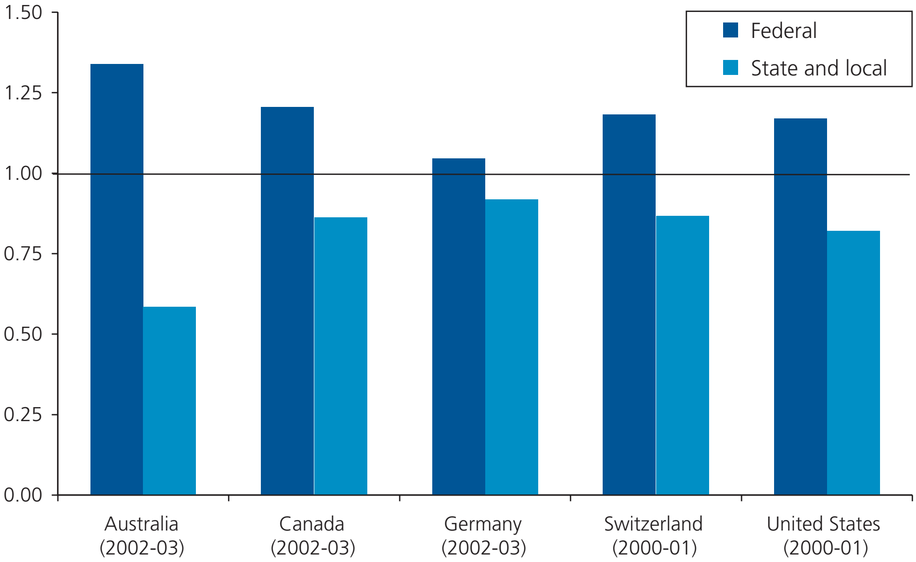
Vertical fiscal imbalance (VFI) is the term used to describe a mis-match between the revenue raising powers and expenditure responsibilities of each level of government, where a shortfall in revenue for one level of government (typically the regional level) is made up for by grants funded from the surplus revenue of the other (typically the central government).

Australia's High Vertical Fiscal Imbalance

A distinguishing feature of the Australian federation compared to other federal systems around the world is the very high level of VFI, or the States' very high dependence on grants from the national government.

FIGURE 1: VERTICAL FISCAL IMBALANCE

Own-Source Revenue/Retained Revenue

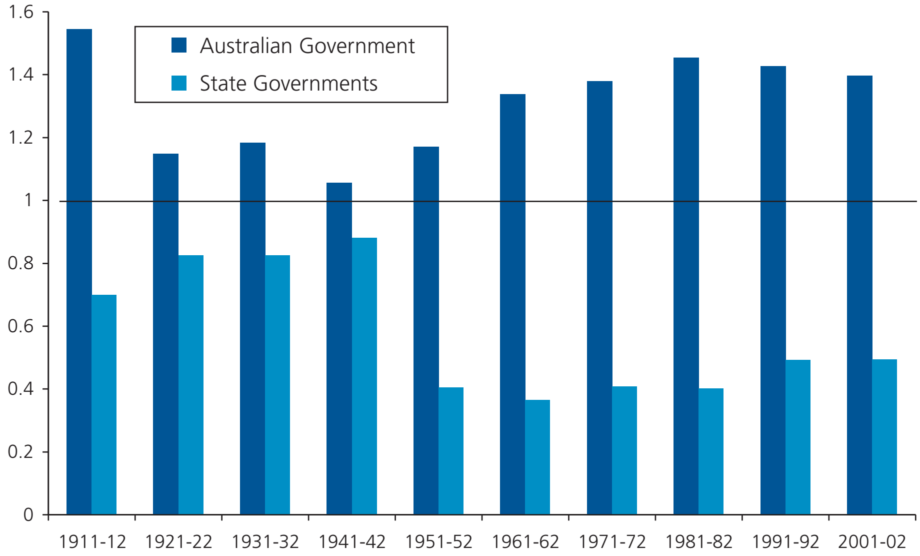


Source: IMF Government Finance Statistics 2004.

The high degree of VFI in Australia largely reflects the erosion since federation of the States' revenue powers, including as a result of:

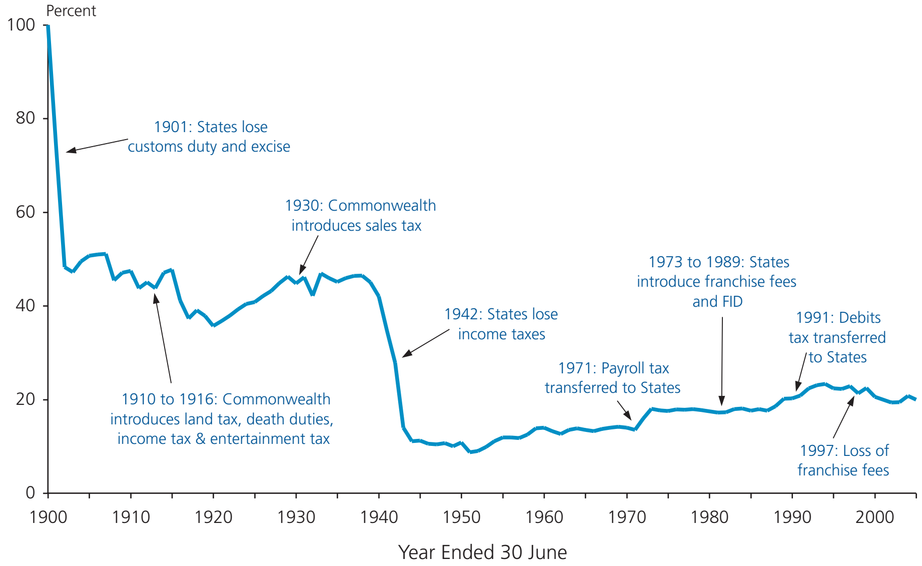
- the Australian Government's takeover of State income taxes in World War II, initially as a temporary wartime revenue raising measure; and
- expansive High Court interpretations of the Australian Government's exclusive 'excise' power under section 90 of the Constitution.

FIGURE 2: VERTICAL FISCAL IMBALANCE SINCE FEDERATION
Own-Source Revenue/Retained Revenue



Source: Vamplew, W., 1987, Australian Historical Statistics, Fairfax, Syme & Weldon Associates, Australia. Australian Bureau of Statistics, Government Finance Statistics.

FIGURE 3: STATE OWN SOURCE REVENUES AS A PERCENTAGE OF ALL STATE/AUSTRALIAN GOVERNMENT REVENUES



Source: Vamplew, W., 1987, Australian Historical Statistics, Fairfax, Syme & Weldon Associates, Australia. Australian Bureau of Statistics, Government Finance Statistics.

Specific events behind the erosion of the States' revenue powers are outlined in more detail in Appendix 1. Also notable is the failure of some of the initiatives since World War II to reduce the imbalance, particularly the introduction by the States of financial institutions duty and 'franchise fees' on tobacco, fuel and liquor, and the transfer of debits tax from the Australian Government to the States. All these taxes have now been replaced by Commonwealth grants.[2] The successful transfer of payroll tax to the States has been something of an exception.

By way of contrast, State and provincial governments in the United States and Canada, for example, continue to collect their own personal income taxes and (in the absence of any equivalent constitutional restriction to that in Australia) retail sales taxes.

2 The franchise fees were replaced by Commonwealth Revenue Replacement Payments in 1997, after the High Court ruled the franchise fees constitutionally invalid. These payments, as well as financial institutions duty and debits tax, have now been replaced by GST grants.

Implications for the Federal System

A degree of VFI ensures capacity for the central government to provide 'equalisation' grants to regional governments to help reduce differences in revenue generating capacity, and in the cost of delivering services. This is generally considered to be valuable to the cohesive functioning of a federation, and is discussed further in the Australian Government Grants to the States section of this paper (under *The Commonwealth Grants Commission*).

VFI reduces government accountability.

However, unlike some other federations, the States' dependence on grants from the Australian Government goes well beyond what is necessary for equalisation purposes. While this provides a degree of financial security for the States against volatility in their own revenue bases, it is also recognised as having some serious down-sides.

- It reduces the accountability of governments to their electorates because it is not clear which level of government is responsible when community expectations for services and infrastructure are not met.

- It exposes State governments to budget uncertainty vis a vis Australian government decisions about the level of grants, including the inherent temptation to shift any national budget shortfalls on to the States. Faced with this uncertainty, States may forego some (especially higher risk) initiatives that could improve economic and welfare outcomes.

- It facilitates the attachment of conditions by the Australian government to a significant proportion of State funding, which if not consistent with overall community priorities can result in a misallocation of resources.

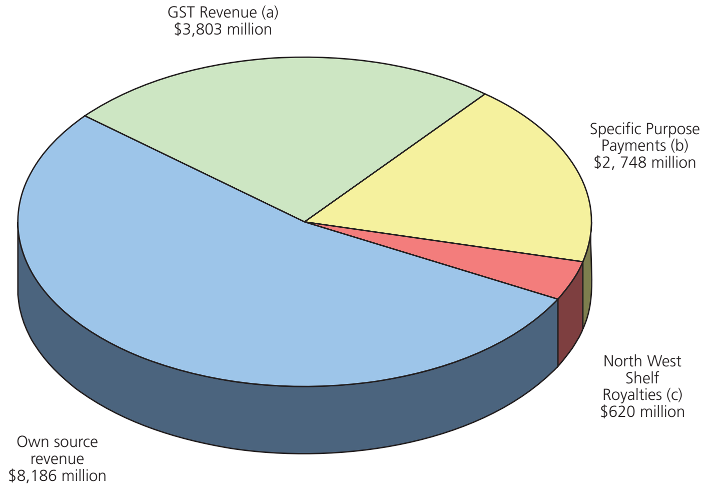
- It reduces incentives for States to put in place growth promoting policies and infrastructure, as the tax benefits flow primarily to the Commonwealth. While some of these tax benefits come back to States through increased GST revenues and (possibly) increased other grants, these grants are allocated between States on equity rather than tax origin principles. Hence the tax benefits of a particular State growth promoting initiative tend to be spread around the nation. This is further discussed below.

Australian Government Grants to the States

Introduction

The Western Australian Government is now reliant on Australian Government grants (consisting of both general and specific purpose grants) for around 50 per cent of its total operating revenue. This is typical of most States, although the proportion is as high as 80 per cent in the Northern Territory. The dependency has increased as a result of the replacement of some State taxes with GST revenue grants (see also below).

FIGURE 4: WESTERN AUSTRALIAN GOVERNMENT REVENUE SOURCES
2005-06



(a) Includes compensation for GST deferred as a result of the Australian Government's decision to allow extended payment arrangements for some taxpayers (mainly small businesses).
(b) Includes payments 'to' and 'through' the State and National Competition Policy payments. Payments 'through' the State include payments to non government schools and local governments.
(c) North West Shelf petroleum royalties are classified as a Commonwealth grant for Government Finance Statistics purposes, reflecting the Australian Government's constitutional responsibility for off shore areas.

Source: Western Australia's 2005-06 Government Mid-year Financial Projections Statement.

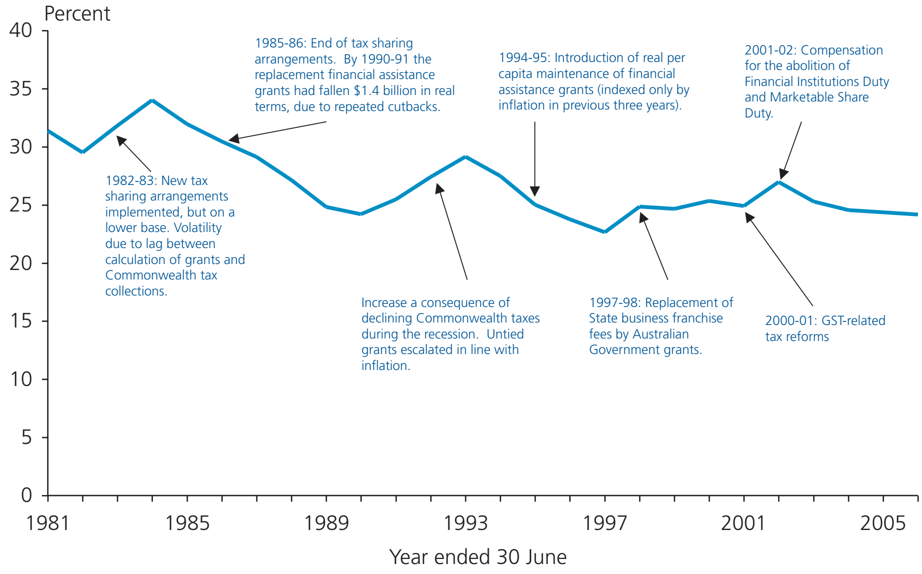
Grants to the States as a share of Australian Government tax collections (and GDP) have fallen over the past two decades.

