Review of
Commonwealth – State Funding

Review of Commonwealth–State Funding

FINAL REPORT

A review of the allocation of Commonwealth Grants to the States and Territories

Review of Commonwealth–State Funding
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Final Report

Presented by
the Committee for the Review of Commonwealth–State Funding

August 2002

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Commonwealth – State Funding

30 August 2002

The Treasurers of New South Wales, Victoria and Western Australia
c/- 1 Treasury Place
MELBOURNE VIC 3000

Dear Treasurers

Thank you for inviting us to undertake the Review of Commonwealth–State Funding. We have been glad of the opportunity to review a very important but not widely understood aspect of Australian governance. We have been greatly assisted in our work by a large number of Australians in all States and Territories, as well as officers of your own three Departments.

We enclose our report, and look forward to participating in the public discussion that follows its release.

Yours sincerely

Ross Garnaut

Vince FitzGerald

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Table of Contents

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Ross Garnaut is Professor of Economics at the Australian National University, where he has held posts in economics since 1972. He was head of the Department and Division of Economics in the Research School of Pacific and Asian Studies (1989–2000) and Foundation Director of the Asia Pacific School of Economics and Management (1998–2000).

He is the author of numerous books and journal articles on public finance, international economics and economic development in the Asia Pacific region. He is Chairman of the Asia Pacific Economic Forecasting Group, Chairman of the Board of Directors of Australian public companies (currently Lihir Gold Ltd, previously the Primary Industry Bank of Australia Ltd, the Bank of Western Australia Ltd and Aluminium Smelters of Victoria Ltd), and a Director of others.

Professor Garnaut has held senior economic and financial advisory positions to Governments in Australia, including as Prime Minister Bob Hawke's economic adviser (1983–95), and in Asia Pacific countries, including to the United States Internal Revenue Service. He was the Australian Ambassador to China (1985–88).

He is the author of the influential report to the Commonwealth Government, *Australia and the Northeast Asian Ascendancy*, and chaired the Commonwealth Government's 1993 Wool Industry Review.

Dr Vincent W. FitzGerald
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Dr Vince FitzGerald is Co-Chairman of the Allen Consulting Group Pty Ltd. He has conducted and led a number of reviews of Government policies, programs and organisations, including reviews of the Export Finance and Insurance Corporation and the Bureau of Meteorology for the Commonwealth Government, and of the Office of the Regulator–General and the Department of Human Services for the Victorian Government.

He has advised two State Governments on national taxation and Federal fiscal relations reform (1996–98). He chaired the Queensland Commission of Audit in 1996, which extensively reviewed the Government's performance in both financial and efficiency and effectiveness terms. He also headed an Allen Consulting Group team that advised on the 1993 Victorian Commission of Audit.

Dr FitzGerald is a regular commentator on State and Commonwealth budgets and superannuation, saving, retirement incomes, health funding policies and long-term fiscal issues. He was the author of *National Saving: A Report to the Treasurer* (1993). He is also a Director of ING Australia Holdings Ltd.

Dr FitzGerald was formerly a senior Commonwealth Government official, heading the Departments of Trade (1986–87) and Employment, Education and Training (1987–89) after experience as Deputy Head of the Departments of Finance (1983–85) and Trade (1985–86). Before that he was the head of several Policy Divisions in the Department of the Prime Minister and Cabinet (1979–83).

Executive Summary

This is the Final Report of the independent Review of Commonwealth–State Funding.

The Review was launched in November 2001 by the Governments of New South Wales, Victoria and Western Australia. The three States established the Review to independently assess the Commonwealth's methods of allocating Commonwealth grants to the States and Territories.[1] The Review has considered untied or general purpose grants (about $32 billion per year) and specific purpose payments (SPPs) (about $21 billion per year). The Review's Terms of Reference are listed in Section 1.3.

The Review Committee comprises Professor Ross Garnaut and Dr Vince FitzGerald. We were asked to assess the current system in terms of economic efficiency, equity, and simplicity and transparency, to consider the relative circumstances of the States and, if recommending reforms, to consider transitional arrangements.

The Review has also published a *Background Paper* (December 2001) that explains Australia's current system of Commonwealth–State financial arrangements, and an *Interim Report* (April 2002) that summarises the outcomes of the Review's consultation process.

Background to the Review

Since World War II, when the Commonwealth took control of income taxation, Australia has had a much larger mismatch between expenditure responsibilities and revenue at each level of government than any other Federation. The mismatch became bigger than ever in the 1990s.

The gap in State funding is filled partly from untied payments, which have been funded mostly by the Goods and Services Tax (GST) since 2000. The 1999 *Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations* provided that the GST pool was to be distributed among the States on horizontal fiscal equalisation (HFE) principles, however, the States disagree about exactly what HFE entails. The Commonwealth Grants Commission (CGC) plays a central role in determining the interstate distribution.

The rest of the gap is filled by SPPs. SPPs are concentrated in areas of central importance to equity and equality of opportunity, such as health and education, and in reality these are now areas of shared responsibility between the Commonwealth and State levels of government. These tied payments have proliferated and in many cases involve dysfunctional attempts by the Commonwealth to micromanage service delivery by the States.

[1] States refers to all Australian States and Territories, and State Governments to all Australian State and Territory Governments, unless specified otherwise.

Overall assessment

Economic efficiency

The current system affects national economic performance in many ways.

- Interstate transfers affect the distribution of population, economic activity and development.
- General purpose payments and SPPs involve significant overhead costs and result in game playing.
- The CGC methods for distributing the GST reward 'cost disabilities' and inefficiency, and distort the size and shape of the public sector in recipient States.
- The CGC approach distributes the revenue benefits from economic development around the nation, without similarly sharing many of the costs of economic development borne by State Governments.

An economic study commissioned by the Review puts the quantifiable economic costs of the interstate transfers through the current system at between $150 million and $280 million each year (Dixon et al. 2002). In addition, administration costs for the CGC and SPPs would exceed that amount.

We suspect that the political economy effects on policies favouring development and growth may be more fundamental problems with the current approach. The need for States to prove continually that their service delivery costs are higher, and that their opportunities to raise revenue are lower than in other States, distorts decision making. Equalising away the fiscal effects of a State's good or poor economic performance dulls incentives for growth-promoting policies. The tendency for recipient States to have disproportionately large public sectors and small private sectors makes their Governments less sensitive to the regulatory and policy requirements of strong economic growth in a market economy.

Equity

The current system attempts to equalise the States. However, the concept of equity among States has no meaning; equity must relate to outcomes for individuals and households. The primary test of whether arrangements are equitable is whether they are progressive in redistributing income 'vertically', i.e. from high-income to low-income households.

A detailed analysis commissioned by the Review shows that, in comparison with other methods such as equal per capita distribution, the CGC methods *do not* improve vertical equity and may actually worsen it slightly – mainly by transferring income from Australians in larger States to people with higher incomes in the two Territories (Harding et al. 2002). This arises from methods that significantly misconstrue the capacity of the Territories to raise their own revenues.

'Horizontal equity' refers to the equitable treatment of people who are equally well off, wherever they live in Australia. It is remarkable that the current system emphasises the importance of horizontal equity yet does nothing to address disparities in access to services between regions within States.

Simplicity and transparency

The current system is incomprehensible to most Australians, obscuring political accountability at Commonwealth and State levels. One dimension of the transparency and accountability problem is the CGC's allocation of untied grants in a way that overrides the allocation of funds to areas such as health and education, which are determined under direct legislative and Ministerial authority through SPPs. Another is that in assessing cost disabilities in service delivery, the CGC seeks to equalise State Governments' 'capacities' to spend without the requirement that the funds be used for the purposes in question.

The proposal for reform

The central aim of Australia's system of Commonwealth–State funding should be equitable outcomes for Australian individuals or households. The system should be simple and efficient, and allow all Governments to meet the basic costs of administering a State, while maintaining incentives for utilising Australia's capacity for economic growth. The centrepiece of the proposed reform is a new cooperative model for SPPs in the key merit areas of health and aged care, and education and training. SPPs in these areas would be broad-banded into two national programs in which the States have clear authority over service delivery, without micromanagement and input controls. A third national program would be established in Indigenous community development. The Commonwealth would have primary control over services provided under this program but would work in cooperation with the States. Opportunities would be sought for rationalising responsibility for functions within or closely related to these three areas.

Under this model, Commonwealth and State ministers would jointly determine objectives that specify outcomes to be achieved for individuals and households across Australia, and corresponding performance measures. Funding would be allocated according to the distribution across the States of requirements for the services concerned (i.e. primarily demographic factors). There would be no general or systematic compensation for cost disabilities.

Many SPPs outside health, education and Indigenous community development would be discontinued, and the funds rolled into the two national programs administered by the States. This would free the States' capacity to maintain (at expanded or reduced levels of support) the activities previously funded by discontinued SPPs. SPPs covering cross-border programs such as national roads, agency-type arrangements for particular services between the levels of government and SPPs going 'through' the States (e.g. non-government schools) would be unaffected.

Directly targeting equity through national programs in the main public service areas that involve both levels of government would allow a much simpler, fairer and more efficient way of allocating the untied grants.

Each State would receive a flat amount calculated to cover the irreducible minimum overhead costs of government. Beyond that, the GST pool would be allocated on an equal per capita basis. Each State would be guaranteed that its untied grants, plus Commonwealth payments to the States in the national programs, would not fall below the 2002–03 level in real per capita terms.

The CGC would revert to the role for which it was established, and assess whether additional assistance was required by a State experiencing severe fiscal difficulty.

The future

The arrangements would be revenue neutral for both the Commonwealth and the States as a whole, compared with the case in which the Commonwealth maintains SPP funding in real per capita terms. The guarantee would mean that the main beneficiaries of the present system would retain their advantages for many years. However, the main gains from reform would be realised relatively quickly by all States and by Australia as a whole.

The new model would remove the institutionalised conflict that the current arrangements create among the States and between the Commonwealth and the States. Present political circumstances – a Coalition Government in Canberra and Labor Governments in all States – provide a unique and favourable opportunity for reform of Commonwealth–State funding arrangements.

The new model would leave Australia as the most egalitarian of the world's Federations but with more certain delivery to all Australians of the services that are most important to equity and equality of opportunity, and at far lower cost to State and national economic development.

Reading the Report

The recommended model of Commonwealth–State financial relations for the future is explained in detail in Chapter 13. Chapter 1 outlines the main line of argument in the Report and Chapter 12 summarises the critique of the current system and the need for reform.

The *Background Paper* (2001) and *Interim Report* (2002) should be read with this Report and are available on the Review's website <www.reviewcommstatefunding.com.au>.

CHAPTER 1: Overview and Summary of Recommendations

- There are serious concerns about the effect of established Commonwealth–State financial arrangements on equity among Australians and on Australia's economic performance both nationally and in each State.
- Current arrangements impose an estimated cost of resource misallocation on the Australian economy in the vicinity of several hundred million dollars per year, plus large costs of administering the system. In addition, they reduce incentives for States to pursue policies that enhance economic growth and improve service delivery.
- The 'black box' nature of current arrangements blurs responsibility and prevents the electorate from holding governments accountable.
- A new model of financial arrangements is proposed to correct these weaknesses and to establish a new *Cooperative Federalism*.
- The model's cooperative approach is critically important for equity and equality of opportunity among Australians.

1.1 Context

Australians have become accustomed to Commonwealth–State financial relations being a locus of continuing conflict between Governments. They understand little of the issues that have been the subjects of conflict, and consign these matters to the dustbin of 'politics'.

This is a pity.

The Australian States have constitutional responsibility for the services of greatest importance to Australians' daily lives, including health, education, community services, and law and order. The constitutional division of taxation powers, as its application has evolved through judicial interpretation and the process of politics, overwhelmingly gives the Commonwealth the main capacity to raise revenue. If States are to deliver services demanded by the community, the Commonwealth has to raise revenue and pass it on to the States. In the process, the Commonwealth can decide how the funds will be allocated among the States and impose conditions on their use.

We take it as given that the Australian Federation will continue to function with a substantial disjunction between revenue powers and expenditure responsibilities. Whenever it has been put to the test, the Federal distribution of expenditure powers has been shown to have electoral support. The States that resisted the Commonwealth's accumulation of control over revenue until the 1970s have now acquiesced in the status quo.

The mismatch between the revenue raising capacities and expenditure responsibilities of the two levels of government is much greater in Australia than in other Federations. It is therefore not surprising that the Commonwealth Government's interventions to redistribute revenue among the States, and its influence on State expenditures through conditional payments, are unusually large. It is these features of the Australian system that cause conflict among Governments.

If conflict among Governments were the only problem, it might be safe for Australians to leave these complex matters to politics and politicians. However, this is not the case. There are serious questions about the effects of the established Commonwealth–State financial arrangements on Australia's economic performance both nationally and in each State. There are serious questions about the effects of these arrangements on the equitable distribution of taxation burdens and on access to government services among Australians. The complexity and, to almost all Australians, the incomprehensibility of the arrangements raise serious questions about the accountability of both Commonwealth and State Governments in our democratic society.

1.2 Background to the Review

Over the last few years of the 20th century, the imbalance in revenue raising capacity moved even further in the Commonwealth's direction, with the High Court invalidating State franchise fees and the States giving up further taxes in exchange for grants distributing the net proceeds of the Commonwealth's Goods and Services Tax (GST). These developments significantly increase the Commonwealth's capacity to redistribute revenue among the States and the impact of its methods for doing so.

These issues were not fully resolved in the negotiations leading to the *Intergovernmental Agreement on the Reform of Commonwealth–State Financial Arrangements* signed by all jurisdictions in mid-1999. In particular, there has been disagreement over whether the Intergovernmental Agreement requires the complex methodology formerly developed by the Commonwealth Grants Commission (CGC) for allocating grants to be applied now and in future to the allocation of the GST pool. This is the background against which the Governments of New South Wales, Victoria and Western Australia asked us to review Commonwealth–State financial relations. The Review's Terms of Reference are as follows.

1.3 Terms of Reference

(1) To review and to report to the Governments of New South Wales, Victoria and Western Australia on the methods of allocating Commonwealth grants to the States, the Australian Capital Territory and the Northern Territory.

(2) In particular, the members of the Review Committee should report on whether the current system is effective in relation to:

- (i) efficient allocation of resources across Australia to enhance national employment and economic growth
- (ii) achievement of equitable outcomes for all Australians
- (iii) simplicity and transparency.

(3) The Review should examine and report on the appropriateness of the pattern of intergovernmental transfers. In assessing whether the system is effective in delivering efficient and equitable outcomes for all Australians, the Report should consider the respective budgetary circumstances of the various Governments, and the respective social and economic characteristics of their residents.

(4) The Review Committee should assess whether alternative approaches to allocating Commonwealth grants to the States would achieve the objectives described in (2) more effectively than the existing system and, if appropriate, recommend options for reform. Any proposals for reform of the current system should address costs and processes of adjustment to change.

(5) The Review should consult extensively with interested parties.

(6) The final Report should be provided to the Treasurers of New South Wales, Victoria and Western Australia no later than 31 May 2002.

It is important to note that the Terms of Reference extend over the range of Commonwealth payments to the States, including specific purpose payments (SPPs).

It is also important to note the requirements in the Terms of Reference to consider the fiscal circumstances of the various States and, if proposals for change are made, to consider transitional arrangement for States that might have problems in rapid adjustment.

We sought and obtained assurances from the three Governments that they were seeking an independent review. This Report reflects our own views as they have developed through extensive consultation with others, consideration of the results of commissioned and other studies, and analysis over the period of our work on this project.

Consultation process

The Review has benefited greatly from consultations with past and present participants in and commentators on Commonwealth–State financial relations – at Commonwealth and State levels, in all States, and on both sides of politics. Many contributors presented their views in a submission to the Review, and more than 70 people participated in a National Forum on Commonwealth–State Funding at Old Parliament House in Canberra on 14 March 2002. All submissions are available on the Review's website.

In the early stages of the Review, a *Background Paper* (2001) was published, which provides background material on Commonwealth–State funding. After the National Forum, an *Interim Report* (2002) was published, which summarises submissions made to the Review and contributions to the National Forum, including our own paper, *Issues in Commonwealth–State Funding* (Garnaut and FitzGerald 2002). These publications should be read with this Report and are also available on the Review's website.

1.4 Issues in Commonwealth–State funding

The core requirement of the Terms of Reference is to review the established arrangements for Commonwealth–State financial relations to determine their effects on efficiency (or economic performance, including growth in employment and incomes), equity, and simplicity and transparency.

Efficiency

We have identified ten types of effects on economic efficiency and growth (also see *Issues in Commonwealth–State Funding* [Garnaut and FitzGerald 2002]):

(1) *The tendency for equalising transfers to reduce the incentives for resources to locate in higher rather than lower productivity locations* – conventionally the dominant economic efficiency consideration in assessing horizontal fiscal equalisation (HFE) arrangements.

(2) *The capacity for investment in human resources development in low productivity regions to enhance national economic potential.*

(3) *Incentives for people to stay in locations where their marginal social product is high.* This is the converse of the effects in (1). It could be present if a lower *fiscal residuum* or other cause of divergence between private and public benefits of emigration caused some people to move out of lower income regions when their marginal social product was higher than in the higher-income region to which they were moving.

(4) *Attraction and retention of high-value mobile resources in an international market.*

(5) *Overhead and transaction costs of managing the system.*

(6) *Duplication, lack of coordination and game playing by officials.*

(7) *Enlarged role of the public sector* – recipient States are less responsive to market economy dynamics and do not spend money so closely in accord with citizens' preferences.

(8) *Grant seeking behaviour* – particularly where States have the capacity to influence the CGC's assessed standard budget.

(9) *Diluted incentives for cost reducing reforms.*

(10) *Impact on the political economy* – States are discouraged from growth promoting policies if the fiscal benefits of stronger growth are mostly transferred to others.

A number of representations to the Review emphasised the last of these effects, however, it is not clear how important this is in practice.

Sir Charles Court, a former Minister for Industry Development and Premier of Western Australia over most of the two decades in which Western Australia moved from being a claimant to a donor State, provides eloquent testimony to the discouraging effect of equalisation in a submission to the Review. In Sir Charles' view, the development of Western Australia's large mineral resources involved huge political effort and acceptance of some political costs including, at the time, the costs of confronting unhelpful Commonwealth Governments. For a State to have the revenue benefits of development (which are not simply 'rents') largely equalised away from it by the CGC (90 per cent equalised away in Western Australia's case), while the CGC does not similarly share around the nation many of the costs of development borne by State Governments, discourages such efforts.

Similar points could be made about incentives for development in States that have always been donor States. The CGC's latest report on relativities explains that New South Wales' grant share fell in 2002–03 due to the buoyancy of its real estate and share markets, resulting in an increased capacity to raise revenue (CGC 2002a). Victoria's grant share fell in the same year because strong wages and salary growth increased its capacity to raise payroll tax. However, are these improved revenues 'rent', or is the prosperity of Sydney and Melbourne related to the economic policies of past and present State Governments? Does equalising away the revenue consequences of State Government decisions affect incentives to maintain growth-promoting policies?

Disincentives to growth-oriented policy are probably even more important in recipient States than in donor States. Here they are reinforced by the political economy effects of a disproportionately large public sector in States that are recipients of HFE transfers [effect (7)].

It is common to perceive the efficiency costs of HFE as arising principally from compensation for disabilities on the expenditure side, through their tendency to discourage movement of people out of high cost locations [effect (1)]. However, considering political economy effects focuses attention on the costs of revenue equalisation as well.

Equity

The pattern of Commonwealth–State financial arrangements affects equity in the distribution of economic benefits among Australians in a number of ways. The Commonwealth's personal income tax and social security systems have powerful effects in reducing inequality in the distribution of incomes, and very large effects on interstate distribution of purchasing power and economic activity. The payments to the States are actually smaller in extent and in their impact on interstate distribution, and they are ambiguous in their impact on equity.

What do we mean by 'equity'? The primary test for whether arrangements promote equity is if a policy transfers income, purchasing power or access to services among Australians, and redistributes from richer to poorer individuals or households. This is known as 'vertical equity'.

However, in public finance there is another common concept of equity that is also relevant to this Review. 'Horizontal equity' requires the similar fiscal treatment of people in similar circumstances and deems a policy inequitable if it increases the burdens or the benefits to some individuals or households relative to others in similar circumstances.

Both concepts of equity can be applied to arrangements altering relative taxes, transfers and access to public services across States.

There is sometimes discussion of equity among 'regions'. Concern for a poor region mostly amounts, however, to concern about low average living standards of individuals and households living in the region. It is possible that the incidence of poverty among individuals and households might sometimes be addressed most effectively by programs to assist development generally in a region with many poor people (in contrast with programs dealing directly with individuals or households).

Can States be treated as *regions* in this sense? If we defined especially poor regions that need help and wealthy regions that should help them, none of the regional boundaries identified would coincide with State boundaries. The Australian Capital Territory has the highest per capita income of the States, but there are particular local government areas in New South Wales and Victoria that have higher per capita income than the Australian Capital Territory. On smaller scales again, there are pockets of people in every State with very high incomes. Similarly, there are poor and declining rural communities in all Australian States. There are poor communities in the Northern Territory, for example some remote Indigenous communities, but most communities in Australia have far lower per capita incomes than Darwin. In the wealthy cities of Sydney and Melbourne there are suburbs with poor levels of community services by Adelaide standards. Residents of large parts of rural Australia have access to services that are greatly inferior to what is available to Hobart residents.

Discussion of equity among States sometimes suggests that something quite different is being considered: the idea that all member jurisdictions of the Federation should continue as viable members, and that a State should be assisted if its fiscal circumstances do not allow it to function as a normal member of the Federation, essentially independently of the circumstances of its individual citizens. This was undoubtedly the spirit in which the Commonwealth responded to fiscal distress in the small States early in the Federation, and in the discussions leading to the formation of the CGC in the 1930s (see Chapter 2).

There is also a conception of equitable distribution in which income and wealth should, in the absence of good reason to the contrary, remain with the people whose efforts have helped create it. Within limits, most people would consider greater vertical equity to be good reason at least to reduce differences in income and wealth, rather than attempt to eliminate them. Support for this concept can be found in all ethical traditions. When redistribution is proposed on grounds of vertical equity, in all contexts except that of intergovernmental transfers in Australia, the case is always for less than full equalisation. The top marginal income tax rate is less than 100 per cent because of the incentive effects of complete confiscation of above-average incomes, but also because most people would not see confiscation as equitable in any sense. Equity does not require imposing absolute equality of capacity to provide services in all States, rather than allowing some superiority of service capacity in particular States, which through some combination of skill, effort, prudence and good fortune have contributed more revenue to the common weal and are more efficient in service delivery.

Two different concepts of equity are applied in the current distribution of Commonwealth grants among the States. For example, SPPs for education and health (and there are many narrow SPPs in both these important sectors) are mostly distributed according to the requirement for the particular service being assisted, and the degree of community need. Typically, the starting point for allocating SPP funds among States is an equal per capita distribution, with adjustments for demographic and other factors affecting requirements for a particular service (e.g. for school education funds, outcomes are influenced by the number of school-age children rather than the total number of citizens). There are some departures from this approach, including several historical departures that have led to relatively low overall SPP payments per capita to Queensland.

GST revenue is distributed among the States as untied grants according to the CGC's conception of HFE. The CGC goal is to provide each State with the capacity to provide the same level of services as others if it performs its functions with average efficiency and uses its opportunities to raise revenue to an average extent. A State receives larger grants if the average cost of delivering services is higher than in other States, or if its revenue raising potential is lower than in other States. The focus is on equality of 'capacity' among States, and not at all on equality in 'access to services' among 'regions' (other than States as regions) or households or individuals. It is accepted that the level of services provided to provincial, rural and remote regions, whether in New South Wales, South Australia or Tasmania, is much lower than in Sydney, Adelaide or Hobart. The CGC's objective is, in effect, to ensure that each State has the capacity to provide services in cities at the average level for Australian cities, and services elsewhere at the average level of deprivation relative to cities.

However, CGC decisions on the distribution of untied funds among the States ultimately determine the allocation of *all* Commonwealth funding to the States. SPPs are treated as State general revenue by the CGC, unless explicitly quarantined by the Commonwealth (which is not done for most of the major SPPs). Higher SPPs based on Commonwealth assessment of relative requirements lead to lower shares of the untied grants pool based on the GST revenue. The CGC effectively overrides the assessments that underlie most SPP allocations, which are determined under direct legislative and ministerial authority.

A number of questions relevant to assessing current patterns of Commonwealth–State funding were identified in *Issues in Commonwealth–State Funding* (Garnaut and FitzGerald 2002). The primary question is: how equitable are Commonwealth–State transfers in terms of their effects on the vertical distribution of income among individuals and households. The National Centre for Social and Economic Modelling (NATSEM) was commissioned to analyse these issues. NATSEM's report, *The Distributional Impact of Selected Existing Commonwealth Outlays and Taxes and Alternative Commonwealth Grant Allocation Mechanisms* (Harding et al. 2002), was presented at the National Forum and is available on the Review's website. NATSEM compared the vertical equity impacts of the existing grant allocation system with those of other Commonwealth fiscal interventions, including major impacts of the social security system and income tax. It also compared alternative systems of distributing Commonwealth funding among the States, according to State of origin of the revenue and an equal per capita basis.

There does not appear to be an 'equity' case for distributing grants to the States beyond the effect it has on income distribution among individuals and households in Australia.

Simplicity, transparency and accountability

The terms of reference related to simplicity and transparency are straightforward. We think that accountability of governments to the electorate requires simplicity and transparency, and so discuss these three criteria together in the Report.

1.5 Overall assessment of current arrangements

The Australian Federation is now a deeply integrated economic entity, with complex redistribution of resources, incomes and fiscal capacity among the States. Transfers of resources among States associated with Commonwealth payments to them are smaller than transfers associated with general taxation and social security. Australia's progressive taxation and social security systems enhance incomes and activity in Tasmania and South Australia and restrict them in some other States, more than the pattern of Commonwealth payments to the States (see Chapter 8). These transfers through general mechanisms are highly progressive at a household level, and reflect community values expressed through the national electoral process.

This Review is concerned with Commonwealth payments to the States. Transfers associated with these payments are smaller than transfers resulting from the social security and tax systems, both in size and importance to equity, but are nevertheless an important part of the national economy.

The Review has examined the ways the established pattern of Commonwealth payments to the States affects national economic performance. Overall, Commonwealth payments impose a substantial static resource misallocation cost on the Australian economy, at a potential cost of several hundred million dollars per year.

The improved Australian economic performance of the past decade is widely recognised as emerging from many reforms to remove arrangements that have caused resource misallocation. In this context, calculation of static resource misallocation costs suggests that reform of Commonwealth payments to the States is a medium-sized reform: somewhere between the larger effects of *A New Tax System* in 2000 and the substantial but more modest effects of the reduction in motor vehicle protection recommended by the Productivity Commission in 1997.

Economic gains from efficiency raising reform are greater than suggested by economic analysis, due to the reallocation of a fixed amount of resources among activities of varying economic value. Additional gains from economic reform may come from changes in incentive patterns that affect the total amount of resources (e.g. changes leading to the inflow of capital or skilled labour, or to greater commitment to education and other means of increasing human capital). Gains may come from changes in incentive patterns affecting the intensity of the search for more productive ways of using resources, or the intensity with which resources are applied to increasing output. Some economic reforms have a powerful dynamic effect through the pressures they apply to Government policy making, leading to other efficiency raising reforms. Opening the Australian capital and goods markets to international competition in the late 20th century is generally considered to have had powerful dynamic effects of this kind.

The dynamic effects of Commonwealth–State financial relations on economic performance would seem to be particularly important. The current arrangements inhibit growth through dynamic processes in several ways:

(1) State Governments have reduced incentives to pursue growth-enhancing policies because of systematic equalisation of the revenue costs and benefits of growth-enhancing or growth-inhibiting economic policies.

(2) Efforts to improve efficiency in service delivery are diminished because payments depend on each State demonstrating that its costs of delivering services are above average.

(3) Blurred lines of responsibility between the Commonwealth and the States for funding and delivering services reduce accountability and the focus on performance.

(4) The current arrangements contain disincentives for Australia's largest cities to accept high levels of immigration, including through the under-investment in urban infrastructure that has been placed under stress by high levels of immigration.

In addition, there are signs that the exceptionally large role of the public sector and exceptionally small role of the private sector in some States that are large recipients of transfers, notably Tasmania and South Australia, have changed the political orientation in ways that are unfavourable to growth. These effects are difficult to quantify. However, a systematic tendency for the recipient states of Tasmania and South Australia to give higher priority to social and environmental development objectives and lower priority to economic development objectives – relative to the donor States – is apparent in recent attempts at grading State policies (Evatt Foundation 2001).

The effects of the current arrangements on equitable distribution are less clear-cut. The concept of equity does not have much meaning when applied to States as entities, independently of individuals and households within the States. At the level of income distribution, taxation burden, and individual and household access to Government services, Commonwealth payments to the States change the distribution without making it significantly more or less equitable. If anything, there is a weak tendency for the current arrangements to shift benefits from relatively poor to relatively rich Australians.

There is one way in which the current system of payments to the States may have a more important, but negative, effect on equity than has been suggested. Under the established arrangements, access to the merit services most important for equality of opportunity can be withheld disproportionately from parts of the Australian community. Health, education and Indigenous community development services are most important in this context.

The established arrangements perform poorly against the criteria of simplicity, transparency and accountability. The search for more perfect ‘equalisations’ has led to ever-increasing complexity in the system, excluding all Australians – except for a few specialists – from understanding how funds are allocated among States and activities. This complexity has also precluded most Australians from gaining a reasonable understanding of which level of government is effectively responsible for the level and quality of various services.

Whatever its merits on grounds of equity and efficiency, there are no doubts about the complexity of the established system of Commonwealth payments to the States. The processes for determining both general purpose grants and SPPs are incomprehensible to almost all Australians. An additional layer of complexity emerges from the interrelationship between these broad funding streams. Inaccessibility creates a problem of accountability for the transfer system and for the activities funded by them, which consequently includes the performance of State Governments and, to some extent, the Commonwealth Government.

With GST grants, the problem of transparency and accountability does not arise from any concealment of the general principles the CGC seeks to apply. However, the CGC does not often provide reasons behind the judgments it makes when applying these principles. The problem arises from the sheer complexity of their divergence from common understandings of equity, and of the calculations made to apply the principles. Similarly complex arrangements have emerged in other areas of public administration where officials have been given an element of autonomy in implementing policy. Australia's genius for almost infinite bureaucratic elaboration of less or more soundly based principles under the banner of equity can be demonstrated by: the old system of made-to-measure tariff protection; the arbitration system; the *Income Tax Act 1986*; superannuation; the social security system; and much business regulation. Complexity creates large compliance costs for system users, increases the difficulty of performance evaluation and efficiency raising reform, and creates problems of accountability in a democratic polity.

Even in principle, the CGC approach to equalisation is far more complex than generally perceived. It differs considerably from commonly held notions of equalisation and equity, and is not transparent to the Australian community.

Simplicity and transparency are even harder to find at the level of detailed implementation. The fine detail of the assessments is even difficult for experts to interpret. It is not easy for the assessors to be held accountable for the subjective judgements involved in decision making (along with much objectively verifiable information) to political representatives and the electorate. In short, the system of allocation of untied grants is largely a ‘black box’.

With SPPs, complexity has different origins and characteristics. Different degrees of conditionality are applied to different sectors and to different programs within sectors. There are around 120 SPPs, most with different rules and processes of administration. Most are based on some conception of ‘needs’, although the methods used to assess needs vary.

The most important source of complexity in SPPs is the blurring of responsibilities between Commonwealth and State Governments. The Commonwealth purports to place conditions on the funds that it provides, while the States utilise the potential for money saved from one activity to be spent on others (fungibility) to retain a considerable degree of actual control. Meanwhile the public has difficulty identifying which level of Government is responsible for good and poor performance.

One consequence of overlapping responsibilities is high compliance costs for people and organisations seeking to utilise government-funded services in areas of shared responsibility. This has been a theme of representations to the Review from business and community welfare groups.

There is consistent support for reforming and simplifying SPPs, including consolidating SPPs in areas of State constitutional responsibility into a small number of national programs. Commonwealth conditions would take the form of jointly developed and agreed broad outcome objectives. Performance against objectives would be monitored, without Commonwealth involvement in the actual management of service delivery. (There may be some areas of shared responsibility where it would be appropriate for the Commonwealth to accept administrative responsibility and for the States to agree on and monitor performance against objectives.)

Cooperative reform of funding and responsibilities for merit services that are most important to equity, and to equality of opportunity – particularly education and health – is the key to achieving greater simplicity, transparency and accountability, and more equitable outcomes for all Australians.

Reforming arrangements for SPP allocation on such a model will also open the way to a simpler and more efficient system for allocating untied grants.

The need for reform

The Review's consultations across the Australian community have demonstrated almost unanimous opinion that SPPs have proliferated to the point where they are dysfunctional in the Australian Federation and in public sector management. However, these payments are targeted at core public services that are most important to equity and equality of opportunity, the funds are distributed under direct legislative and ministerial authority and accountability, and funding is tied to use for the intended purposes. Reform of Commonwealth–State financial relations must encompass fundamental changes to SPPs in these merit areas rather than abolishing them.

The distribution of untied grants is more contentious. In particular there are widely differing views on the application of HFE and the role of the CGC.

Much of the continuing conflict between Commonwealth and State Governments derives from the States' uncertainty about funding levels and an associated requirement of endless negotiation. This weakness of our Federation does not need to be permanent.

Uncertainty about the total payments of untied grants to the States has been reduced considerably by the arrangements for distributing GST revenue to the States, which were introduced in 2000. More generally, this is an important basis for reducing uncertainty.

1.6 The new model

A new model for Commonwealth–State financial arrangements is described in Chapter 13. The new model has the following main features:

Many SPPs would be abolished in their present form.

Exceptions are cross-border programs such as national road funding, and certain areas where the Commonwealth essentially enters into an agency-type arrangement with a particular State or States (e.g. to provide security for a Commonwealth meeting), and existing SPPs 'through' the States (where funds are simply on-passed, e.g. to government schools). Funding from abolished SPPs would be transferred into three cooperative national programs for the Health and Aged Care, Education and Training and Indigenous Community Development sectors. The States would be free to reduce their commitments to these sectors in line with the shift of Commonwealth resources towards them and to use the savings to compensate for SPPs forgone in other areas. Ministerial councils, chaired by a Commonwealth Minister, would provide the national programs with broad objectives in outcome terms. The Ministerial Councils would define criteria and measures by which outcomes would be assessed against objectives. In the Health and Aged Care and Education and Training Programs, control of service provision would be the unambiguous responsibility of the States. In the Indigenous Community Development Program, the Commonwealth would have overall control of services provided under this program and coordinate with State service delivery. Opportunities would be sought for further rationalisation of functions within or closely related to these areas between the levels of government.

The Commonwealth would undertake to provide funding to the Health and Aged Care and Education and Training programs that at least maintained the real per capita levels of SPPs to be replaced in 2002–03 for Australia nationally, after deducting funding for SPPs dedicated to Indigenous services which would be allocated to the Commonwealth-administered Indigenous Community Development Program. Funding for the three national programs would be distributed across the States according to broad criteria agreed by the ministerial councils. The criteria would be predominantly demographic measures of distribution across States of the requirement for the program. There would be no general or systematic allowance for cost disabilities. In State activities currently covered by SPPs that are earmarked for removal, but are outside the three cooperative national programs, funding would be the unambiguous responsibility of the States.

The reformed SPP system would become the primary vehicle for achieving equitable access to public services.

Accordingly, existing general purpose grants, of which 90 per cent is GST revenue, would be distributed to the States according to a reformed conception of HFE. The distribution formula would provide for a lump sum to be made available to each State in recognition of irreducible minimum overhead costs of government. This would be expected to grow in nominal terms at a rate close to the rate of inflation, as minimum costs of government are not related to population. Above this lump sum, general purpose grants would be allocated among States in proportion to population and would be expected to grow with GST revenue – i.e. broadly in line with national income.

The Commonwealth would maintain its current commitments to untied funding. All GST revenue would continue to be provided to the States, along with competition policy payments, which would continue to be indexed by the Consumer Price Index. The Commonwealth would also include the funding previously committed for budget balancing assistance to the States ($1.7 billion in 2002–03; declining to zero by 2007–08).

The current budget balancing guarantees on revenue to individual States would be replaced by a guarantee to each State that the sum of its untied grant and funding for the two national programs for which it has primary responsibility would not fall below the 2002–03 level in real per capita terms.

The CGC would be restored to a role similar to that which it played from its establishment in 1933 to the 1970s.

It would also review periodically the level of the lump sum allocated to the minimum overhead costs of government.

At the request of some State Governments, the CGC could review the guarantee on minimum untied grants to a State that had enjoyed exceptionally strong economic growth.

At the request of any State that, in its own view, was experiencing such large fiscal problems that its capacity to operate effectively as a member of the Australian Federation was at risk, the CGC would assess whether a larger guaranteed minimum grant was required.

Each State would be guaranteed that the sum of general purpose payments and the Commonwealth's contributions to the two national programs administered by the States in each future year would be at least as high in real per capita terms as the sum of these payments in the base year (2002–03).

The arrangements are designed to be revenue neutral for the Commonwealth and all States in the base year; and thereafter for the Commonwealth and the States as a group, where the comparator is maintenance of real per capita SPPs at their 2002–03 level.

The case for the new model

The proposed model would establish a basis for a new cooperative Federalism.

It would remove built-in conflict between the Commonwealth and the States on the amount of payments, and among the States on their distribution. Commitments on minimum levels of funding would be reasonable in the light of the Commonwealth Government's *Intergenerational Report* (2002b) (see Chapter 12).

The new model would establish a cooperative basis for delivering services that are critically important for equity and equality of opportunity among Australians.

It would restore incentives for State Governments to pursue policies that promote economic development and reduce service delivery costs.

The new model would support more efficient allocation of Australian resources and lead to a higher level of national economic output. The reallocation of resources would occur gradually as a result of the guarantees on minimum funding to each State. Nevertheless, a high proportion of the gains would be realised while the guarantees remained influential.

Some States which are the recipients of transfers under the current arrangements expect – or at least hope – that their shares of GST payments would be even higher in future, and may see the proposed model as a threat to this hope. We suggest that a rational comparison of the recommended model with the risky possibilities from the current, disputed arrangements may lead them to consider the reform proposal more favourably.

The proposed guarantees on minimum levels of untied grants preserve elements of recipient States' advantages over long periods and entrench historically high recent transfers to several States. The recognition of overhead costs is favourable to the less populous States. The recommendation that population and not State of origin should be the basis of allocation beyond coverage of government overheads is, in itself, highly redistributive towards low income States.

These benefits would be more secure if they were the subject of agreements among all States, rather than being the subject of continuing dispute as now seems inevitable under the current application of HFE.

The proposed guarantee on minimum SPP levels would remove a major element of uncertainty for all States.

Recipient States would share in the improvements in national economic performance within the new model. Growth in any part of the deeply integrated Australian national economy provides opportunities for all Australians. The high mobility of the Australian population and relatively high levels of international migration cause growth and rising costs in some regions to generate movement of people and economic activity to other places. In this, the fortunes of different Australian regions are more closely linked through the operation of the market economy than in other Federations.

Above all, recipient States would have favourable funding arrangements maintained without constantly having to prove their economic disabilities to the CGC and to other Australians. They would maintain favourable funding arrangements without having to prove that their service delivery costs were exceptionally high. The incentive structure for growth-promoting economic policies would be much stronger, since they could plan on utilising the fiscal dividends of more rapid growth in ways that secured benefits for their electorates.

For this reason, the benefits of the new model may turn out to be especially large in the recipient States. South Australia, Tasmania, the Australian Capital Territory and the Northern Territory do not need to be economic 'basket cases' (see Chapter 12). Each of these States has opportunities for strong economic growth in the decades ahead, and has important comparative advantages in the contemporary national and international economies. Several have Governments that recognise opportunities for growth, and are introducing policy reform to utilise their States' opportunities. The new model would support uninhibited commitment to policies that accelerate development in recipient States. The fiscal benefits of each State's success would be available for improving services or further promoting development within the State.

The outcome would be exciting and rewarding for the whole of Australia, and not only for people living in States which have for too long regarded themselves, and been regarded by others, as not fully sharing in the economic dynamism of modern Australia.

CHAPTER 2: How the System Grew: A History of Commonwealth Grants to the States

- The guiding principles of Australia's Commonwealth–State financial arrangements have changed significantly since Federation.
- The principle used to distribute funding among the States is horizontal fiscal equalisation, although there is no agreement between the States on what horizontal fiscal equalisation means in practice.
- Since its establishment in 1933, the Commonwealth Grants Commission has had significant influence on the interpretation and application of horizontal fiscal equalisation. It has changed its interpretation over time from one of limiting disadvantage, to full equalisation of all States – including specific purpose payment allocations.
- Reforms accompanying the introduction of the *New Tax System* in 2000 have improved Commonwealth–State financial arrangements, although further reform is needed to remove continuing weaknesses.

2.1 Introduction

In Australia, more than other Federations, there is a huge mismatch between the Federal Government's dominance of revenue raising powers, and the States' constitutional responsibility for providing basic services. This mismatch is known as vertical fiscal imbalance. It stems partly from the original assignment of expenditure functions and revenue raising powers in the Australian Constitution. It is also partly a consequence of subsequent High Court interpretations (Dollery 2001) that have sanctioned the Commonwealth's monopolisation of the income tax base (constitutionally a shared base) since World War II, and virtually excluded the States from any taxation related to the sale of goods.

On the other hand, there is less imbalance in Australia than the other Federations between the fiscal strength and capacity of Governments on the same tier of the political structure, for example, between States. Fiscal imbalances at this level are due to differences in the average cost of carrying out government functions (e.g. due to differences in administrative scale) relative to differences in the ability to raise revenue (e.g. due to differences in natural resources).

Horizontal fiscal equalisation (HFE) refers to arrangements within a Federation to reduce or eliminate differences in the fiscal ability of States to carry out the functions for which they are responsible.

At Federation, it was envisaged that sharing the Commonwealth's ostensible surplus revenue through grants would not be a permanent feature. It was expected that assistance to States with fiscal difficulties would be exceptional rather than ongoing. Yet, particularly in recent decades, a high degree of HFE has evolved as an ongoing feature of Australia's intergovernmental financial relations. This Review questions the current practice of HFE, not the ultimate aim of achieving equitable outcomes for all Australians. This chapter examines the development of intergovernmental fiscal arrangements in Australia since Federation. It focuses on changes in the application of HFE in the distribution of general purpose grants and the increasing role played by specific purpose payments (SPPs).

2.2 Federation, distribution of surplus revenue, and specific purpose payments

Vertical fiscal imbalance has been a feature of Commonwealth–State relations in Australia since Federation. When the States (then colonies) agreed to join the Federation, they ceded control over customs and excise duties to the Commonwealth. Before Federation, these duties comprised 76 per cent of the colonies' taxation. In recognition of this, the basis for an intergovernmental revenue sharing arrangement was included in the Constitution drafted in the 1890s and implemented from 1 January 1901. Section 87 provided that the Commonwealth return three-quarters of these duties to the States, without any controls on the way money was spent for ten years.

The Constitution also provided that surplus revenue of the Commonwealth be paid to the States. The Commonwealth initially had far greater capacity to raise revenue than the States. However, the States maintained their expenditure responsibilities in areas such as law and order, commerce and industry, transport, water supply and sewerage, and education and health. The States' problems were exacerbated when the *Surplus Revenue Act 1908* ended delivery of surplus revenue to the States to prepare for the Commonwealth's introduction of pensions. Talks betweens the States and Commonwealth took place from 1906 to 1909 in an effort to find a compromise over this loss of revenue, and in 1909 it was finally decided that the Commonwealth would provide grants to the States on an equal per capita basis. This system endured until 1927 despite opposition from some States, in particular Tasmania, Western Australia and South Australia.

Some States demanded additional assistance in the form of special grants. Section 96 of the Constitution enabled the Commonwealth to grant financial assistance to States in the form of general revenue, SPPs and equalisation grants. Special grants were made to States with consistently weak financial positions, beginning with Western Australia in 1910–11, extending to Tasmania in 1912–13 and to South Australia in 1929–30. These States became regular recipients of these grants, which were to a considerable extent made on an ad hoc basis. Consequently a degree of horizontal fiscal imbalance emerged, seemingly as more than a transitional feature. Fiscal dependence on the Commonwealth, combined with political debate on the economic side effects of Federation (notably the impact of a uniform external tariff), saw special grants to the States become an increasingly important feature of Commonwealth–State funding from 1910 to the 1920s (CGC 1995).

Western Australia was particularly disadvantaged by some effects of Federation, with the Commonwealth granting it a special exception to the application of the national tariff, to phase out by 1906. When the special tariff expired, Western Australia's problems had not significantly eased, and it applied for and relied on the Commonwealth's special grants for support well into the 1920s (Mathews and Jay 1997).

The concept of equalising grants became a feature of the intergovernmental system more generally, mainly in recognition of Tasmania's situation (Matthews and Jay 1997). After experiencing fiscal trouble both before and after the Federation, Tasmania first applied for special financial assistance in 1911. The State became increasingly vocal in expressing grievances regarding the fiscal impact of the Federal system. While Western Australia was most affected by the uniform national tariff, Tasmania and South Australia also felt the effects. All three States expressed concern about the impact of the *Navigation Act 1912*, which artificially inflated the freight costs for manufactured goods, and the *Commonwealth Conciliation and Arbitration Act 1904* (CGC 1995).

Requests by Western Australia, South Australia and Tasmania for special assistance increased throughout the 1920s and early 1930s. These requests were subjected to, at best, haphazard assessment by a variety of bodies and institutions (Prest 1964). Several Royal Commissions examined the impact of Federation on States. The first of these was the 1925 *Royal Commission on the Finances of Western Australia as Affected by Federation*.

Support for a new method of assisting the States emerged from a 1925 Royal Commission on the problems of Tasmania, with Hobart statistician L.F. Giblin convincing the Royal Commission to suggest a shift away from the equal per capita distribution system.

In 1926, Giblin advocated a system of differential per capita payments, arguing for the establishment of an independent institution to distance grant allocation from the political process (Prest 1964). He believed the per capita system of payment, in place since World War I, could be made to function more efficiently (CGC 1980). Further support was presented before the 1928 Royal Commission on the Constitution, most notably from Giblin, J.B. Brigden and L.G. Melville. In 1929 the Labor Party, which had refused representation on an independent institution in opposition, was elected. As the report's recommendations faded into obscurity (CGC 1995), grant allocations continued to be dealt with at the political level.

2.3 Creation of the Commonwealth Grants Commission

At the end of 1931 the Federal Labor Party under Scullin was defeated by Joseph Lyons' United Australia Party. A former Premier of Tasmania, Lyons was more sympathetic to the problems experienced by the less financially robust States, which were being discussed in Cabinet in conjunction with the proposal to establish an independent institution (May 1971). Lyons referred to these discussions when introducing the 1932–33 Budget in September, but no action was taken that year, increasing strains in Commonwealth–State financial relations (Hodgins et al. 1989). By this stage, the weaker States were actively campaigning for the establishment of an institution to inquire into the financial status of the less populous States, and were frustrated by the inactivity in this area. At the January 1932 Premiers' Conference, Tasmania asked the States to support the creation of an institution to conduct inquiries into special grants (CGC 1995). The three claimant States then presented a combined submission to the Commonwealth in January 1933.

The problems experienced by both claimant and donor States greatly worsened during the Great Depression. Export prices fell substantially, disproportionately affecting exporting States such as Western Australia, with the effects exacerbated by the Scullin Government's large increase in tariff protection. This encouraged a growing secessionist movement in Western Australia (Hodgins et al. 1989), which led to majority support in a secession referendum in 1933. (The submission to secede was rejected by the British House of Commons Joint Select Committee in 1935.) Secessionist sentiments from the west reinforced the pressure on the Commonwealth Government coming from Tasmania and South Australia to establish an institution to advise on the distribution of special grants (May 1971).

The proposed Commonwealth Grants Commission (CGC) would assess and make recommendations on the applications of claimant States for Commonwealth funding. There was much debate about the need for such an entity, how much power it should have, and the issues it should cover. The Commonwealth Grants Commission Bill of 1933 initially provided for a five-member Commission, with member terms of five years. Debate centred on issues of power, with the less populous States concerned that the CGC would obstruct what needed to be done. Several members of the Federal Parliament believed a specialised body was unnecessary and suggested that a Parliamentary inquiry, even a long-running one, would perform more efficiently (Brigden, cited in Prest and Mathews 1980).

The supporters of the creation of the institution ultimately won the political contest, with the larger States apparently regarding the CGC as irrelevant. The claimant States were its main advocates, with the other States not attaching great importance to its work until they recognised the potential for adverse effects late in the 20th century.

Devising initial CGC principles (1933–36)

The CGC grappled with formulating principles to guide the allocation of funds to claimant States, concluding after its first three years that distinct differences among States would require an ongoing and carefully calculated system of compensation. It decided that there was no point in trying to equalise all States completely, and that calculating relativities based on the costs of Federation to the States would see even donor States labelled with an ostensible disability in terms of intergovernmental funding (CGC 1980). After its first year, the CGC established that it should not calculate grants according to Federal disabilities but assess claimant States according to the 'needs' principle (i.e. their budgetary needs relative to a 'normal' State's standard expenditures and revenues [May 1971]).

The principle of financial need, derived from the work of L.F. Giblin in the mid- to late-1920s, came to guide the CGC when it assessed special grant requirements of claimant States. Financial need was defined in the CGC's *Third Report* as follows:

> Special grants are justified when a State through financial stress from any cause is unable to efficiently discharge its functions as a member of the Federation and should be determined by the amount of help found necessary to make it possible for that State by reasonable effort to function at a standard not appreciably below that of other States (p. 75).

It is unclear how wide the CGC intended the reach of 'standards not appreciably below that of other States' to be, but its analysis and recommendations demonstrate that it was mostly concerned with helping distressed States, rather than equalising all States to a similar standard. At that stage, the CGC was concerned with claimant States only, seeking to alleviate their fiscal difficulties and not to achieve equal standards over a range of services. Even so, the Commonwealth Treasury opposed the CGC on this, believing the grants were larger than necessary due to the chosen methodology (May 1971). The Commonwealth was 'not entirely satisfied with the "needs" basis' (Maxwell 1980). The 'needs' basis, originally designed to assist smaller States in financial distress, has evolved over time. In recent decades it has metamorphosed into the doctrine for comprehensive equalisation encompassing all States.

At first, the CGC did little to ease the tensions in intergovernmental financial relations, with Western Australia continuing to threaten secession and pressure continuing from Tasmania and South Australia. The CGC confirmed that Western Australia, South Australia and Tasmania required special consideration as claimant States (Hodgins et al. 1989).

The Commonwealth expressed dissatisfaction with the CGC in several arenas. In 1935 the Treasury disagreed with the approach and conclusions of the CGC, with then Commonwealth Treasurer R.G. Casey criticising the CGC methodology and performance (CGC 1995). Prime Minister Lyons attempted to hand the role performed by the CGC over to the Interstate Commission, for which provisions had been made in the Constitution. Western Australia and South Australia pressured Lyons to push the changes through, but there was no progress until April 1936 when Lyons decided to extend the CGC for another twelve months while legislation to resurrect the Interstate Commission was drawn up (CGC 1995).

By the time this legislation was introduced, however, it was too late to create the Interstate Commission before the CGC expired. The CGC appointments were extended for another six months (CGC 1995). A 1937 election stifled further attempts at reform, with CGC appointments extended again. The issue was abandoned in the late 1930s when war precautions consumed the attention of Parliament (May 1971). Although revisited in 1945 and 1947, by then the CGC was too well embedded in Commonwealth–State financial relations to be readily removed (May 1971).

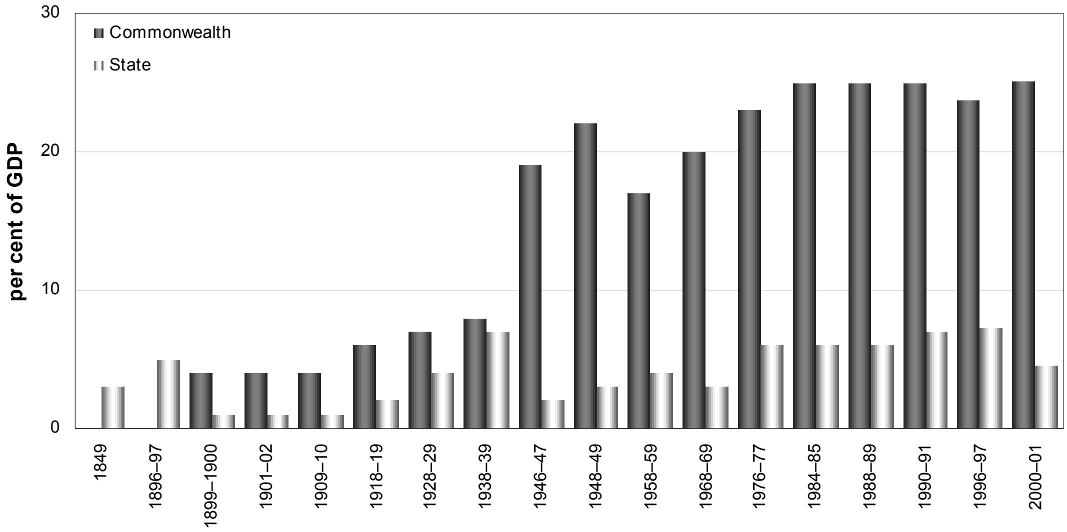
2.4 Increased vertical fiscal imbalance through Commonwealth monopolisation of income tax

The CGC's role and responsibilities expanded from 1942 to 1945. At the June 1941 Premiers' Conference the States rejected a Commonwealth proposal to levy uniform income tax legislation for the duration of the war, but in May 1942 the Commonwealth used its expanded wartime powers to override them.

After the War, and with subsequent High Court sanction, the Commonwealth used its grants powers to block the States from re-entering the income tax field, with the *States Grants (Tax Reimbursement) Act 1946* obliging States either to forgo levying income taxes or to operate without Commonwealth grants (Mathews and Jay 1997). This effectively excluded the States from taxing income, and the Loan Council, established in 1927 to regulate and coordinate borrowing by the Commonwealth and State Governments, severely restricted them in their borrowings (Mathews and Jay 1997). Constitutionally the States could still levy income taxes, but they would have to do so in addition to the Commonwealth tax and re-establish separate administration. This was politically infeasible.

Figure 2.1 compares State and Commonwealth tax revenues over time as a percentage of gross domestic product. It shows the dramatic impact of the assumption of control of the income tax by the Commonwealth on vertical fiscal imbalance. Between 1938–39 and 1946–47 Commonwealth tax revenue as a percentage of gross domestic product more than doubled. This is mirrored by a large reduction in States' tax revenue.

FIGURE 2.1: Taxation as a percentage of gross domestic product



Source: Smith 2000; ABS cat. no. 5512.0

The Commonwealth's introduction of uniform income tax legislation was the first in a series of significant changes in the CGC's operational environment. At this stage, the CGC was given the additional duty of overseeing applications for additional funding due to inadequate reimbursement from the Commonwealth.

To compensate for the impact of uniform income tax, tax reimbursement grants to the States were created under the *States Grants (Income Tax Reimbursement) Act 1942*. The grants were implemented from 1942–43 and reimbursed States for the average amount of income tax raised in 1939–40 and 1940–41. After World War II, a formula was applied to the reimbursements for ten years to make the grants proportionate to the States' populations, adjusted for age and population density (Mathews and Jay 1997). By 1957–58 tax reimbursement grants were distributed by the CGC entirely on the basis of adjusted populations (Mathews and Jay 1997). In 1959–60 the grants became known as financial assistance grants. The States tried to regain access to income tax in the 1950s, but the Commonwealth decreed that since uniform income taxes had only been imposed through Commonwealth legislation, income tax would remain a Commonwealth monopoly. In effect, the Commonwealth used the States' refusal to play according to the Commonwealth's rules at the 1941 Premiers' Conference to retain more fiscal power than it had first proposed.

The years after World War II were fiscally difficult for the States, with the three claimant States coming to depend heavily on grants recommended by the CGC (Prest 1964). During the 1940s and 1950s, pressure on States' finances continued to increase due to the costs of improving services such as education and health for a rapidly growing population. The extreme vertical fiscal imbalance that emerged from World War II was exacerbated by the Commonwealth's domination of the Loan Council. The Commonwealth also began to offer SPPs, reflecting its policies and priorities for the areas concerned (Mathews and Jay 1997). In response, at the March 1959 Premiers' Conference, the States attacked the Commonwealth's fiscal powers. Three months later, the tax reimbursement grants were replaced by financial assistance grants, confirming the States' reliance on Commonwealth grants.

States continued to protest vigorously against the uniform tax legislation, with New South Wales and Victoria deeply dissatisfied with the Commonwealth's monopolisation of income tax. Victoria challenged the uniform legislation, but the High Court decreed that the Commonwealth was within its rights to implement the legislation under wartime powers, and it could use its grants power to dominate the income tax field under peacetime conditions (Economic and Budget Review Committee 1986). In the second Uniform Tax Case in the High Court, in August 1957, the judiciary once again supported the Commonwealth (Reid, cited in Prest and Mathews 1980). The Premiers' Conference in March 1959 focused on the return of income taxation powers to the States and, although agreement was not reached, another Premiers' Conference later that year saw the Commonwealth concede that intergovernmental grants should be changed to recognise that grants had become more than simply financial compensation for State income tax revenues forgone (Prest 1959).

While South Australia, Tasmania and Western Australia continued to receive special grants according to CGC criteria, the need for review was also apparent when Victoria and Queensland applied for special grants in 1957. Income tax reimbursement grants had grown to become the largest part of Commonwealth grants in 1958–59, and were determined according to a formula that accounted for increases in population and the Australian average wage rate (Prest 1959).

The CGC initiated a new scheme that increased grants in consideration of States' more difficult fiscal circumstances. It calculated the gross financial assistance grant in 1959–60 according to the old formula but incorporated further payments from the Commonwealth (Reid, cited in Prest and Mathews 1980). At this stage the CGC assessed only special grants for the claimant States (now fewer) that were essentially supplementary to the tax reimbursement grants (CGC 1995). The new plan was implemented on the understanding that Queensland and South Australia would only apply for claimant status in dire circumstances. Although the CGC's role was ostensibly reduced it maintained that the amount of required investigation work would remain much the same in each of these two States, irrespective of the size of the grant, and that the CGC would need to maintain its continuous review of the budgets of the non-claimant States, particularly South Australia and Queensland (Reid, cited in Prest and Mathews 1980).

2.5 Whitlam's centralism and Fraser's New Federalism

The biggest shifts in intergovernmental fiscal relations through the 1960s and 1970s were the centralisation that took place during the Whitlam Government, with its a huge increase in SPPs, and the Fraser Government's attempts at partial reversal and reform through its *New Federalism* policy. *New Federalism* saw the CGC determine per capita relativities and become responsible for the distribution of general revenue grants among all States – a major expansion from its original role of dealing with claimant States.

Under the Whitlam Government, the Commonwealth shifted to spending heavily in areas that were constitutionally the States' responsibility. This was a major new development in intergovernmental fiscal relations (Hancock and Smith 2001). SPPs quadrupled between 1959–60 and the early 1970s, growing significantly faster than general revenue grants (Mathews and Jay 1997). Substantial SPPs were established in the areas of education, housing, health, urban and regional development, and transport. The Whitlam Government absorbed responsibility for the size and direction of new programs in local government and also sought to direct their implementation. It argued the case for its heavy involvement in areas of traditional State responsibility by attacking the States' failure to provide services and maintain and extend infrastructure (Mathews and Grewal 1997). The States responded that the loss of their major tax source and lack of full compensation through general revenue grants had prevented them from providing adequate services.

Between 1972–73 and 1975–76, grants to the States increased from 8.1 per cent to 11.2 per cent of gross domestic product (Federal–State Relations Committee 1998). The legislation governing the CGC was amended at this time to give it additional power to advise on local government funding and on special assistance to States. Following the formulation developed in the mid-1930s, the *Grants Commission Act 1973* stated that grants would be allocated 'for the purpose of making it possible for a State, by reasonable effort, to function at a standard not appreciably below the standards of other States'.

When the Fraser Government replaced the Whitlam Government in 1975, there had been increasing tension between the Commonwealth and the States over grant conditions and natural resources. This encouraged the new Commonwealth Government to offer some compromise (Hodgins et al. 1989). Although the Fraser Government moved towards a system of tax sharing entitlements, increased funding to local government was broadly maintained. The CGC's role in allocating grants to local government was abolished and funding was distributed among States on an equal per capita basis. SPPs decreased from 4.6 per cent to 3.5 per cent of gross domestic product between 1976–77 and 1982–83. This coincided with the commencement of the 'inclusion approach' where the CGC considered the distribution of school grants (1976) and then hospital grants (1977) when assessing untied grants (Mathews and Grewal 1997).

Under the Fraser Government's new system, the States would receive a direct share of personal income tax. The *States (Personal Income Tax Sharing) Act 1976* prescribed payment to the States of a fixed share (just over one-third) of Commonwealth personal income tax collections. It also incorporated a guarantee that no State would receive less funding than the amount payable under Whitlam's *State Grants Act 1973–1975* (Economic and Budget Review Committee 1986). There would also be a shield against States suffering falls in income tax yields (Mathews and Grewal 1997). The four less populous States (then excluding the Territories) were still free to apply for grants over and above their tax reimbursement grants. A Council for Intergovernmental Relations was to take up the role of investigating and allocating funds between States. When this body failed to emerge, its relevant functions fell to the CGC, despite the role being affected by the fact that most of the Fraser reforms had not worked as intended (Mathews and Grewal 1997).

Another important aspect of the Fraser Government's *New Federalism* policy was the establishment of arrangements under which the Commonwealth would administer any income tax surcharges (or grant rebates) applied by the States, through the *Income Tax (Arrangements with the States) Act 1978*. No State Government sought to levy such surcharges or give rebates.

The 1977 Premiers' Conference discussed a review of relativities, to be carried out by 1980–81. This led to equalising across all States rather than just claimant States (Hancock and Smith 2001). Whether the CGC should undertake the review was debated and a special division of the CGC was ultimately allocated the responsibility. While relatively broad equalisation was suggested (CGC 1995), the terms of reference for the review retained the longstanding principle that grants should allow recipient States to provide services at a standard not appreciably below that of the others, rather than specifying full equalisation.

New Federalism failed because the Commonwealth did not make room for the States in the income tax field, despite seemingly being willing to decentralise some of its fiscal power (Hodgins et al. 1989). The Fraser reforms appeared to aim to resolve vertical fiscal imbalance but, in practice, did not do so. Fraser reflected on his *New Federalism* policy in a submission to this Review (2002):

> In Government, I made some effort to reduce, and had some modest success in reducing the role of tied (specific purpose) payments to the States, which are the main source of the overlapping responsibilities. I notice that those modest gains have since been lost…the second major problem is the imbalance between the States' large responsibilities for expenditure programmes and their capacity to raise revenue through sensible means…the Government I led sought to address this problem by legislating to facilitate the re-entry of the States to the income tax field. In retrospect, for this innovation to have been practically useful, the Commonwealth would have needed simultaneously to have reduced its rates of income tax and its grants to States, in a way that was fiscally generous to the States and to citizens.

2.6 Hawke and the Premiers

The Hawke Labor Government came to power in 1983 and introduced a new approach to providing general revenue assistance at the 1983 Premiers' Conference following more closely CGC recommendations (Mathews and Grewal 1997). During the considerable fiscal tightening to shift the Commonwealth budget from substantial deficit to substantial surplus in the second half of the 1980s, general revenue grants were tightly constrained and aggregate Commonwealth grants were reduced significantly. General revenue grants were reduced and SPPs increased, leading some States to believe that their political autonomy was seriously threatened (Mathews and Grewal 1997). During the Hawke–Keating period, gross Commonwealth payments to the States decreased from 9.7 per cent of gross domestic product in 1982–83 to 7.1 per cent in 1994–95. General revenue grants fell from 5.3 per cent of gross domestic product to 3.3 per cent, whereas SPPs increased from 3.5 per cent to 3.8 per cent of gross domestic product.

Tensions associated with these pressures generated a push to improve intergovernmental financial relations. In 1990 Prime Minister Hawke proposed a new approach, in which different levels of government would work in partnership to enhance national efficiency, improve Governments' abilities to make joint decisions, and balance competition and cooperation to promote better delivery and quality of services. A series of Special Premiers' Conferences from October 1990 led to a wide-ranging review involving the Commonwealth and State Governments. The Review examined the allocation of functions between levels of government (Mathews and Grewal 1997). Premiers' Conferences in July and November of 1991 saw the successful development of agreements on major issues in Australian fiscal federalism.

The promise of reform was then, however, overshadowed by the struggle for leadership of the Labor Party, culminating in Paul Keating becoming prime minister in December 1991. Keating set aside the central part of the understanding between Hawke and the Premiers on Cooperative Federalism.

The period of the Hawke and Keating Labor Governments saw the relative importance of SPPs creep back to and beyond mid-1970s levels. The discussion that led to greater cooperation on fiscal federalism had been based on the increasing recognition of problems associated with SPPs. As Hawke noted in his submission to this Review (2002):

> the conditions that the Commonwealth applied to many payments to the States led to officials of the two levels competing with each other, to confusion, to lack of clarity of lines of responsibility, and to avoidable imperfections in the delivery of services. The system built conflict into Commonwealth–State relations, which was especially damaging at a time when my Government's reform programme required co-operation over many matters.

One major element of the understandings between Hawke and the Premiers survived into the Keating prime ministership. Agreements on competition policy contributed to substantial productivity gains in public utilities in particular. Competition policy agreements, introduced in 1995, were supported by additional and substantial untied grants distributed on an equal per capita basis. These have been indexed to increases in the Consumer Price Index and are a continuing element of Commonwealth–State financial relations.

2.7 Howard's New Tax System

Early in the life of the Howard Government, State finances received a jolt from the loss of State business franchise fees, invalidated by the High Court (*Ha and Lim v. New South Wales 1997*). This increased vertical fiscal imbalance further . The High Court's decision that New South Wales tobacco franchise fees were invalid raised questions about the validity of similar ad valorem fees in all States on tobacco, petroleum products and alcoholic beverages. Subsequently, the Commonwealth agreed to increase its customs and excise duty on tobacco and petroleum products and the rate of wholesale sales tax on alcoholic beverages, and to return the proceeds to the States.

In 2000 the Howard Government implemented *A New Tax System*, with the Goods and Services Tax (GST) as its centrepiece. This reform embodied a major change to Commonwealth–State financial relations. The introduction of the GST was accompanied by an intergovernmental agreement between the Commonwealth and the States. It provided the States with much greater certainty about growth in untied grants from the Commonwealth. It also exacerbated vertical fiscal imbalance as it involved the States forgoing some of their remaining taxes and reducing gambling tax rates. The Intergovernmental Agreement outlined the new arrangements for Commonwealth–State financial relations. It provided for GST to be allocated among the States by the CGC on HFE principles.