Nonetheless, Australian Government grants to the States (collectively) as a proportion of Australian Government taxes fell substantially over the past two decades, forcing the States to turn to their narrower, less economically and socially desirable tax bases (e.g. by liberalising gambling activity in some cases) to fund increasing expenditure pressures.

- The replacement of some of the States' less desirable taxes (e.g. financial transaction taxes) by the GST saw a one-off increase in grants to the States as a share of Australian Government taxes.

- However, while the GST has grown strongly, this has not resulted in any ongoing increase in the States' grants as a share of national taxes. This partly reflects the strong growth in company tax collections relative to the GST revenues.

FIGURE 5: GRANTS TO THE STATES AS A SHARE OF AUSTRALIAN GOVERNMENT TAX COLLECTIONS

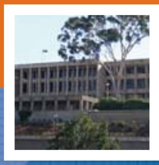


Source: Commonwealth's Final Budget Outcome and Commonwealth Budget.

Highlighting the vulnerability that comes with the States' high reliance on Australian Government grants, for an extended part of this period the Australian Government indexed general purpose grants to the States (then known as financial assistance grants) by only an inflation factor. At various stages it even reduced grants in real terms, or withheld grants specifically to help balance its own budget.

There are also several more recent examples of the Australian Government reneging on promised funding. At the national level, it unilaterally changed part of the formula for calculating the top-up grants required to ensure that the States were not financially worse off in the early period of the GST funding arrangements (see also below). It has also unilaterally decided to discontinue National Competition Policy (NCP) payments after 2005-06.[3]

3 NCP payments recognised that the fiscal benefits from reforming anti-competitive laws and institutions would accrue mainly to the Australian Government through increased income and company tax collections, while the cost of implementing the reforms would fall mainly to the State governments. One example has involved the States opening up public sector statutory monopolies such as electricity generators to private sector competition, effectively redirecting tax revenue from the States to the Australian Government.




- At the State level, the Australian Government reneged on a commitment to match Western Australia's investment in an airborne geological survey program for the mining industry. The State Government invested $12 million in this project (starting from 2004-05) to ensure that it could go ahead.

General Purpose Grants

General purpose grants carry no restrictions on how the money can be spent by the States, and consist primarily of GST revenue grants (which have replaced financial assistance grants). They account for around 55 per cent of Western Australia's total grants.

The GST Funding Arrangements

In June 1999, the Australian and State Governments signed the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (IGA). Under the IGA, the Australian Government agreed to pass on the revenue from the GST to the States. In return, the States gave up other revenues (e.g. financial assistance grants and financial institutions duty) and took on new expenditures (e.g. the First Home Owners Grant scheme).

One of the main purposes of the GST funding arrangements was to improve the financial position of the States, by ensuring that the States had access to a growing revenue base. Although all States are now[4] financially better off than they would have been under the old arrangements (after an initial period in which top-up grants were needed), the new arrangements have in fact increased the States' financial dependence on the Australian Government (and the potential for the Australian Government to influence States' affairs).

- As required by the IGA, the States have abolished a number of their own taxes under the IGA, so that there are less revenue sources under the States' direct control.[5]

- States cannot choose (individually or collectively) to increase their revenue from the GST because the GST is an Australian Government tax[6] and the IGA provides that amendments to the GST require the unanimous agreement of the Australian Government and all State governments.

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4 New South Wales benefits in 2004-05 and 2006-07 onwards, but not 2005-06.

5 By replacing financial assistance grants to the States, the GST also enabled the Australian Government to abolish its own narrowly based, distortionary wholesale sales tax, and reduce personal income tax rates.

6 The GST is imposed under Australian Government legislation and administered by the Australian Taxation Office. The High Court's interpretation of section 90 of the Australian Constitution bars the States from imposing taxes on the sale of goods.

Stamp Duties for Review under the IGA

The IGA included a requirement for State governments to abolish certain taxes and to review the need to retain six categories of other taxes by 2005. Most of the taxes listed for review were listed for early abolition under the original IGA, but a revised IGA was needed when the Australian Parliament voted to remove fresh food from the GST base (reducing the annual revenue yield from the GST by around 15 per cent).

The Western Australian Government has met its commitments under the IGA by repealing financial institutions duty and stamp duty on listed share transactions (both from 1 July 2001) and debits tax (from 1 July 2005). In addition, it has already repealed three of the six categories of stamp duty listed for review – stamp duty on unlisted shares, stamp duty on leases and stamp duty on cheques (all from 1 January 2004).

Nevertheless, the Australian Government argued strongly that the Western Australian Government would be in breach at least of the spirit of the IGA if it did not agree to a schedule for the abolition of the remaining IGA taxes,[7] given the relative strength of GST revenue collections. However, the validity of this claim depends on an interpretation of the intent at the time the IGA was signed, about which there are divergent opinions.

- Furthermore, the latest projections indicate that the annual benefits to Western Australia from the GST will, if anything, be slightly less than originally envisaged, by 2008-09 (see also Figure 8 in the last section of this chapter).

The State Government responded that the abolition of the remaining IGA stamp duties would need to be weighed up against overall budget priorities. Independent legal advice provided by Mr Malcolm McCusker QC to the Public Accounts Committee of the Western Australian Parliament confirmed that Western Australia was not in breach of the IGA by not abolishing all stamp duties listed for review under the agreement.

The potential for punitive measures to be imposed by the Australian Government on Western Australia has been averted as a consequence of the State Government embarking on a comprehensive review of its State tax system, in consultation with the Western Australian community, and announcing as an early outcome of that review a schedule for abolishing the stamp duties in question over the next few years.

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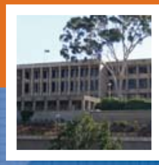
7 This also applies to New South Wales. Other States submitted to the Australian Government Treasurer a proposed schedule that would see the IGA taxes in those States phased out by no later than 2010-11.



The Commonwealth Grants Commission

Horizontal Fiscal Equalisation

The Commonwealth Grants Commission (CGC) is an Australian Government statutory authority with generally four or five independent Commissioners appointed in consultation with the States. It makes recommendations to the Australian Government Treasurer on each State's share of GST revenue grants (previously financial assistance grants).

GST grants are allocated to equalise States' fiscal capacities.

The CGC bases its recommendations on a principle known as horizontal fiscal equalisation (HFE). The aim of HFE is to enable each State to provide the same standard/level of services, were it to make the same effort to raise revenue from its own sources.

The starting point is for each State to receive its population share of grants. Adjustments are then made for different costs faced by State governments in providing services, and States' differing capacities to raise revenues from their own sources, to the extent that these differences are measurable and are due to unavoidable factors (e.g. high cost remote communities) rather than policy choices or relative efficiency.

The CGC adjusts States' GST revenue grants for differing costs and revenue raising capacities.

The CGC aims neither to reward nor penalise States for differences in policies or efficiency of service delivery. For example, current methodology assumes that Western Australia raises gambling taxes in line with its assessed capacity to do so (based on national average gambling tax efforts), notwithstanding the State Government's policy (unique among the States) to prohibit gaming machines in hotels and clubs.

Commonwealth Grants Commission Reviews

Each year, the CGC updates its calculation of State grant shares using the latest available data (e.g. on State revenue bases and the composition of State populations). The CGC also undertakes a major review of the methodology used to implement HFE every five or six years. The last review was completed in February 2004 and the next review is due to report in February 2010.

Western Australia's Declining Funding Share

As indicated in Figure 6, Western Australia's share of grants under the Grants Commission process declined sharply over the 10 years to 2003-04.

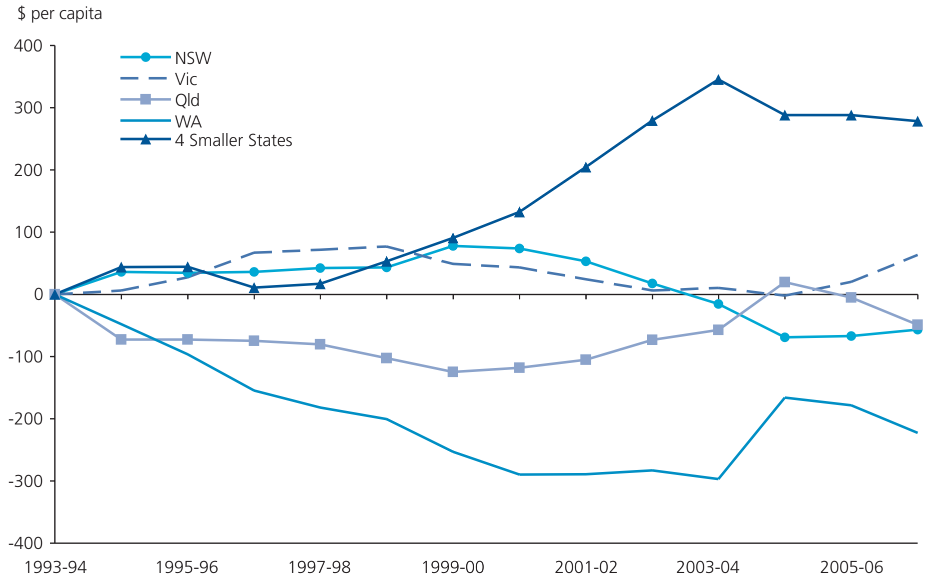
Grants to Western Australia have declined sharply.

More recently, Western Australia's share of grants has increased, as a result of the correction of certain methodology deficiencies as part of the CGC's 2004 Review, which increased the State's grants by around $250 million in 2004-05. However, this was not enough to offset past losses, with Western Australia's grants in 2006-07 still being $451 million below what they would have been if the 1993-94 'relativities' had still applied (in 2005-06 terms).

The decline chiefly reflects the rapid growth in the State's royalty collections (particularly from North West Shelf LNG and oil). The Grants Commission effectively redistributes to other States all but Western Australia's population share (around 10 per cent) of any increases in mining revenues (relative to the other States), through adjustments to GST grant shares (except to the extent that this is attributable to increases in, or differences from average, royalty rates).

FIGURE 6: IMPACT OF GRANTS COMMISSION RECOMMENDATIONS

Change in Per Capita Grant Share Compared with 1993-94
(2005-06 terms)



Source: Department of Treasury and Finance estimates using Commonwealth Grants Commission data.

Issues in Horizontal Fiscal Equalisation

As acknowledged previously, mechanisms that assist fiscally weaker States are generally considered to be fair and conducive to a well-functioning federation. Furthermore, Western Australia benefited significantly from the Grants Commission process in days past (and even now is broadly 'breaking-even' under the current GST distribution).

A particularly contentious aspect of Australian HFE is the assessment of 'locational' disabilities such as dispersion, isolation, diseconomies of small scale and urbanisation. In net terms, Western Australia is a major net beneficiary from these disability assessments. It is often argued that compensating States for higher locational costs is inefficient.

- However, Australia's wealth is ultimately mainly dependent on economic activity in its dispersed areas, where the economic case for subsidies is strong, as these are the areas where there are strong externalities from the provision of economic and community services.

In other respects the HFE formula is considered to have some serious conceptual deficiencies.