Under the new arrangements there has been a large reduction in the proportion of tied grants in payments to the States.

2.8 Defining horizontal fiscal equalisation

The CGC has been intimately involved in defining and interpreting the concept of HFE. Its role has expanded from a narrow focus on the fiscal distress of claimant States to a central role in allocating a major part of State revenue among all States. The principles it applies have also evolved, particularly since the 1970s, from a focus on limiting disadvantage to the recent application of full equalisation to all States, including the overriding of SPP allocations.

The *First Report* of the CGC in 1934 stated that 'some redistribution of revenue must be accepted as almost inevitable in any Federation' (CGC 1934).

Although this report did not contain any concrete declaration of principle, the CGC later reported that it followed a modified principle of financial need, calculating grants to enable claimant States 'with reasonable effort, to put their finances in about as good a position as that of the other States' (CGC 1934). Following publication of the *First Report*, Commonwealth Grants Commissioner L.F. Giblin stated in a letter to leading economist (later Chairman of the CGC) Sir Leslie Melville: 'there was in fact a difficulty in finding a generally acceptable form of words for the general principle' (CGC 1995). The *Second Report* (1935) contained a chapter setting out the CGC's principles:

> the fundamental law for all Government is self-preservation. It is on this basic principle that we put special grants. The Federation must preserve itself (and) cannot allow any of its constituent members to fail. Some States are certainly in serious financial difficulties. It must be made possible for them to function as States of the Commonwealth at some minimum standard of efficiency (CGC 1935, p. 37).

The *Third Report* (1936) defined the principles more explicitly, stating that:

> in our second report we developed the tentative principles of the first, and concluded that the relative financial position of the States, when analysed with sufficient care and understanding, was the only basis on which grants should be made. Further consideration and another year's experience have led us to the following conclusion:
>
> Special grants are justified when a State through financial stress from any cause is unable efficiently to discharge its function as a member of the Federation and should be determined by the amount of help found necessary to make it possible for that State by reasonable effort to function at a standard not appreciably below that of other States (CGC 1936, p. 75).

Yearly CGC reports from the 1930s to the early 1970s show that this definition remained the basis for allocating grants to claimant States throughout that period, notwithstanding the concurrent increase in grants. The *Grants Commission Act 1973* enshrined the definition in legislation by defining a grant of special assistance to a State as one made 'for the purpose of making it possible for a State, by reasonable effort, to function at a standard not appreciably below the standards of other States'.

The 1977 *Special Assistance for States Report*, while quoting the principle from the *Third Report*, stated:

> this principle has remained unaltered as the basis on which the CGC's recommendations have been made but, from time to time, methods of applying the principle have been adapted to changing circumstances (CGC 1977, p. 35).

While the CGC claims, in this and other comments, that its concept of HFE principles has not changed (even though the wording has evolved), it concedes that application of HFE varies according to circumstances: 'fiscal equalisation is not a definitive concept and different results will ensue according to the basis upon which comparisons are made for equalisation purposes' (CGC 1979).

In 1981 the CGC started conducting reviews and producing general revenue grant relativities reports. More noticeable changes to the HFE definition are evident from this time. The terms of reference for the first review, *Report on State Tax Sharing Entitlements 1981*, stated that the review should be:

> a) on the basis of the principle that the respective payments to which the States are entitled under the Act should enable each State to provide, without imposing taxes and charges at levels appreciably different from the levels of the taxes and charges imposed by the other States, government services at standards *not appreciably different* from the standards of the government services provided by the other States.
>
> b) taking account of differences in the capacities of the States to raise revenues, and *differences* in the amounts required to be expected by the States in providing *comparable government services* (CGC 1981, p. 5; italics added).

Chapter 2 of the same report discussed the development of equalisation principles:

> The Commonwealth Grants Commission referred to its equalisation criterion as the principle of financial need. *In fact, as applied by the Commission before 1975, a claimant State's financial need as interpreted by the Commission fell somewhat short of full fiscal equalisation…* special grants received by a claimant State would not necessarily enable it to provide government services at standards comparable to those of the standard States even if it imposed taxes and charges comparable to those of the standard States (CGC 1981, p. 20; italics added).

Chapter 2 also reported on current arrangements for assessing a claimant State's financial needs:

> The foregoing description of the application of the fiscal equalisation principle to the assessment of a claimant State's needs has been oversimplified… such a brief description cannot adequately convey the extent of the detailed examination by the Commission of the numerous problems and issues involved in the equalisation process (CGC 1981, p. 23)

The terms of reference for the 1985 *Report on Tax Sharing Relativities* and 1988 *General Revenue Grant Relativities Report* were almost identical to the 1981 wording:

> the Commission's assessment should:
>
> a) be based on the application of the principle that the respective tax sharing grants to which the States are entitled should enable each State to provide, without having to impose taxes and charges at levels appreciably different from the levels imposed by the other States, government services *at standards not appreciably different* from the standards provided by the other States; and
>
> b) take account of differences in the capacities of the States to raise revenues; and differences in the amounts required to be expended by the States in providing government services of a comparable standard (CGC 1985, p. 116, 1988, p. xviii-xix; italics added).

The terms of reference for the 1993 Review included:

> The Commission's assessment should:
>
> a) be based on the application of the principle that the respective general revenue grants and hospital grants to which the States are entitled should enable each State to provide, without having to impose taxes and charges at levels appreciably different from the levels imposed by other States, government services at *standards not appreciably different* from the standards provided by other States; and
>
> b) take account of differences in the capacities of the States to raise revenues, and differences in the amounts required to be spent by States in providing *government services of a comparable standard* (CGC 1993, p. vii; italics added).

As can be seen, the terms of reference throughout the 1980s included essentially the same clause as the one stated in 1993. In this report, the CGC sets out its own interpretation of the principle of HFE, which appears to move away from the requirements of the terms of reference and to introduce the concept of full equalisation:

> The principle of fiscal equalisation is that each State **should be given the capacity to provide the same standard of State-type public services as the other States, if it makes the *same effort to raise revenues* from its own sources and conducts its affairs with an average level of operational efficiency** (CGC 1993, p. 6; bold and italics added).

In describing the standard of services, the CGC uses a mixture of words including 'same' and 'average' in its definition, while the terms of reference uses 'not appreciably different' and 'comparable'.

Only in 1999 did the terms of reference given to the CGC fall into line with the full equalisation formulation it proposed in the 1993 Report:

> The Commission's assessment should:
>
> a) be based on the application of the principle that the respective general revenue grants and hospital funding grants to which the States are entitled should enable each State to provide the average standard of State-type public services assuming it does so at an average level of operational efficiency and makes the average effort to raise revenue from its own sources;
>
> b) take account of differences in the capacities of the States to raise revenues and differences in the amounts required to be spent by the States in providing an average standard of Government services (CGC 1999a, p. vii).

Here, for the first time, a change in the wording of the terms of reference is clear (resembling the alternative definition of the CGC in 1993), which moves away from the concept of 'not appreciably different' to mention of 'average standard'. Once again, however, within the main report (Chapter 2), the CGC moved away from these new terms of reference, and restated the principle to make full equalisation even more explicit:

> The meaning of horizontal fiscal equalisation as applied in Australia has remained much the same since the very early days of the Commission, though its expression has varied from time to time. For this review, we have adopted the following definition:
>
> **State Governments should receive funding from the Commonwealth such that, if each made the *same effort* to raise revenue from its own sources and operated at the *same level of efficiency*, each would have the capacity to provide services *at the same standard*** (CGC 1999a, p. 4; bold and italics added).

In 1993 and 1999 the CGC redefined HFE away from the wording in the terms of reference. The CGC asserts continuity of the definition notwithstanding that it has clearly changed in meaning, as well as in the scope of application (to all States rather than claimants only). In truth, the actions of the CGC have changed much more over time than the words used to describe them. Payments allowing a State to function as a member of the Commonwealth in times of fiscal stress were transformed by the end of the 20th century into payments to provide capacity for the provision of equal services of all kinds, whatever the costs of delivery. In fact, they have been transformed into payments allocated in a way that that States doing better than the standard are equalised down, and those falling below the standard are equalised up.

In a recent address to the National Forum on Commonwealth–State Funding, the Chairman of the CGC, Alan Morris, stated that: 'the concept of fiscal equalisation has remained unchanged since it was articulated by the Commonwealth and the States in 1977' (2002 p. 5). Mr Morris explained that in 1977 the equalisation principle was defined in the following way:

> That each State should be able to provide State Government services of a recurrent kind of the same standard as other States without imposing higher rates of taxes or charges; differences in revenue capacities and in the relative costs of providing comparable Government services should be taken into account (p. 4).

As discussed in Section 2.5, the 'same standard' wording arose at the 1977 Premiers' Conference when discussing terms of reference for a review (later allocated to a special division of the CGC) on tax sharing arrangements. This wording does not, however, appear in the terms of reference for the 1981 *Review of State Tax Sharing Entitlements*. Notwithstanding comments on the definition of HFE, it is clear that this 1977 wording was not reflected in the CGC's instructions. The operative definition of HFE retained its limited character from 1936 until the 1990s, when full equalisation was adopted in terms of reference in 1999.

2.9 The Intergovernmental Agreement

The States have recently disputed what they actually agreed to in relation to the interpretation of HFE when they signed the 1999 *Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations*. The Intergovernmental Agreement states that GST revenue will be made available to the States, and distributed on the advice of the CGC according to 'HFE principles', which it does not define or interpret further.

In a submission to this Review, Victoria states that it signed the Intergovernmental Agreement in agreement with the broad principles of HFE, but not the definition favoured by the CGC in recent years (2002a). Victoria also says that it signed up subject to the view that reform of Commonwealth–State funding is still necessary. Western Australia has articulated a similar position in its submission (2002), questioning in particular the CGC's narrow interpretations of 'what States do' and 'policy neutrality'. However, South Australia, Tasmania and, to some extent, Queensland claim the Intergovernmental Agreement was signed with the understanding that HFE in the agreement is as applied by the CGC in 1999. The New South Wales submission to this Review (2002) differs in that it agrees with HFE only in its broadest sense. It points to correspondence and public statements incorporating its views at the time the Intergovernmental Agreement was signed.

The Intergovernmental Agreement provides considerable assurance to the States on the amount of untied grants, so long as it continues to be honoured by the Commonwealth.[2] However, it leaves the Commonwealth with considerable discretion over SPPs and, therefore, over total payments to the States.

The Intergovernmental Agreement was associated with a shift from the institutionalisation of Commonwealth–State conflict over amounts of untied grants to institutionalising State–State conflict over the allocation of those grants. Consequently, since 1999 the larger States have become more heavily involved in the HFE process as than ever before, as reflected in the current disagreement. This will change the politics of Commonwealth–State financial relations fundamentally over time.

There was much discussion among the States in the lead up to the Intergovernmental Agreement, with concern focused on GST revenue distribution. Contemporary documents confirm the wide range of interpretations applied to HFE. All that can be said with certainty is that there was widespread support for some redistribution from fiscally strong to fiscally weak States, and disagreement about how it should be done.

For these reasons, the Review Committee thinks that Mr Morris went further than justified by the historical record in his address to the National Forum:

> Since the Agreement doesn't define HFE, and it is not defined in any legislation, the Commission has assumed that Heads of Government, when they signed the Agreement, understood the principle of HFE to be that articulated by the Commission in its 1999 Review Report (2002 p. 6).

[2] The arrangements can be changed unilaterally by Commonwealth legislation.

2.10 The future

The signing of the Intergovernmental Agreement in 1999 considerably eased tensions over total untied payments to the States, but increased vertical fiscal imbalance. It left uncertainty about total payments to the States because of constraints on the amount of funding for SPPs. It institutionalised conflict among the States over distribution of general purpose grants. The GST and the Intergovernmental Agreement provide a good starting point for the correction of longstanding problems with Commonwealth–State relations, but further reforms are needed.

CHAPTER 3: The Current System

- Commonwealth grants to State Governments currently total around $53 billion per year – approximately 40 per cent of the States' revenue.
- Around 60 per cent of these grants are general purpose grants (untied) and can be used by the States for any purpose. The remaining 40 per cent are specific purposes payments (tied) and must be spent in specific areas such as health or education.
- When the Intergovernmental Agreement was introduced in 1999 to implement the GST and related tax reforms, the Commonwealth said that States would be no worse off under the new arrangements.
- Under the Intergovernmental Agreement, GST revenue is used for general purpose grants. States will receive budget balancing assistance until their shares of the GST revenue pool are enough to compensate for any losses from recent tax reforms. They will also continue to receive competition policy payments.
- The growth rate of Commonwealth payments to the States depends on what happens to specific purpose payments.

3.1 A summary of Commonwealth grants to the States

This chapter provides a brief overview of the system of Commonwealth grants to State Governments, with emphasis on the allocation of grants among States. Commonwealth grants to State Governments currently total around $53 billion per year, representing 27 per cent of total Commonwealth expenditures (Table 3.1).

More than half the grants (around $32 billion) are general purpose, or untied, grants – i.e. they can be used by the States for any purpose. The remainder ($21 billion) are tied grants earmarked for specific purposes such as defined elements of health, education, roads and housing.

TABLE 3.1: Commonwealth payments to the State/local sector, 2002–03

	$m
Grants provided to States for general purposes	**31 876**
GST payments	29 380
Budget balancing assistance	1 741
National Competition Policy payments	740
Special Revenue Assistance (to the ACT)	15
Grants provided to States for specific purposes	**21 650**
Specific purpose payments 'to' the States	15 827
Specific purpose payments 'through' the States to other institutions	5 491
Specific purpose payments direct to local government	332
Total	**53 526**

Source: Commonwealth Government 2002a

3.2 Impact of the Intergovernmental Agreement

The Commonwealth's introduction of the Goods and Services Tax (GST), with the assignment of all proceeds to the States (less the cost of administration by the Australian Taxation Office), represents an important milestone in Commonwealth–State financial relations. GST-based grants are untied and replace two categories of untied grants, financial assistance grants and revenue replacement (of State franchise fees) payments. The *Intergovernmental Agreement on Reform of Commonwealth–State Financial Relations* sets out the basis for this reform, including agreements by the States to abolish some of their own taxes and reduce gambling tax rates. The States also agreed to bear the cost of the First Home Owners Scheme.

The Intergovernmental Agreement provided that no State's budget would be worse off as a result of the introduction of the GST and related measures. Currently, total GST revenue received by the States is less than the sum of the States' own revenue forgone and additional expenditure responsibilities. Consequently, the Commonwealth is funding shortfalls for individual States through budget balancing assistance until GST revenues grow to the level of the revenue sources that have been replaced.

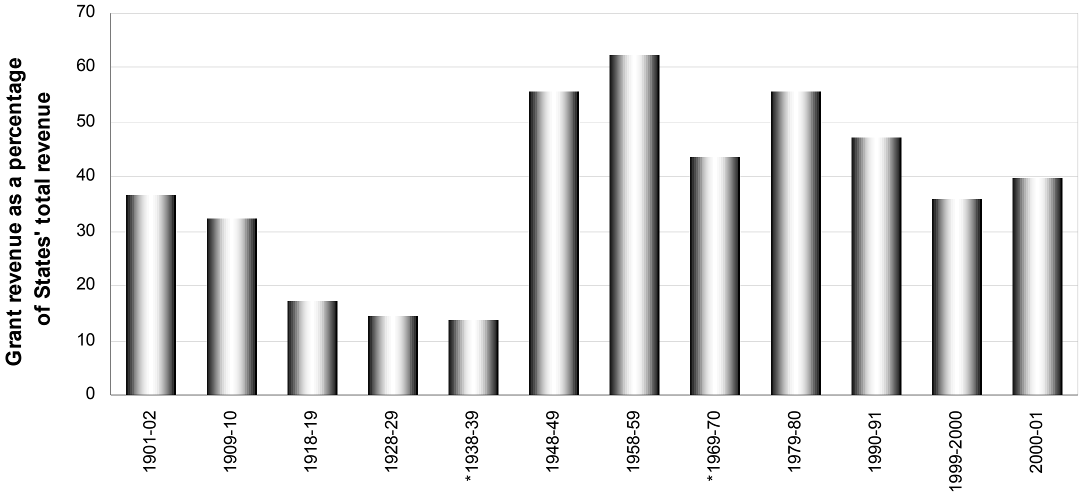
The States now have access to the proceeds of a broad-based growth tax, albeit one that the Commonwealth controls, as agreements such as this Intergovernmental Agreement have no constitutional status. There has been no change to the extent and nature of specific purpose payments (SPPs), or to the arrangements for allocating general revenue assistance among the States as they applied in 1999.

The Intergovernmental Agreement stipulates that:

> The Commonwealth will continue to provide Specific Purpose Payments (SPPs) to the States and Territories and has no intention of cutting aggregate SPPs as part of the reform process set out in this Agreement, consistent with the objective of the State and Territory Governments being financially better off under the new arrangements.

While not of the magnitude of the changes of 1942 when the States 'temporarily' vacated the income tax field in favour of the Commonwealth, the Intergovernmental Agreement has increased an already high vertical fiscal imbalance between the States and the Commonwealth. State dependence on the Commonwealth will increase further as the GST is projected to grow faster than most (typically inefficient and indirect) State taxes. Figure 3.1 depicts the change in vertical fiscal imbalance over time, including the uptake of the GST in the first year.

FIGURE 3.1: Change in vertical fiscal imbalance over 100 years of Federation

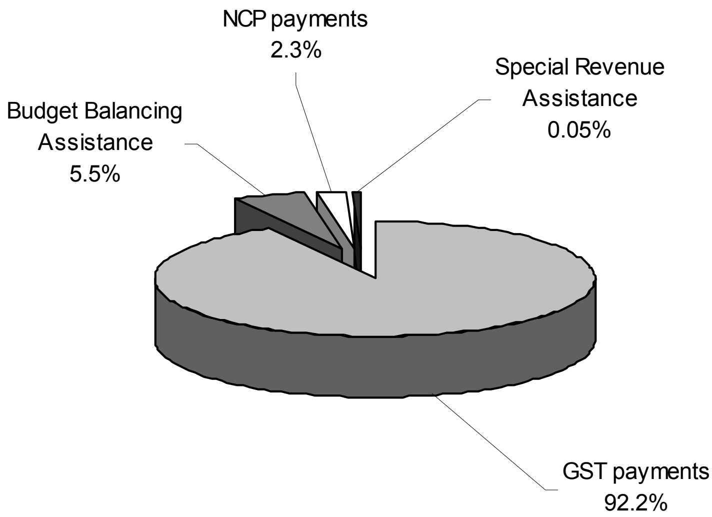


Source: Matthews and Jay 1997; ABS cat. no. 5512
Note: Years marked * include local government

3.3 General purpose grants

GST revenues passed from the Commonwealth to the States are the major component of general purpose grants, accounting for around $27 billion or 92 per cent (Figure 3.2).

FIGURE 3.2: General purpose grants to the States, 2002–03



Source: Commonwealth Government 2002a

GST payments

The GST is currently insufficient to cover revenues given up by the States. The Commonwealth will pay around $2.5 billion in budget balancing assistance in 2002–03 to meet its commitment under the Intergovernmental Agreement that no State will be financially 'worse off' under GST. In the longer run, however, growth in GST revenue is expected to obviate the need for ongoing budget balancing assistance payments to the States. The last payments are expected to be made in 2006–07.

The CGC allocates GST proceeds (and previously financial assistance grants) to the States on the principles of HFE. HFE, as articulated by the CGC, aims to give each State the same capacity to provide services if it makes an average effort to raise its own revenue (see Chapter 4).

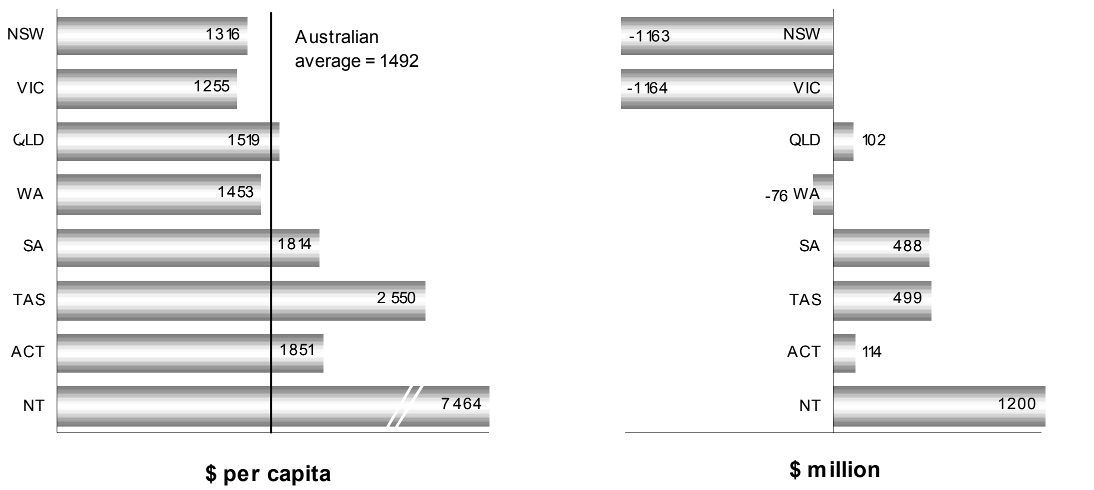
Allocation of GST revenues

A State's GST revenue entitlement is based on the application of the CGC's per capita relativities to a combined pool of GST revenue and hospital funding grants. The GST revenue entitlement for each State is its share of the combined pool less its hospital funding grant entitlement determined under the Australian Health Care Agreements. The practical effect of this is that the Australian Health Care Agreements are overridden by the distribution determined by the CGC.

New South Wales, Victoria and Western Australia (the donor States) receive a share of GST revenue that is less than their share of the national population, while all other States (the recipient States) receive a greater than population share of GST revenues (Figure 3.3).

FIGURE 3.3: Distribution of GST revenue, 2002–03

Distribution ($ per capita) Variation from equal per capita ($ million)



Source: Commonwealth Government 2002a

Budget balancing assistance

The distribution of budget balancing assistance varies widely among the States, as some States have lost less revenue than others through the national tax changes and need less compensation. For example, Queensland did not impose a financial institutions duty and, therefore, lost less revenue through the tax changes (which abolished financial institutions duty).

National Competition Policy payments

The other significant component of general purpose grants is National Competition Policy payments. These payments, which were introduced in the early 1990s, are indexed to inflation and now total around $700 million per year. They are provided to the States in return for implementation of competition policy reforms, and are allocated on an equal per capita basis.

Special revenue assistance

The Australian Capital Territory receives $14 million in special assistance to compensate it for circumstances in its relationship with the Commonwealth that do not apply in other States (i.e. Canberra is the national capital). In the past, other jurisdictions (principally the Northern Territory in recent times) have also received special assistance for budget difficulties.

3.4 Specific purpose payments

Role of specific purpose payments

SPPs are grants from the Commonwealth to the States for specified services (such as health, education, roads and the environment). They will comprise about $21 billion, or 40 per cent of total grants to State Governments in 2002–03.

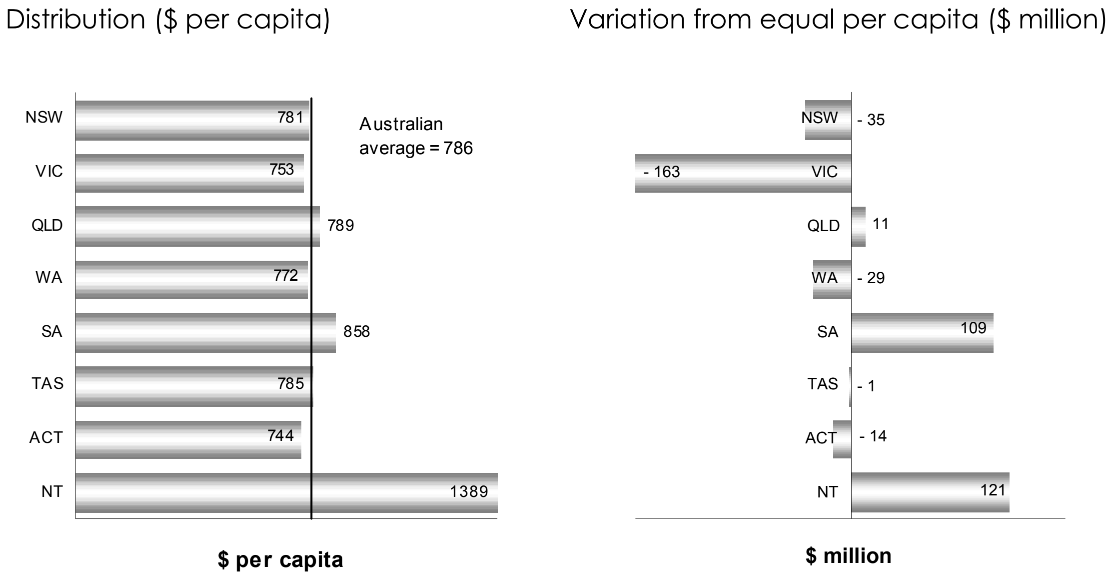
SPPs are based on individual agreements between a State or States and the Commonwealth Government. They are used by the Commonwealth for a variety of reasons, including the pursuit of Commonwealth objectives in areas of State constitutional responsibility, the achievement of national standards and payments for the delivery of Commonwealth programs (see Chapter 5).

Current distribution and transfers among the States

SPP distribution among the States is based on a variety of mechanisms, including population shares, Commonwealth discretionary allocations and formulae that attempt to capture the cost of, and/or demand for, services funded by the SPP.

Queensland, South Australia and the Northern Territory have shares of SPPs that are greater than their population shares, while SPP shares for all other jurisdictions are below their population shares (Figure 3.4).

FIGURE 3.4: Distribution of SPPs 'to' the States, 2002–03



Source: Commonwealth Government 2002a
Note: excludes mining royalties

CHAPTER 4: Allocation of General Purpose Grants

- The Commonwealth Grants Commission applies horizontal fiscal equalisation by developing per capita grant relativities to distribute GST revenue among the States.
- These relativities are based on the Commonwealth Grants Commission's complicated methodology, which uses over sixty models that aim to equalise States' expenditure needs and revenue capacities.
- The measures are intended to be policy neutral and reflect what States do in practice.
- Problems with the Commonwealth Grants Commission's methodology include extreme complexity, the use of unsubstantiated judgements and the assumption of standard policy.
- The Commonwealth Grants Commission's per capita grant relativities result in New South Wales, Victoria and Western Australia being 'donor' States, receiving less than an equal per capita share of the GST pool. The remaining States are 'recipient' States and receive more than an equal per capita share.

4.1 Types of Commonwealth grants

Goods and Services Tax (GST) revenue comprises around 90 per cent of general purpose grants. When current transitional arrangements are completed, the GST will fund all general purpose grants other than National Competition Policy payments and Special Revenue Assistance for the Australian Capital Territory.

Other general purpose grants that are not funded from the Commonwealth's own revenues (see Chapter 3) are:

- budget balancing assistance, which is paid to meet the net revenue shortfalls for each State arising from GST-related tax reforms. Budget balancing assistance should diminish to zero as the GST revenue grows, although this is expected to take several years
- competition payments, which are paid to the States in return for implementing competition policy reforms, and allocated on an equal per capita basis among the States. These ongoing payments were not affected by the 2000 tax reform

- special revenue assistance, which compensates the Australian Capital Territory for expenditures that relate to its national capital role and do not apply in other States. In the past, other jurisdictions (principally the Northern Territory) have also received special revenue assistance for budgetary difficulties. Although the payments to the Australian Capital Territory have declined over time, there has been no suggestion that they cease and they have not been affected by tax reform. The new model for Commonwealth–State financial relations, introduced in Chapter 1 and defined in Chapter 13, does not embody any change in these arrangements.

4.2 Overview of horizontal fiscal equalisation

The Commonwealth Grants Commission (CGC) determines the allocation of GST revenues among the States according to its interpretation of horizontal fiscal equalisation (HFE). The GST replaced the Commonwealth financial assistance grants allocated by the CGC. (See Chapter 2 for a detailed explanation of how the CGC's interpretation and application of HFE has changed over time.)

The CGC, reflecting its current terms of reference, now defines HFE as follows:

> State Governments should receive funding from the Commonwealth such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standards (CGC 1999a).

To implement this principle, the CGC aims to give a higher share of grants to States that have below-average capacity to raise their own revenues and/or have to spend more to provide the same standard of services as other States. The CGC considers all non-commercial areas of revenue raising, recurrent spending and some capital spending. It generally does not consider revenue and expenditure of State-owned businesses.

The CGC provides a higher share of grants to States that receive lower levels of specific purpose payments (SPPs), on the presumption that all sources of funds increase States' ability to provide services. In this way, HFE effectively overrides the Commonwealth's decisions (usually made in consultation with the States) on the distribution of most SPPs.

The CGC is not concerned with how much States actually spend or how much revenue they actually raise. Rather, it seeks to measure how much States would spend or collect if they applied national average policy.

To do this, the CGC aims to identify and quantify disability factors (which are areas outside States' control that affect their expenditure requirements or their ability to raise revenues) for each area of State expenditure (e.g. schools) and revenue (e.g. land tax).

Major disability factors

Indicators of demand:

- population size
- population age and sex structure (also an indicator of cost) (e.g. a higher demand for police services for young adult males, a higher demand for hospital services by the elderly)
- income (e.g. a greater demand for health and welfare services from low income people)
- Indigenous population (also an indicator of cost) (e.g. higher hospital admission rates)
- number of welfare recipients (e.g. as recipients of concessions for State services)
- use of public versus private services (e.g. government versus non-government schools [States provide higher funding per student for government schools])
- industry size (e.g. affects need for industry regulation).

Indicators of cost:

- degree of low English fluency (e.g. when interpreters are required)
- community size and remoteness (e.g. small uneconomical schools must be provided in remote locations)
- isolation from other States (e.g. interstate freight costs)
- wage, rental and electricity costs (which form part of service delivery costs)
- road length (which affects road maintenance costs).

Major revenue bases:

- wages and salaries (payroll tax)
- land values (land tax)
- mining industry profits by the CGC’s definitions.

The CGC only considers factors relevant to the extent that they actually influence State spending or revenue raising, based on national average policies applied by the States. The CGC does not judge whether or not these policies are appropriate.

When assessing disability factors, the CGC considers the type and standard of services provided, on average, to different population groups and in different types of locations. For example, the CGC takes into account that services are provided to a different standard in remote compared with metropolitan areas, and that despite greater resources being provided for Indigenous Australians, outcomes for them are generally not to the level achieved for non-Indigenous Australians. The CGC does not seek to judge whether the average differential in provision of services across groups is appropriate.

When assessing revenue bases, the CGC attempts, by referring to national average tax rates, to measure capacity to raise taxes. The revenue base assessed is often (but not consistently) the base specified in legislation.

In summary:

- The CGC's assessments are based on what States spend (on average), not the outcomes achieved.
- The CGC's assessments are based on the taxes and rates that States legislate, not the burden of these taxes on the economy or potential alternative revenue sources.
- The CGC does not give the States the capacity to provide the same services or outcomes for persons in all locations, or to all types of persons.

Disability factors enable the CGC to determine States' relative spending requirements and revenue raising capacity for each area of spending and revenue raising. The factors are then applied to national per capita State spending and revenue raising in each area to produce standardised expenditure (dollar estimates of States' spending requirements) and standardised revenues (dollar estimates of States capacity to raise revenue). In effect, the standardised estimates represent what States would spend or raise if they followed a hypothetical national average State policy (known as the 'standard policy').

To the extent that States' per capita standardised expenditures and revenues differ from the national per capita level of State spending and revenue raising, the differences are offset by a higher (or lower) per capita share of GST revenues.

The CGC methods are designed to be policy neutral and aim to prevent States from significantly affecting their disability factors. In this view, States' ability to influence their grants is small (usually a small fraction of the change in spending or taxing).

Although the CGC determines how much each State would need to spend to provide a national average standard of services (if it makes an average effort to raise its own revenues), there is no requirement for States to provide that standard of services (or raise that amount of revenue).

For example, a State may choose to spend more than the national average on a particular function (e.g. education). However, as that State will get no additional funding if it does so, it will have to fund that additional expenditure by:

- spending less on other functions
- having above national average revenue raising effort
- running a larger deficit or smaller surplus.

4.3 Implementing horizontal fiscal equalisation

The CGC process

The process of assessing each State's share of the grants has two main aims. Firstly, it aims to identify the factors outside States' control which affect their expenditure requirements or revenue raising ability. Secondly, it aims to quantify the impact of these factors on State expenditure requirements or revenue raising ability. The CGC undertakes this analysis for each area of State expenditure and category of revenue typically used by the States. The CGC approach on both the expenditure and revenue sides raises a range of issues that are canvassed in Chapters 9, 10 and 11.

States' GST grant entitlements are calculated using the following formula:

- a per capita share of the total pool of funds
- plus *expenditure needs* to reflect differences in the demand for, or cost of, services between States (e.g. due to socio-demographic and location characteristics)
- plus *revenue needs* to offset differences in assessed revenue raising capacity between States (e.g. differences in assessed capacity to collect mining royalties)
- plus *needs for SPPs* to offset differences in the per capita level of SPPs received by the States.

Expenditure needs reflect the difference between each State's per capita standardised expenditure requirements, and national per capita State spending. States' assessed relative expenditure requirements are based on many indicators of demand and cost of services, including population size and age structure; income; Indigenous population; degree of low English fluency; number of welfare recipients; community size and remoteness; isolation from other States; use of public versus private services; wage, rental and electricity costs; industry size; and road length.