- It reduces incentives for States to encourage economic development, as the fiscal benefits from economic development are redistributed among all States.
  - In addition, while the CGC's revenue base assessments reflect the actual economic circumstances faced by each State (including implicitly the effectiveness of State spending and other policies in promoting development),[8] the CGC's expenditure assessments reflect average spending levels on services (allowing for locational, population and industry characteristics).[9]

The CGC process reduces incentives for economic development and does not recognise all economic development expenditures.

- Asymmetry also exists to the extent that not all types of costs that States incur in supporting economic development (e.g. common-use industrial infrastructure, geological mapping programs and certain subsidies for electricity in remote areas) are recognised.
  - Minority reports by one Commissioner in the CGC's 2004 Review supported Western Australia's views on this matter, and specifically stated that the CGC's approach on cross-subsidies for electricity unfairly penalises the State.
- The HFE formula tends to lock in the existing lower standards of services in rural and remote areas (relative to cities), including for indigenous communities. The formula only recognises the extra costs of providing services in these areas at the level these services are actually currently provided (using national averages), thereby denying States such as Western Australia some of the wherewithal to deliver improvements.
- Accurately measuring and fully separating out the impact on States' relative costs and revenues of policy differences (as opposed to underlying needs or capacity) is likely to remain an elusive objective for the CGC. For example, is Western Australia's relatively large mining revenue base solely a reflection of capacity, or partly of policies that have been more conducive to resource development?[10]

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8 The CGC's assessments of revenue capacity reflect the application of average revenue raising policies (e.g. average tax rates and average level of tax progressivity) to each revenue base.

9 For example, the CGC's cost allowances for Western Australia's remote areas would be largely the same regardless of the State's actual spending in those areas (a partial exception is arterial roads, where the CGC's assessments reflect the actual lane kilometre length of roads provided, though not the standard to which these roads are provided and maintained). If the State enhanced its social and economic support for remote areas, there could be significant economic and revenue benefits. However, while the State's GST grant would be reduced on account of the revenue benefits, there would be little change to the grant on account of the additional spending.

10 Equalisation of royalty revenues is also problematic from an intergenerational equity perspective – States cannot readily set aside these revenues as an investment for the future, even though they are derived from finite resources (albeit only finite in the very long term, in the case of some of Western Australia's mineral and energy resources).

At a more practical level, since the early 1980s the CGC has implemented comprehensive assessments of States' relative service delivery costs and revenue capacities, and a 'zero-sum-game' approach whereby an increase in one State's grant is at the expense of the others. The detailed methodologies used are highly technical and would only be understood by a small number of practitioners around the country, reducing the transparency of the system.

Accordingly, the Australian and State Governments and the CGC have now agreed that the HFE process needs to be simplified. A terms of reference for reviewing the CGC's methodology by 2010 was agreed to at the March 2005 meeting of Treasurers, including an emphasis on the simplification objective (subject to consistency with HFE principles).

A GP shortage has put pressure on State-funded emergency departments in regional hospitals, some of which now take appointments.

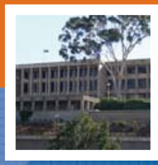
Apart from the inherent conceptual and practical difficulties, it is considered that the CGC's current methods have not fully recognised Western Australia's specific needs in a number of areas. For example, it is considered that the greater needs of Western Australia's Indigenous people compared to other States are currently under-recognised, as is the high cost of providing health services in remote areas due to the lack of private practitioners.

- The Department of Health in Western Australia has noted that in the Kimberley region the shortage of doctors has led hospitals to establish an appointments system for people to attend their emergency departments (with costs funded by the State instead of through the Medicare system). The CGC process provides Western Australia with only partial compensation for the additional use of hospital services.

Other areas where the CGC's methods are considered to need improvement to better reflect Western Australia's needs are the general indexes used to determine relative costs of providing services in rural and remote areas, and the cost of social and roads infrastructure.

Western Australia will work within CGC processes where possible to improve outcomes.

While there is scope to address weaknesses and gaps in the current assessments, the deficiencies in the current system of HFE (particularly incentive effects) could only be fully redressed by abandoning this system altogether and implementing an alternative system of assisting the financially weaker States. In the meantime, Western Australia is working within the current system to help improve the outcomes to be delivered in the 2010 Review.




Specific Purpose Payments

Specific purpose payments (SPPs), also called tied grants, are grants for specified State services or activities and typically have a range of conditions attached to their use that are set out in individual agreements between the Australian Government and the States. Distinctions are made between:

- SPPs 'to' the State, that support specific areas of State responsibility;
- SPPs that are on-passed 'through' the State primarily to local governments and private schools; and
- North West Shelf royalty payments (which are reported in Government Finance Statistics as SPPs because of the Australian Government's constitutional jurisdiction over offshore areas).

There are nearly 100 separate SPPs, although a small number account for a large proportion of the total annual payments (SPPs for hospitals, other health payments, schools, vocational training, local government and roads).

There are nearly 100 separate SPPs.

TABLE 1: SPECIFIC PURPOSE PAYMENTS 'TO' AND 'THROUGH' WESTERN AUSTRALIA

	2004-05 Actual		2005-06 Forward Estimates	
	$m	Percent of total WA SPPs	$m	Percent of total WA SPPs
SPPS 'TO'				
Australian Health Care Agreement	796	30%	821	30%
Other Health	285	11%	258	10%
Government Schools	244	9%	282	10%
Vocational Training	111	4%	113	4%
Road Programs	105	4%	120	4%
SPPS 'THROUGH'				
Non-government Schools Assistance	504	19%	518	19%
Local Government Financial Assistance Grants	177	7%	187	7%
OTHER SPPS[(a)]	389	15%	409	15%
TOTAL SPPS	**2,611**	**100%**	**2,708**	**100%**

(a) Comprise a large number of smaller specific purpose payments.
Note: Columns may not add due to rounding.
Source: Western Australia's 2005-06 Government Mid-year Financial Projections Statement.

In 2005-06, Western Australia expects to receive 9.6 per cent of total Australian Government SPPs 'to' States (compared with Western Australia's 9.9 per cent share of the national population).

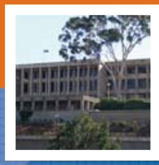
The distribution of individual SPPs between the States is based on a variety of arrangements, including population shares, historical shares, Australian Government discretionary allocations and various formulae that attempt to reflect relative costs or demand. For example, government schools funding takes into account the number of school-aged children in each State.

However, the majority of SPPs are effectively redistributed among States through adjustments to GST revenue grants, according to the CGC's assessment of needs. Thus, if a State receives more than its needs-based share of an SPP, its GST share will be reduced (and vice versa).

Various indexation arrangements apply to SPPs, some allowing for growth only in costs (based on underlying inflation and growth in minimum wages that essentially requires productivity increases to be achieved by the States), and others also including provision for demand growth.

- As noted, past experience has highlighted the States' vulnerability to cuts in Australian Government grants as part of the Australian government's budget process. Since the advent of the GST (and the Australian Government's reneging on NCP payments), SPPs are now more directly exposed to this risk than general purpose grants.

- The 2003-2008 Australian Health Care Agreements, which comprise the single largest SPPs granted to the States, were particularly impacted by a cut in Australian Government funding compared to the previous agreements (placing more pressure on already rapidly increasing State own-source funding for public hospitals).

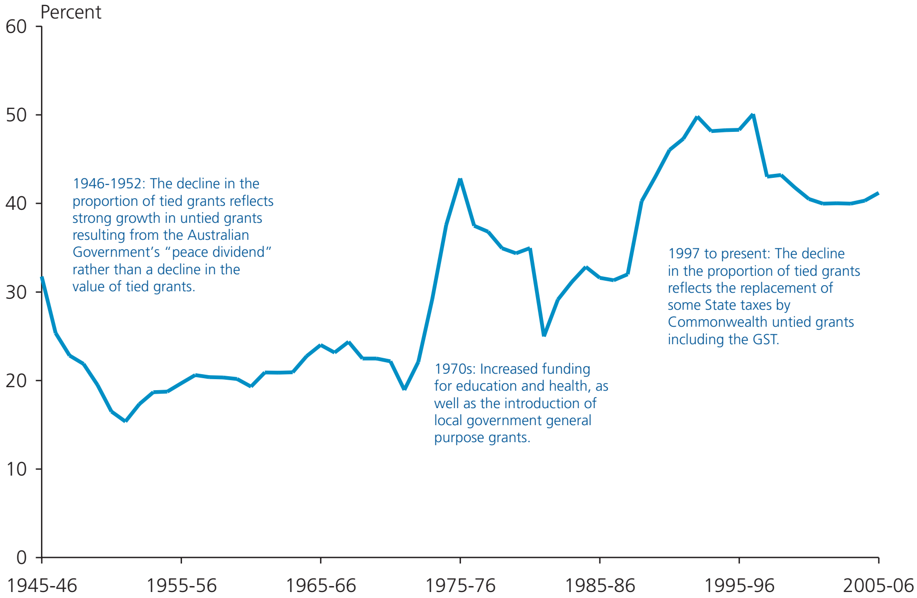


Growth in SPPs Grant Share and in SPP Conditions

Over time, SPPs as a share of Australian Government grants have risen substantially. At the same time, conditions on SPPs have become increasingly prescriptive.

Conditions on SPPs have become increasingly prescriptive.

FIGURE 7: SPPS AS A PROPORTION OF TOTAL GRANTS TO THE STATES

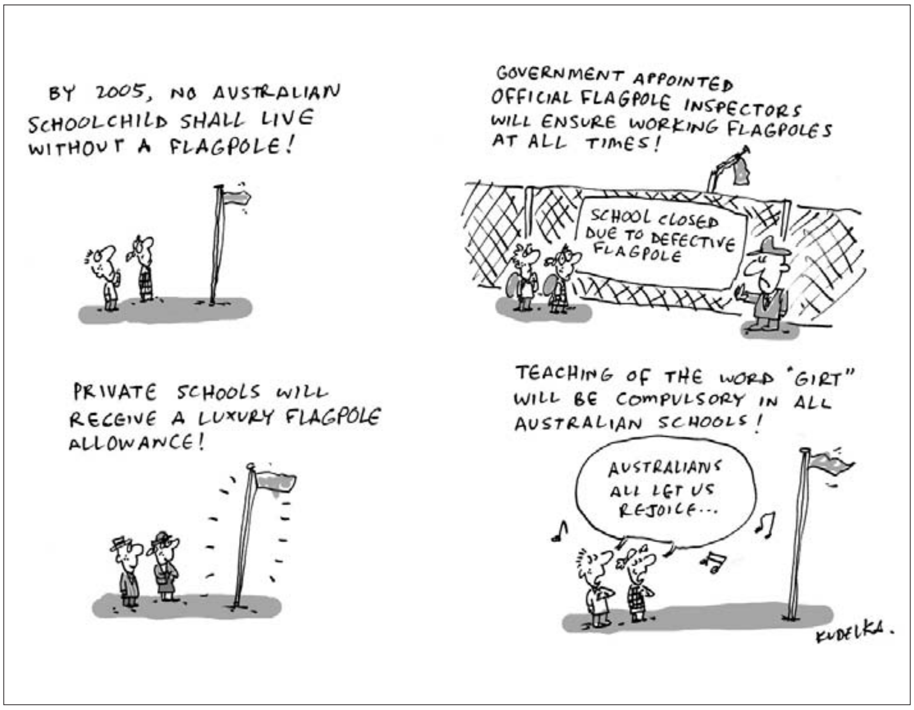


Source: Commonwealth's Final Budget Outcome and Commonwealth Budget.

- Matching conditions that prescribe how much a State must spend from its own sources on a partly SPP-funded service have become the norm, often with no regard for differences between States in pre-existing 'effort'.
  - The *National Action Plan on Salinity and Water Quality* is a significant recent example in Western Australia. The State was required to match new funding contributed by the Australian Government with new money of its own, despite its substantial existing programs in this area.
- Some SPPs now effectively prescribe how (and when) services are to be delivered or how the service delivery agency or projects are to be managed (including in an industrial relations context), in addition to requiring Australian Government as well as State government approval of individual projects under the SPP program.
  - The new SPP on vocational education and training requires the States to offer Australian Workplace Agreements (and performance pay) to TAFE staff.

- All new capital grants of over $10 million[11] are contingent on States adopting the Australian Government's implementation guidelines for the National Code of Practice for the Construction Industry (which limit the role of unions).

- A condition in the most recent government schools funding agreement that all schools install flagpoles and fly the Australian flag attracted the interest of al least one national satirist.



Jon Kudelka
The Australian, 2004

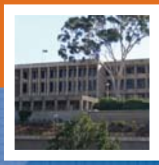
Implications for the Efficient Allocation of Resources

While it could be hypothesised that the trend towards a greater number and higher proportion of SPPs with more conditions could be partly attributed to developments in transport, communications and information technology altering the nature of 'spill-over' effects and scale economies, this justification for specific central government policy interventions is not readily apparent in a majority of cases.

Conditions on SPPs can lead to reduced service outcomes, higher taxes and a misallocation of resources.

Although less evident when State economies and revenues are growing strongly, financial conditions on SPPs can have a significant negative impact on State government budget flexibility. Where the conditions do not demonstrably address national interest objectives and are inconsistent with State priorities, the result may be reduced service delivery outcomes, higher State taxes and a misallocation of resources.

11 Or as little as $5 million if the grant represents at least half of the total project value.




As noted by Ahmad and Searle in the June 2005 IMF Working Paper *On the Implementation of Transfers to Subnational Governments*:

> *While matching requirements might induce greater effort on the part of recipients, this could cause distortions leading to less spending elsewhere, with possibly deleterious effects on the overall welfare of the recipient populations. In other cases … matching grants have been criticised as leading to greater spending as well as additional taxation …*

The risk of resource misallocation is potentially exacerbated by the multiplicity of SPPs in similar program areas. In Australia, there are four separate SPPs relating at least in part to the housing needs of disadvantaged people — the Housing Agreement, Supported Accommodation Assistance Program, Home and Community Care and the Disability Services Agreement.

- Matching conditions in each one may prevent States from switching their own-sourced funding between the four programs to achieve the best overall outcomes for the community.

Conditions on the level and application of funding can also reduce incentives for States to adopt more innovative, cost-effective service delivery methods, as any savings achieved cannot be redirected to other priority areas.

Non-financial conditions on SPPs may be well intentioned in terms of encouraging improvements in productivity and efficiency. However, there is a danger of the national government being presumptuous about what methods of service delivery or management will deliver the best outcomes for the community in local circumstances.

All these considerations point to a clear case for Commonwealth-State agreements to focus on common outcome-based objectives rather than prescriptive financial and other requirements.

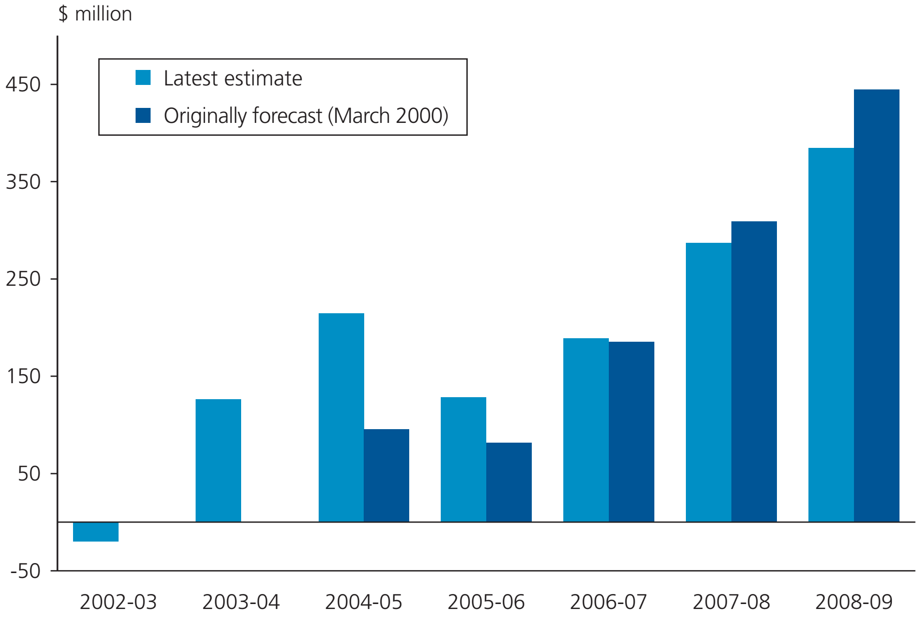
Looking Ahead

The GST funding arrangements are still in their relative infancy, and have been characterised so far by stronger than originally projected growth in the GST and associated revenue benefits for the States. Notably, however, on the basis of the latest projections (including published Australian Government GST forecasts), by 2008-09 the annual benefits of the GST funding arrangements to Western Australia will, if anything, be slightly less than those originally projected.

This outcome reflects a downward revision to the long-term projections of GST growth, and an upward revision to State revenues foregone (including financial assistance grants) and required State expenditures (including GST administration costs) under the GST agreement. A period of slower economic and consumption expenditure growth nationally, and therefore slower GST growth, will impact significantly on Western Australia's revenues even if the State's economy continues to perform strongly.

FIGURE 8: ESTIMATED IMPACT OF GST TAX REFORM

Western Australia



Note: This chart takes into account the abolition of debits tax from July 1 2005.

Source: Estimates are based on projections produced for the March 2000 Treasurers Conference (the 2008-09 estimate was produced although not reported to this Treasurers Conference) and the 2005-06 Commonwealth Mid-Year Economic and Fiscal Outlook (adjusted to reflect the same range of abolished taxes as the March 2000 projections, and the same petroleum revenue replacement payment indexation as stipulated in the Intergovernmental Agreement – the indexation was unilaterally removed in 2002 by the Australian Government).

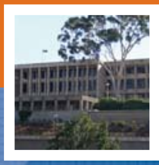
- Slower growth in the national GST pool would be exacerbated in Western Australia by a declining share due to the State's stellar economic performance relative to other States and the lagged impact of the Grants Commission process. This could exert medium term budget pressures on a State still experiencing the strong expenditure demands that also flow from a booming local economy.

The centralist tendencies of Australian governments suggest that they may try to appropriate GST revenue growth benefits.

Furthermore, the centralist tendencies of Australian governments suggests that over the medium term they will increasingly look for opportunities to appropriate GST revenue growth benefits for their own purposes. Cuts in SPPs are one avenue, against which the IGA provides only minimal discouragement.[12]

Another scenario is that Australian governments will seek to shift a greater proportion of emerging expenditure pressures on to the States. In the renegotiation of the Supported Accommodation Assistance Program during 2005, the Australian Government indexed its own funding by less than real terms but used strengthened matching arrangements to force the States to increase their proportional contribution from an average of 40/60 to 50/50.

12 The IGA provides that the Australian Government 'has no intention of cutting aggregate SPPs … consistent with the objective of the State and Territory Governments being financially better off under the new arrangements'. State Heads of Treasuries have sought to apply a minimum 'real per capita' growth interpretation to this clause.




- The responsible Australian Government Minister explicitly quoted 'windfall gains from [the] GST' as a reason why the States should contribute more.

- The Australian Government's 'bravado' may increase with its control of the Senate, although it is hoped that this situation may also stir senators to give more recognition to their role as guardians of the States' interests.

A more extreme scenario would involve the Australian Government placing conditions directly on GST revenue grants to require the States to spend these in accord with Australian Government priorities. However, as this would be a breach of the IGA,[13] a continuation of the current trend of stronger matching conditions on SPPs (effectively prescribing how the States must spend their own source and general purpose funds as well as the SPPs) seems more likely.

In the longer term, a risk for the States is the Australian Government reneging on the IGA, reclaiming the GST and reinstating a system of financial assistance grants with limited indexation. Under this scenario, the Australian Government may seek to spend its net additional revenues directly on its own priorities.

A risk for the States is the Australian Government reneging on the IGA.

The IGA seems relatively 'safe' while the Australian Government's own retained revenues are growing strongly. The risk of under-funding of State type services and excessive reliance on the less efficient taxes still available to the States would also need to be recognised. Nevertheless, there are already instances of the Australian Government independently delivering programs in areas of State responsibility (according to its own priorities).

- Under the Australian Government's school infrastructure policy, Parent Committees are to apply direct to the Australian Government for funding for public school projects. Apart from potential mis-matches with State programs, substantial additional bureaucracy would appear to be an inevitable consequence.

- The Australian Government is moving to establish 25 Australian Technical Colleges (initially promising two in Western Australia), effectively in competition with State TAFE colleges.

  - While there are inherent benefits in competition and what should, in this case, be enhanced service delivery for small numbers of senior school students (years 11 and 12), the risk of duplication and loss of system integration/cohesiveness needs careful management.

  - Western Australia missed out in the first announcement of new colleges. The Federal Minister for Vocational and Technical Education indicated that this was because of the State Government's involvement in preparing both proposals despite it doing so in collaboration with the local communities concerned.[14]

13 The IGA provides that 'GST revenue grants will be freely available for use by the States and Territories for any purpose'.

14 In mid-September 2005 the Federal Minister announced a successful bid for an Australian Technical College with two campuses to be based in Armadale and Gosnells.

Principle of subsidiarity: *functions should be devolved to the lowest–tiered government that is sufficiently capable of delivery.*

In all of the above scenarios, the risk of resource misallocation and sub optimal outcomes will increase, particularly in Western Australia because of the State's unique features and the greater scope for misalignment between the Australian Government's priorities and the needs (and priorities) of the State community. The subsidiarity principle of federalism suggests that, in general, these needs will be better appreciated by the State Government.

In light of the current resource boom in Western Australia and large increases in own-source revenues, the State also faces a substantial reduction in its GST grant share. This will highlight the importance of the Grants Commission and the Australian Government ensuring that the State's associated expenditure needs are adequately recognised, as the State's underlying total revenue growth will otherwise be insufficient to meet these needs.

Fiscal Transfers Other Than Grants

Putting Grants and the Grants Commission in Context

The distribution of GST grants (and, effectively, most SPPs) between States by the Grants Commission on the basis of HFE principles is one high-profile instance of the redistribution of resources across States by the Australian Government. As noted earlier, this is aimed at 'equalising' the capacity of States to provide a similar standard/level of services to their constituents.

However, all Australian Government revenue raising and spending tends to redistribute resources between States, usually in favour of State communities that are less well off. For example, States with higher incomes and business profits contribute more to total Australian Government taxes, while those with younger, healthier populations draw less on social security benefits.

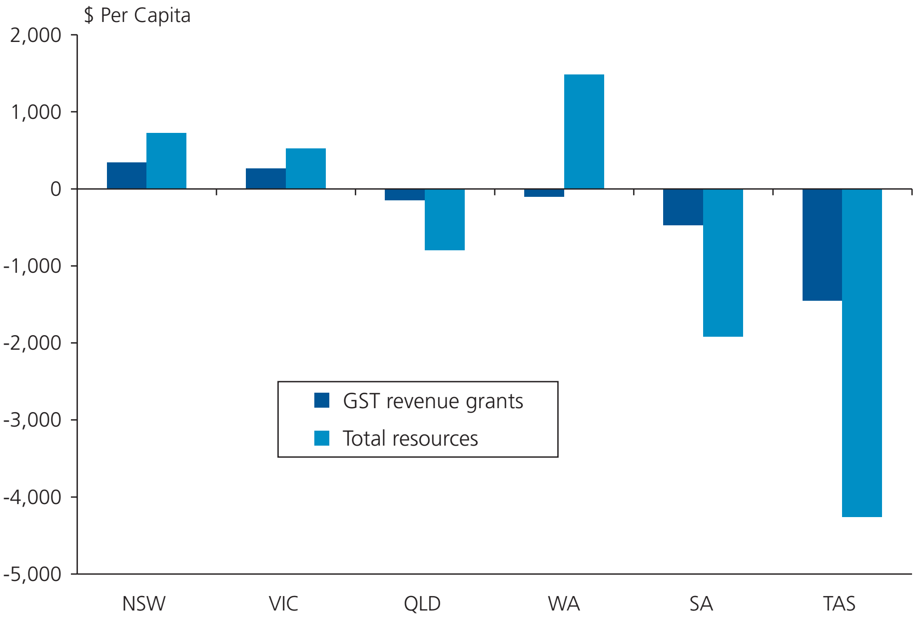
Australian Government revenue raising and spending tends to redistribute resources to less well off communities.