Revenue needs are calculated in a similar way. In CGC terminology, advantages that a State may have due to an above-average per capita capacity to raise revenue, or a below average per capita cost of service delivery, are equalised away. States' relative revenue capacities are based on the sizes of their revenue bases, such as wages and salaries (payroll tax), land values (land tax) and mining industry profits (as defined by the CGC). Most SPPs from the Commonwealth are treated as revenue. A State that receives relatively high per capita SPP funding has its share of GST revenue reduced.

When calculating allowances for differences in State spending requirements, the CGC also considers the type and standard of services provided on average by States to different population groups or in different types of locations. For example, the CGC accepts that services are provided to different standards respectively in remote, rural, provincial and metropolitan areas, and that outcomes for Indigenous people are generally not to the level achieved for non-Indigenous people. Accordingly, the CGC equalisation does not give the States the capacity to provide the same outcomes for people in all locations, or to all groups of people.

Table 4.1 illustrates the impact of the CGC's assessment of varying needs on the 2002–03 allocation of GST revenues and hospital funding grants.

TABLE 4.1: Commonwealth Grants Commission: Contribution of needs to grant shares, 2002–03 ($ per capita)

		NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Per capita share of GST pool	a	1 848	1 848	1 848	1 848	1 848	1 848	1 848	1 848
Needs adjustments									
Expenditure	b	-48	-338	-69	357	29	457	30	6 320
Revenue	c	-156	69	63	-225	336	579	272	148
SPPs	d	33	27	29	-176	-4	-10	-20	-465
Total	e=b+c+d	-172	-242	23	-43	361	1026	283	6 003
Grant entitlement	f=a+e	1 676	1 606	1 871	1805	2 209	2875	2131	7 851
Relativity	g=f/a	0.906	0.868	1.012	0.976	1.194	1.554	1.152	4.245

Note: GST pool includes GST revenue and hospital funding grants

This brief description of the CGC's approach does not demonstrate the extreme complexity of the actual methodology applied.

As data to implement this formula are not available for the grant allocation year, actual calculations are based on a rolling five-year average of data before the grant allocation year. Notional equalisation grants are assessed for each of the five years. These grants are then converted into relativities that express the per capita equalisation grant for each State as a ratio of the national average per capita equalisation grant.

These relativities are then averaged over five years and applied to States' populations to determine their grant shares. The CGC updates its relativities each year by rolling forward the five-year data period by one year (i.e. the earliest data year is dropped, and a new data year is introduced). It also incorporates any revised data for the remaining four years. These annual updates do not change the CGC's assessment methods, unless the CGC judges that some new development must be taken into account. The CGC will, however, correct mistakes due to human error.

The CGC undertakes a major review of its methods approximately every five years. It undertakes its own research, receives submissions from each State, visits them to consult with State service providers and managers, and holds conferences. The revised methods form the basis of the relativity calculations for the following five years.

The annual updates and major reviews are given formal authority by the Commonwealth Government, through the provision of terms of reference to the CGC.

The CGC calculates a second set of relativities for distributing financial assistance grants that would have been paid under pre-GST funding arrangements. The difference between this calculation and each State's revenue from the CGC equalisation formula determines each State's budget balancing assistance.

While the CGC has long been involved in determining the allocation of Commonwealth grants to the States, there have been significant changes in its role over time. Of particular note is the expansion of its role in determining the distribution of general purpose grants and the shift in its interpretation of HFE from limited assistance to States experiencing financial hardship to one of full equalisation among States across all government activities. These changes are discussed in detail in Chapter 2.

Impact of horizontal fiscal equalisation

New South Wales, Victoria and Western Australia receive shares of GST revenues that are less than their shares of national population, while all other jurisdictions receive shares of GST revenues that are greater than their population shares (see Figure 3.3).

States' shares of general purpose grants have changed significantly over the past twenty years (see Table 4.2). These grant shares have largely (but not completely) been determined by the CGC according to its interpretation of the principle of HFE.

The shares of Western Australia, Queensland and the Australian Capital Territory have fallen noticeably. Until 1997–98 Western Australia received above its per capita share of general purpose grants. Shares for other States have increased to varying extents, with the increase being most rapid in Tasmania.

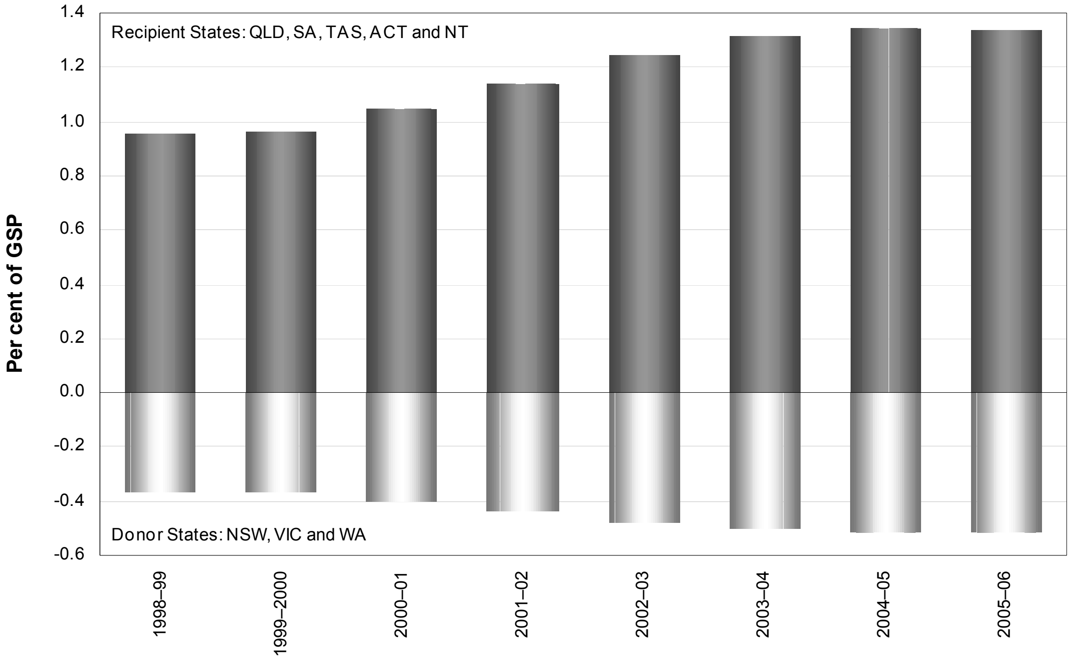
TABLE 4.2: Relative per capita shares of general purpose grants (Australia = 100)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
1983–84 to 1987–88	79.4	79.7	109.3	117.8	122.3	147.5	208.2	551.9
1988–89 to 1992–93	78.8	78.3	107.0	118.5	126.6	149.6	190.9	595.3
1993–94 to 1997–98	83.7	84.7	103.6	104.4	119.7	161.1	115.5	586.9
1998–99 to 2002–03	84.4	81.6	102.9	92.9	128.5	186.8	128.1	611.5

Note: Australian Capital Territory relativity prior to 1988-89 has been notionally set at the 1988-89 level

The aggregate redistribution of general purpose grants has also changed over time, as measured by the aggregate deviations in each direction from equal per capita funding. Figure 4.1 shows the growth in the aggregate redistribution as a percentage of gross state product since 1998–99 when Western Australia joined New South Wales and Victoria as a 'donor' State. Since then, the redistribution has grown rapidly and is projected to grow considerably over the next few years (according to South Australian Department of Treasury and Finance estimates).

FIGURE 4.1: Aggregate transfers as a percentage of GSP



Note: Estimates used for 2003-04 to 2005-06 from South Australian Department of Treasury and Finance (unpub.)

4.4 Issues around horizontal fiscal equalisation

The summary of the CGC's HFE process suggests it is orderly and precise (see Section 4.3). However, the process has many contentious aspects.

Currency of data

This use of historical data means that there is a lag of two to six years between changes in States' circumstances and their impact on the CGC relativities. For example, additional State revenues generated by the Sydney Olympics for New South Wales in 2000–01 became part of that State's budget in that year, but will be shared among the States by the CGC over the years 2002–03 to 2006–07.

Complexity

The CGC process is exceedingly complex, with heavy use of formulas and documentation running to nearly 2000 pages of annual reports and working papers. The complexity reflects the CGC's attempts to account for the numerous factors affecting States' expenditures and revenues in fine detail.

This complexity makes it difficult for the process to be reviewed effectively.

Judgements

Many elements of the CGC's calculations reflect its judgements about how to quantify factors, and the extent to which factors affect State expenditures and revenues. Unfortunately, the data needed to establish or quantify disabilities is often not available or is of such poor quality that judgement and indirect measures are used instead.

The basis for judgements is not always clearly documented, and judgements can change significantly over time. Despite many years of close examination by the CGC and the States, there continues to be intense debate and analysis about the correct quantification of expenditure and revenue needs.

Some examples of judgements used by the CGC include:

- Indigenous people, as identified in the Census self-enumeration counts, and with the same sociodemographic and locational characteristics, are homogeneous across the country in their service requirements.
- State economic policies, including tax levels have no effect on States' relative economic performance (i.e. States have no influence on their tax bases).
- Various disability factors are adjusted for potential policy influences or data uncertainties through discounting by 50 per cent (e.g. factors covering wage and rent costs).
- Canberra is more isolated than Adelaide.
- Retention rates in the post-compulsory years of schooling are due to differences in state policy.

To date, the CGC has not made much use of the annual assessment of the costs of government service delivery coordinated by the Productivity Commission. The CGC has noted, for example, that the health cost data seem unreliable. The Productivity Commission work may eventually help to determine Australian best practice efficiency benchmarks (after controlling for cost factors, quality of service and long-term effects of different policy settings).

Standard CGC policy

The CGC's assessments of disability factors are based on the concept of a standard policy – that States, on average, take certain factors into account when setting levels of spending and revenue raising. But standard policy is difficult to observe, and often has to be assumed.

Tax policy is often (but not consistently) based on approximations of the legal assessment framework. However, the legislation does not show States' underlying intent, the circumstances they considered (e.g. the capacity to pay), or how they would deal with the different circumstances faced by other States. Tax policy is also restricted to the tax bases to which States currently utilise. Potential alternative revenue sources are not considered.

Expenditure policy is based on resource allocation by type of service, location and sociodemographic characteristics, insofar as they can be determined. Again, this does not reveal States' underlying outcome objectives, the circumstances that they took into account in choosing the mix of services, or how they would behave in different circumstances. The CGC assumes that standard policy is a uniform standard mix of services and mechanical micro-resource allocation formulae. In practice, States vary the mix of services and resource allocations to achieve broad objectives. Unlike the CGC, States recognise that services are interconnected (e.g. improving Indigenous education outcomes is contingent on improving health, housing and economic circumstances). The CGC puts much more effort into understanding States' treatment of symptoms (e.g. hospitalisation for acute illness) than States' efforts to treat the underlying problems (e.g. health improvement initiatives). On a related issue, the CGC has difficulty identifying the needs that drive expenditure on pure public goods.

Policy neutrality

The achievement of policy neutrality is seen as fundamentally important to the equity and efficiency of equalisation. Equalisation cannot be considered equitable if States can manipulate the outcome, and any incentive to manipulate the outcome will distort States' policy making. However, in reality this cannot be an overriding principle.

Despite all the apparent precision, the accurate identification and quantification of policy neutral disabilities often remains elusive. The available data are usually inadequate to permit such quantification without large elements of judgement, the complexities are so great in some cases as to defeat even expert analysts, and the complex interplays between policy and disabilities cannot be disentangled. For example:

- To what extent have States influenced their current revenue collections through the influence of good or bad past policies on economic performance? The CGC does not attempt to resolve this, but takes the current situation as given.

- To what extent have States influenced their current spending needs through past policies? The CGC tends to be sensitive to this, and uses non policy-influenced indicators such as age or Aboriginality (although data on the latter is affected by policy, for example through community attitudes). As with revenue, the effects of policy on expenditure requirements through its influence on general economic performance are not considered. How are we to interpret wide variations in services provided which are not reflected in these objective measures? As unrecognised disabilities (hence flaws in equalisation)? Or as consequences of past policy? Or of different present policy settings?
- To what extent has equalisation itself influenced State policies? For example, States with high capacity in unused tax bases will have little incentive to exploit these bases if they are compensated for their disadvantages in the standard tax bases.

Interaction between horizontal fiscal equalisation and specific purpose payments

The CGC's treatment of SPPs is complex.

- Most recurrent SPPs are subject to equalisation with GST grants adjusted to offset differences in per capita receipts from SPPs. State expenditures (for which the CGC assesses needs) include expenditures financed by these SPPs.
- In a few cases, this process extends to some Commonwealth own-purpose expenditures, which are considered notional SPPs and substitutes for States' own expenditures.
- In some cases, the CGC excludes recurrent SPPs from equalisation because they reflect needs that the CGC has not considered, or have strong conditions attached to their use that are seen as limiting State policy choice, or reflect fee-for-service arrangements.
- Capital SPPs are not subject to direct equalisation, but a measure of HFE is achieved indirectly as the CGC recognises that the level of capital SPPs received over time has influenced the level of States' debt. This is considered in the CGC's assessments of spending on interest payments. However, not all capital SPPs have been included in this calculation.
- The Commonwealth specifically excludes some SPPs from the CGC process through directions provided in its terms of reference to the CGC. The CGC excludes others itself.

Including SPPs in the equalisation process has generated controversy over whether the CGC should effectively override the allocation of SPP funds agreed between Commonwealth and State ministers. Although the Commonwealth ultimately accepts the CGC's recommendations, it is unclear that the people concerned understand the extent to which the allocation of untied grants is setting aside the intended allocation of SPPs and substituting the CGC's allocation.

The equalisation of SPPs adds an additional layer of complexity to an SPP system which is already complex (see Chapter 5). Arguably, the equalisation of SPPs has:

- led to some complacency in SPP negotiations on the distribution of funding between States. For example, the distribution of disability services funding is highly anomalous, but accepted on the basis that it is 'fixed' by the CGC
- led to the Commonwealth imposing tighter conditions on SPP funding to achieve its output and outcome objectives. Because additional funding provided by the Commonwealth for a specific purpose in one State will be redistributed away, it becomes common for the Commonwealth to lock the State into spending on that purpose through narrow conditions.

Simplicity and transparency aspects of SPPs, and anomalies and unintended consequences, are examined further in Chapter 11.

CHAPTER 5: Specific Purpose Payments and Overall Payments to the States

- Specific purpose payments, as a share of total Commonwealth grants to the States, increased from 22 per cent in 1942–43 to 50 per cent in 1999–2000, before falling back to 40 per cent under the Howard Government's *New Tax System*.
- These payments help States to meet their major service delivery costs (e.g. in health and education). They also provide targeted funding for special groups.
- Specific purpose payments are generally in the form of agreements between Commonwealth and State Governments, and include conditions on the availability and use of funding.
- There are around 120 specific purpose payments ranging in value from $6 000 to $6.6 billion per year. Most specific purpose payment funding is for health and aged care, education and training, and social welfare and housing.
- A significant share of specific purpose payments is redistributed by the Commonwealth Grants Commission, despite their original allocation under Ministerial agreement.
- States have already agreed that specific purpose payment arrangements need to be reformed. Fixing the current system would boost States' ability to respond to community needs, increase incentives to improve service delivery, and reduce unnecessary duplication between the Commonwealth and State Governments.

5.1 The role of specific purpose payments

For the States, specific purpose payments (SPPs) are an important source of Commonwealth funds that help to:

- meet the general cost of major areas of State service delivery
- realise service outcomes for the community beyond those that could otherwise be achieved through State revenues
- support special assistance to targeted groups.

SPPs are subject to individual agreements which attach a variety of terms and conditions to the grants. They are also usually classified as:

- payments 'to' the States, which are programs administered by the States ($16 billion in 2002–03)

  or

- payments 'through' the States, which are on-passed to other bodies, principally non-government schools and local governments ($5 billion in 2002–03).

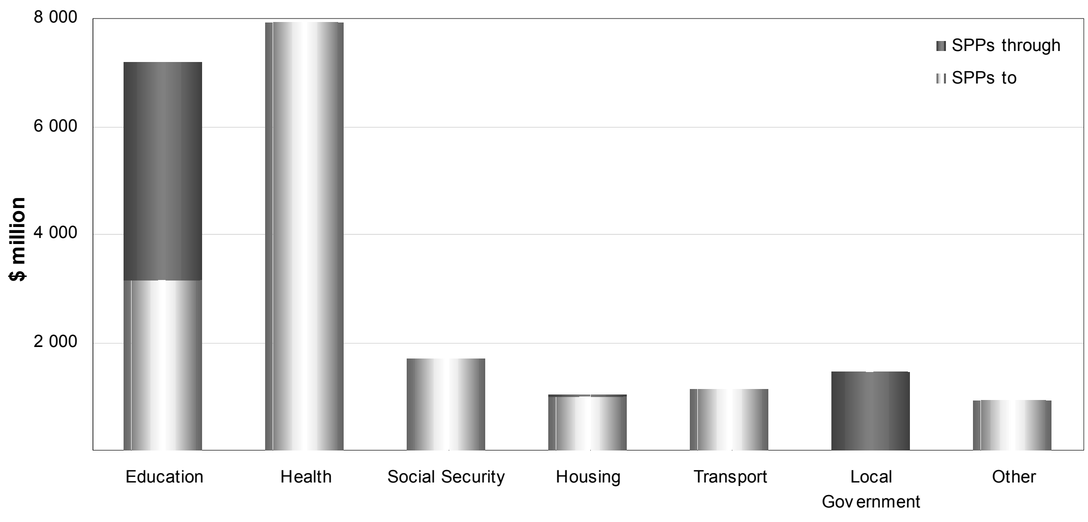
Section 96 of the Constitution provides a legal basis for SPPs (and other Commonwealth grants): 'the [Commonwealth] Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit'. The Commonwealth uses Section 96 to substantially influence almost all areas of State expenditure responsibilities. In 2000–01 Commonwealth SPP funding comprised over 20 per cent of the States' total revenues.

The Commonwealth uses SPPs for a number of reasons, including to:

- introduce programs reflecting Commonwealth wishes in areas of State constitutional responsibility (most SPPs)
- impose or encourage national standards (e.g. free public health and vocational training standards)
- pay States for the delivery of Commonwealth programs (there are only a few examples of this sort, e.g. funding legal aid for Federal law cases)
- compensate States for the cost of Commonwealth initiatives (e.g. for increased access to pensioner concessions)
- comply with international obligations (e.g. payments to help manage World Heritage areas).

Figure 5.1 illustrates the concentration of SPPs in the areas of health and education.

FIGURE 5.1: Composition of estimated SPPs 'to' and 'through' the States, 2002–03



Source: Commonwealth Government 2002a

Most SPP arrangements involve the Commonwealth contributing funding to what effectively becomes a joint program. SPPs typically have conditions attached to their use and are often considerably smaller than the amounts the States spend on the relevant services. SPPs finance approximately 35 per cent of States' expenditure on health and 27 per cent of States' expenditure on education.[3]

5.2 Scope and make-up of specific purpose payments

There are currently around 120 individual SPPs. In addition, many contain sub-programs that effectively operate as SPPs in their own right, with terms and conditions separate from the main SPP.

SPPs are distributed in two ways. Most SPP funding (73 per cent or $15.8 billion in 2002–03) is to the States. States administer SPPs 'to' the States in areas of direct State responsibility, but pass on SPPs 'through' the States to the final recipients (primarily local governments and private schools). The Commonwealth provides some funds directly to local governments through SPPs.

Most Commonwealth SPPs cover the annual operating costs of particular programs (known as recurrent funding – 85 per cent in 2001–02). The remainder cover construction and maintenance of fixed assets (capital funding). A few SPPs have elements of both recurrent and capital funding (e.g. the Government Schools SPP).

While SPPs cover almost all government functions, most funding is concentrated in health, education, vocational training, local government and roads. SPPs for health and education comprise about 71 per cent of total SPP funding, although they make up only a minority of the number of programs (18 per cent). The largest number of SPPs and the greatest amount of SPP funding are for the provision of health services (Table 5.1).

[3] Commonwealth payments to higher education institutions are made directly, and not part of SPPs 'to' or 'through' the States.

TABLE 5.1: SPPs by functional area, 2002–03

Function	Current $m	Capital $m	Total $m	%
SPPs 'to'				
Health	7 910.5	5.9	7 916.4	51.1
Education	2 936.3	230.8	3 167.2	20.4
Social security and welfare	1 653.1	43.7	1 696.8	11.0
Transport and communication	38.3	1 097.7	1 135.9	7.3
Housing and community amenities	8.7	990.3	999.0	6.4
Other purposes	336.5	1.5	338.0	2.2
Agriculture, forestry and fishing	151.5	0.0	151.5	1.0
Public order and safety	70.1	0.0	70.1	0.5
Fuel and energy	0.0	20.4	20.4	0.1
Total 'to'	**13 104.9**	**2 390.3**	**15 495.2**	**100.0**
SPPs 'through'				
Education	3 919.4	90.8	4 010.2	73.1
Local government	1 436.1	0.0	1 436.1	26.2
Housing and community amenities	0.0	39.6	39.6	0.7
Total 'through'	**5 355.5**	**130.4**	**5 485.9**	**100.0**
Royalties	337.4		337.4	
Total SPPs	**18 797.8**	**2 520.7**	**21 318.5**	**100.0**

Source: Commonwealth Government 2002a

The ten largest SPPs 'to' by value account for over 86 per cent of total SPP 'to' funding (Table 5.2). The 'other' category comprises a large number of small SPPs relating mainly to environmental programs, infrastructure and one-off projects.

TABLE 5.2: Ten largest SPPs 'to' by value, 2002–03

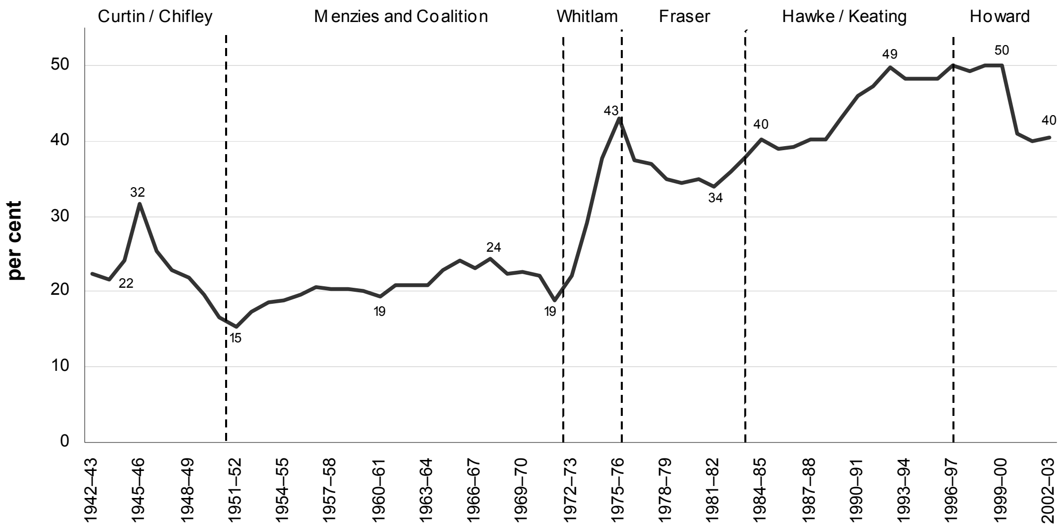
SPP	$m	%
Australian health care agreement	7 059.0	45.6
Government schools	1 696.3	10.9
Vocational education and training	1 032.5	6.7
Road programs (mainly National Highways)	978.3	6.3
Commonwealth–State housing agreement	824.2	5.3
Home and community care	674.1	4.4
Commonwealth–State disability agreement	515.6	3.3
Highly specialised drugs	345.3	2.2
Targeted and joint programs government schools	324.1	2.1
National public health	194.7	1.3
Other	1 851.0	11.9
TOTAL	**15 495.2**	**100.0**

Source: Commonwealth Government 2002a

5.3 Distribution and trends

SPPs have become substantially more important over time. Figure 5.2 shows the increase in SPPs from 22 per cent of total Commonwealth payments in 1942–43 to 50 per cent in 1999–2000. The decline in 2000–01 corresponds with the introduction of the GST and the *New Tax System*.

FIGURE 5.2: SPPs as a percentage of total payments to the States



Source: Commonwealth Government (Budget Papers, various years)

SPPs were introduced in the 1920s to assist in road construction and debt management. They remained limited in scope until World War II, from which time the number of tied grant programs gradually increased. Early SPPs were for housing, education, agriculture, some health programs and infrastructure developments. The importance of SPPs escalated markedly in the mid-1970s under the Whitlam Government, with comprehensive funding for education and public hospitals and the provision of general purpose grants for local government (see Figure 5.2). The proportion of tied funding eased moderately under the Fraser Government. Since then, SPPs have increased steadily as a proportion of total Commonwealth funding to the States.

The distribution of SPPs among the States is based on a variety of indicators, including population shares, Commonwealth discretionary allocations and various formulae that attempt to reflect costs or demand.

Table 5.3 shows the distribution of total SPPs in 2002–03, compared to State population shares.

TABLE 5.3: Distribution of total SPPs, 2002–03

State	Total SPPs $m	Share of SPPs %	Population share %	SPPs per capita $
NSW	6 981.5	33.3	33.6	1 054
VIC	5 101.3	24.3	24.9	1 038
QLD	3 931.6	18.7	18.9	1 058
WA	2 066.5	9.8	9.9	1 062
SA	1 701.5	8.1	7.7	1 126
TAS	498.4	2.4	2.4	1 058
ACT	353.3	1.7	1.6	1 114
NT	347.0	1.7	1.0	1 726
AUST	**20 981.1**	**100**	**100**	**1 065**

Source: Commonwealth Government 2002a
Note: Excludes royalty payments

Table 5.3 indicates a modest net transfer of SPP funding from more to less populous States (which receive a greater than equal SPP share per capita). These figures exclude royalties which, though classed as an SPP, are akin to State revenues passed through the Commonwealth.

Over time, the share of SPP funding received by each State has varied significantly, with the most pronounced net movements in the five smaller States. This largely reflects the variable methods chosen by the Commonwealth to distribute SPPs between States. New South Wales, Victoria and Queensland have received less than their population shares of SPPs, while all other States have received greater than their population shares of SPPs (Table 5.4). The shares of SPPs provided to Western Australia, Tasmania and the Northern Territory have fallen substantially over the past twenty years, while other States have received roughly the same or increasing shares of SPPs.

TABLE 5.4: Relative per capita SPPs, Australia = 100

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
1983–84 to 1987–88	96.9	90.6	87.1	113.8	112.8	141.8	104.6	320.0
1988–89 to 1992–93	96.9	96.5	97.8	99.4	104.5	128.9	105.4	217.7
1993–94 to 1997–98	95.3	93.4	99.1	105.1	117.3	118.5	106.8	192.3
1998–99 to 2002–03	98.0	94.9	100.2	100.7	106.5	113.8	108.3	183.4

Notes: Australian Capital Territory relativity prior to 1988–89 has been notionally set at the 1988–89 level.
Royalties are treated as State own source revenue

Table 5.5 shows trends in total grants from the Commonwealth to the States. Only New South Wales and Victoria have consistently received less than a per capita share of total grants, with the other States generally receiving above per capita shares. Western Australia's share of total grants has fallen from well above average to below average. Queensland and the Australian Capital Territory have experienced a declining trend in their shares of total grants, while the shares of total grants for New South Wales and Victoria have increased.

TABLE 5.5: Relative per capita total payments, Australia = 100

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
1983–84 to 1987–88	86.2	83.9	100.6	116.2	118.6	145.3	167.8	462.2
1988–89 to 1992–93	86.9	86.3	102.9	110.0	116.9	140.3	153.7	428.4
1993–94 to 1997–98	89.1	88.8	101.5	104.7	118.6	141.1	111.5	401.9
1998–99 to 2002–03	91.1	88.1	101.6	96.8	117.7	151.0	118.3	402.0

Notes: Australian Capital Territory relativity prior to 1988-89 has been notionally set at the 1988-89 level.
Royalties are treated as State own source revenue

5.4 Features

SPP agreements range in value from $6 000 per year to $6.6 billion per year, from programs that are administered by one person part-time to those employing over fifty people full time, and from one-off grants to ten-year programs. However, they have a number of common elements:

- funding is provided for a defined policy purpose
- the States are often subjected by the Commonwealth to input controls. They may be required to provide matching funding (typically dollar for dollar), or a minimum level of funding from their own sources (often as 'maintenance of effort' conditions, i.e. requiring States to maintain their funding, typically in real terms)
- rules are prescribed for managing programs and approving projects
- States are required to report on performance to the Commonwealth
- agreements often specify criteria for access to services (e.g. the Australian Health Care SPP requires States to provide free hospital services to anyone who wants them).

SPP agreements usually last between one and five years, with larger SPPs generally applying for longer periods. The Commonwealth also uses SPPs to provide funding to States for special one-off purposes (e.g. the Sydney Olympics) or for particularly large or important capital projects to which it is contributing (e.g. the Darwin to Alice Springs railway).

SPP agreements are not legally binding, but are administrative and political agreements that impose conditions on Commonwealth grants. However, recipients of SPP funding are generally required to demonstrate, through various accountability and reporting requirements (including performance indicators), that funds have been expended in accordance with the terms and conditions of the SPP agreement.

The following overview of seven major current SPPs illustrates their common features, including the Commonwealth's imposition of restrictive conditions. The two largest are the Australian Health Care Agreement and Government Schools SPPs. The Australian National Training Authority Agreement and Commonwealth–State Housing Agreement demonstrate some problems with SPPs. The Supported Accommodation Assistance Program is an example of a relatively effective SPP agreement.

Australian Health Care Agreement

The Commonwealth and the States jointly fund public health services, which are delivered by the States through public hospitals. The Australian Health Care Agreement is the basis for the Commonwealth's financial contribution to the States' health care delivery, and makes up approximately 90 per cent of total health SPPs. The Commonwealth provides a range of smaller health SPPs, including funds for highly specialised drugs, national public health, essential vaccines, and blood transfusion services. The number and variety of payments and the range of conditions introduces problems of complexity and accountability that suggest there would be benefits in integrating related activities into a single program (i.e. broad-banding).

The current agreement covers 1998–99 to 2002–03, and funds about 40 per cent of total expenditure on public hospitals. Funding is also provided for projects designed to improve the efficiency and effectiveness of health and emergency services provided by public hospitals including components for mental health, palliative care and National Health Development. To receive National Health Development funds, States must receive Commonwealth approval for strategic plans describing how the funds will be spent.

The agreement is based on the following principles:

- public hospital services are provided free of charge to people who elect to be treated as public patients
- access to these services is on the basis of clinical need and within a clinically appropriate period
- people have equitable access to public hospital services, regardless of their geographic location.

There are no requirements for States to match Commonwealth funding. However, the SPP includes what is effectively a 'maintenance of effort' condition. In this case maintenance of effort is defined in output rather than input terms. States are required to provide public hospital services that, at a minimum, are equal to services provided by public hospitals in each State on 1 July 1998. This prevents States discontinuing the provision of services.

A new condition introduced in the current agreement requires States to meet minimum targets on the number of admitted patients.

Funding is adjusted each year for population growth and changes in composition (including the impact of population ageing), increasing hospital utilisation, the rate of private health insurance coverage and hospital cost increases.

Government Schools

The States are responsible for funding primary and secondary education, while the Commonwealth supplements State funding to government schools so that they can provide educational programs directed towards achieving the Commonwealth's schooling priorities. Commonwealth SPPs account for 12 per cent of government school funding.

In 2001 the States negotiated a new SPP agreement for Commonwealth funding for schools, which makes funding available on a per-student basis for general recurrent purposes (e.g. teachers' salaries), capital works and targeted programs (e.g. literacy programs for disadvantaged students).

The Commonwealth has introduced tighter conditions in this latest agreement which runs from 2001–04. States are not required to match Commonwealth funding, but they must commit to the *National Goals for Schooling in the 21st Century* and achieve certain performance measures and targets. The Commonwealth Education Minister now has increased powers to regulate performance measures and targets under legislation. The first targets set through the regulations require all Year 3 students to meet national benchmarks in reading, writing, spelling and numeracy each year. If targets are not met, the Commonwealth Minister can require that funds be repaid and can reduce or delay future payments.

Vocational Education and Training

Under the Australian National Training Authority Agreement, the Commonwealth contributes to the funding of a national vocational education and training system. A new agreement was recently negotiated for 2001–03.

The agreement commits the Commonwealth and the States, in partnership with industry, to work together to increase the participation of Australians in an integrated national vocational education and training system.

State and Commonwealth Ministers for vocational education and training form a Ministerial Council which oversees the agreement. Each State submits an annual vocational education and training plan to the Council for approval before a State can receive Commonwealth funding. To receive growth funds States must comply with user choice policy and principles, and the vocational education and training plan must also satisfy Commonwealth requirements for an innovation strategy, additional State-sourced funding and for planned growth in total activity, including new apprentices.

The Ministerial Council also approves the split of funds between recurrent, capital and national projects and the distribution of funds between States. Recurrent funding allocations are based on population shares, and capital funding allocations are based on historical analysis.

Under the current agreement, each State must at least maintain its expenditure at the level of the year preceding the agreement, and commit to achieving an increase in the number of new apprentices. The Commonwealth provides additional funding on the condition that the States match this funding dollar for dollar from their own sources.

The *Australian National Training Authority Act 1992* requires States to provide the Australian National Training Authority with an annual audit report, which must specify funds spent over the year and certify that amounts were spent according to the purposes for which the Authority allocated them. In addition the States are required to contribute to the annual national report on vocational education and training.