Cross-Subsidies Between States — the Full Picture

The Department of Treasury and Finance estimates the 'net fiscal subsidy' provided by each State by comparing the State of origin of all revenues received by the Australian Government (based on the location of economic activities generating these revenues) against the distribution across States of benefits generated by Australian Government spending (based on the location of the recipients of benefits).

FIGURE 9: REDISTRIBUTION OF RESOURCES

2003-04



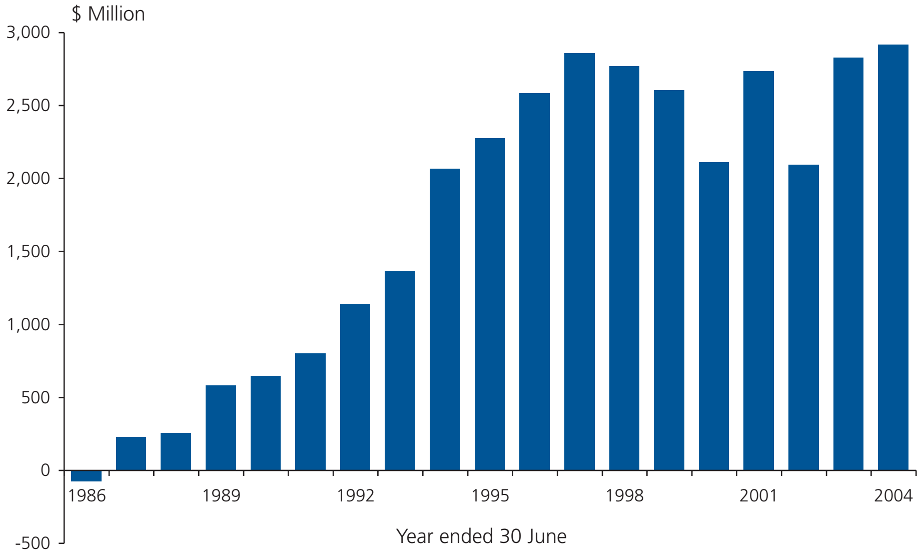
Source: Department of Treasury and Finance estimates, using a range of data sources including the Commonwealth's Final Budget Outcome and Australian Bureau of Statistics Catalogue Nos. 3101.0 and 5220.0.

In 2003-04 the Australian Government raised around $3 billion more revenue from Western Australia than it returned in expenditure.

In 2003-04, it was estimated that Western Australia received $196 million more in GST revenue grants than the amount of GST that was raised in Western Australia. However, when all Australian Government revenues and expenditures are taken into account, the Australian Government raised around $3 billion more in taxes and other revenues from Western Australia than it returned to Western Australia in expenditures.

In per capita terms, Western Australia's contribution is substantially larger than the other two contributors, New South Wales and Victoria (the other States are all net recipients). Western Australia's net fiscal subsidy to the Federation has grown substantially over the last two decades, coinciding with the boom in petroleum production (including LNG) and the emergence of Western Australia as a force in the Australian economy generally.

FIGURE 10: WESTERN AUSTRALIA'S NET FISCAL SUBSIDY TO THE FEDERATION



Source: As per figure 9.

The Western Australian Economy

Western Australia has a highly export oriented, resource rich economy. High levels of investment and strong growth in exports have resulted in Western Australia growing by 4.1 per cent per annum over the past decade. This is significantly higher than growth of 3.7 per cent per annum recorded nationally. In 2004-05, Western Australia's growth rate of 2.7 per cent was above the national figure of 2.3 per cent.

Western Australia's strong growth performance has been underpinned by healthy increases in business investment. Between 2000-01 and 2004-05, business investment in Western Australia grew by 71.7 per cent compared to 53.2 per cent nationally. Much of this investment has occurred in the resource sector. A number of projects have recently been (or are soon to be) completed, which will boost export volumes.


The export oriented nature of the Western Australian economy is illustrated by the fact that in 2005 the value of its merchandise exports accounted for more than 30 per cent of merchandise exports nationally. By contrast, Western Australia only accounted for 9.8 per cent of the nation's merchandise imports.

In 2005, mineral and energy exports (e.g. iron ore, petroleum, gold, alumina) comprised 84 per cent of the value of Western Australia's export commodities. Other major identifiable export categories include agricultural products (8.7 per cent) and elaborately transformed manufactures (5.1 per cent).

Also in 2005, Western Australia's trade surplus (exports minus imports) rose to $28.3 billion. This compared with a trade deficit nationally of $17.0 billion ($45.3 billion if Western Australia's surplus is excluded).

Japan is Western Australia's largest export destination, accounting for 23.2 per cent of the State's exports in 2005. Exports to China have grown by 30.8 per cent per annum over the past five years. As a result, China has overtaken South Korea as the State's second largest export market, accounting for 19.8 per cent of the State's exports over 2005.

Over the year to February 2006, Western Australia recorded the lowest average unemployment rate of all States at 4.4 per cent, compared to 5.1 per cent nationally. At the same time, the State had the nation's highest participation rate at 67.8 per cent (well above the average of 66.7 per cent). Employment growth in Western Australia was 5.4 per cent, compared to 2.9 per cent nationally, over the same period.

Western Australia also has the highest per capita gross State product of all States, standing at $47,539 in 2004-05. This is about 12 per cent higher than the national average ($42,437 in 2004-05).

Western Australia's future growth prospects remain strong. According to Access Economics, Western Australia's gross State product is forecast to grow by 4.1 per cent per annum over the five years to 2009-10. This is the fastest forecast growth rate of any jurisdiction, other than the Northern Territory (4.4 per cent).

Business investment is expected to continue to play an important role in Western Australia's economic prosperity. Access Economics' Investment Monitor estimates that Western Australia has 17.6 per cent of the nation's investment projects under construction, and 21.2 per cent of projects committed. It also indicates there are $117.9 billion worth of current and prospective projects in Western Australia, equating to almost 30 per cent of current and prospective projects nationally.

The volatility in Western Australia's net fiscal subsidy reflects, among other things, fluctuations in exchange rates and oil prices, which influence the value of Australian Government revenues sourced directly or indirectly from Western Australia's mining sector (including company tax, Petroleum Resource Rent Tax, royalties and excise, and personal income tax).

Table 2 provides an estimated breakdown of the components of Western Australia's net contribution over the last three years. Apart from the strong contribution to Australian Government revenues, the State draws significantly less than its overall population share of services and personal benefit payments (e.g. pensions) from the Australian Government.

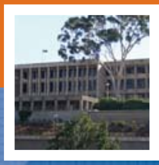
Western Australia's low draw on national personal benefit payments would in part reflect that in recent times it has regularly had the lowest unemployment rate in the nation (monthly volatility aside), combined with the highest labour force participation rate. The State's draw on medical benefit payments is also low, in part reflecting a State-wide shortage of GPs and demographic factors.

TABLE 2: COMPONENTS OF WESTERN AUSTRALIA'S NET CONTRIBUTION TO THE COMMONWEALTH

Relative to Western Australia's population share

	2001-02 $m	2002-03 $m	2003-04 $m
Personal Income Tax	-193	-44	-84
Company Tax	417	671	762
Fuel Excise (net of rebates)	360	366	458
Taxes & Royalties on Petroleum Extraction	1,055	1,413	1,083
Commonwealth Services[(a)]	650	669	716
Personal Benefit Payments	461	472	577
Payments to State and Local Governments[(b)]	-274	-286	-157
Other	-383	-433	-439
Total	**2,095**	**2,827**	**2,916**

(a) Departmental expenditures, including defence.
(b) Includes GST revenue grants.
Source: As per figure 9.



Implications for Western Australia's and the Nation's Prosperity

Again, it must be recognised that mechanisms that redistribute resources to the less well off, and to fiscally weaker States, are generally considered to be fair and conducive to a well functioning federation. While data for only relatively recent periods are available, Western Australia was undoubtedly in the latter category of States for a significant part of its earlier history.

- Furthermore, the $3 billion per annum subsidy would not be an accurate estimate of the financial benefit to Western Australia of seceding from the federation (e.g. because it would exclude the cost of duplicating certain defence assets and other central government infrastructure and services), nor is secession an option proposed in this paper.

However, to the extent that the 'net fiscal subsidy' analysis incorporates (as one component) the outcome of the GST distribution arrangements, the same less-than-full recognition of Western Australia's needs, and disincentives to economic development, noted in the section on the Grants Commission are reflected here. While some trade-off between the equity-based objectives of 'equalisation' and economic objectives is reasonable, economic development is also necessary for improved living standards and welfare outcomes.

Looking beyond the GST and other grants to the States, it also seems likely (as documented below) that a component of the large subsidy provided by Western Australia would reflect inadequate recognition of the State's needs in the Australian Government's direct spending and revenue raising – a probable consequence of Western Australia's remoteness from the seat of national government power and its relatively small (yet diverse) population (together with its unique geography and economy).

Particularly to the extent that Western Australia is still in a relatively early stage of its development (with much of its economic potential still to be realised), failure to recognise the State's needs in a way that holds back its further development is likely to be to the detriment of national economic and welfare outcomes. Some examples of potential failures in this regard, nominated by a range of State agencies, are as follows.

Failure to recognise Western Australia's needs is likely to be detrimental to national economic and welfare outcomes.

Direct Support for Major Projects

The Australian Government receives the majority of the fiscal returns from Western Australia's major resource projects through its broad revenue bases – especially Petroleum Resource Rent Tax, income and company tax (this is partly a symptom of VFI, and a significant contributor to the State's large net fiscal subsidy). In addition, a large proportion of the State's share of fiscal benefits tends to be redistributed to the other States by the CGC process (see above). Yet the Australian Government makes very little contribution to the infrastructure and other costs of supporting such developments.

The Australian Government often receives the lion's share of government revenues from Western Australian resource projects.

Indeed, in their 2005 *Western Australian Infrastructure Report Card*, Engineers Australia commented as follows.

> *The Federal Government contribution to infrastructure funding is poor, particularly in regard to export related infrastructure where significant benefits from exports accrue to the Commonwealth. Examples of this include development of the Burrup Peninsula, the Ravensthorpe Nickel Project and the State's share of the Auslink program. The State Government is looking for a more mature partnership with the Federal Government in this regard and is pursuing a more cooperative approach.*

Some examples of the relative costs and benefits to the Australian and Western Australian governments from resource projects are as follows.

- The Gorgon gas project is forecast to improve national GDP by $21-31 billion, and the Australian Government's budget balance by $11-14 billion. However, after taking account of State expenditures to service the increased population resulting from the Gorgon development, and the redistribution of net revenue benefits by the CGC, Western Australia's forecast net fiscal benefit is only $300 million. Other States will receive a net fiscal benefit of around $3 billion.

- The Burrup Peninsula gas processing developments are forecast to improve national GDP by $3.6 billion and generate nearly $600 million in net fiscal benefits for the Australian Government. However, after taking into account State expenditures and the redistribution of net revenue benefits by the CGC, Western Australia is actually expected to incur a net loss of $60 million. Other States will receive a net fiscal benefit of around $450 million.

  – The State has committed $160 million in multi-use infrastructure assistance for the Burrup Peninsula to assist the requirements of the Burrup Fertilisers project and other potential projects in that area. In addition, $24 million will be committed if a second project is commenced. None of this will be recognised by the CGC.

- The Australian Government's revenues from the Ravensthorpe nickel project are expected to be almost seven times larger than the Western Australian Government's. Yet the State Government is contributing $55 million to this project (including in the form of power and water infrastructure, port upgrades, road works and school upgrades), compared to the Australian Government's contribution of around $11 million.

The Australian Government has in the past offered financial assistance directly to companies. This is in contrast to Western Australia's preferred approach of providing multi user infrastructure that can be accessed by a number of projects.

Direct assistance to companies has major weaknesses. The project proponent will use it to maximise its own benefits, rather than necessarily putting in place the infrastructure that would yield maximum benefits for the community as a whole through facilitating the development of other (possibly competing) projects.



- Experience also shows how difficult it is to 'pick winners', with the Burrup Peninsula projects offered Australian Government assistance (being Methanex, Syntroleum and GTL Resources), not ultimately proceeding.
  - The Australian Government is understood to have provided approximately $30 million to Syntroleum (which was seeking to commercialise new gas and liquid technology), prior to the company becoming insolvent.

A State would have a stronger incentive to fund investments whose benefits are likely to be spread around the nation if Commonwealth funding mechanisms were in place to ensure a fair sharing of the costs or benefits. Without such Commonwealth support, the State's cost-benefit analysis will compare the full cost against only a fraction of the total benefit, and so is likely to reach the 'wrong' conclusion from a national welfare perspective. This is particularly the case where the fiscal benefits for governments are a significant proportion of the total benefit, and these primarily accrue to other jurisdictions (as in the resource developments listed above).

A partly analogous situation is the National Reform Agenda, agreed at the February 2006 COAG meeting, which seeks (among other things) to improve 'human capital' through improvements in health and education. These are largely areas of State responsibility, but improved human capital will yield substantial fiscal benefits for the Commonwealth. The Commonwealth has indicated that it will provide funding to States if it is needed to ensure a fair sharing of the costs and benefits of reform.

Arrangements for sharing the benefits from offshore resource projects

The Australian Constitution does not contain any specific provisions defining the ownership or management of offshore waters. However, in 1973, the Australian Government introduced legislation (later upheld by the High Court), which gave it sovereignty over internal waters (less inland waters), the territorial sea and the Continental Shelf.

Under current arrangements, the Australian Government and the States share royalties derived from projects in coastal waters (which are a defined area), while the Australian Government receives all royalties from projects beyond coastal waters (with the exception of royalties from the North West Shelf project, which are shared with Western Australia).

There is a strong case for implementation of an agreement between the Australian and Western Australian Governments to share the benefits from future petroleum projects beyond the State's coastal waters.

There is a strong case for the Australian and Western Australian governments to share the benefits from future petroleum projects.

- The State plays a key role in the promotion, development and management of offshore projects, incurring significant expenditures to address the on-shore infrastructure requirements, and potentially bearing certain financial risks. The State would have a greater incentive to promote such projects if it received a share of the revenues.

– The demands on the State of liquefied natural gas (LNG) projects are particularly high, as the gas needs to be brought on shore to be processed, generally in relatively remote areas with limited existing economic or social infrastructure.

– Under an arrangement with the Australian Government, the State undertakes administrative functions associated with offshore petroleum projects (e.g. ensuring the operations comply with environmental requirements and work safety standards).

– The State may be exposed to risks such as liability for carbon dioxide escaping into the atmosphere or into other producers' reservoirs, after the closure of LNG projects such as Gorgon (which proposes to inject carbon dioxide 'waste' into aquifers beneath Barrow Island).

- The Australian Government has a moral obligation to share revenues by virtue of the 1967 and 1979 'Gentlemen's Agreements' to share royalty revenues with the States. Past Australian Governments have reneged on these agreements.

- In its 1993-94 *Annual Report*, the Industry Commission proposed that the States take over the Australian Government's Petroleum Resource Rent Tax to help redress vertical fiscal imbalance.[15]

As previously noted, the CGC redistributes around 90 per cent of increases in Western Australia's mining royalties to other States. Any new revenues that could be negotiated would be similarly redistributed unless the Australian Government specifically 'quarantined' the revenues from the HFE process.

An alternative, as detailed in the previous section, is direct Australian Government funding for the infrastructure costs incurred by the State Government associated with resource projects. The CGC impacts of this option are uncertain, but probably more amenable to 'quarantining'.

Even if a substantial portion of the benefits of a revenue or cost-sharing arrangement with the Australian Government (including risk sharing) were distributed among other States, the remaining share would still significantly improve Western Australia's incentive for promoting and facilitating offshore projects. Support for this outcome could be sought from other States.

- The high prospectivity of the submerged lands off the Western Australian coast, with a number of new LNG projects possible in coming years (e.g. Browse Basin, Woodside's Pluto project and BHP Billiton's Scarborough project), and the potentially large returns to the Australian community, make this an important national issue.

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15 Industry Commission, 1994, *Annual Report 1993-94*, Australian Government Publishing Service, Canberra.

Services in Rural and Remote Communities

Below average levels of general service provision in rural and regional areas of Western Australia can also hinder economic development, including by making it more difficult for resource developers and supporting businesses to attract and retain skilled staff.

- Telecommunications services in rural and remote areas are well below metropolitan standards. While the Australian Government has initiated some programs to provide affordable broadband services in these areas, most have required State government matching funding, even though telecommunications is the Australian Government's responsibility under section 51 of the Constitution.

  – The Australian and Western Australian Governments each contribute 50 per cent to a Western Australian-based broadband demand aggregation broker. However, the Australian Government's contribution is capped at $100,000 per annum, so that the State Government is required to meet any excess costs.

  – The State has been successful in winning funding from the National Communications Fund for Network WA, and from the Coordinated Communications Infrastructure Fund for the Ngaanyatjarra Lands Telecommunications Project and Kimberley Broadband Solutions. In each case, however, matching funding has been required.

  – In 2004, the Western Australian Government committed $3 million to ensuring near continuous mobile phone coverage along the Great Northern Highway. The State sought a matching contribution from the Australian Government, and is still waiting for a favourable response, before it invites proposals from service providers.

Programs to provide affordable broadband services have required State matching contributions, despite being an Australian Government responsibility.

- The quantum of Australian Government financial assistance grants to local governments is insufficient to meet the needs of rural and remote councils assessed by the Western Australian Local Government Grants Commission.

  – This is an increasing problem because of the lack of real per capita growth in these grants over time.

  – This problem is also exacerbated by the Australian Government's grants distribution rule that requires each local government to be paid at least 30 per cent of an equal per capita share of the pool of local government financial assistance grants provided to the State, regardless of assessed needs. This boosts the funding of metropolitan councils at the expense of the more needy rural and remote councils.

- The Australian Government subsidises nursing home beds, but has largely withdrawn from providing capital grants for aged care infrastructure. This is a problem for rural and remote areas because the small client base in these areas means that it is generally not viable for community organisations to provide the infrastructure, particularly given the higher building costs in remote and rural areas.

Aboriginal Communities

There is considerable scope for the Australian and State governments to work together to improve the well-being of Aboriginal people.

Aboriginal people continue to face starkly lower standards of living compared to national averages (as demonstrated, for example, by life expectancies, infant mortality rates and unemployment statistics). Sharing the benefits of economic development with Aboriginal communities and involving Aboriginal communities directly in economic development, may provide part of the answer.

Under the Constitution the Australian Government has power to make special laws with respect to Aboriginal people living in the States. While this does not imply that the Australian Government is solely responsible for the welfare of Aboriginal Australians, it suggests that the Australian Government has at least a shared responsibility with the States.

The following highlight some issues of concern and opportunities in relation to funding of services to Aboriginal people in Western Australia.

- The Department of Housing and Works has advised that Australian Government municipal services funding levels for Aboriginal communities have not been increased for approximately the past decade. This has resulted in communities expending collected rent monies on diesel fuel, at the expense of housing repairs and maintenance.

- The Departments of Local Government and Regional Development, and Industry and Resources, have noted the opportunity for increased investment in Aboriginal economic development programs, including work-readiness programs for communities located in close proximity to resource based industries.

- The Department of Indigenous Affairs has suggested that there are an increasing number of Aboriginal communities and organisations in crisis in Western Australia. Under the post-ATSIC arrangements, the Office of Indigenous Policy Coordination is now responsible for coordinating Australian Government service delivery to Aboriginal communities and organisations, but has limited experience and resources.

- The Health Department has noted that only two Western Australian Aboriginal communities currently benefit from the Australian Government's Primary Health Care Access Program, which provides for funds that would ordinarily have been spent on Medicare-subsidised services (were sufficient health services available) to be applied to a range of health services tailored to addressing local health issues.

Auslink

Western Australia's share of the Auslink National Network Programme (which is primarily funding for road projects) is only about 8 per cent. This is much less than the State's 10 per cent population share, 22 per cent share of the National Road Transport Network and 30 per cent contribution to national merchandise exports.

Western Australia receives a low share of Australian Government road funding.

An important reason for Western Australia's low funding share is the relatively limited scope of the Auslink National Network in Western Australia compared with other States. For example, the Auslink network includes only one of the two major Perth Darwin routes (the North West Coastal Highway, which connects three of the top six tonnage ports in Australia, is not part of the network). By comparison, the Network includes two routes from Melbourne to Brisbane, two routes from Brisbane to Darwin, and a series of routes from Sydney to Brisbane.

The Commonwealth has also declined to increase its funding contribution to the Perth Bunbury Highway project to reflect significant cost increases attributable largely to an overheated construction sector.

Given the importance of transport infrastructure to economic development, there is a case for a much larger share of funding to be directed to Western Australia (as supported by Engineers Australia in their *Western Australian Infrastructure Report Card*). Notably, Western Australia's low share of road funding in recent years has not been offset by an increase in its GST share under the HFE arrangements. The Grants Commission has yet to determine whether Auslink funding will in future be treated any differently in the HFE arrangements.

Funding for Sports Infrastructure

The Australian Government does not have an on-going program for funding sports infrastructure, as this is primarily a State and local government responsibility. However, it arguably does have shared responsibility for (and on occasions provides) assistance for sporting events of international significance or for stadiums hosting national competitions, all of which contribute to economic development.[16]

Western Australia has not received any substantial sport infrastructure funding from the Australian Government in the past decade.

- The Australian Government contributed substantial funding and services to the Sydney 2000 Olympics (over $1 billion), and has done likewise for the 2006 Commonwealth Games in Melbourne (around $300 million).
- In contrast, no Australian Government funding was provided for the most recent international sporting competitions held in Western Australia, including the World Swimming Championships in 1998.

16 This is supported by the findings of a 1997 Australian Parliamentary inquiry ("Rethinking the funding of community sporting and recreational facilities: a sporting chance"), which remarked that 'there is a role for the Commonwealth Government in relation to providing sporting and recreational facilities'.

The Australian Government occasionally also provides ad hoc assistance for sporting infrastructure. In the lead up to the November 2004 Federal election, the Australian Government committed around $38 million over three years for community sports facilities.

- This comprised funding to redevelop Kogarah Oval ($8 million) and Penrith Stadium ($10 million) in New South Wales, Whitten Oval ($8 million) and Kardinia Park ($2 million) in Victoria, seven projects in Tasmania ($7.8 million) and 27 other minor projects ($2 million), the majority of which were in New South Wales (with the remainder in Victoria, Queensland and South Australia).

- No funding from this program was allocated to Western Australia. This State has not received funding of a comparable magnitude from the Australian Government for a decade, when $8 million was granted towards the upgrading of Subiaco Oval in 1995.

Australian Government Discretionary Grants

The inter-State distribution of the total pool of discretionary grants is not transparent.

The Australian Government provides funding on a competitive basis to community groups, universities, businesses and government agencies for a range of purposes. The relevant Minister or government department determines which applicants receive funding and may or may not impose conditions on the grants.

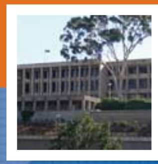
There is a perception among Western Australian Government departments that the State receives a relatively low share of discretionary grants.