Commonwealth–State Housing Agreement

The Commonwealth-State Housing Agreement covers housing assistance for people whose needs for appropriate housing, in the judgement of the parties, cannot be met by the private market. The agreement covers public and community housing, home purchase assistance and private rental assistance.

About 80 per cent of the funding is provided as base funding, while the remaining 20 per cent consists of identified programs for Indigenous housing, community housing and crisis accommodation. Base funding is distributed between States on a per capita basis and is subject to a 1 per cent efficiency dividend each year. It is also contingent on States matching 50 per cent of the Commonwealth's contribution from their own sources, with restrictions on how States can meet this requirement. Funds from the sale of assets created from previous agreement funding cannot be used for matching. The identified programs are distributed among the States by the Commonwealth.

Commonwealth–State Housing bilateral agreements include performance measures that States must report against. Where requirements have not been met, the Commonwealth may withhold a portion of financial assistance until it is satisfied that obligations have been met.

Supported Accommodation Assistance Program

The Supported Accommodation Assistance Program involves the Commonwealth contributing to the funding of transitional accommodation and a range of related support services for the homeless. The current program runs from 2000–05.

In conjunction with the States, the Commonwealth is responsible for developing a national strategic plan, evaluation, data, research and reporting. The States manage the program and its day-to-day administration.

The Commonwealth contributes 60 per cent and the States contribute 40 per cent of the base funding. This is maintained in real terms via annual indexation of Commonwealth funding and is contingent on States meeting the accountability and reporting requirements in the agreement. Unlike previous agreements, the current program includes growth funds that the Commonwealth does not require the States to match.

The program is underpinned by a memorandum of understanding that requires the program to focus on the achievement of outcomes and be managed and evaluated on the basis of results. Outcomes and performance indicators now form part of the reporting framework in bilateral agreements between the Commonwealth and each State. Under previous agreements, reporting was tied to financial accountability and included detailed reporting on individual services and activities.

Home and Community Care

The Home and Community Care SPP funds community care services for the frail aged and younger people with disabilities, and their carers. The program aims to support people who live at home and avoid premature or inappropriate admission to residential care. Agreements are made between the Commonwealth Department of Health and Aged Care and each State health department. This is one of the more complex SPP arrangements, even after simplification by removing the need for Commonwealth approval of individual projects.

The Commonwealth provides approximately 60 per cent and the States approximately 40 per cent of funding, with all money going into one pool and being subject to the same conditions. Funding levels are determined annually through a system of Commonwealth offers and State replies.

The Home and Community Care SPP has extensive administrative arrangements.

- A National Triennial Plan (jointly agreed to by Commonwealth and State Ministers) sets out priorities, strategic directions and estimated funding for the next three years.
- National Program Guidelines have been developed over time that set outline parameters for the national program and guide the setting and monitoring of program standards, accountability, assessment and fees. The Commonwealth and State Ministers jointly agree on the application of the guidelines in each State.
- A jointly approved Program Management Manual.
- Advisory and consultative mechanisms at national, State and regional levels.
- Each State must agree with the Commonwealth on an annual plan, which sets out priorities (determined via community consultation) and proposed funding and outputs. States may vary actual regional outputs and funding slightly for each region.
- States can approve individual projects within regions, as long as they advise the Commonwealth of approvals within fourteen days. Unless otherwise agreed, Commonwealth and State Ministers announce project approvals and funding allocations jointly.
- At the end of each financial year, the States report to the Commonwealth whether planned outputs were achieved and whether funding was allocated as planned. Reports must include data collected by service providers on the client characteristics, and the number, type and quality of services provided.
- States are required to enter agreements with service providers, that set out the services to be provided (in measurable outputs) the quality of standards to be achieved and the means of monitoring and measuring the standards.
- Comprehensive quarterly data collection requirements.

If the Commonwealth has reasonable grounds (e.g. service outputs not being attained), it may revert to the previous arrangement where the Commonwealth and State approved individual projects jointly. It can withdraw funding in the following year if States do not meet the conditions of the agreement.

Natural Heritage Trust

The Natural Heritage Trust is a series of environmental and natural resource management projects which has consisted of twenty-three separate SPPs, but will be reduced to four separate programs with the extension of the Trust from 2002–03. The following comments relate to the original arrangements.

The Natural Heritage Trust is administered jointly by the Commonwealth Departments of Environment and Heritage (the environmental component) and Agriculture, Fisheries and Forestry (the agricultural component). A variety of State agencies administer the different programs.

Projects must comply with a range of general Natural Heritage Trust requirements, including respective Commonwealth–State partnership agreements. These agreements outline each program's objectives, and describe how they are to be delivered, the outcomes sought, cost sharing arrangements and processes for evaluation and monitoring. States are generally required to match Commonwealth funding dollar for dollar.

Project proposals are assessed by technical, regional and State panels. Panel membership must be agreed with the Commonwealth.

Regional Assessment Panels advise on local and regional project priorities and on implementation of regional plans. The State Assessment Panel then advises both the State Minister and the Commonwealth Natural Heritage Trust Board on priorities for both regional and community projects and relevant State and national program projects.

A Commonwealth Ministerial Board makes the final decision on recommendations.

The Natural Heritage Trust criteria have been criticised for not recognising the varying requirements of different regions across the country. It has also been criticised for focusing on outputs (often of questionable long-term value) rather than outcomes. Outcomes focus on the intended impact on a particular group or the entire population whereas outputs are products or services produced or delivered by a department for external customers, which are in line with the broad outcomes.

5.5 Issues

States have long considered that SPP arrangements can result in adverse outcomes, particularly where SPP conditions control the use of these funds and also seek to determine States' own expenditures. Issues include:

- a reduction in States' ability to respond to the needs of their communities in a timely and effective way
- a reduction in incentives for States to develop new models of service provision to achieve outcomes more efficiently and effectively
- duplication and overlap in administration and expenditure responsibilities between the Commonwealth and the States.

Focus on inputs or outputs, rather than outcomes

A major problem with SPPs is their focus on inputs and, to a lesser extent, outputs – rather than results or outcomes.

The Commonwealth has often sought to limit States from substituting Commonwealth SPP funding for State expenditure on programs by applying restrictive conditions on State inputs. These conditions are usually in the form of 'maintenance of effort' and 'matching' clauses. The conditions reflect the Commonwealth's emphasis on the resources associated with SPP programs, rather than with the results of the activity.

Matching and maintenance of effort conditions lock a proportion of State funds into particular programs or areas. They do not allow funds to be reallocated to address changing needs. They do not allow savings to be achieved through greater efficiencies or better targeting of the program to needs. Input controls are inappropriate in SPP arrangements given the community interest in accountability is on what is achieved (outcomes) rather than processes and inputs.

A 1995 Inquiry by the Commonwealth Joint Committee of Public Accounts, *The Administration of Specific Purpose Payments: A Focus on Outcomes*, found that input controls in SPP agreements have significant disadvantages. The Inquiry concluded that the Commonwealth's imposition of these controls and States' subsequent attempts to minimise their impact are counterproductive, when the Commonwealth and States should be cooperating on the development of shared SPP objectives.

Restrictive input controls

Restrictive input conditions are usually in the form of maintenance of effort and matching clauses. Maintenance of effort clauses make receiving SPP funds conditional on States maintaining existing levels of expenditure in that area. Matching clauses in SPPs require States to provide their own funds for a program before the Commonwealth will contribute (e.g. dollar-for-dollar). These requirements have a number of disadvantages.

- A focus on input controls does not place clients first, particularly for SPPs providing services directly to individuals and groups within the community.
- A focus on inputs distracts attention from meeting SPP objectives and does not provide any indication of what is being achieved via the service provision.
- Input controls limit incentives for service providers to improve their efficiency, and prevent the redirection of efficiency savings into other areas of expenditure.
- Input controls do not allow service providers the flexibility to move funds between program elements within SPPs to ensure that overall objectives are achieved.

These restrictions lock a State into expenditure levels in particular areas, even if budget priorities and local requirements change. In some cases States may also be left entirely responsible for a program when Commonwealth attention shifts to a new area.

Despite these problems, input controls are often favoured by service delivery agencies in the States (and sometimes in the Commonwealth) because intergovernmental agreements protect these programs from ordinary budget scrutiny.

Commonwealth imposition of these controls and subsequent attempts by States to minimise their restrictive impact are a major cause of conflict in SPP negotiation and administration. It would be more productive for the Commonwealth and States to cooperate in the development of shared SPP objectives.

The Commonwealth's preoccupation with inputs rather than outcomes was criticised by the Joint Committee of Public Accounts' 1995 Report. The Report recommends replacing input controls, such as maintenance of effort clauses and matched funding agreements, with performance agreements that include measurable outcomes.

Inflexibility

Providing Commonwealth funds to the States in the form of SPPs significantly reduces the ability of State Governments to address policy priorities from a regional perspective.

Circumstances in each State are different and resources often need to be directed differently. However, SPP arrangements inevitably follow a uniform approach. For example, the matching condition in the *National Action Plan for Salinity and Water Quality* does not consider existing State effort, so a State already committing large resources to the area must contribute the same level of additional resources as a State that is applying less resources.

In addition, States must nominally accept Commonwealth priorities in particular program areas, as well as the Commonwealth's terms, conditions and reporting arrangements. In reality, there has been considerable scope for States to use the fungibility of money and game playing of various kinds to subvert the Commonwealth's objectives when they are not shared by the State. Over time, the Commonwealth tends to respond by seeking to tighten controls, leading to more sophisticated game playing by the States.

The net result is a significant loss of flexibility for States seeking to pursue their objectives efficiently. This has costs, because circumstances vary and resources often need to be applied differently across States. Furthermore, the needs of the population within each State are affected over time by changing demographic, economic and social characteristics. The States are often better placed to identify and address these changes, but to do so they need flexibility in the application of funds. However, in many SPPs (e.g. the *Regional Remote Power Program*) the Commonwealth sets project approval criteria or requires programs and strategies to reflect national priorities, rather than tailoring these to individual circumstances in each State. The merits of SPP arrangements that increase the distance between decision making and service delivery are questionable.

Financial risk

Conditions on SPPs can lead to States assuming additional financial risks, including pressure to maintain services when facing a reduction in Commonwealth funding.

Commonwealth SPP funding has also been eroded over time by other arbitrary changes. For example, since 1996–97 certain recurrent SPPs have been subject to an ongoing annual efficiency dividend (reduction) of 1 per cent. The Commonwealth's rationale for the efficiency dividend is that it reflects (and provides incentive for) public sector productivity improvements over time. This implicitly assumes there are adequate indexation arrangements to cover the increase in costs before any productivity improvements. However, there are cases in which the inflation index used already includes the effect of productivity gains, so that a separate productivity dividend means the Commonwealth is effectively deducting an efficiency dividend twice.

States face the full cost risk of their own programs, but may discontinue or curtail these programs if the cost becomes too great. However, the conditions attached to SPPs may restrict States from responding to changes in the fiscal environment.

Even though the Commonwealth may cease funding for an SPP, or decrease it significantly, both clients and service providers are likely to pressure State Governments to continue the program (e.g. the Dental Health Scheme) at the same level. Sometimes the Commonwealth will only specify funding for the first year.

The Commonwealth tends to increase its demands and controls on the States in programs in which it has been involved over a long time, in exchange for continued or additional funding.

There are also perennial disputes about the adequacy of Commonwealth allowances for cost escalation over time. Indexation or escalation arrangements often do not accurately reflect demand and cost increases in delivering a specified service (e.g. for public hospital patients), pressuring States to make up the cost difference or reduce the quantity or quality of services over time. Naturally, the Commonwealth prefers States, rather than itself, to carry risk when it wishes to contain and reduce its expenditures. For example, the Commonwealth–State Disability Agreement contains an indexation formula calculated each year. This parameter, referred to as the Wage Cost Index 2, is based on 10 per cent of the increase in the Consumer Price Index and 90 per cent of the increase in the Safety Net adjustment for low-paid workers. However, costs in this sector often increase by more than the Consumer Price Index, and wage rises are often higher than Safety Net increases.

Disincentives for efficient and effective service delivery

SPPs often restrict States' scope to provide services in innovative and flexible ways. This reduces, correspondingly, the potential to achieve effective outcomes. This problem is demonstrated when an SPP focuses on one particular service in isolation. For example, improving health or education outcomes in Australia's remote Indigenous communities may require attention to be given to housing, water, sewerage and economic development.

The current Australian Health Care Agreement provides another example. It includes what is effectively a maintenance of effort condition, but in output rather than input terms. The agreement locks each State into delivering the services it was providing at the start of the agreement (in July 1998). This prevents States from restructuring service delivery to realise outcomes that are desired by the Commonwealth, as well as the State Governments.

Matching and maintenance of effort conditions in SPPs act as disincentives to more efficient service delivery because they prevent States from applying savings generated by genuine efficiency improvements, or improvements in external factors, to other programs.

For example, the Supported Accommodation Assistance Program is concerned with reducing the level of homelessness. Yet if economic conditions improve, leading to reduced unemployment and an associated reduction in demand for Supported Accommodation Assistance Program services, the conditions in the agreement prevent States from switching funds between the Supported Accommodation Assistance Program and related public housing and social welfare programs to achieve an even greater reduction in homelessness.

Duplication in policy making and administration

SPPs are invariably administered, managed and accounted for on an individual basis by both Commonwealth and State Governments. Commonwealth officials oversee the activities of State officials who then monitor program delivery in their own jurisdictions. This blurs accountability and generates inefficiency.

Administrative duplication is greatest where Commonwealth funds are provided to the States through a considerable number of small SPPs, where details must be submitted for every program or where the Commonwealth must approve individual projects. Detailed progress reporting on the application of inputs for each program, and prescriptive accounting and audit requirements, also increase the administrative burden.

SPPs often require the establishment of project consultation mechanisms involving multi-tiered committees, advisory systems and, finally, joint Ministerial approvals. The ineffectiveness of these costly arrangements becomes apparent when the Commonwealth overrides recommendations from the advisory bodies. For example, regional and State panels assess technical aspects of project proposals for funding under the Natural Heritage Trust. Final approval rests with a Commonwealth Ministerial Board once Commonwealth officials have reviewed State recommendations.

In many instances, projects recommended by the States following this process have not been accepted because of a different Commonwealth interpretation of eligibility criteria. Similarly, the Commonwealth has approved projects that the States did not originally recommend.

These outcomes lead to stakeholder confusion and disenchantment over responsibility for program administration and what the program is trying to achieve.

Interaction with horizontal fiscal equalisation

The actual effects of SPP distribution on transfers across States is obscured because the Commonwealth Grants Commission (CGC) effectively overrides the transfers when it allocates untied grants. For most SPPs the CGC effectively sets aside the allocations determined by the Commonwealth under legislative and Ministerial authority in the portfolio area concerned – typically in consultation with the States – and substitutes its own assessment.

Reform directions

The problems with SPPs identified in this chapter are recognised by Commonwealth and State Governments alike. They are recognised even more clearly, and painfully, by the clients of the services funded by SPPs. The problems arising from the controls on inputs rather than monitoring of outcomes have been explicitly recognised in recent statements by Commonwealth ministers and broadly accepted by State Governments.

In reality, the enlarged role of SPPs since the 1970s has effectively converted some areas of State constitutional responsibility into areas of shared responsibility between the Commonwealth and the States. This has been accepted to a considerable extent by the Australian community. As a result, it is not possible to solve the problems of SPPs simply by abolishing them.

SPPs should be reformed to achieve effectively and accountably the best outcomes possible in the key areas of public service delivery on which they are focused – particularly in health, education and Indigenous community development.

CHAPTER 6: Comparative Fiscal Positions

- The original purpose of Commonwealth–State transfers was to make sure that States facing financial difficulty could maintain their viability as a member of the Federation.
- Comparing States' budgetary positions and expenditure per capita over time shows no sign that recipient States are generally subject to fiscal stress or under pressure to raise taxation and reduce expenditure.
- Today, transfers bear no relation to fiscal difficulty. Instead they are based on an extreme application of a particular conception of horizontal fiscal equalisation. However:
  - while the Australian Capital Territory and Queensland are the only debt-free States, they both receive revenue from States in weaker fiscal positions
  - donor States tend to exert more effort in generating revenue than the recipient States, despite their comparable expenditure and budget outcomes.

6.1 Overall fiscal position

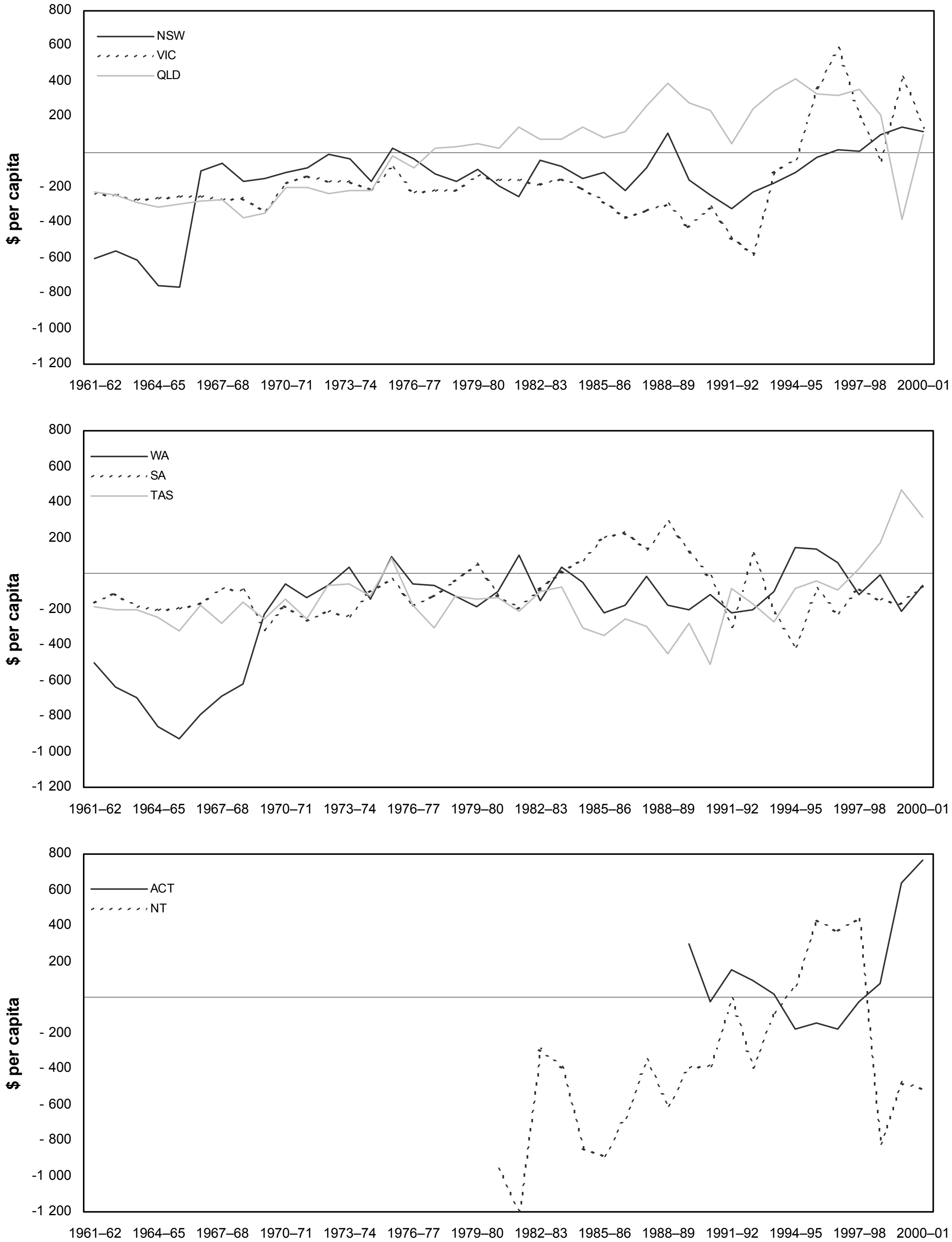
Cash result

The original role of interstate fiscal transfers was to help maintain the viability of Federation by supporting State Governments in fiscal difficulty. This was a central focus of the Commonwealth Grants Commission (CGC) in its early decades. If some States made a larger effort to raise revenue than others and were remarkably prudent in expenditure, but still faced severe budgetary stress, it was thought appropriate for them to receive special assistance.

The original purpose of the CGC has evolved over time to an expansive equalisation system encompassing all States, whether or not they are in fiscal difficulty.

The variability of the cash results of all States has increased over the past two decades (Figure 6.1). The cash results of New South Wales, Victoria, Queensland, Tasmania and the Australian Capital Territory have generally improved in recent years, with each reporting a cash surplus in 2000–01. Western Australia, South Australia and the Northern Territory recorded a deficit in 2000–01.

FIGURE 6.1: Cash result, 1961–62 to 2000–01 ($ per capita)



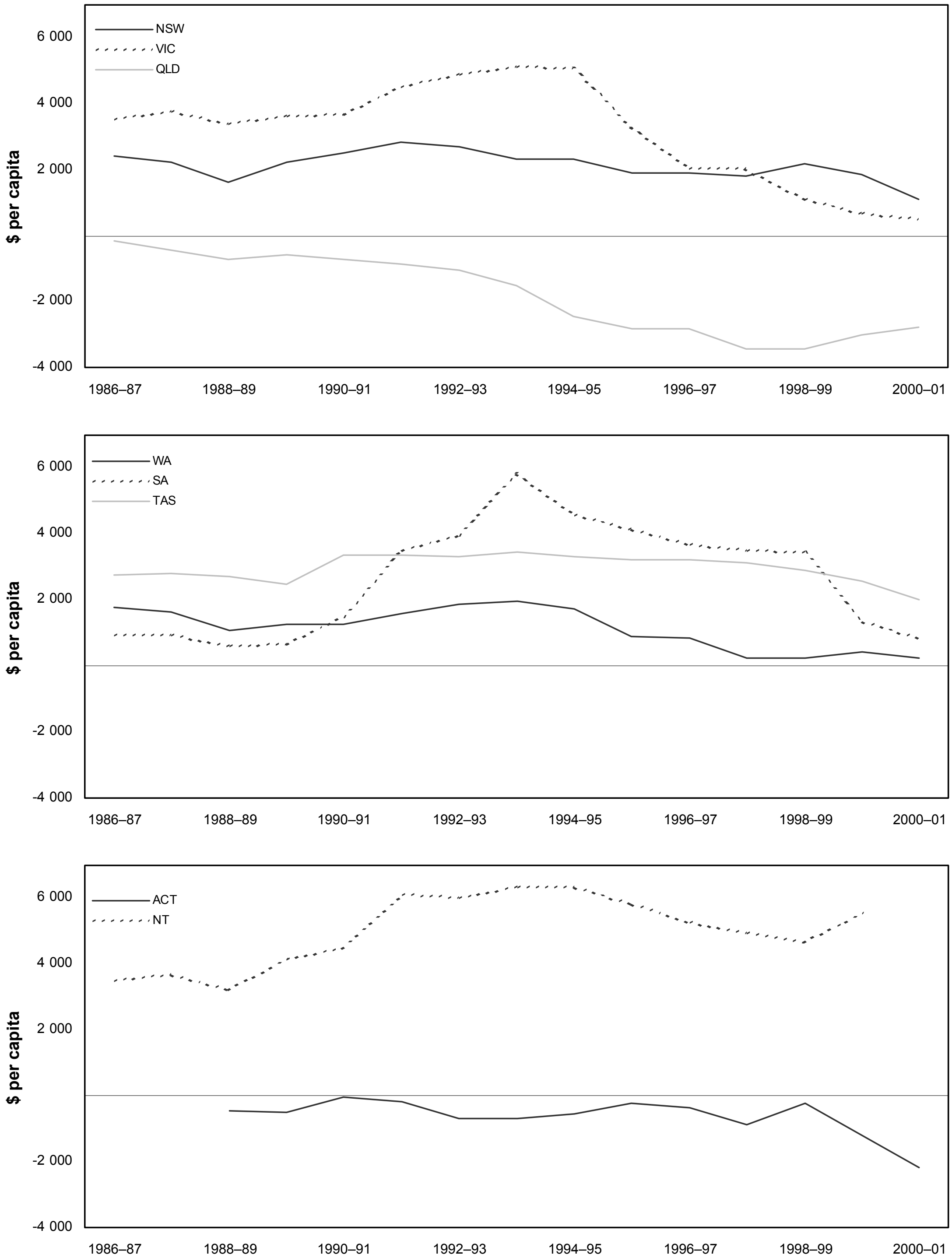
Note: Data adjusted for inflation. Figures are in 2000–01 dollars.

Net debt

The general government sector net debt of most States, excluding Queensland and the Australian Capital Territory, peaked in the early to mid-1990s (Figure 6.2). Queensland and the Australian Capital Territory are the only States with negative net debt positions, which have been consolidated over the last decade.

The net debt positions of all other States, except the Northern Territory, improved over the period. Victoria experienced the largest improvement, followed by Western Australia and New South Wales. In recent years, net debt levels in Victoria and South Australia have fallen significantly.

FIGURE 6.2: Net debt, 1986–87 to 2000–01 ($ per capita)



Note: Data adjusted for inflation. Figures are in 2000–01 dollars.

6.2 State expenditure levels

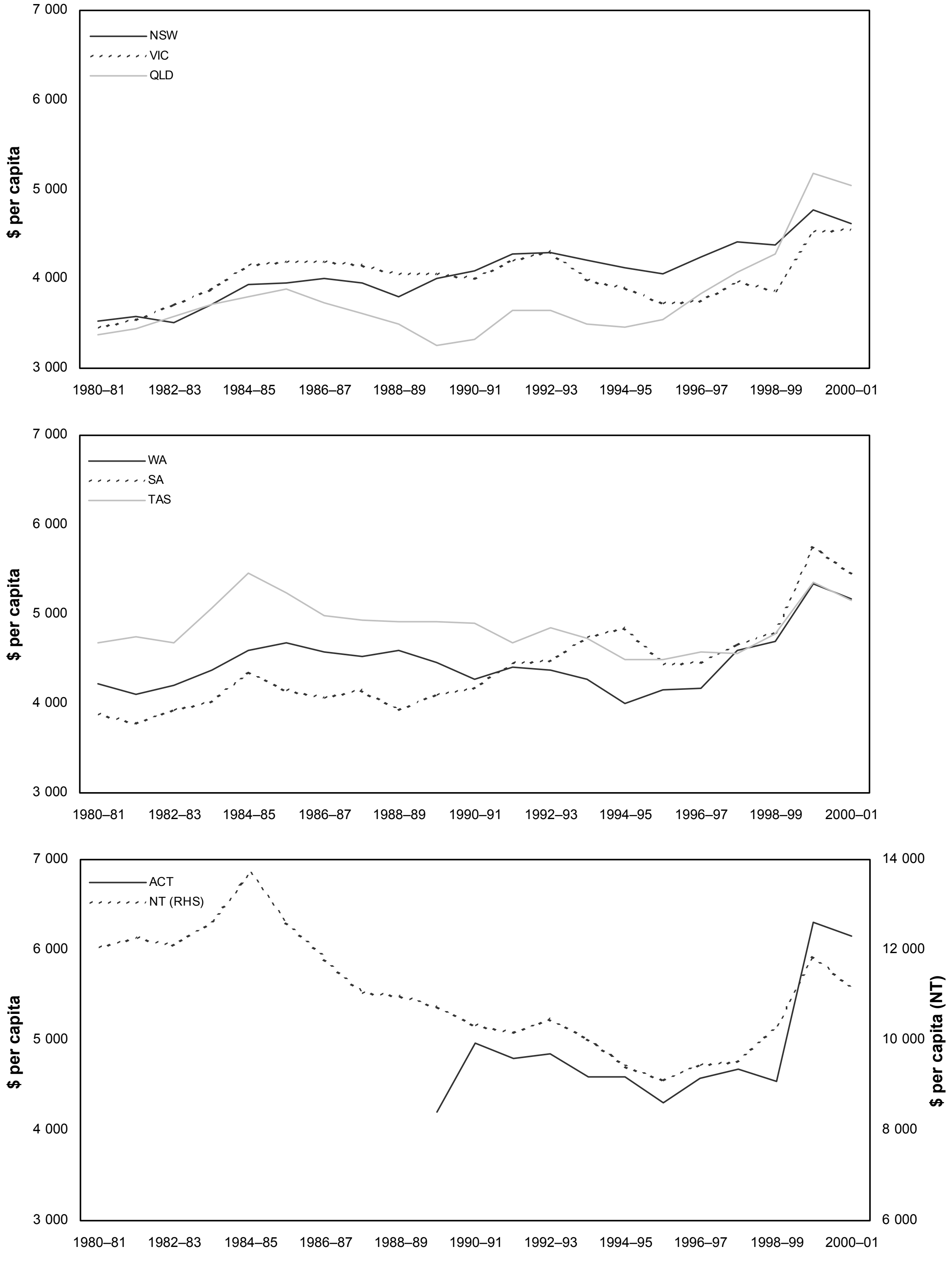
State expenditure

Expenditure in all States, excluding the Northern Territory, has generally risen in real per capita terms over the past twenty years.

Typically, recipient States have higher levels of expenditure than donor States (Figure 6.3), which is very different from the situation in other Federations (see Chapter 7).

The Northern Territory has had by far the highest expenditure of all States in per capita terms. Total spending in Tasmania has also been relatively high over the past twenty years and in the Australian Capital Territory and South Australia over the last ten years. In contrast, expenditure in New South Wales, Victoria and Queensland has been relatively low.

FIGURE 6.3: Total spending, 1980–81 to 2000–01 ($ per capita)

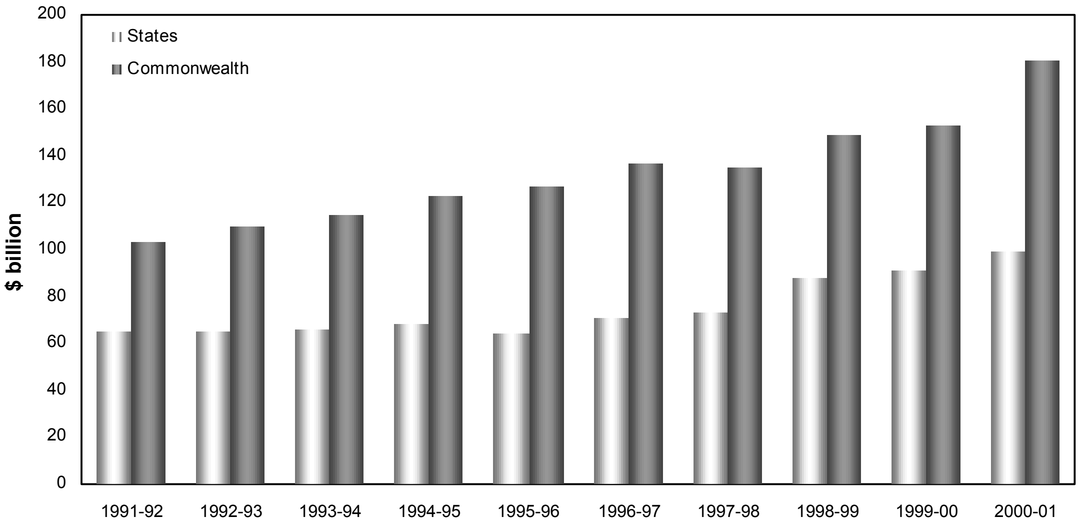


Note: Data adjusted for inflation. Figures are in 2000–01 dollars.

Commonwealth and State expenditure levels

Commonwealth expenditure has grown faster than States expenditure from 1991–92 to 2000–01 (Figure 6.4). This is because, unlike the Commonwealth, the States have not had access to growth taxes and growth in Commonwealth grants to the States has not matched growth in Commonwealth revenue. The relatively strong growth in Commonwealth expenditure was concentrated in the first half of the 1990s. State spending has kept pace from 1996–97.

FIGURE 6.4: Commonwealth and State expenditure, 1991–92 to 2000–01



Note: Data adjusted for inflation. Figures are in 2000–01 dollars.

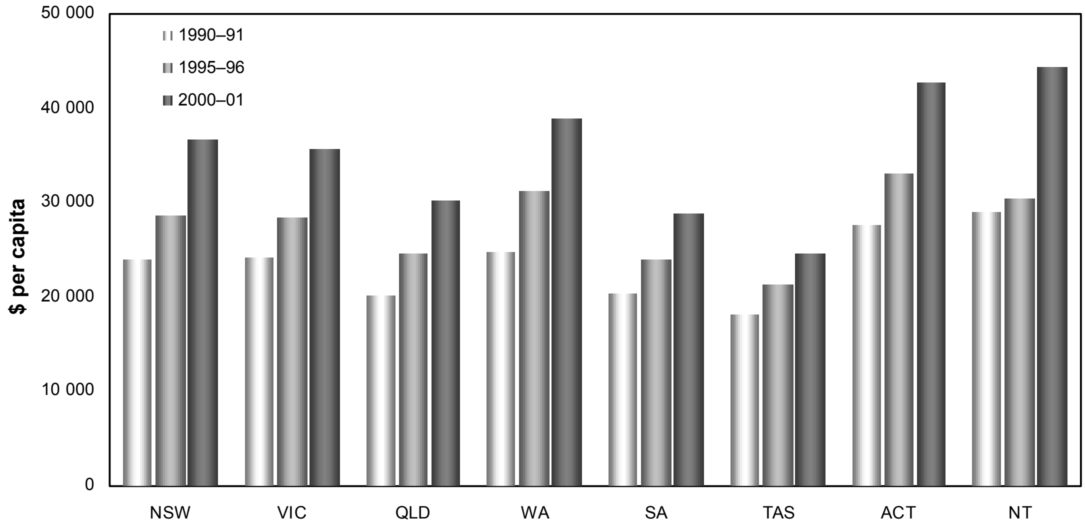
6.3 Taxation effort

Taxation revenue raising capacity

In general, taxes can only be paid out of the income generated by an economy. Even where the legal incidence of a tax is applied to an asset (e.g. land tax), taxpayers must fund their tax liability out of the income created by the asset or from other income or the tax would be unsustainable. When a landowner can pass the tax on to the tenant, the tenant must then fund the tax out of his or her own income. Further, there are many ways to raise tax revenues by using different bases and tax parameters which have similar incidence on taxpayers. The available bases are, to some extent and to differing degrees, substitutes. The relative capacities of State economies to raise tax revenue (per capita) can be assessed to some extent on a global basis by comparing income levels measured by per capita gross state product.

The Northern Territory had the highest gross state product per capita from the early 1990s and again in 2000–01, while the Australian Capital Territory had the highest gross state product per capita for the rest of the 1990s (Figure 6.5).

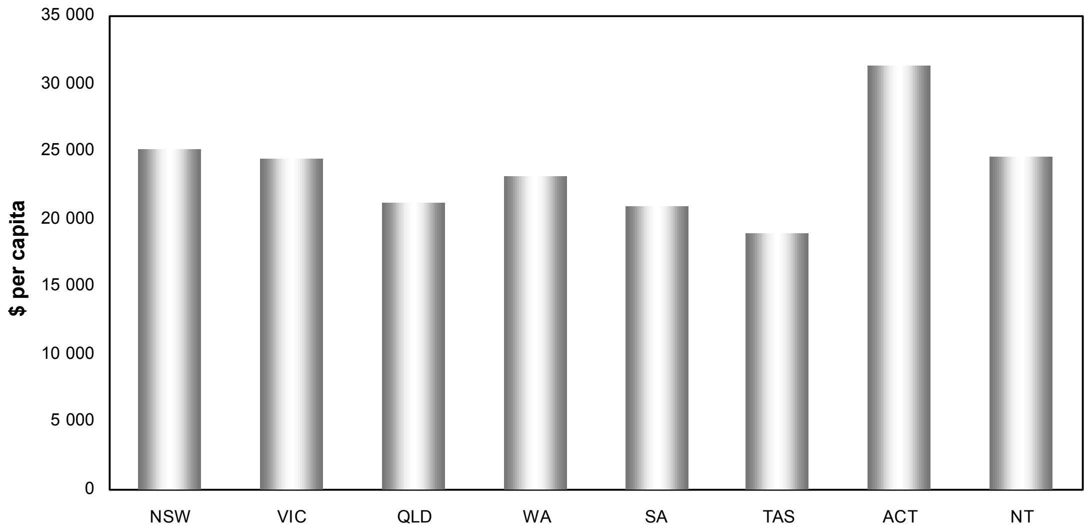
FIGURE 6.5: Gross state product per capita, 1990–91, 1995–96 and 2000–01



Note: Data adjusted for inflation. Figures are in 2000–01 dollars.

An alternative indicator of the relative capacities of State economies to raise tax revenue from individuals in their jurisdictions is household disposable income per capita. In 2000–01 the Australian Capital Territory had the highest household disposable income per capita (Figure 6.6).

FIGURE 6.6: Household disposable income, 2000–01



Note: Data adjusted for inflation. Figures are in 2000–01 dollars.

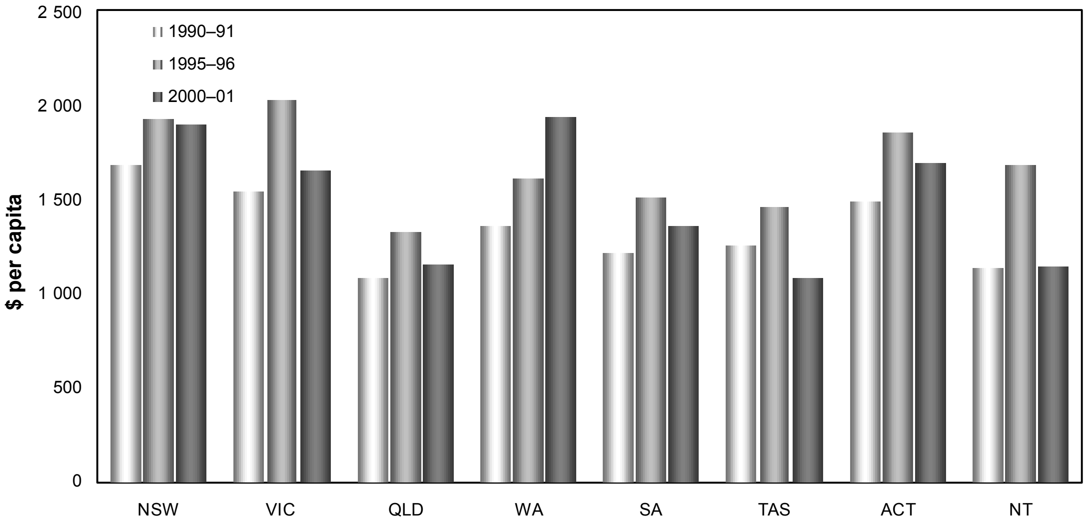
When using household disposable income per capita to measure relative capacities of State economies to raise tax revenue, one other factor should be considered. A State may have a high capacity to raise revenue, as reflected by gross state product per capita, but with a considerable part of this capacity in areas not subject to the currently utilised range of State taxes.

For example, much of the Australian Capital Territory's economic activity is generated by activities of the Commonwealth Government and cannot be directly captured by the current tax regime. However this activity acts to increase the Australian Capital Territory's average per capita income, which increases the capacity of residents to pay all taxes, including stamp duties and land tax.

Taxation revenue

The tax revenue raised by all States grew in per capita terms between 1990–91 and 1995–96. Taxation rates ratios fell in all States in the five years to 2000–01, with the abolition of a range of taxes in the context of the Intergovernmental Agreement covering the introduction of the Goods and Services Tax (GST). In 2000–01 tax revenue raised per capita was substantially greater in the donor States (particularly New South Wales and Western Australia) than in the recipient States (particularly Tasmania, Queensland and the Northern Territory).

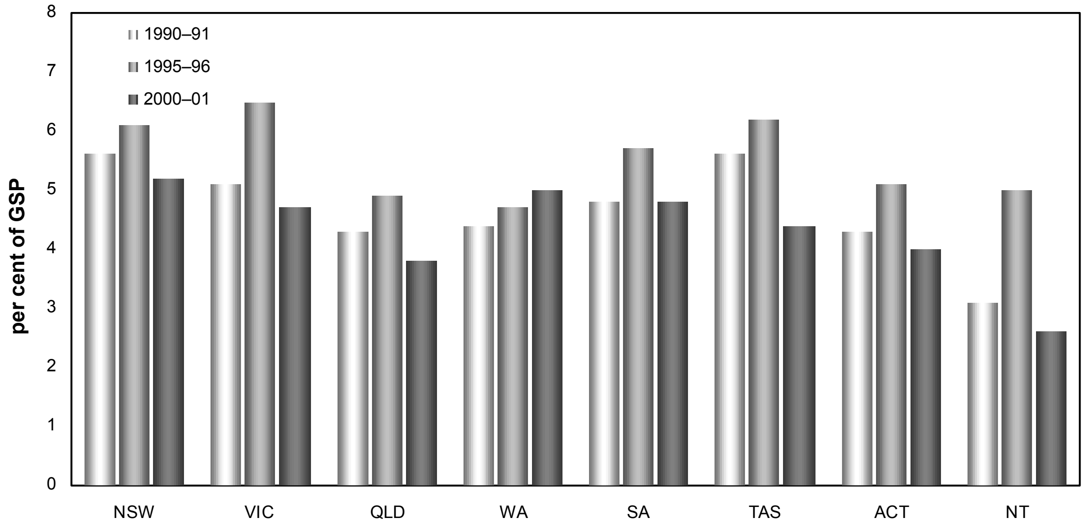
FIGURE 6.7: Tax revenue per capita 1990–91, 1995–96 and 2000–01



Note: Data adjusted for inflation. Figures are in 2000–01 dollars.

Taxation revenue was particularly low as a share of gross state product in the Northern Territory and Queensland (Figure 6.8).

FIGURE 6.8: Tax revenue as a percentage of gross state product, 1990–91, 1995–96 and 2000–01



Note: Data adjusted for inflation. Figures are in 2000–01 dollars.

Contracts and conveyances duty

In 2000–01 New South Wales raised more than any other State from contracts and conveyances duty in terms of actual dollars and dollars per capita (Table 6.1). However Victoria had the highest effective tax rate for contracts and conveyances duty, followed equally by South Australia and the Northern Territory.

TABLE 6.1: Comparison of collections from contracts and conveyances duty, 2000–01

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
$ million	2 267	1 284	700	530	283	56	79	28
$ per capita	348	267	194	279	189	119	252	142

Source: State and Territory Treasuries (unpub.)

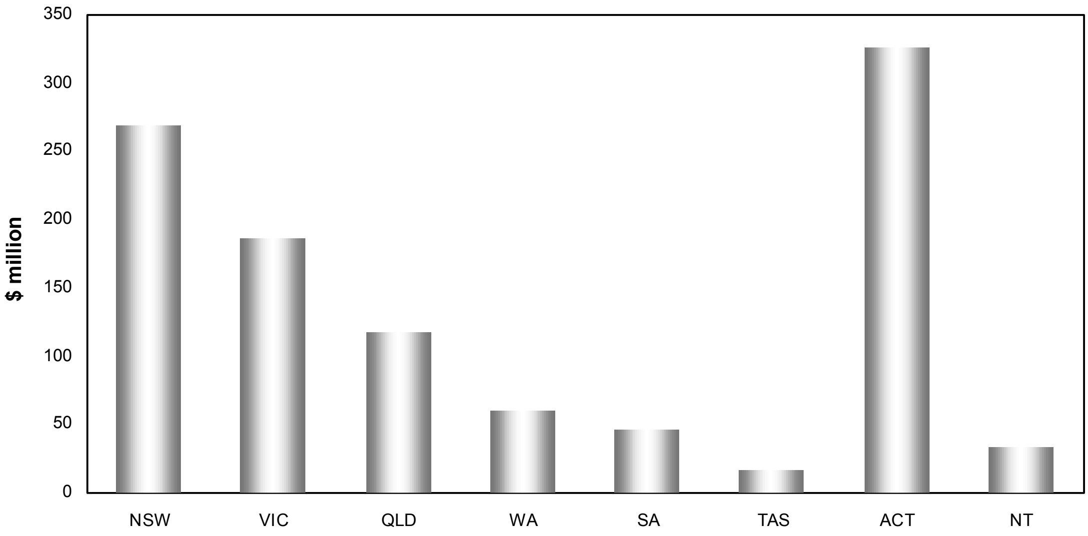
6.4 Special features of the Australian Capital Territory

There has been much discussion of the apparent anomaly that the Australian State with the highest per capita income – the Australian Capital Territory – receives interstate transfers.

The prominence of Commonwealth Government activities in the Australian Capital Territory, and the exemption of its activities from State taxation, leads to a revenue loss that exceeds the general purpose grants it receives in excess of its per capita share.

The exclusion of the Commonwealth Government from payroll tax liability affects the capacity of the States to raise revenue from this source. The Australian Capital Territory is most affected by this exclusion, and its loss of revenue is estimated at $326 million in 2000–01. This section discusses the special position of the Australian Capital Territory in relation to its potential to raise revenue.

FIGURE 6.9: Estimate of revenue loss from payroll tax exemption, 2000–01



Source: CGC 1998

Removing the mutual exemption of the two layers of government from each other's taxation has been discussed widely. There would be advantages in removing the exemptions, and taking this step would immediately move the Australian Capital Territory from the list of recipient States.

However, if this rationalisation did not eventuate, it would remain curious for the Australian Capital Territory – with its exceptional revenue raising capacity – to receive transfers from other States, as distinct from specific purpose payments (SPPs) in recognition of the Territory's national role. The Australian Capital Territory chooses to tax payroll at lower effective rates than the donor States. It chooses to tax real estate sales at substantially lower rates than the large States. It also chooses not to ask the Commonwealth to facilitate the application of the small surcharge to income tax that would remove the anomalous transfers from other States – a constitutionally available option. A high-income State is entitled to forgo potential revenue from these and other tax bases. Few would question choice of lower tax combined with constraint on provision of services. However, the possibilities for generating additional tax revenue from the exceptionally high incomes in the Australian Capital Territory are strong reasons for modifying the system that results in revenue being transferred from all Australians to Australians in the richest jurisdictions.

6.5 The States' overall fiscal situations

There is no sign that the recipient States are generally subject to fiscal stress or under pressure to raise taxation and reduce expenditure relative to donor States. Queensland Government finances are the strongest of all the States, despite the fact that it has the lowest tax regime. The Australian Capital Territory and Queensland are the only debt-free States. In the Australian Capital Territory's case, this is largely the result of receiving assets without debt from the Commonwealth at the time of self-government. Other recipient States are not in such strong fiscal positions. Donor States tend to have relatively high tax rates, low expenditure levels and budget outcomes that are similar to those of recipient States.

CHAPTER 7: Other Federations

- While Australia has very little fiscal or economic disparity between its States, it makes the largest and most explicit efforts to remove horizontal imbalances.
- Australia is the only Federation that interprets horizontal fiscal equalisation as 'full equalisation' of revenue raising capacity and expenditure needs.
- Canada and Germany only partially equalise revenue capacity, and do not equalise expenditure. The United States uses no formal equalisation at all.

7.1 Introduction

This chapter compares Australia's Federal fiscal arrangements with those of comparable Federations of Canada, Germany and the United States of America. It focuses particularly on vertical fiscal imbalance, on horizontal fiscal equalisation (HFE) arrangements and on use of specific purpose payments (SPPs).

High vertical fiscal imbalance does not cause large horizontal fiscal imbalance between Governments at a State level. However, a larger degree of vertical fiscal imbalance facilitates employment of equalisation policies by national governments.

Equalisation transfers in Federations usually aim to reduce fiscal disparities between State-level governments that arise from differences in economic scale, rates of growth, income, wealth, revenue bases or expenditure needs. The degree of revenue and expenditure decentralisation in each country affects the strength of tendencies towards high horizontal transfers: the more decentralisation, the greater the total disparities associated with a given level of variation in the revenue raising capacity or expenditure needs of State Governments (Peloquin and Chong, forthcoming).

Australia is a highly centralised Federation with relatively little fiscal or economic disparity between States before equalisation. Australia makes the largest and most explicit efforts to remove horizontal imbalances. It is the only Federation that applies full HFE to both revenue raising capacity and expenditure needs. Canada and Germany equalise partially and the United States uses no formal equalisation at all, although there is an equalising tendency in its increasing use of SPPs.

7.2 Vertical fiscal imbalance and the control of revenues

Australia has by far the highest degree of vertical fiscal imbalance across the four Federations (Table 7.1).

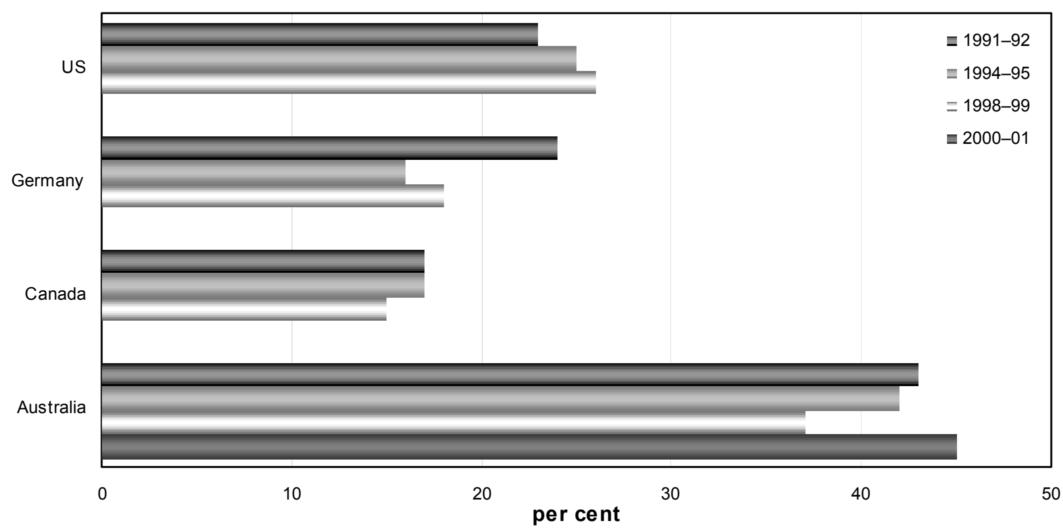
TABLE 7.1: Grants to States as a percentage of State revenue, expenditure and total Federal outlays, 1998–99

	Percentage of state revenue	Percentage of state expenditure	Percentage of total federal outlays
Australia	38.1	37.1	25.8
Canada	15.2	15.0	15.6
Germany	18.5	17.7	15.9
United States	22.5	25.7	13.0

Source: ABS cat. no. 5512.0; IMF 2001

During the 1990s Federal grants fell as a proportion of State expenditure in Australia, Canada and Germany. In Australia this was reversed by the introduction of the Goods and Services Tax (GST), when States gave up a number of their own taxes in exchange for GST-based grants. Figure 7.1 shows the increase in grants as a percentage of States' expenditure in 2000–01. In the United States, the use of grants, specifically tied grants, increased.

FIGURE 7.1: Grants as a percentage of total State expenditure



Source: ABS cat. no. 5512.0; IMF 2001

Three main tax bases determine the level of vertical fiscal imbalance between Federal and State Governments:

- income
- sales of goods and services
- natural resources.

Income taxes

In Australia, the States have constitutional access to the income tax base (including taxes applied on personal and corporate income). However the Commonwealth has effectively blocked the States from accessing income tax since World War II – except for a politically unacceptable offer to the States to add income tax surcharges made by the Fraser Government.

In Germany, the Basic Law specifies financial relations between the Federation and the States, which are known as Länder. The Basic Law prescribes tax legislation and, in the case of income and corporate profits tax, how much tax revenue will be distributed between tiers of Government. The Federation and the Länder mostly share income and corporation tax revenues. This reduces the need to use grants for equalisation purposes (Table 7.2).

TABLE 7.2: Distribution of public incomes across Government levels, Germany (%)

	WAGES AND INCOME TAX	CORPORATION TAX	VAT
Federation	42.5	50	52.2
Länder	42.5	50	45.7
Communes	15	0	2.1

Source: Kienemund 2000

The United States Constitution and Canadian Tax Collection agreements effectively serve the same purpose, but allow interstate variations in tax rates by providing for shared Federal–State access to income tax bases. The States generally apply their own taxes over Federal income taxes. In the United States, both tiers of government tax personal income, although Federal income taxes limit the amount States can collect. To minimise administration efforts and costs, States in the United States that choose to tax income tend to piggyback on Federal tax structures and returns.

The Canadian Provinces, excluding Quebec and Ontario, set their personal and corporate income tax rates as a proportion of that charged by the Federal Government. The Provinces piggyback their income taxes onto the Federal Government's income tax to minimise administration costs (as in the United States), and the Federal Government centrally collects these taxes, returning their shares of revenue to the Provinces.

Sales taxes

The Australian States' inability to raise revenues through major tax bases extends to sales taxes on goods. Constitutionally, the States can tax services, but relatively few commercially provided services lend themselves to being used as tax bases, other than via a broad value added tax like the GST.

Germany's revenue sharing arrangements also apply to its value added tax, which is split primarily between the Federation (52 per cent) and the Länder (46 per cent).

Each Canadian Province levies its own sales tax. Sales tax is collected by the Federal Government, which then returns proceeds to the Provinces in which they have been collected. In addition, the Federal Government administers a separate GST and retains the revenue for Federal expenditure. The Provinces of Nova Scotia, New Brunswick and Newfoundland have, with the agreement of the Federal Government, adopted a Harmonised Sales Tax that combines Provincial sales taxes and the Federal GST into a single tax.

The United States is one of the few developed countries without a broad-based national sales tax, with the sales tax base under State control. One reason the Federal Government has not introduced a national sales tax is that State and local authorities object to Federal encroachment on an area that has traditionally been a tax base for themselves.

Resource taxes

In Australia and Canada, States have constitutional ownership of mineral rights and responsibility for managing mineral leasing – except in distant offshore areas. However, in Australia the most profitable natural resources are in offshore areas – Bass Strait, the Northwest Shelf and the Timor Sea – and partially or entirely under Commonwealth control. In the Northwest Shelf, the Commonwealth Government and the Western Australian Government agreed several decades ago to share royalties in specified proportions. The agreement on sharing Northwest Shelf royalties reflected the Commonwealth's recognition of the State's large fiscal and other contributions to development of the project. The Commonwealth collects the royalties and pays Western Australia its share as an SPP.

In Australia, the States directly collect royalty revenues from onshore mining. All potential State revenues from mineral rent, including Commonwealth payments to Western Australia for the Northwest Shelf, are included in the assessment of each State's revenue raising capacity, and consequently accounted for in the horizontal fiscal equalisation process. They are mostly equalised away from the State in which they are generated, albeit in an manner that bears no close relationship to either mineral rent or mineral revenues (see Chapter 11).

The Canadian Constitution gives Provinces the power to levy and collect revenues from natural resources. There has been controversy about the inclusion of resource revenues in the determination of Provinces' revenue raising capacity – a key factor in the Canadian fiscal equalisation process. Newfoundland and Nova Scotia state that 85 per cent of new resource revenues are offset by reductions in equalisation payments, which discourage resource industry development and deny Provinces the benefits of a valuable revenue generating asset.

Unlike Australia, Canada's most valuable natural resources are located onshore under provincial control. The largest resource is petroleum in Alberta. Alberta's natural resource wealth comfortably surpasses that of all other Provinces, providing it with by far the largest revenue raising capacity. This advantage is mostly not equalised away, and growth in resource taxation revenue results in a corresponding increase in Alberta's overall revenue.

In the United States resource taxes are collected and retained by the States, with the exception of distant offshore waters, as in Australia. Certain resource-rich States rely heavily on these taxes. Alaska collects around half its revenue from resource taxes (which do not include royalties). These taxes may account for 10 per cent of all revenues in other resource-rich States. The Federal Government collects substantial revenues from offshore petroleum, although as a proportion of total mineral rents it collects much less than the Australian Government.

In Germany, only the Federal Government has access to resource revenue from mineral rent.

Non-tax revenues

Table 7.3 compares non-tax revenues (excluding grants) as a proportion of total State revenues across the four Federations. Revenues include dividends from government business enterprises and financial investment income and vary in importance across States.

TABLE 7.3: Non tax revenues as a proportion of State revenues (%)

	1998–99	2000–01
Australia	24.8	23.7
Canada	17.7	na
Germany	10.0	na
United States	31.0	na

Source: ABS cat. no. 5512.0; IMF 2000

Implications for vertical fiscal imbalance

There is a clear link between Australia's high degree of vertical fiscal imbalance and the States' lack of access to the major tax bases. As the States cannot levy income or sales taxes, they rely heavily on Commonwealth revenue from these tax bases which are redistributed to them via grants.

In Canada, the degree of vertical fiscal imbalance between the Federal Government and the Provinces has been increasing, despite the Provinces' raising of funds by applying income and sales tax over Federal taxes. This is partly due to the relative revenue mixes of the two levels of government. The fastest-growing revenue source – income tax – represents a much smaller proportion of revenue for the Provinces than the Federal Government.

Germany has relatively low vertical fiscal imbalance, largely due to revenue sharing arrangements defined in the Basic Law. However, the imbalance has increased since unification in 1990 with the former eastern Länder far more reliant on fiscal transfers from central government than their western counterparts.

The United States has relatively little vertical fiscal imbalance. It has a decentralised system that enables the States to employ any tax not denied to them by the Constitution, and provides them with access to all three main income bases. The States tax personal income by piggybacking on the Federal tax structure but by tradition, have exclusive access to sales taxes. Some States also collect substantial revenue from resource taxes. The relative importance of various tax bases varies greatly across the States. For example, in 1998 Washington received over 58 per cent of its revenue from sales tax but no revenue from income taxes.

7.3 Inequality at State level

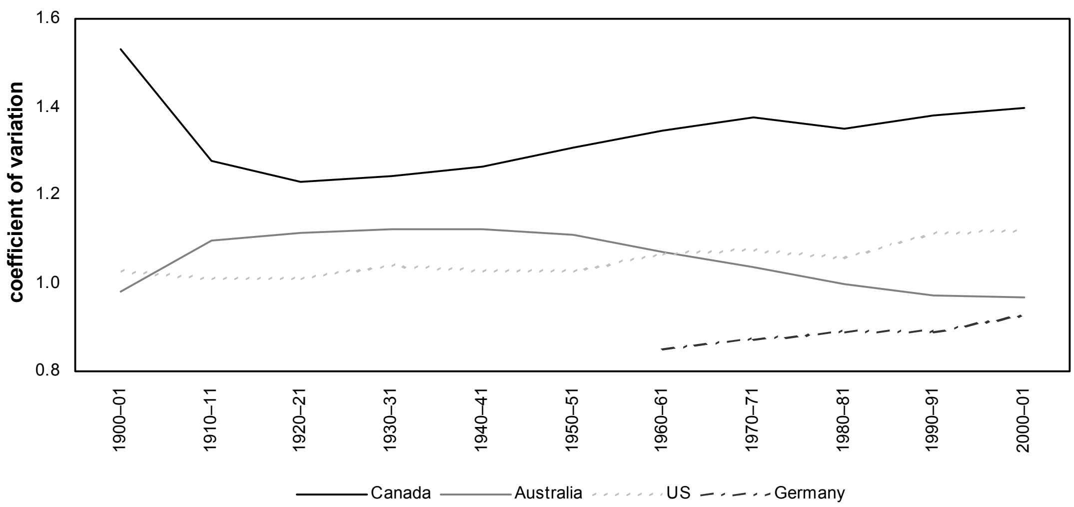
The objective of any system of HFE is to reduce inequalities between States. In Australia, it is contended by some that States would greatly and increasingly diverge in population and economic wellbeing without the comprehensive equalisation employed by the Commonwealth Government.

We have formed the view that inequalities among Australian States are inherently low for reasons other than the HFE system of interstate transfers. These reasons include high internal mobility of population, which has been supported by high levels of international migration.

Population

The divergence between State populations in Australia, Germany, Canada and the United States during the 20th century is shown in Figure 7.2. Population dispersion can be used to show whether the distribution of populations among States is narrowing or widening over time.[4] Population convergence (shown by a falling coefficient of variation) indicates slower population growth in the larger, more populous States, relative to less-populous States.

FIGURE 7.2: Divergence between State populations in Australia, the United States, Canada and Germany in the 20th century



Source: Statistics Canada 2002; United States Census Bureau 2002; ABS cat. no. 3101.0 and 3102.0; Statistisches Bundesamt 2002

Since the mid-1960s Australian State populations have converged, while United States and Canadian State populations have diverged. It is particularly interesting to compare Australia and Canada as they both have a small number of States in geographically and climatically challenging locations, but different histories of divergence between their larger and smaller States. Over the last half-century, State populations have tended to converge in Australia and diverge in Canada.

Australia is the only Federation to experience population growth in all States in the last twenty years. Tasmania's population growth of 10 per cent was stronger than that of the weaker States in other Federations, with population declining in some of the United States' rust belt States,[5] Canada's Atlantic Provinces and former East German Länder.

The most varied population change across States is in the United States. In recent decades there has been notable interstate migration from the northeast rust belt States to the sun belt States of Arizona, Utah, Nevada and California in the southwest. Part of the movement has been motivated by retirement lifestyle choices and location of footloose industries, supported originally in some sun belt States by lower labour costs, and lower State and local taxes.

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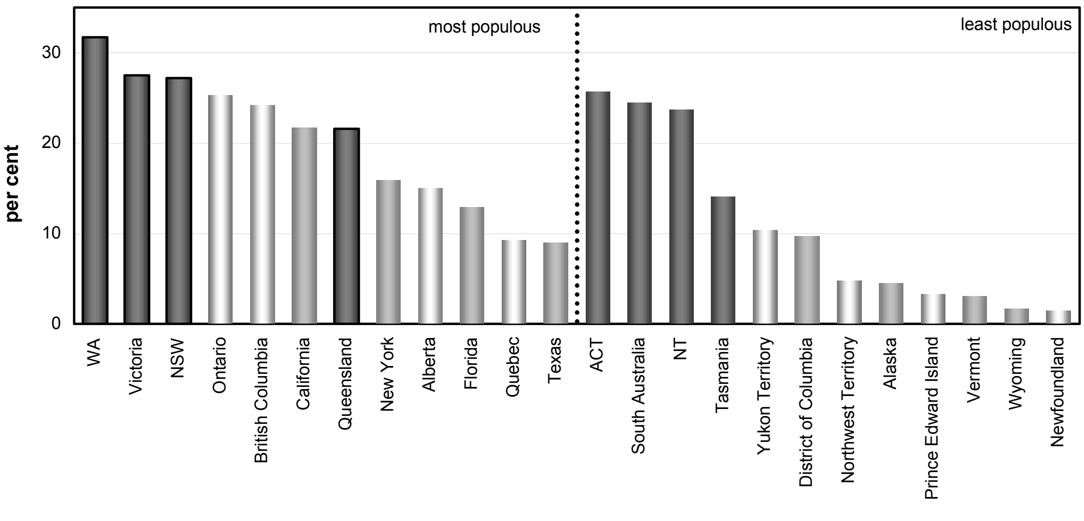
4 The measure of convergence adopted here is the coefficient of variation, which includes values for all States.
5 The heavily industrialised northeastern area of the United States, which contains older industries and factories.

Populations in some Australian States have grown fast relative to others at some times and slowly at others. For example, Victoria experienced net interstate emigration in the early 1990s, but that pattern has reversed over the past few years. So far, no Australian State has experienced a decline in population except over very short periods, although Tasmania's population stagnated between the 1996 and 2001 census. While Queensland, the Northern Territory and Western Australia – Australia's sun belt – have been growing faster than average, growth in most States is close to the national annual average.

Australia has experienced significant population increases since World War II, with international migration contributing much of the increase. In 1947 the proportion of Australians born overseas was 10 per cent, increasing to 24 per cent by 2000 (ABS 2002a). In Canada, the proportion of population born overseas increased from 14.7 per cent in 1951 to 16.8 per cent by 1996. In the United States, the overseas born proportion was lower – rising from 6.9 per cent of the total population in 1950 to 7.9 per cent in 1990 (2000 Census data unavailable).

Figure 7.3 charts the proportion of State populations born overseas for the most and least populous States in Australia, Canada and the United States. It shows a more widespread settlement of immigrants throughout Australia than in the other Federations.

FIGURE 7.3: Proportion of State population born overseas in the most and least populous States in Australia, Canada and the United States



Sources: ABS 1996; Statistics Canada 1996; United States Census Bureau 1990

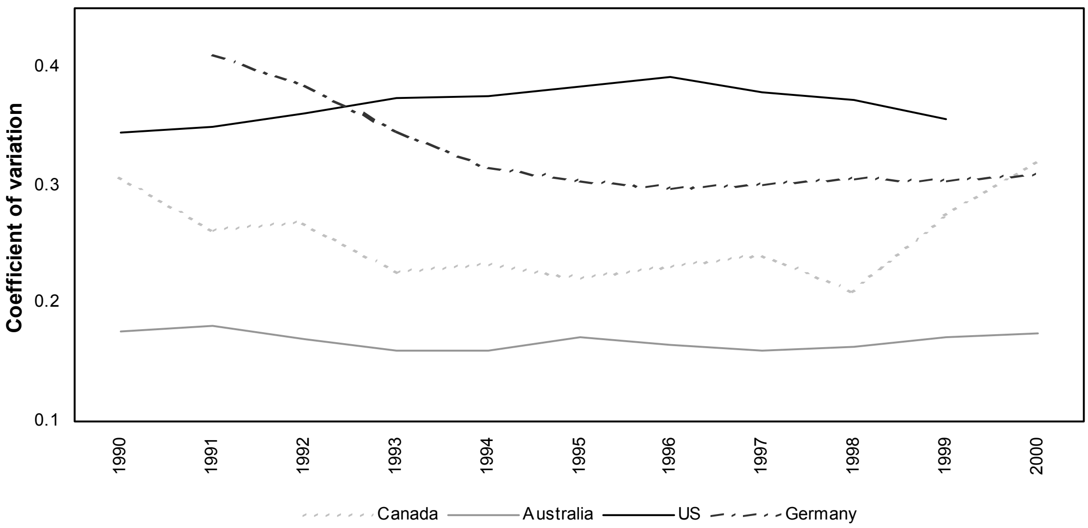
Examining foreign-born populations as a proportion of the four most and least populous States in each Federation shows that international migration has played a major role in driving growth in all Australian States. As expected, international migration has driven growth in Australia's largest States more than in Canada and the United States. The populations of Western Australia, New South Wales and Victoria, similar to but more than Ontario and California, have contained high proportions of immigrants. Less populous States in the United States and Canada have had constrained population growth and low levels of immigration, whereas in Australia all States have attracted significant proportions of international migrants.

Economic output

Gross state product variance between States across the four Federations during the 1990s is shown in Figure 7.4. Dispersion of State economic growth is measured by the coefficient of variation. This statistic provides insights into whether gross state product per capita distribution among States is high or low, and whether it is narrowing or widening. The coefficient of variation is used to measure this convergence. For example, a decreasing coefficient of variation over time indicates converging gross state product per capita among States (i.e. average output in the poorer States growing more quickly than in the richer States).