- For example, since 2003, the Australian Government has allocated $38 million to the provision of food innovation grants under its National Food Industry Strategy. Although a number of Western Australian companies have applied, only one is understood to have been successful, receiving a grant of $320,000 (less than 1 per cent of the total pool).

It has not been possible to determine whether this example is representative of how Western Australia fairs under discretionary grants generally. It is understood that the Australian Government maintains a register of these grants, but it is not publicly available.

Impact on Western Australia of other National Government Policies

The impact of Australian Government tariff, taxation and (including more recently) industrial relations policies have all been prominent issues in Western Australia since federation.



Tariffs

Australian Government tariff policies have adversely affected Western Australia.

- Despite significant reductions over time, the Productivity Commission estimated that in 2003-04 the Australian Government provided the equivalent of an estimated $7.5 billion in industry assistance in the form of tariffs, supporting the manufacturing sector.
  - In its *Trade and Assistance Review 2003-04*, the Commission stated that the resulting higher prices of manufactured inputs meant that net tariff assistance to other sectors (agriculture, mining and services) was negative.
  - Analysis by the Commission in its December 2000 report indicated that the removal of tariffs would increase Australia's GDP by 0.08 per cent. The benefits would be greatest for Western Australia and the Northern Territory, which would experience increases in their gross State product of 0.21 per cent and 0.22 per cent respectively.

Taxation

- The changes to Australian corporate taxation announced in the 1999 *New Tax System* reduced corporate tax rates at the expense of the accelerated depreciation system for certain assets. The removal of accelerated depreciation has disadvantaged the long-term, high-risk developments that are common in Western Australia.
  - The Australian Government has subsequently introduced a system of effective life depreciation for specific classes of assets, including petroleum production assets. However, the periods over which assets can be written off are longer than the original periods, and some long term assets are not covered by the new arrangements.

The Australian Government has resisted calls to introduce a flow through share scheme.

- In addition, the Australian Government has so far resisted arguments to introduce a 'flow through share' (FTS) scheme to promote mineral exploration, despite similar schemes existing in Australia for investment in timber plantations or olive groves and evidence of a successful FTS scheme for mineral exploration in Canada.
  - Under a FTS system registered companies could issue FTSs to private investors, who would be able to claim a tax deduction for their investment at their respective marginal tax rates (similar to franking credits). This would reduce the cost of capital for small mineral exploration companies.
  - Under the existing Australian tax system, large companies with sufficient cash flows are able to deduct mineral exploration expenditure against profit made elsewhere. However, small specialist exploration companies often do not have cash flows against which they can offset exploration expenses.

- Tax incentives of this nature could also be justified on the basis that some of the benefits from mineral exploration do not accrue to those that undertake the expenditure. This is because all exploration adds to the stock of knowledge, which helps future exploration programs.

The value of income tax zone rebates has declined dramatically over time.

- Based on a study undertaken by KPMG, the value of Australian Government income tax zone rebates designed to compensate for harsh climatic conditions, isolation and the higher costs of living in remote areas, has declined dramatically over time.[17] As a result they would do little to help attract workers to remote areas.

Industrial Relations

The Australian Government has sought to impose its industrial relations policies on the States.

- The Australian Government has recently sought to impose its industrial relations policies on the States primarily through its section 96 powers (e.g. the National Building Code and Australian Workplace Agreement conditions in certain SPPs) and corporations powers in the Australian Constitution.
  - It is unfortunate that there appears to have been little consultation and collaboration on this issue (at least in the sense of genuine negotiation as opposed to coercion), but rather a unilateral approach by the Australian Government (which will achieve significantly less than full coverage of workplaces in Western Australia).
  - The inclusion of ancillary conditions in individual SPPs such as industrial relations obligations may distract the focus of governments from the principal policy areas and objectives that the SPPs relate to (e.g. training, roads) and reduce their ability to achieve cooperative reforms in these areas.

Agricultural Issues

Australian Government import assessments are putting Western Australia's agricultural industries at risk.

- The Department of Agriculture has expressed concern that Biosecurity Australia's 'one size fits all' approach to completing risk assessments for proposed imports into Australia may not provide adequate protection for Western Australia's plant and animal industries.
  - The Department has considered it necessary to allocate resources to reviewing these risk assessments to ensure that Western Australia remains free of pests and diseases present in other States and countries that export to Australia.

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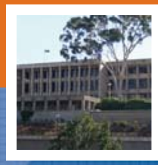
17 KPMG 2002, *Review of the Zonal Tax Rebate Scheme*, KPMG, March 2002.



- Under National Competition Policy (NCP) requirements, Australian and State governments were required to review restrictions on the export of grains, including 'single desk' policies, which legally require growers to sell their harvests to a monopoly exporter. Restrictions were to be removed if they were deemed not to be in the public interest.

  – The Western Australian Government has reformed its grain legislation (which covers barley, canola and lupins) consistent with these requirements. According to an independent review by RSM Bird Cameron in 2005, this has led to a noticeable improvement in cash prices paid to growers.

  – However, the Australian Government has decided not to reform restrictions on the export of wheat. This is in spite of an adverse National Competition Council assessment that the Australian Government had not met its NCP obligations by demonstrating that retention of the export single desk is in the public interest.

National Competition Council: The Australian Government has not met its NCP obligations.

The Way Forward

There is significant scope for improved collaboration between the Australian Government and the States (both nationally and in Western Australia) in areas of shared responsibilities, to enhance service delivery outcomes for the community (e.g. in health, education, transport and disability services, where the two levels of government are now responsible for separate component services that contribute to common objectives).

- This applies at both bureaucratic and Ministerial levels. The aim should be to better understand each other's needs and priorities, and seek ways to achieve mutually beneficial outcomes. It implies a strong and reinvigorated role for the Council of Australian Governments (COAG)[18] and other intergovernmental institutional arrangements.

Successful examples of collaboration include the following.

- The establishment of new Australian-State Government funded after hours General Practitioner clinics near public hospital emergency departments in Perth, to provide more appropriate treatment to many patients who would otherwise present to the latter.

- Recent counter-terrorism initiatives, supported by an intergovernmental agreement and cooperative legal arrangements (including the referral of State powers to make laws on counter-terrorism to the Australian Government).

- Although the potential fruits remain to be realised, agreement arising from the February 2006 COAG meeting for a 'national reform agenda' to improve efficiency, productivity and workforce participation, building on the successful NCP initiative.

- Under an agreement with the Australian Government, the Western Australian Family Law Court also exercises jurisdiction over Australian Government family law matters. This allows Western Australia to offer its citizens a 'one stop shop' for family law matters.

However, apart from those instances already highlighted in this paper, feedback from State agencies has highlighted several examples in Western Australia of lack of central-State government collaboration, leading to poorer outcomes for the community.

18 Comprising the Prime Minister and Premiers/Chief Ministers of all States and Territories. COAG currently meets on only an irregular basis and with limited opportunity for the States to contribute to the agenda.



- The Australian Government recently announced the Australian Network of Industry Career Advisers program to assist people aged between 13 and 19 years. It has specifically excluded all State government departments, TAFE colleges and schools from participating. The program disregards existing State initiatives and may complicate service delivery.

- The Australian Quarantine and Inspection Service has shown a lack of willingness to share pest interception and other data with its State-level counterparts that will ultimately bear responsibility for a number of quarantine programs. A strong partnership between the two levels of government is considered essential for an effective quarantine system.

- In recent years, the Australian Government has increased the nation's intake of humanitarian and non-humanitarian migrants, with minimal notice to State governments. Humanitarian migrants in particular require high levels of State government services to meet their complex health, education and housing needs. There is a need for greater collaboration between the Australian and State Governments so that increased service usage can be planned for and resourced.

Genuine central-State government negotiation and collaboration may allow the Australian federation to operate broadly as its forefathers intended, even in the face of very high VFI. This needs to occur at the bilateral as well as the multilateral level, to ensure recognition of diversity between the States.

Otherwise, Western Australian governments may have little choice but to take a stand against encroaching Australian Government centralism that is not clearly in the State or national interest, as has been witnessed recently in the case of the stamp duties listed for review under the GST agreement.

- Although the absence of a united front from all States and the community's natural dislike of stamp duties made this a challenging case for the State Government to 'win', the position it took was understandable in the context of the principles and precedent at stake.

Lacking other bargaining chips or negotiating strength, it is considered that Western Australia's best strategy for entrenching federalist principles on individual issues is sound argument, focussing on the implications for resource allocation and local and national community outcomes, backed by education programs and effective communication of the State's needs and priorities to the Australian Government.

- An important such argument is that there would be improved national welfare and economic outcomes if arrangements were in place for a fairer sharing of the costs and benefits of State initiatives that generate significant national benefits, including fiscal benefits for the Australian Government and other jurisdictions.

As part of this strategy of sound argument, the State should seek enhanced accountability from the Australian Government on its resource allocation decisions, including the criteria underlying those decisions. For example, inter-State distributions of Australian Government own purpose outlays and discretionary grants are not readily apparent from its budget papers.

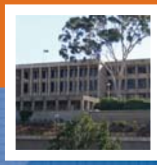
An issue highlighted by several Western Australian Government agencies is the need to further develop and improve networks with their Australian Government counterparts. To this end, the State Government is establishing a Western Australian Government Office in Canberra. Its functions will include:

- promoting an increased awareness of the State Government's interests and priorities among Commonwealth Government departments, national industry associations, the media and diplomatic missions in Canberra;
- enhancing understanding within State agencies of new and emerging Commonwealth Government policies and initiatives;
- assisting State Government Ministers and agencies through attending meetings at their request, assisting with visits and providing an office base for Ministers and officials visiting Canberra; and
- identifying and providing information on Commonwealth funding and grant programmes that might benefit the State.

In a similar vein, more priority could be given to nomination of Western Australians to national boards and committees, including the Commonwealth Grants Commission (see also below), and to whole-of-State government submissions to national inquiries (e.g. conducted by the Productivity Commission and Federal Parliamentary committees).

- The Australian Government should also be encouraged to base more of its officials in Western Australia. For example, Trades Recognition Australia has not had a Western Australian-based representative for some years. This means that new arrivals to Western Australia who wish to have their trade skills recognised must undertake the assessment process by mail or bear the cost of flying an assessor from Queensland if a face-to-face assessment is required. This is of particular concern during the current skills shortage.

More specifically in relation to VFI, the question has been asked in some quarters (including by some States) as to whether it really matters. This paper suggests that (in the absence of genuine collaboration) it does matter for a State such as Western Australia because of the scope it leaves (through the dependence of the State on Australian Government grants) for misalignment between national public policy and local community needs.




- However, the only practical means of addressing VFI may be through further fundamental national tax reform, which seems unlikely to attract support from governments or the community in the near term. The alternative of transferring core policy, funding and service responsibilities to the Australian Government (e.g. public hospitals) may only exacerbate lack of recognition of Western Australia's needs.

A renewed push for sharing of royalties/PRRT from the potential raft of future LNG projects is warranted as one means of reducing the revenue imbalance. This may be supported by other States (who would benefit through the current system of HFE), and backing could also be sought from the project developers (who may benefit from the enhanced incentives for the State to support their project).

In the absence of national tax reform to reduce VFI, preservation of the GST funding arrangements is considered worth fighting for. The GST is no panacea for the State's fiscal security. However, it seems clear that to lose the long-term revenue growth benefits of the GST having sacrificed various State taxes that were inefficient but gave the State a greater degree of fiscal independence and flexibility, would be a significant step backwards.

- Retaining the untied nature of the GST grants is also crucial, to avoid further diluting the States' fiscal sovereignty.

In relation to HFE, it is considered that the State should keep an open mind on fundamental reform, beyond the CGC's current 2010 Review, that would fully address the current disincentives to economic development, while protecting the position of individual jurisdictions. All jurisdictions with significant growth potential, not just Western Australia, would be direct beneficiaries, and ultimately the nation as a whole would gain.