Per capita gross state product has been far more equal across Australian States than in the other Federations. The convergence of the German Länder is unsurprising given the unequal starting point at the time of unification. States in the United States are the most divergent and have remained that way for most the decade. Canada's statistics are slightly skewed after 1999 by the separating out of Nunavut from the Northwest Territories in that year.

FIGURE 7.4: Gross state product per capita – divergence between States in Australia, the United States, Canada and Germany,1990–2000



Source: Statistics Canada 2002; Bureau of Economic Analysis 2002; Bavarian Government 2002; ABS cat. no. 5220.0

With the overall distribution of population and economic growth across States being more equal and generally more convergent in Australia than in other Federations, it is curious – at first sight – that Australia has a much more comprehensive approach to equalisation, and has moved further in this direction over recent decades.

7.4 Comparing fiscal disparities and equalisation

Australia is the only Federation that fully equalises revenue and expenditure capacity. In Canada and Germany, equalisation payments are based on an agreed formula that adjusts only partially for differences in revenue raising capacity, and only for differences in costs of providing services where considered sufficiently significant. The United States does not formally equalise through transfers to the States.

TABLE 7.4: Standard deviation of fiscal disparities across States in Australia, Canada, Germany and the United States ($US per capita at Purchasing Price Party = 1.3)

	Pre-equalisation	Post-equalisation
Australia (revenues)		
All States and Territories	199	0
Excluding NT [(a)]	214	0
Australia (CGC expenditure need)		
All States and Territories	1 553	0
Excluding NT	200	0
Canada (revenues)		
All Provinces	1 655	1 192
Excluding Alberta [(a)]	836	148
Germany (revenues)		
Pre-equalization	644	
After inter–State equalisation		322
After Federal supplementary grants [(b)]		317
US (revenues)		
All States and Washington DC	369	369

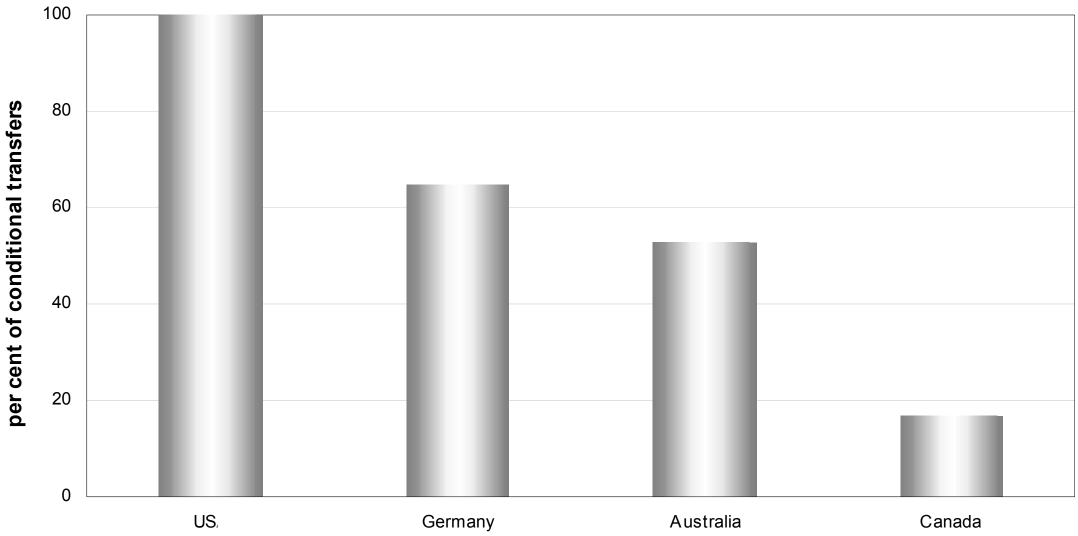
Source: Peloquin and Chong 2002

[(a)] Alberta, with its exceptionally large petroleum revenues, is an 'outlier'

[(b)] Excludes 'special needs' components for debt relief and transitional challenges faced by Eastern Länder. Includes a 'needs' adjustment for city Länder whereby their population is weighted by 1.35 in recognition of the fact that residents of neighbouring Länder use services they provide.

The degree of conditionality on transfers varies across Federations (Figure 7.5). While the United States does not have any formal equalisation system, its conditional expenditure programs are increasingly important. These SPPs are favoured in the US because it is accepted that the Federal Government has the task of raising taxes and should be responsible for determining the use of these funds. Other views are prominent in other Federations. In Australia and Germany, conditional grants make up between one-half and two-thirds of grants to the States. Transfers in Canada are overwhelmingly unconditional, and major transfers take the form of block funds to avoid distorting Provincial priorities.

FIGURE 7.5: Proportion of conditional transfers in total Federal payments to the States (1996)



Source: Watts 1999; Statistics Canada 2002

Canada

In Canada, the Federal and Provincial Governments have access to all major tax bases. However, there are substantial differences in revenue per capita among the ten Provinces and three Territories due to economic disparities and the high degree of decentralisation of revenue sharing.

Canada employs three major programs of Federal transfers to the Provinces. One program directly addresses the issue of equitable access to core public services (health, education, social assistance and services). The other programs aim to reduce fiscal disparities among the Provinces and Territories. The equalisation programs are partial, and bottom-up rather than top-down. The stated aim of Canada's arrangements is 'ensuring that all Canadians receive reasonably comparable levels of public service, wherever they live' (Department of Finance Canada 2002). Prime Minister Jean Chretien described the Canadian approach to equalisation in his speech to open the International Conference on Federalism in October 1999:

> We have constitutionalised the principle of equalisation payments so that Canadians in poorer Provinces can receive a comparable level of services as their fellow citizens in richer Provinces. As well, the Federal Government makes large transfers to the Provinces for health, social assistance and post-secondary education.

Canada is unique in that one Province, Alberta, has a revenue raising capacity far greater than the others due to substantial revenues from natural resources. Table 7.4 demonstrated that around half of the pre-equalisation inequality is attributable to Alberta's resource revenues.

In 2001–02 transfers are expected to total CA$1 444 per capita. The most revenue-poor Province is Newfoundland, which receives more than twice the national average per capita transfer. The revenue-rich Provinces of Alberta, British Columbia and Ontario receive around CA$335 per capita below the national average. The breakdown for each Province is illustrated in Table 7.5.

TABLE 7.5: Federal transfers to Canadian Provinces, 2001–02

	Newfoundland	Prince Edward Island	Nova Scotia	New Brunswick	Quebec
CA$ million	1 549	3 87	2 244	1 914	12 367
CA$ per capita	2 900	2 792	2 380	2 530	1 670
% of revenue	39	41	41	38	25

	Ontario	Manitoba	Saskatchewan	Alberta	British Columbia
CA$ million	13 128	2 369	1 358	3 388	4 535
CA$ per capita	1 108	2 061	1 336	1 107	1 108
% of revenue	20	35	23	16	20

Source: Department of Finance, Canada 2002

The Territories receive more equalisation transfers than the Provinces per capita, reflecting their limited revenue raising capacity and needs and costs arising from their remoteness and sparse populations (Ma 1997). The economic position of the Canadian Territories is hampered by location and climate, and differs greatly from that of the Australian Territories which, by contrast, have tended to grow more rapidly than Australia as a whole. In Australia, the Northern Territory is expected to have the most rapid growth of the Australian States for the foreseeable future.

TABLE 7.6: Federal transfers to Territories, 2001–02

	Northwest Territories	Nunavut	Yukon
CA$ million	565	642	379
CA$ per capita	13 853	22 933	12 690
% of revenue	57	84	70

Source: Department of Finance, Canada 2002

The Canada Health and Social Transfer provides the largest Federal transfers to Provincial and Territorial Governments. It supports health care, post-secondary education, social assistance and social services programs. In 2001–02 the Canada Health and Social Transfer provided 74 per cent of all transfers to the Provinces and Territories, or CA$34.6 billion of the CA$47 billion of total Federal transfers (Department of Finance Canada 2002). This block-funded transfer gives Provinces and Territories flexibility when administering social and health programs, and when allocating funds among programs (Rayner et al. 2001).

While the Canada Health and Social Transfer allows Provinces more control over program spending, conditions are attached. These are outlined in the *Canada Health Act 1984,* which regulates the public health care system and attempts to prevent discrimination in provincial social programs against recent migrants from other Provinces. Conditions are not onerous as there is no requirement to maintain a particular level of spending in an area or to achieve a particular outcome. There is no mechanism for Federal auditing beyond the legislated requirement to provide information to assist the Federal Minister of Health in determining whether conditions have been violated. In practice, it has been very difficult for the Federal Government to enforce these conditions without negotiating with the Provinces.

In April 1996 the Canada Health and Social Transfer replaced the specific purpose transfers of the Established Programs Financing and the Canadian Assistance Plan programs. Uneven per capita allocations are a legacy of the previous systems. The 1998 Budget announced that previous disparities in funding would be eliminated by 2001–02 when all Provinces would receive equal per capita Canada Health and Social Transfer entitlements. Equal per capita distribution is recognised as being significantly equalising because it involves the distribution of Federal funds from Provinces with revenue raising capacities above the average to those below the average.

The Canadian Equalisation Program is a constitutionally mandated unconditional block transfer program. It was established in 1996 and its objectives are specified in terms reminiscent of pre-1977 Australian fiscal equalisation objectives. Federal Equalization payments enable less prosperous provincial Governments to provide their residents with public services that are reasonably comparable to those in other Provinces, at reasonably comparable levels of taxation (Rayner et al. 2001). The equalisation formula lowers revenue differentials but does not eliminate them, and does not consider expenditure needs.

The Equalisation Program embodies bottom-up equalisation; that is where revenue-poor Provinces are equalised up towards the national average. The revenue-rich Provinces are not equalised down, as is the case under a full equalisation formula, although implicit redistribution occurs because more Federal funds come from the Provinces paying proportionately more in Federal taxes. The overall effect falls well short of the extreme equalisation implemented in Australia.

Canada's equalisation program is aimed at lifting the fiscal capacity of the eight revenue-poor Provinces towards the levels of Alberta and Ontario. The revenue raising capacity of the revenue-poor Provinces is not fully equalised to the national average (Coulombe and Merette 2000).

TABLE 7.7: Equalisation entitlements, 2001–2002 (CA $m)

	Newfoundland	Prince Edward Island	Nova Scotia	New Brunswick
Entitlement	1 074	260	1 326	1 202

	Quebec	Manitoba	Saskatchewan	British Columbia
Entitlement	4 719	1 207	398	132

Source: Department of Finance, Canada 2002

In 2001–02 the Federal Government distributed CA$10.4 billion of equalisation entitlements to eight revenue poor Provinces (Table 7.7). Equalisation payments for the Provinces are calculated (as specified in Federal legislation) by determining a Province's tax capacity, i.e. the per capita revenue a Province could raise by applying national average tax rates to its tax bases. Each Province's tax capacity is then compared to the standard (the average fiscal capacity of the five middle-income Provinces – British Columbia, Manitoba, Saskatchewan, Ontario and Quebec). A Province with a per capita tax base below the standard receives an equalisation payment equal to the difference between the Province's tax capacity and the standard tax capacity, multiplied by the Province's population (Ma 1997). In 2001–02 the standard ensured that all Provinces had revenues of at least CA$5 964 per resident to fund public services (Department of Finance Canada 2002).

The Equalisation Program used to distribute Federal transfers to the Provinces is not regarded as appropriate for the Territories because they are more dependent on Federal transfers. The Canadian Territories have limited capacity to raise revenue and are reluctant to increase personal or corporate tax rates because it would create further incentive for relocation.

In Canada, the Territorial Formula Financing is the fiscal mechanism governing transfers between the Federal and Territorial Governments. The Territorial Formula Financing is an untied Federal transfer to the Territorial Governments to enable the Territories to provide comparable public services to those offered in the Provinces. It is governed by agreements between the Federal and Territorial Ministers of Finance (Department of Finance Canada 2002).

The Territorial Formula Financing is based on a gap-filling principle, with the Federal Government providing cash payments to cover the difference between Territorial Governments, expenditure costs and their revenue raising ability. The Territorial Formula Financing provides a financial incentive for the Territories to promote economic activity and encourage greater self-sufficiency (Department of Finance Canada 2002) and is the largest source of Territorial Government revenue.

Canada has the largest fiscal disparity of the four Federations before equalisation of $US1 655 per capita. The post-equalisation fiscal disparity of $US1 192 is larger than the pre-equalisation position of the other Federations (Table 7.4).

Germany

Germany's system of fiscal equalisation, set out in the *Basic Law 1949*, is based on providing 'equivalent' living conditions across the Länder. This principle has never been interpreted as seeking to provide 'equal' living conditions.

The Basic Law provides for each government to receive sufficient revenue to undertake its activities and fulfil its responsibilities. All three tiers of government share in the personal income tax, while the Federation and the Länder share corporate taxes and proceeds from the German value added tax.

A distinctive feature of German fiscal federalism is the extensive political and constitutional interlocking of the Federation and the Länder. The Länder are more directly involved in Federal decision making than States in any other Federation. Both levels of government are involved in decisions on revenue sharing and equalisation mechanisms (Watts 1999). The Federal Government has a broad range of exclusive and concurrent legislative powers, but the Länder are constitutionally responsible for implementing most of these laws. The first ministers and some cabinet ministers of the Länder sit in the Federal second chamber, the Bundesrat, which has veto powers on Federal legislation affecting the Länder.

After Germany's reunification in 1990, five new Länder from the former East Germany were added to 11 Länder of the former West Germany to form the new Federation. The economic and cultural disparity between the East and West German Länder was, and remains, substantial. The eastern Länder have a taxable capacity significantly lower and demand for Government services is high. The eastern Länder are recipients under the three schemes of intergovernmental transfer in Germany.

Germany's constitutional provision for interstate transfers to cover part of the horizontal imbalances is unique. Initially this was the only method of equalisation, prior to the supplementary per capita payments derived from the value added tax (Watts 1999).

Revenue sharing alleviates the differences in regional tax potential, particularly via the redistribution of Länder value added tax collections. Currently, the Länder receive 44 per cent of value added tax, with seventy five per cent of this distributed on an equal per capita basis. This important means of equalisation is known as first-tier equalisation and is an implicit form of HFE, transferring revenues from Länder with value added tax capacities above the average to those below the average VAT capacity (Watts and Hobson 2000).

The remaining 25 per cent of the value added tax is distributed to Länder with below-average revenue raising capacity as a net scheme, with payments to recipient Länder covered by donor Länder contributions. This is a second-tier process of equalising the Länders' revenue capacities.

Supplementary grants are a form of vertical equalisation to address special expenditure needs of certain Länder. The Bundesrat provides cash transfers to poorer Länder to compensate for revenue shortfalls after equalisation. Most of these unconditional grants enable the eastern Länder to promote investment and economic growth. Some western Länder receive grants to offset losses since the eastern Länder were incorporated into the Federation, as do the Länder of Bremen and Saarland to assist in debt servicing (Ter-Minassian 1997).

This two-tier HFE process aims to raise the poor Länder to 95 per cent of average tax capacity. Supplementary grants are then distributed for particular needs to raise the resources of the poorer Länder to 99.5 per cent of overall average income. A large disparity remains between city Länder of Berlin, Hamburg and Bremen, and other Länder, mainly due to a special needs adjustment which weights the city Länder populations by a factor of 1.35 to recognise that residents of neighbouring Länder use city Länder services.

In addition to supplementary grants, there are also vertical conditional grants for Federal co-financing of certain Länder projects. These grants are governed by a series of conditional treaties and agreements. Conditional grants in Germany are not completely constraining because the Länder, through their representatives in the Bundesrat, can determine conditions attached to grants. The Federal Government sets goals with the input of the Länder in the Bundesrat, while the Länder administer the majority of Federal programs and policies.

Conditional grants largely fall into two categories: joint tasks and specific grants-in aid. Joint tasks apply to areas such as university construction, regional policy, agricultural structural policy and coastal preservation, planning education and fostering research. Specific grants-in-aid are given to Länder for regional and local investments in certain policy areas. There is no general system of compensation for above-average costs of providing services.

United States

The United States has no system for allocating general purpose grants to the States to achieve HFE. It has significant fiscal disparities between States but emphasises the States' autonomy rather than equalising to eliminate disparities.

While there is no systematic method for equalising State fiscal capacity, implicit equalisation occurs indirectly through more than 200 specific Federal grant-in-aid programs, as approved by Congress. In 2001 grant-in-aid programs represented, on average, 25 per cent of total State and local revenues (Office of Management and Budget 2002). Congress has made considerable use of these conditional grants to pursue nationally defined policies, support modernisation of State-administered systems and assist State Governments with redistribution policies.

The evolution of the United States Federal system has seen the Federal Government assume increased financial responsibility for government programs. However instead of spending this money directly, it has transferred considerable funds to State and local governments, allowing them to retain administrative control over their traditional programs.

The United States emphasises conditional or categorical grants to a greater degree than other Federations. Most transfers are categorical grants to the States to provide money for a specific program. Money is distributed to the States according to legislation that includes factors to measure the needs of the community, capacity to provide public services, cost of providing public services, and tax effort made by the community to provide public services. The four most important categories of Federal aid to States are health, income security, education and training, and transportation (Ma 1997).

Davis and Lucker argue that conditional grants serve United States needs better than unconditional grants as the major interregional disparities are service levels, rather than taxes: 'Congress wants to focus on particular services rather than on the general level of service or tax capacity, a substantial portion of the remaining grant system is focused on very narrow purposes' (cited in Ma 1997, p. 5). Undoubtedly the high value attached to State autonomy within the Federation would generate reaction against the high proportion of tied grants if vertical fiscal imbalance were as large in the United States as in Australia

While the United States has no explicit system for equalising States, the allocation of funding for specific services has a significant and varying impact across the States. Some States receive considerably more Federal funding than they pay in Federal taxes, while the tax burden for other States far exceeds the funding they receive (Leonard and Walder 1999). The States receive approximately US$1.5 trillion in domestic Federal expenditure per year, and this flow of funds rearranges the geographic location of economic activity with varying impacts across the States.

A joint publication by Harvard University and the Office of Senator Daniel Patrick Moynihan provides data on the balance of payments – the difference between Federal spending received and taxes paid in each State. States recording a surplus receive more in Federal spending than they contribute in taxes, and deficit or donor States pay more in Federal taxes than they receive in spending.

Thirty-one States had balance of payments surpluses in 1999–2000, with ten receiving US$2 000 or more per capita. New Mexico was the largest recipient with US$4 000 per resident, over US$800 per person more than the next highest, Montana. Connecticut was the largest donor State with a deficit of nearly US$2 800 per capita, more than US$500 greater than New Jersey. Seven other States had deficits of more than US$1 000 per capita, principally in the northeast, mid-Atlantic and Great Lakes regions.

In net terms, eleven States received over US$5 billion each and all of those were southern States. The largest recipient by far was Virginia with over US$21 billion, followed by Maryland and Alabama, which both received over US$9 billion. The largest donor State was California, contributing over US$23 billion, due to its large population (33 million or 12 per cent of the national population). The next largest donor State was Illinois with a deficit over US$20 billion, while New Jersey, New York and Michigan all contributed over US$10 billion each.

The Western Australian Government has conducted similar analysis of ‘fiscal subsidies' within the Australian Federation. Under this approach, a State provides a fiscal subsidy to the Federation if total Commonwealth revenues derived from that State exceed total Commonwealth outlays to that State (Western Australian Treasury 1999). This analysis has excluded the Australian Capital Territory to avoid the unique circumstances of the Territory inflating the outcome, namely the Australian Capital Territory’s receipt of Federal funding that is perceived as serving the nation; accompanied by Australian Capital Territory residents’ high personal income taxes and low level of benefit payments received.

The analysis finds that Western Australia provides the highest per capita fiscal subsidy, followed by Victoria and New South Wales. The Northern Territory is by far the largest Australian recipient, receiving US$6 321 compared to the US$3 944 received by the largest United States recipient, New Mexico.[6] Gross state product per capita in the Northern Territory is 16 per cent higher than the national Australian average (Bureau of Economic Analysis 2002), whereas New Mexico’s gross state product per capita is 15 per cent below the United States average. Considering that Australian average incomes are much lower than in the United States, the standard deviation between the contributions made by the Australian States is much greater than States in the United States.

[6] Currency based on $US1=$1.3 at Purchasing Power Parity exchange rates, OECD.

Comparison with Australia

Given Australia's high degree of vertical fiscal imbalance, grants from the Federal Government form a larger proportion of State revenue than in comparable Federations (Ter-Minassian 1997) (Table 7.8 and Figure 7.5). The proportion of conditional transfers is highest in the United States where all transfers from the Federal Government to the States are conditional.

The proportion of total State revenue made up by conditional transfers is a measure of Federal constraint on State autonomy. In Australia, the United States and Germany, this ranges from 10 to 30 per cent. Canada's is relatively low at 2 per cent, reflecting the autonomy enjoyed by the Canadian Provinces.

TABLE 7.8: Total transfers and conditional transfers as a percentage of State revenue and Federal transfers, 1996

	Intergovernmental transfers as % of State revenue	Conditional transfers as a % of Federal transfers	Conditional transfers as a % of total State revenue
Australia	41	53	22
United States	30[(a)]	100	30
Germany	19	65	10
Canada	20	19	2

Source: Watts 1999; Statistics Canada 2002
[(a)] 1994

In Australia, Germany and Canada, a series of intergovernmental bodies have been established to facilitate Federal financial arrangements. In Australia, the Commonwealth Government distributes grants shares as recommended by the Commonwealth Grants Commission (CGC), which is a statutory authority. In contrast, elected bodies determine equalisation transfers in the other three Federations. In Germany and the United States, the Federal Government determines grants but involves State representatives in the legislature approval process. In Canada, the Federal Government, whose legislature contains no provision for formal representation from Provincial Governments, controls equalisation arrangements, although numerous joint committees meet with provincial representatives.

In Australia, the CGC distributes general purpose grants using a system that measures the States' fiscal capacities and needs. The Australian objective of providing the capacity to provide the same standard of service in all States takes the concept of equalisation further than in Canada and Germany where the stated goals are comparative service delivery and equivalent living conditions respectively.

Australia is the only Federation in this comparison of HFE that measures the relative revenue raising capacities and expenditure needs of each State. When the CGC was first established it sought to raise poorer States up to the standard, but since 1977 it has sought also to equalise the richer States down to the standard (Watts 1999).

In Canada and Germany, the equalisation standard mainly considers the States' revenue raising capacity. On the revenue side Germany attempts, but not completely, to equalise down Länder with greater financial capacity. In Canada, revenue-poor Provinces are equalised up to a specified level while revenue-rich Provinces are not equalised down.

Conversely, the United States – with relatively large interstate disparities but no formal equalisation system at all – has greater tolerance for horizontal imbalances. The United States Government provides individuals with certain levels of particular services, rather than attempting to equalise the capacity of States across all services as in Australia. The United States considers that diversity and fiscal autonomy for each level of government is more important than HFE.

Australia's extreme system of interstate equalisation is famous. For example, in the words of Canada's leading authority on Federal finances: 'Egalitarian Australia, which is blessed with relatively modest interstate disparities in revenue capacity, goes to great lengths to fully equalize on both the revenue and expenditure aspects' (Watts 1999, p. 51).

CHAPTER 8: Federal Policy Effects on Interstate Distribution of Incomes and Economic Activity

- The effects of Commonwealth policies on the distribution of income and activity among the States are part of the debate on the objectives and outcomes of Commonwealth–State financial arrangements.
- Analysis by the Review suggests that Commonwealth policies and the current GST redistribution do not improve national economic growth or smooth growth rates across States.
- Current redistribution of GST revenue among the States reinforces the arbitrary distribution of production and welfare impacts of Commonwealth policies.

8.1 Introduction

Redistribution of Goods and Services Tax (GST) proceeds among the States affects the relative welfare of individuals and households, and the distribution of economic activity and population across Australia. However, these effects are superimposed on those of a range of other Commonwealth policies which also affect those patterns, in some cases more profoundly.

In the early decades after Federation, the then smaller States, especially Western Australia and Tasmania, argued that the costs to them of Commonwealth policies – especially tariff protection, centralised wage-fixing and cabotage in interstate shipping – were particularly high. Chapter 2 notes that the demand by several States for compensation contributed to the establishment of the Commonwealth Grants Commission (CGC).

No State now discusses the need for compensation for Federation. Nevertheless, the effects of Commonwealth policies on the distribution of income and activity among the States are part of the debate on allocation of Commonwealth payments to States. It is therefore useful to examine the present grant allocation arrangements, and their rationale and effects, within the context of other Commonwealth policies and arrangements.

Commonwealth policies have a strong redistributional impact on personal incomes. For example, high-income earners generally contribute more in taxes than they receive in benefits (including services) from the Commonwealth, while low-income earners contribute less. Similarly, the social and economic diversity of regions around Australia means that the net impact on regions (as distinct from individuals) of Federal policies varies. For example, regions with a high proportion of wealthy taxpayers contribute more in taxes than they receive in benefits.

This chapter focuses on the eight Australian jurisdictions, although the points made apply conceptually to smaller (or indeed larger) regions. The impact of Commonwealth policy on regions is measured in two main ways:

(1) the net welfare benefit or *fiscal residuum* to individuals in a region, i.e. the total level of Commonwealth public services and benefits received, less Commonwealth taxes paid (both directly and indirectly)

(2) the impact on each region's level of production, i.e. the net Commonwealth contribution to purchasing goods and services from the region less the net Commonwealth impact (via taxes) on the cost of these outputs.[7]

In both cases, there are not only first-round effects but flow-on effects that can only be comprehensively assessed through a full general equilibrium analysis which has not been undertaken for this Report.

Further, (1) and (2) differ slightly because production, consumption and ownership can all be in different regions, with all factors (excluding land and other natural resources) mobile to some extent. The existence of an external sector and various other effects add to the differences. For example:

- pensions paid in region A may increase demand for goods produced by a company in region B, possibly owned by someone in region C

  or

- tax on a company operating in region A will reduce the income of shareholders residing in region B, reducing their demand for goods purchased in region C.

Often the regions of production, consumption and factor ownership are the same. However, marked differences can occur.

There are also problems with presenting the effects on production within regions as the available data are a mixture of individual welfare and production effects.

[7] Contributions to the purchase of outputs in a region can be direct (e.g. Commonwealth direct payment to service provides) or indirect (e.g. income support enabling recipients to purchase goods and services). Contributions can also be negative (e.g. taxes on consumption and income). Impacts on the cost of outputs include Commonwealth taxes on production and inputs and can be negative (e.g. production bounties reducing pricing to purchasers). A full equilibrium analysis needs to recognise that Commonwealth taxes and expenditures change the demand and supply curves for outputs and factors, and lead to further price effects.

8.2 Commonwealth income transfers and production effects

The allocation of GST proceeds among the States provides a clear example of how Commonwealth fiscal policies can affect interstate income redistribution. Table 8.1 shows in per capita terms how the GST proceeds are disbursed across States on the basis of the CGC's application of horizontal fiscal equalisation (HFE) principles.

TABLE 8.1: Individual welfare transfers via GST redistribution, 2000–01 ($ per capita)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Collections	1 383	1 260	1 172	1 152	1 156	1 068	1 524	1 061
Grants	1 117	1 063	1 295	1 251	1 519	2 102	1 512	6 239
Transfer	-266	-197	123	99	363	1 034	-12	5 178

New South Wales and Victoria provide large transfers to the other States via the GST redistribution. These transfers can largely be interpreted as net welfare benefits to residents of a State (as GST-funded State expenditures largely flow through to individuals in that State, and most GST is raised from Australian residents).

The net first round impacts of this redistribution on production differ slightly across States, reflecting the consumption of overseas and interstate-produced goods and services. Table 8.2 incorporates rough adjustments to reflect a production effect basis (i.e. the impact on production in each State). This assumes that State GST expenditures largely flow through to the purchase of outputs from the State, with standard proportions of consumption sourced from imports,[8] locally produced and consumed goods, and nationally traded manufactured goods.

TABLE 8.2: Production effects from GST redistribution, 2000–01 ($ per capita)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Collections	1 285	1 411	1 129	1 136	1 322	1 180	963	909
Grants	1 117	1 063	1 295	1 251	1 519	2 102	1 512	6 239
Transfer	-168	-348	166	116	198	922	549	5 330

In most cases, other than redistribution of the GST proceeds, there is little direct correspondence between Commonwealth spending and revenue raising. It is useful to compare the distribution of the program (e.g. Commonwealth spending on defence) across States against some neutral benchmark (e.g. equal per capita).

[8] Price effects on the Australian economy work through the impact on exchange rates. An equal per capita negative production effect across States is assumed for GST paid on imports.

Tables 8.3 and 8.4 allocate the impacts of Commonwealth expenditures by State (approximately, and excluding GST-based grants), according to a welfare transfer and a production effect basis respectively. This allocation reflects the assumptions detailed later in this chapter.

Against the equal per capita benchmark, there are very marked variations in expenditures across States for both transfers of individual welfare and effects on production by State.

TABLE 8.3: Individual welfare transfers from Commonwealth expenditures, 2000–01 ($ per capita)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Expenditure distributions								
Defence	730	730	730	730	730	730	730	730
Other final consumption and capital expenditures	1 881	2 026	1 560	1 563	1 844	2 003	1 834	2 696
Grants to other governments (excluding GST)	1 314	1 267	1 308	1 528	1 426	1 524	1 805	2 038
Subsidies [(a)]	63	63	63	63	63	63	63	63
Personal benefit payments and grants to non-profit organisations	3 368	3 315	3 274	3 092	3 704	3 971	2 847	2 306
Total	**7 356**	**7 401**	**6 934**	**6 976**	**7 766**	**8 291**	**7 279**	**7 833**
Equal per capita benchmark	7 311	7 311	7 311	7 311	7 311	7 311	7 311	7 311
Transfer	**46**	**91**	**-375**	**-333**	**457**	**981**	**-30**	**524**

[(a)] Excludes fuel rebates

TABLE 8.4: Production effects from Commonwealth expenditures, 2000–01 ($ per capita)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Expenditure distributions								
Defence	712	526	846	597	537	338	3 059	4 128
Other final consumption and capital expenditures	1 486	1 630	1 164	1 168	1 449	1 608	25 822	2 301
Grants to other governments (excluding GST)	1 314	1 267	1 308	1 528	1 426	1 524	1 805	2 038
Subsidies [(a)]	44	43	70	202	19	60	0	178
Personal benefit payments and grants to non-profit organisations	3 275	3 754	3 021	2 985	3 778	3 579	1 964	2 099
Total	**6 830**	**7 220**	**6 409**	**6 480**	**7 209**	**7 109**	**32 650**	**10 744**
Equal per capita benchmark	7 311	7 311	7 311	7 311	7 311	7 311	7 311	7 311
Transfer	**-479**	**-89**	**-900**	**-829**	**-100**	**-200**	**25 341**	**3 435**

[(a)] Excludes fuel rebates

Assumptions for allocating Commonwealth expenditures to determine individual welfare transfers and effects on production

Expenditures are allocated on the following assumptions.

- Expenditures on defence generate production effects within a State, but equal per capita welfare benefits across States.
- Other expenditures on final consumption and capital will generate welfare benefits within the State, except in the Australian Capital Territory where most expenditures are for the provision of services to all States.[9] These expenditures affect production in the States where they are made.
- Grants to State and local governments represent welfare transfers and effects on local production.
- Subsidies to industry generate equal per capita welfare benefits across the nation, but affect production in the State in which they are made.
- Personal benefit payments and grants to non-profit institutions are welfare benefits in the State where they are made. They are converted to production effects by assuming that standard proportions are spent on imports (terms of trade impacts are distributed equally per capita), locally produced and consumed services, and nationally traded manufactured goods.

Source: All data sourced from the ABS State Accounts (including unpublished data), apart from the grants to Governments, which are from Commonwealth Budget Papers. Any expenditures not listed (e.g. interest) have been assumed to contribute no net welfare benefits or production effects, compared to an equal per capita allocation.

[9] Expenditures above the Australian Capital Territory's per capita share are distributed equal per capita across all States.

Tables 8.5 and 8.6 show approximate allocations of Commonwealth revenues by State (excluding GST), according to an individual welfare and production effect basis respectively. This allocation reflects the assumptions outlined above.

As with expenditures, Commonwealth revenues again show substantial variations against the equal per capita benchmark for both welfare and production impacts.