Garnaut and FitzGerald's August 2002 report *Review of Commonwealth-State Funding* provided one model for reform. This envisaged the GST distribution being changed over time to an equal per capita basis, subject to:

- each State being guaranteed that its total grants would be at least maintained in real per capita terms;

- each State receiving a flat dollar amount to recognise the minimum costs of government;

- the Grants Commission retaining a role in determining the need to assist States experiencing severe financial difficulty; and

- using three broad-banded SPP programs (health and aged care, education and training and indigenous community development) as the vehicle for achieving equitable access to public services.

The absence of a Western Australian representative on the Commonwealth Grants Commission since the new system was introduced in 1981 may also have been to the State's disadvantage, in terms of ensuring full understanding of the State's relative needs.

In relation to SPPs, in the June 2005 IMF Working Paper *On the Implementation of Transfers to Subnational Governments*, Ahmad and Searle indicate that:

> *In developed countries, very detailed earmarking has been generally replaced by looser sectoral conditionality leading to an emphasis on block grants that require that the funds be used say for education, but with greater flexibility on the precise spending items to be determined by the recipient government.*

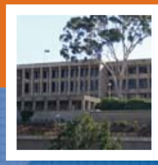
Ideally funding currently provided through prescriptive SPPs should instead be only identified as being for particular purposes (e.g. health), without specific conditions on service delivery. Accountability should focus on outcomes and outputs (i.e. on what is achieved rather than what is spent), encouraging efficiency and innovation (and enabling areas where performance could be improved to be pinpointed).

As an interim step, the Australian government should make controls on the level and application of funding more flexible, including by tailoring them to individual State circumstances, broadening the scope of relevant State expenditures that 'count' (i.e. for matching or maintenance of effort purposes) and relaxing required financial contributions where efficiency improvements or improved outcomes from switching resources to related programs can be demonstrated.

The Commonwealth-State financial relationship is considered to have special significance in the context of the current resources boom in Western Australia, given the sharing of the fiscal benefits among all jurisdictions (with the Australian Government being easily the biggest beneficiary). Optimising development requires the Australian Government to work with the States to adopt an integrated approach to infrastructure assistance and to remove tax and other disincentives to development.

As the boom also involves the mining and export of what are ultimately finite community-owned resources, a challenge is also to lock in the benefits for future generations. This requires appropriate re-investment in debt retirement, and in the infrastructure, education, science and research and development required to develop new, sustainable industries, including those that build on Western Australia's competitive advantage in resources (e.g. mineral processing technologies, clean fuels etc.).

Under Australia's federal system, Western Australian governments cannot achieve such a vision on their own.



Appendix 1: A History of Western Australia in the Federation

Western Australia was founded as a British colony on 18 June 1829. While other States became self-governing in the mid-1800s, Western Australia's geographic isolation and initial economic stagnation postponed its self-government until the 1890s.

The discovery of significant deposits of gold in Coolgardie (1892) and Hannans (1893), now known as Kalgoorlie, triggered an influx of people from other colonies and from overseas. During the 1890s, the State's population increased from 47,000 to 179,000. Other parts of the economy also flourished, with significant growth in external trade, investment and agriculture.

The newly arrived settlers from the other colonies, commonly referred to as *t'othersiders*, were supportive of joining the proposed federation. Other Western Australians were reluctant to join the federation, fearing the competition in inter-colonial trade that would arise as a result of the removal of duties on agricultural products, and the impact of tariffs on the colony's local industries.

By 1898, all the other colonies had agreed to federate, and the pressure for a referendum in Western Australia was mounting. Various representatives from the gold mining municipalities and other nationalistic groups such as the Federal League, the Australian Natives' Association and Australian Workers' Association, formed the Reform League, which threatened to separate from the colony unless the Government proceeded with the referendum.

A referendum was called for 31 July 1900. The vote in favour of federation returned an overwhelming majority of 44,652 against 19,636.

The Constitution

The Australian Constitution defined a narrow and limited set of powers for the Federal Government, reflecting the intention of the founders of the federation to restrict the scope of federal authority. Under section 51 of the Constitution, the Federal Government was granted power to make laws for defence, external affairs, navigation, immigration, international and interstate trade, currency, postal and telecommunication services and invalid and old age pensions.

Australian Government powers were defined narrowly, reflecting an intention to restrict federal authority.

- State Parliaments are also able to legislate on these matters, but Federal laws take precedence (section 109) and States may not raise any military force without the consent of the Federal Parliament (section 114).

The remaining powers were left to the States. These included law and order, transport services, local government, education, housing and health. However, subsequently the Commonwealth has gained major influence over State matters through section 96 conditional grants (see below) and the High Court's acceptance that Commonwealth legislative powers over such matters as interstate commerce and external affairs give it power to legislate in other areas that might impinge on those matters (examples include the Commonwealth's authority over airports arising from Australia's being a signatory to the Convention on International Civil Aviation, and Commonwealth laws prohibiting damage to regions that are included in the World Heritage list).

As the Constition was framed, the States and the Australian Government were intended to have concurrent powers over all forms of taxation except customs, tariffs and excise duties, which were to be exclusive to the Australian Government. The States were concerned about transferring their powers to tax trade to the Australian Government. However, the founders of the Federation had a vision for the new nation to be a common market with internal free trade and a common external tariff.

The States are legally free, but financially bound to the Australian Government.

Alfred Deakin wrote as early as 1902 that the Constitution left the States 'legally free, but financially bound to the chariot wheels of the Central Government'.

The Australian Government was granted the authority to levy income taxes. However, it was expected that this authority would only be used in times of national emergency. The income tax power is not an exclusive power, and the States retain power to levy their own income tax.

In recognition of the States' large dependence on customs revenue, section 87 of the Constitution (the 'Braddon Clause') stated that the Australian Government was required to return 75 per cent of the customs and excise revenue to the States in the first 10 years following federation, and thereafter as Parliament saw fit. In addition, section 94 of the Constitution indicated that the surplus of Australian Government revenue would be distributed to the States.

Under section 95 of the Constitution, Western Australia, which received over 62 per cent of its revenue from customs duties in 1900-01, was allowed to phase out its tariffs over a five-year period.

Section 96 of the Constitution, under which the Australian Government was granted powers to make grants to any State 'on such terms as it saw fit' and on which much of the present structure of federal financial relations is based, was a late addition, and was seen at the time as a protective mechanism for the States.

Commonwealth-State Financial Relations

By the end of the first decade after federation, the Australian Government's rising expenditures on age pensions and other areas began to erode the surplus revenue available to return to the States. In 1908, the High Court, upheld the Australian Government's *Surplus Revenue Act*, which allowed it to retain the surplus revenues previously distributed to the States.

Per capita grants to the States were introduced in 1910 11 as a replacement for payments under the Braddon Clause. However, this involved a 30 per cent cut in grants with no indexation. Western Australia and other less populous States, whose revenue bases had been particularly impacted by federation, began to receive compensation from the Australian Government in the form of special grants in the same year.

During World War I, the Australian Government significantly increased its control over the economy, commerce, trade and social services. To finance rising expenditures, the Australian Government introduced its own income tax in 1915, existing side by side with State income taxes.

The first significant tied grants appeared in the 1920s, with annual road grants being provided from 1923-24, and annual interest and sinking fund contributions on State debt from 1927-28. However, tied grants were relatively limited until the end of World War II.

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In 1926, the High Court ruled in the Australian Government's favour in determining that, under section 96 of the Constitution, it could extend tied grants to the States for the purpose of achieving results in areas of exclusive State responsibility (i.e. for which the Australian Government could not have legislated directly). Conditions could influence the expenditure of State's own-source revenues, and did not need to be financial in character.

During the 1920s and early 1930s, requests from Western Australia, South Australia and Tasmania for special financial assistance were subject to a series of Royal Commissions and Joint Committees. Because their economies were largely dependent on primary production these States argued that they were adversely affected by tariffs. Based on the recommendations of these reviews a series of special grants were made to these States.

Anti-federal sentiment in Western Australia increased considerably in the 1920s. Many Western Australians felt they had lost more than they gained by joining the Federation. For example, the removal of local tariffs on Eastern States' manufactured goods meant Western Australia's small industries were unable to compete, Australian Government protection of Queensland sugar raised local prices, federal arbitration increased wage rates and the *Navigation Acts* raised shipping freights.

The vote for secession had a majority of two to one.

A referendum was held in April 1933 to decide whether or not Western Australia should secede from the Commonwealth. The vote for secession had an overwhelming majority of two to one. However, a petition to this effect presented to the British Government was rejected on the grounds that the British Parliament could not act without the consent of the Australian National Parliament.

The CGC was established in an attempt to bring equality to States' fiscal circumstances.

The establishment of the Commonwealth Grants Commission (CGC) in 1933 attempted to address the political instability caused by State financial difficulties during the Depression and bring some equality to States' fiscal circumstances. The Commission's first report in 1934 considered the cases put forward by the 'claimant' States of Western Australia, South Australia and Tasmania and recommended that they receive special financial assistance grants.

In 1946, the Australian Government advised the States that it would retain its income tax powers indefinitely.

In 1942, the High Court upheld the Australian Government's decision to temporarily take control over all State income taxes and replace them with a uniform national income tax. In 1946 the Australian Government advised the States that it would retain its income tax powers indefinitely. Furthermore, grants paid to the States as compensation for losing their taxation powers were conditional on States vacating the income taxation field.

The first Commonwealth-State Housing Agreement was signed in the mid-1940s. Thereafter, the Australian Government initiated a series of tied grant programs, including for improved dairy farm practices (from 1948-49), tuberculosis hospitals (from 1949-50), universities (from 1951-52), agricultural advisory services (from 1952-53), blood transfusion services (from 1953-54) and mental institutions (from 1955-56).

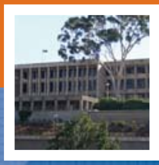
Western Australia remained a claimant State until the late 1960s.

Western Australia remained a 'claimant' State until the late 1960s when it began to benefit from a major resource boom, mainly as a result of the Australian Government agreeing to lift the iron ore export embargo that had existed since 1938. Fuelled by rising demand from Japan, America and Britain, the North West resource industries began to transform a once isolated colony into a global minerals and energy province, and a source of immense wealth for the nation.

Tied grants escalated markedly during the mid-1970s, principally because of increased funding for education and health. In the mid-1950s, there were 12 tied grant programs, but the number more than tripled by the early 1970s.

In 1975 the Fraser Government was elected with a policy of 'New Federalism', which included a system of personal income tax sharing. From 1976-77 States received a fixed percentage of Australian Government personal income tax receipts (latter this was changed to total Australian Government tax collections), initially distributed between the States according to the existing shares of financial assistance grants.

In 1981 the Grants Commission released its first report on tax sharing relativities, ushering in the present 'zero sum game' system of comprehensive Horizontal Fiscal Equalisation. This report recommended the first of the many large reductions in Western Australia's share of grants, which would partly reflect the development of the North West Shelf petroleum project.



- While the 1981 report was not acted on, subsequent reports (from 1982) were generally accepted by the Australian Government, although there were phasing in arrangements in the initial years.

From 1985 a pool of financial assistance grants replaced the tax sharing arrangements.

In 1997, the High Court ruled that State business franchise fees (imposed on retailers and wholesalers of liquor, tobacco and petroleum products) were excise taxes and therefore unconstitutional (section 90 provides the Commonwealth with exclusive powers to raise customs and excise duties). This was the culmination of a long sequence of High Court rulings on section 90, which have prohibited any sort of State tax on goods.

In 1997, the High Court ruled that State business franchise fees were not constitutional.

- The Australian Government agreed to compensate the States for their loss of business franchise fees by providing Revenue Replacement Payments, which were funded by an increase in the Australian Government's taxes on the same products. This further increased the States' reliance on grants from the Australian Government.

The Australian Government and the States agreed to a range of tax reforms and new funding arrangements in the 1999 *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*. Under the agreement, the Australian Government provides all revenues raised from the GST to the States. In exchange, the States agreed to forego other revenues and take on new expenditure responsibilities.

The new arrangements have given the States access to a growing revenue source. However, using its legislative powers the Australian Government could unilaterally alter the funding arrangements (particularly in light of its current Senate majority).

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