TABLE 8.5: Individual welfare transfers from Commonwealth revenues, 2000–01 ($ per capita)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Revenue distributions								
Personal income tax	4 373	3 955	3 433	4 022	3 461	3 120	5 831	3 717
Companies tax	1 882	1 871	1 656	2 028	1 631	1 463	1 835	2 083
Petroleum production revenues	190	190	190	190	190	190	190	190
Excise duty on petroleum sales	477	443	531	574	504	483	983	976
Liquor	114	95	89	101	91	75	136	114
Tobacco	240	248	231	203	268	290	234	237
Customs duty	239	239	239	239	239	239	239	239
Other indirect taxes on sales	145	140	132	141	116	110	177	128
Production	30	30	30	30	30	30	30	30
Total	**7 690**	**7 212**	**6 532**	**7 529**	**6 530**	**6 001**	**9 155**	**7 714**
Equal per capita benchmark	7 231	7 231	7 231	7 231	7 231	7 231	7 231	7 231
Transfer	**-459**	**20**	**699**	**-297**	**702**	**1230**	**-1 923**	**-482**

Note: excludes GST

TABLE 8.6: Production effects from Commonwealth revenues, 2000–01 ($ per capita)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Revenue distributions								
Personal income tax	4 373	3 955	3 433	4 022	3 461	3 120	5 831	3 717
Companies tax	1 940	1 920	1 489	2 233	1 439	1 104	1 847	2 344
Petroleum production revenues[(a)]	0	310	0	1 142	0	0	0	44
Excise duty on petroleum sales	479	534	471	493	538	488	333	574
Liquor	104	111	89	94	105	90	83	84
Tobacco	235	271	218	210	270	258	161	186
Customs duty	261	139	303	300	169	239	45	397
Other indirect taxes on Sales[(b)]	138	155	125	130	141	126	109	104
Production	22	44	19	37	45	36	0	1
Total	**7 552**	**7 438**	**6 146**	**8 663**	**6 167**	**5 461**	**8 810**	**7 450**
Equal per capita benchmark	7 231	7 231	7 231	7 231	7 231	7 231	7 231	7 231
Transfer	**-321**	**-207**	**1 085**	**-1 431**	**1 064**	**1 770**	**-1 579**	**-219**

[(a)] Attributes taxes on Bass Strait petroleum production to Victoria, Northwest Shelf to Western Australia and the Timor Sea to Northern Territory, although part of each of these is now in offshore waters constitutionally within the jurisdiction of the Commonwealth.
[(b)] Excludes GST

Assumptions for allocating Commonwealth revenues to determine individual welfare transfers and effects on production

Revenues are allocated on the following assumptions:

- Personal income tax reflects an equal welfare and production allocation, based on Australian Tax Office data on income tax by place of residence.
- For a production basis, company tax is allocated according to the Australian Bureau of Statistics estimates of gross operating surplus for relevant activities by State (a rough measure of company tax liability as this surplus does not reflect allowable company tax deductions for depreciation and interest). Differentials from equal per capita State allocations are discounted 50 per cent to reflect a welfare basis (reflecting the assumption that the incidence of company tax falls partly on shareholders – distributed equally across States – and partly on labour located in the same State).
- Petroleum production revenues reflect production levels with an equal per capita welfare allocation (as this incidence is likely to fall on shareholders).
- Petroleum excise revenues (net of rebates) are allocated according to the location of sales. Production allocation assumes the excise impacts on standard proportions of spending on imports (terms of trade impacts are distributed equally per capita), locally produced and consumed services, and nationally traded manufactured goods.
- Tobacco and alcohol excises, and other indirect taxes on sales (residual wholesale sales tax, wine equalisation tax and luxury car tax) are allocated according to the location of consumer sales (using relevant components of household final consumption expenditure from the Australian Bureau of Statistics). Production allocation is estimated in the same way as petroleum excise.
- Customs duty has an equal per capita welfare allocation. Production allocation is estimated by distributing customs duty according to equal per capita shares and adding the differential per capita impact of tariff protection (The Productivity Commission has made estimates of the impact of tariff protection for each industry. This was allocated between States by Australian Bureau of Statistics data on turnover by manufacturing industry.)
- Production allocation for other indirect taxes on production (primary industry charges and levies, and interstate road transport charges) is based on where they are levied, from Australian Bureau of Statistics and Commonwealth Budget data. It has an equal per capita welfare allocation.
- Any revenues not listed (e.g. dividends) are assumed to contribute no deviation of welfare benefits or production subsidies from an equal per capita allocation.

Tables 8.7 and 8.8 combine the results of Tables 8.1–8.6 to show the net impact of Commonwealth fiscal policies on each State.

TABLE 8.7: Individual welfare transfers from Commonwealth expenditures and revenues, 2000–01 ($ per capita)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
GST	-266	-197	123	99	363	1 034	-12	5 178
Expenditures	46	91	-375	-333	457	981	-30	524
Revenues	-459	20	699	-297	702	1 230	-1 923	-482
Total	-678	-86	448	-531	1 522	3 245	-1 965	5 220

TABLE 8.8: Production effects from Commonwealth expenditures and revenues, 2000–01 ($ per capita)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
GST	-168	-348	166	116	198	922	549	5 330
Expenditures	-479	-89	-900	-829	-100	-200	25 341	3 435
Revenues	-321	-207	1 085	-1 431	1 064	1 770	-1 579	-219
Total	-968	-644	351	-2 145	1 161	2 491	24 312	8 546

Two conclusions can be drawn:

(1) Commonwealth policies transfer large amounts of income to individuals in some States from those in others, and enlarge production in some States and contract it in others.

(2) The transfers and effects of GST redistribution generally reinforce the effects of other Commonwealth policies, with the exceptions being the Victorian welfare transfer (where the GST redistribution loss more than offsets net gains from other Commonwealth policies), and the Western Australian welfare and production effects (where the GST redistribution effect partially offsets the negative impacts of other Commonwealth policies).

8.3 Impact of Federal policies on States' production

It is beyond the scope of the Review to improve on the first round analysis shown in Tables 8.5 and 8.6 and assess general equilibrium impacts of Commonwealth production subsidies on State levels of production, employment and incomes. However the relative impacts on production in each State can be expected to broadly correlate with the relative production effects shown in Table 8.8.

The Productivity Commission has examined in great depth the interstate distributional effects of one Commonwealth taxing policy – tariffs. Tariffs that remain in Australia after liberalisation in the late 20th century hurt all States, particularly Western Australia (Table 8.9). Table 8.9 also shows the close relationship between production subsidies through the tariff and the level of production in each State. States with large positive Federal production effects, excluding the Australian Capital Territory, gain the least from removing these tariff subsidies and vice versa. The correspondence is by no means exact. For example, Western Australia would receive a relatively high gain from removal of tariffs because it has little protected manufacturing and disproportionately large mining, agricultural and pastoral industries with relatively low protection.

TABLE 8.9: Impact of Tariffs, 2000–01

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
GSP gain from removing tariffs								
%	0.07	0.02	0.11	0.21	0.02	0.07	0.06	0.22
$ per capita	26	7	33	85	6	17	26	98
$ million	167	34	120	156	9	8	8	19
Contribution of customs duty to production subsidies								
$ per capita	-22	100	-64	-61	70	0	-206	-158
$ million	-144	482	-230	-116	104	-0.07	-65	-31

Source: Productivity Commission 2000

8.4 Trends

Transfers of income across States, and differential encouragement of economic activity between States, have grown markedly over the last ten years (Tables 8.10 and 8.11). The pattern of donors and recipients is unchanged in nearly all instances over this time.

TABLE 8.10: Welfare transfers from Commonwealth expenditures and revenues ($m)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
1985–86	-1 167	-792	831	11	845	449	-741	564
1990–91	-2 440	-503	1 083	-261	1 338	690	-481	573
1995–96	-2 658	108	845	-1 213	1 981	1 008	-637	566
2000–01	-4 409	-415	1 611	-1 007	2 283	1 526	-614	1 025

TABLE 8.11: Production effects from Commonwealth expenditures and revenues ($m)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
1985–86	-649	-2 779	313	-477	772	288	1 932	600
1990–91	-2 971	-1 339	33	-1 631	1 368	423	3 615	502
1995–96	-4 356	-1 157	11	-2 681	1 648	690	5 042	804
2000–01	-6 292	-3 091	1 262	-4 069	1 742	1 171	7 599	1 679

Positive and negative factors driving these trends vary across the States. Major factors influencing the direction of the overall impacts include:

- Defence expenditures are the main reason behind the increase in the Northern Territory's production impact. They also noticeably increase the Australian Capital Territory's production effect, and reduce Victoria's production effect.
- Commonwealth final consumption expenditures, excluding Defence, are the main reason behind the increase in the Australian Capital Territory's production effect and increase the Northern Territory's welfare transfer. They significantly reduce Western Australia's welfare and production effects, and increase these effects in Queensland and South Australia.
- Taxes and royalties on petroleum production have caused net movements in production impacts in Victoria and Western Australia.
- Personal income tax is the main reason for the decline in the Australian Capital Territory's welfare transfer and also contributes significantly to net movements in other States.
- Company tax has caused net movements in New South Wales, Queensland, Western Australia, South Australia and Tasmania.
- Commonwealth grants (including the GST) are the main reason behind the increase in the Northern Territory's welfare transfer, and contribute substantially to the increase in its production impact. They have also caused net movements in South Australia and Tasmania, but have worked against net movements in Victoria and the Australian Capital Territory's welfare transfer.

- Personal benefit payments, including grants to non-profit institutions, have caused net movements in transfers for Western Australia, South Australia and Tasmania, and increased Victoria's production effect. They have worked against the net movements in Queensland and the Northern Territory, and decreased the Australian Capital Territory's production effect.
- Customs duties have caused net movements in production effects for Queensland, Tasmania and the Northern Territory, but have blocked net movements in Victoria and Western Australia.

(Unless otherwise noted, these factors have contributed in the same direction as the net movement in transfers or effects for each State.)

Other indirect taxes (e.g. sales tax, the GST) have had a mixed impact on net movements, with the effect often being quite different on the individual welfare and production sides.

8.5 Comparisons with State incomes and growth

It is reasonable to ask whether the pattern of welfare and production transfers between States induced by Commonwealth policies can be broadly rationalised in terms of income redistribution or economic assistance objectives.

Welfare

Table 8.12 compares the individual welfare transfers (including the redistribution of the GST) to State product, the broadest measure of State income. A broad tendency for income to be redistributed from higher-income to lower-income States is evident, with the Northern Territory, a high-income State with a high positive welfare transfer, a conspicuous exception.

A detailed comparison of welfare transfers to the per capita gross state product variations suggests significant variance in the degree of income equalisation across States. Some of this can be interpreted as progressive (e.g. the progressively greater relative subsidies to Queensland, South Australia and Tasmania), but no pattern is discernible among States with above-average per capita gross state product.

Excluding GST slightly reduces variation, which suggests that the present redistribution of the GST proceeds may contribute to anomalous income redistribution outcomes (Table 8.12). The major study commissioned to assess these effects more precisely has drawn the same conclusion (see Chapter 9). Results suggest that several Commonwealth fiscal policies radically compress vertical income distribution. However payments to the States have little effect, with some tendency to make the distribution of income among Australian households slightly more unequal.

TABLE 8.12: Welfare transfers compared to gross state product, 2000–01

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Welfare transfer ($ per capita)								
Including GST	-678	-86	448	-531	1 522	3 245	-1 965	5 220
Excluding GST	-412	111	325	-630	1 159	2 212	-1 954	42
GSP	36 735	35 694	30 283	39 063	28 797	24 657	42 875	44 384
Variation in GSP per capita from national average								
$ per capita	1 969	929	-4 483	4 297	-5 969	-10 109	8 109	9 618
%	6	3	-13	12	-17	-29	23	28
Welfare transfer as a proportion of variation in gross state product								
Including GST	-34	-9	-10	-12	-25	-32	-24	54
Excluding GST	-21	12	-7	-15	-19	-22	-24	0.4

An alternative view of income distribution effects might attach social value to transfers to the States which were experiencing economic stagnation or decline, with the transfers placing a cushion beneath the decline to reduce adjustment costs. Unlike other Federations, no Australian State economy has experienced sustained decline or stagnation in population or economic activity. Some recipients of net welfare payments have experienced strong economic growth (Queensland and the Northern Territory) and others below average growth (South Australia and Tasmania) (Tables 8.12 and 8.13).

Production

Commonwealth policies aim to achieve an appropriate degree of vertical income redistribution without compromising long-term national economic development. To achieve this, Federal policy production impacts should be directed to where they can most profitably contribute to national productivity or, at least, not disproportionately to regions with less potential for growth.

In the short term, productivity is tied to the existing pattern of capital investment and natural endowments. The rates of economic and population growth achieved over a long time in different regions might provide a crude indicator of potential for long-term growth, although these rates will also have been influenced by Federal policies affecting productivity. Growth must be examined over a long time to filter out policy and cyclical economic influences, and identify inevitable influence from the changing long-term economic environment.

Table 8.13 compares current production cross-subsidies against measures of underlying economic growth potential – population growth and gross state product growth over ten years (arguably too short a time frame, but results do not differ significantly over longer periods).

TABLE 8.13: Production subsidies compared to gross state product and population

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Production Effect, 2000–01 ($ per capita)								
Including GST	-968	-644	351	-2 145	1 161	2 491	24 312	8 546
Excluding GST	-800	-296	185	-2 260	964	1 569	23 762	3 216
Growth from 1990–91 to 2000–01 (%)								
GSP (real)	70	60	84	85	47	37	67	85
Population	11	9	23	17	4	1	9	19
GSP per capita	53	47	50	58	41	36	53	55

These results need to be interpreted carefully, as the extent of product impacts has grown substantially for most States, which is likely to have improved or impeded economic growth. For example, the performances of the Northern Territory and the Australian Capital Territory are likely to have been partly improved by increasing production impacts of Commonwealth policies, while New South Wales and Western Australia's performances have been impeded by a nearly tenfold decrease in production impacts over fifteen years.

There does not appear to be any tendency for interstate transfers to reinforce Australia's long-term growth, or any coherent relationship between State growth trends and growth performance (Table 8.13). States with similar economic growth are receiving widely different levels of production support, which is shown in the following groupings:

- high-growth: Queensland, Western Australia, Northern Territory
- middle-growth: New South Wales, Victoria, Australian Capital Territory
- low-growth: South Australia, Tasmania.

The differences are clearest in the high-growth group – Queensland receives production support of $350 per capita, the Northern Territory receives $8 500 per capita, and Western Australia loses $2 100 per capita.

There is no general tendency towards allocating resources to their most productive location. South Australia and Tasmania, with the lowest growth, receive the highest production impacts among the States (excluding the Territories), while Western Australia, with equal-highest growth in gross state product, receives the largest negative effect.

Table 8.13 also suggests that GST redistribution contributes to the divergent level of economic assistance provided to States. Only in Western Australia does the GST distribution on its own operate in the opposite direction to other factors in economic terms, acting to reduce slightly the overall negative economic effect of Federal policies on economic activity in that State.

8.6 Conclusions

The analysis in Tables 8.12 and 8.13:

- does not support the hypothesis that interstate distribution effects of current Commonwealth policies have an equalisation rationale. GST redistribution simply reinforces the arbitrary effects of other policies. Commonwealth payments to the States are different from the social security and taxation systems, with their powerful compression of the vertical distribution of income (see Chapter 9)
- suggests that Commonwealth policies result in strong relative production effects between States that neither reinforce national economic growth nor counteract tendencies towards differential rates of growth across States. The distribution is, in fact, largely arbitrary across States, with no tendency made to shift resources to or away from higher productivity areas.

The present GST redistribution reinforces significantly the apparently arbitrary distribution of production and welfare impacts of other Federal policies across States.

CHAPTER 9: Equity

- Current Commonwealth–State financial arrangements have little effect on reducing extremes in the distribution of income among Australians (vertical equity). In fact, current arrangements tend to make the distribution of income among Australian individuals and households slightly more unequal.
- Analysis of the effects of Commonwealth expenditure and Commonwealth payments to States consistently shows that the Commonwealth's social security system and progressive income tax rates have the largest impact on the vertical equity of individuals and households.
- The current system also fails to ensure equal treatment of people in similar fiscal positions (horizontal equity). This is because it focuses on States rather than households or individuals, and because untied funds are not required to be spent on areas for which they are allocated.
- Replacing the complicated current system with a simple equal per capita redistribution of funding between the States may even reduce inequality, especially if it were accompanied by effective measures to provide merit services to all Australians.

9.1 Are current arrangements for distribution among the States equitable?

Equity is a subjective concept that depends on values which change over time. In the early decades of the 20th century when citizens often identified more strongly with their home State than with the nation, and where secession was considered a realistic alternative to continued membership of the Federation in some States at some times, intrinsic horizontal equity among States was probably seen as more important than it is today. Other conceptions of horizontal equity, in terms of similar treatment of individuals and households in similar circumstances wherever they live in Australia, have become relatively more important more recently.

Through the 20th century, increasing emphasis has been placed on vertical equity among Australians relative to horizontal equity (Garnaut and FitzGerald 2002). Today, the vertical distribution of income is almost universally considered the primary gauge of equity. Policies to assist a State or region may be partly motivated by equity, for example to increase job opportunities for people in economically depressed regions. Whatever their motivation, effects on equity of policies changing income distribution among States or regions can only be judged in terms of outcomes for individuals or households in those areas, relative to individuals and households (in both the same area and other areas).

Chapter 1 notes that other tests of equity have sometimes been considered relevant. There is some support for an earner's test – that, in the absence of good reason to the contrary, it is equitable for income to be left with the person who generated it. This is qualified by the near universal acceptance that some intervention to redistribute income and access to services is justifiable on grounds of vertical equity. But the qualification does not extend to support for confiscating all above average individual or household income, which would follow from raising living standards of the poor to average.

Outside Australia welfare economists sometimes apply a more severe test – that there can be no certainty that a change in the distribution of income is equitable from the perspective of all unless it increases the income of at least one person without reducing the income of anyone else. One difficulty with applying this test is in defining the appropriate baseline distribution. Is this the distribution present under established policy, the distribution as political authorities have promised it for the future, or even what some citizens believe has been promised for the future? Government, let alone reform, would be impossible if the latter perspectives were dominant. However, the presence of this perspective suggests that significant policy changes require long periods of adjustment.

9.2 The primary test: vertical distribution of income

How does Commonwealth Government policy, in particular policy related to Commonwealth–State funding, affect the vertical distribution of income in Australia?

To answer this question, the Review commissioned a major piece of research from the National Centre for Social and Economic Modelling (NATSEM) at the University of Canberra (Harding et al. 2002).

The NATSEM study covered household-weighted and person-weighted distribution of income. It reported the effects of Commonwealth policy on the distribution of income using two separate techniques – the Gini coefficient[10] and distribution across income deciles.[11]

Table 9.1 sets out the effects of Commonwealth policy on income distribution as measured by the Gini coefficient. A lower coefficient points to more equal distribution. Coefficient values are shown for:

- the current system of grants allocation
- the replacement of the current system by two hypothetical benchmark scenarios specified by the Review Committee:
  - an *equal per capita* allocation of Goods and Services Tax (GST) revenue
  - a *State of origin* allocation (i.e. returning GST proceeds to the States that generated them)
- a number of different stages of income, with progressive effects of successive layers of government policies affecting income distribution shown.

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[10] The Gini coefficient measures the extent to which the distribution of income among individuals or households deviates from a perfectly equal distribution. Zero represents perfect equality, while one represents absolute inequality.
[11] In a decile analysis, households or individuals are grouped into ten groups of equal size by income.

TABLE 9.1: Gini coefficients for selected equivalent income measures under the current system and the two benchmark scenarios, 2000–01

	Current system	Equal per capita	State of origin
Household weighted			
Equivalent private income	0.520	0.520	0.520
Equivalent Federal income	0.297	0.297	0.297
Equivalent SPP income	0.271	0.271	0.271
Equivalent final income	0.252	0.251	0.252
Person weighted			
Equivalent private income	0.478	0.478	0.478
Equivalent Federal income	0.277	0.277	0.277
Equivalent SPP income	0.247	0.247	0.248
Equivalent final income	0.228	0.226	0.227

Source: Harding et al 2002

Income definitions

Gini coefficients are shown in Table 9.1 for a series of four income definitions.

(1) *Private income* is the amount of income received by each household from the effort (e.g. wages, self-employment) and/or investments (e.g. dividends, interest) of its members.

(2) *Federal income* is the sum of private income and the imputed value of Commonwealth own-purpose expenditures with personal benefits attributable to households, minus the imputed value of Commonwealth taxes paid. This income definition seeks to isolate the impact of Commonwealth own-purpose spending and taxation on Australian household income distribution, but income tax and social security payments have the largest effect on household income distribution.

(3) *SPP (specific purpose payments) income* is the sum of Federal income, the imputed value of all SPPs delivered through and to the States and all other revenue assistance, but excluding GST-financed revenue assistance, which is allocated by the Commonwealth Grants Commission (CGC). This appears to be a complicated definition of income, but the aim is to show what the distribution of income looks like just before the CGC distributes the GST funds to the States and the States spend those funds.

(4) *Final income* is the sum of private income and the imputed incidence of all of the expenditures and taxes modelled in the NATSEM study. The major use of SPP income is to analyse the impact of the CGC by subtracting SPP income from final income. The difference between these two measures shows the estimated expenditure benefits accruing to households from general purpose grants disbursed by the CGC.

The net redistributive impact of all the expenditures and taxes included in the NATSEM study is to reduce income inequality (Table 9.1). As expected, the Commonwealth's own-purpose expenditures and taxes have had the greatest impact, substantially reducing the Gini coefficient from 0.520 to 0.297. This is largely due to the effective targeting of social security cash transfers to low-income households and the progressive nature of the income tax system (i.e. it takes more from higher income households than lower income households, and delivers more to relatively low-income households).

Both SPPs and general purpose payments contribute to further reductions in income inequality; SPPs by more than general purpose payments (as allocated by the CGC). Expenditures on health, education, housing and other SPP-financed activities reduce the Gini coefficient from 0.297 to 0.271. Expenditures on health, education, housing and other State services funded by untied grants under the current grants allocation system further reduce income inequality from 0.271 to 0.252.

Table 9.1 also presents estimates of the degree of income inequality resulting from two benchmark scenarios. Under the equal per capita scenario, the current distributions of SPPs and general purpose payments are replaced by allocation among States in proportion to population. Under the State of origin scenario, the current distribution of SPPs and general purpose payments are replaced by allocation according to the state of origin of GST collections. Neither affects private income or Federal income and there is little or no difference between the scenarios and the Gini coefficients for SPP income under the existing system.

The equal per capita and State of origin distributions involve only minor changes in SPP payments, but significant changes to the allocation of untied grants. The Gini coefficient for equivalent final income under the State of origin scenario is unchanged, and is slightly lower (by 0.001) under the equal per capita scenario (although this is not statistically significant). In any event, the results demonstrate that an equal per capita or State of origin distribution would not increase the inequality of equivalent final income distribution (and may slightly reduce it) compared to the current system.

These results are for households. In income distribution studies, analysts often examine the characteristics of people according to the characteristics of the households in which they live (Harding 1997). Results are then person-weighted, rather than household-weighted. It was theoretically possible that varying distributions of people within households across States could lead to the household-level results giving misleading estimates. For example, this might have occurred if a particular State had a very high proportion of single-person households.

To check the sensitivity of results to household weighting rather than person weighting, NATSEM also conducted this analysis for persons. The values of the Gini coefficients for persons are always lower than the matching Gini coefficient for households because higher income households tend to have more people. In the NATSEM analysis the decline in the person-weighted Gini coefficient for equivalent final income from 0.228 under the current system to 0.226 under equal per capita and 0.227 under State of origin is similar to the relative change in the household-weighted results. Weighting by persons rather than households does not therefore appear to influence the assessment of the distributional impacts of the alternative scenarios.

Another way of looking at the impact on inequality is to examine the change in final income accruing to households ranked by deciles of equivalent final income. In Table 9.2, the bottom decile consists of the 10 per cent of households with the lowest equivalent final income under the current system (decile 1).

TABLE 9.2: Average equivalent final incomes by decile, 2000–01 ($)

Decile	Current system	Equal per capita	State of origin	Change from current system	
				Equal per capita	State of origin
1 (poorest)	6 887	6 911	6 886	24	-1
2	16 319	16 355	16 283	36	-36
3	18 884	18 940	18 872	56	-12
4	20 754	20 790	20 736	36	-18
5	22 657	22 722	22 710	65	53
6	24 876	24 941	24 984	65	107
7	27 832	27 872	27 907	41	76
8	31 547	31 548	31 565	1	19
9	36 890	36 743	36 767	-147	-123
10 (richest)	52 045	51 855	51 920	-190	-125

Source: Harding et al 2002

The differences in the alternative scenarios are more noticeable when examined by decile of equivalent final income, rather than by Gini coefficient changes. In Table 9.2, the equal per capita distribution appears more progressive than current Commonwealth arrangements as it results in household equivalent final incomes increasing in the lower and middle-income deciles and decreasing in higher income deciles. For example, under the equal per capita scenario household equivalent final income in decile 1 increases by $24 a year, but declines in the top decile by around $190 a year.

The impact of State of origin distribution on inequality is more difficult to interpret, as households in both the top and bottom deciles make relatively small losses in comparison with current arrangements.

One obvious conclusion to be drawn from Table 9.2 is that, overall, Commonwealth policy causes income distribution to be far more equal. Commonwealth payments to States, and State expenditure of these payments, contribute little to compression of the vertical distribution, with SPPs having slightly more impact than the CGC's distribution of general purpose payments. More importantly, the analysis shows that vertical distribution would be no less equal, and possibly a bit more equal, if general purpose grants were allocated equally per capita rather than in the current manner determined by the CGC.

Table 9.3 shows the net gain or loss for each State from the current system and the benchmark scenarios, distinguished by definition of income.

TABLE 9.3: Estimated gain or loss by State, 2000–01 ($ per capita)

	Federal effect	SPP effect	CGC effect	Overall effect
Current system				
NSW	-3 135	1 332	1 117	-687
VIC	-2 662	1 283	1 064	-314
QLD	-1 708	1 322	1 296	911
WA	-2 898	1 390	1 252	-256
SA	-1 556	1 449	1 518	1 411
TAS	-734	1 538	2 102	2 906
ACT	-6 366	1 373	1 518	-3 475
NT	-4 323	2 043	6 207	3 927
Equal per capita				
NSW	-3 135	1 337	1 263	-535
VIC	-2 662	1 305	1 265	-92
QLD	-1 708	1 332	1 265	889
WA	-2 898	1 406	1 265	-227
SA	-1 556	1 374	1 264	1 082
TAS	-734	1 482	1 265	2 012
ACT	-6 366	1 379	1 264	-3 723
NT	-4 323	1 723	1,265	-1 335
State of origin				
NSW	-3 135	1 445	1 408	-283
VIC	-2 662	1 343	1 255	-64
QLD	-1 708	1 178	1 146	616
WA	-2 898	1 437	1 142	-319
SA	-1 556	1 221	1 145	810
TAS	-734	1 091	1 060	1 417
ACT	-6 366	1 777	1 525	-3 064
NT	-4 323	1 266	1 043	-2 014

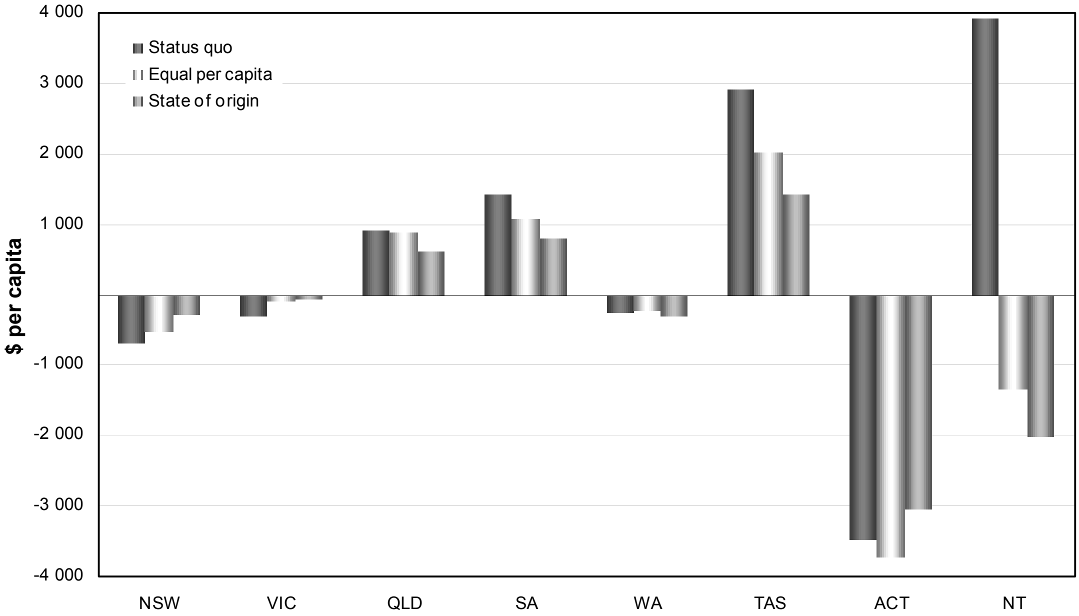
Source: Harding et al 2002

The Federal effect shown in the first column is the estimated net impact of the $132 billion of Commonwealth taxes required to finance the $132 billion of expenditure benefits allocated in the NATSEM study. The SPP effect refers to the impact upon each State of SPPs directed ‘through’ and ‘to’ the States, plus general revenue assistance. For this column and the CGC effect, demonstrating the impact of CGC grants, all States have a positive balance because new benefits to households are added, but taxes are not. The overall effect shows the impact of all the selected Commonwealth outlays and taxes included in the NATSEM study.

The largest per capita net losses from all policy redistributions analysed by NATSEM are borne by Australian Capital Territory residents who, on average, each pay an estimated $3 475 more in taxes than they receive in benefits. (Chapter 8 examines how the Australian Capital Territory boosts its revenue from extremely large Commonwealth purchases of Australian Capital Territory produced outputs.) New South Wales residents are also net losers, by an average of $687 per person. Victorians and Western Australians make small net losses.

Figure 9.1 shows the estimated per capita gain or loss per capita by State from the current distribution and the equal per capita and state of origin scenarios.

FIGURE 9.1: Estimated per capita gain or loss by State from the current and per capita distribution of general purpose payments, 2000–01



Source: Harding et al 2002

Northern Territory residents receive the largest advantage from current arrangements, with each person receiving $3 927 net more than they pay in taxes. Tasmanians are also big net winners, followed by South Australians and Queenslanders. The existing system redistributes income to residents in these States away from Australian Capital Territory, New South Wales, Victorian and Western Australian residents.

Under both the equal per capita and State of origin scenarios, per capita *losses* in New South Wales and Victoria would be reduced. Conversely per capita *gains* in Queensland, South Australia and Tasmania are reduced. Both scenarios would reverse existing gains for the Northern Territory. Outcomes for the Australian Capital Territory and Western Australia vary depending upon which scenario is considered.

Commonwealth fiscal interventions have major effects on relative per capita incomes across States, with the pattern of payments to the States of considerable importance to this interstate redistribution.

9.3 Horizontal distribution – equal treatment of equals

How does the established pattern of Commonwealth payments to the States affect the horizontal income distribution, i.e. treat all Australians in similar economic circumstances in a similar way?

The most powerful Commonwealth fiscal interventions are via the taxation and social security systems. These systems broadly meet the test of horizontal equity – with some exceptions that do not appear to have systematic regional biases.

The provision of government services is less satisfactory from the perspective of horizontal equity. Fair distribution of services most important to equality of opportunity in Australia – notably education and health – is especially important to Australians' conception of equity. Community development services for Indigenous people are also of special importance to equality of opportunity.

There are well-known systematic regional differences in the quality of services available to Australians (e.g. between metropolitan, provincial, rural and remote areas). Some differences are inevitable, reflecting differences in the costs of provision of services in different locations, while others are possibly amenable to policy change.

States are mainly responsible for delivering the services most important to equality of opportunity, known as *merit services*. However the Commonwealth influences outcomes by allocating SPPs to these activities, which effectively splits responsibility for service delivery between the levels of government. Commonwealth resources also flow to merit services by providing general purpose payments to expand States' capacity to provide services generally.

Allocating SPPs to the main merit services gives some priority to equitable horizontal distributions throughout Australia, which is reflected in Commonwealth conditions placed on the use of funds. However these efforts and conditions are to a considerable extent negated by the CGC's treatment of SPPs as untied revenue to the States.

The CGC's application of horizontal fiscal equalisation (HFE) in the late 20th century has failed as an instrument of horizontal equity on two grounds:

(1) it focuses on horizontal equity between States, and not between individuals and households

(2) to the extent that States might be a relevant category for HFE purposes, it focuses on providing fiscal capacity to provide merit services to various communities, without requiring funds to be spent in accordance with their allocation.

Considering the definition of HFE, it is illuminating to examine James M. Buchanan's *Federalism and Fiscal Equity* (1950), which stated that an ideal HFE system would deal with transfers between individuals, not States, but that such an idea may be impractical (Walsh 1989).

Moreover, no Australian State appears to be severely depressed financially. Every State has areas of particular need – in metropolitan, rural or regional areas – often existing alongside areas of relative prosperity and economic dynamism. There are good reasons in a Federation to provide support for a State that encounters serious difficulty and threats to its financial viability. While ensuring that all States remain financially viable may indirectly affect equity, there is no sense in which the concept of equity can usefully be applied to States. The current system should be assessed against equity criteria on the basis of the outcomes it achieves for Australian individuals and households – not States.

It is possible to base an HFE distribution on monitoring and evaluating outcomes without prescribing them, but the evolution of the CGC's approach has created a system that equalises States' 'capacity' to provide services, not service provision. Supporters of the system suggest that equalising the capacity of States of a Federation may be the only feasible method, but Buchanan argued that individuals should still feel the effects of equalisation, even if it had to be filtered through the States.

The associated divergence between equalisation of capacity to provide services across States, and equal treatment of individuals in access to merit services, is considerable. Large differences between levels of services available in metropolitan, provincial, rural and remote regions are accepted and in some respects entrenched by the system. And there are major examples of States applying the exceptional costs allocated to support the provision of high-cost services to some communities, for other purposes.

We believe that equitable access to services in merit areas, such as health, education and housing, is best dealt with directly through national arrangements in those areas, covering respective roles in funding and management of service delivery. Such arrangements work best when allocations and attached conditions:

- reflect consultation between Commonwealth and State Ministers and their departments
- are founded on agreement on broad outcome objectives and priorities, and include ways to measure outcomes
- eschew Commonwealth intrusion into State service delivery.

9.4 Other conceptions of equity

The concern for equity among Australian States that was apparent in the early years of Federation is less relevant today, but still impinges on the equitable treatment of individuals across States. Many Australians hold the view that it is inequitable to transfer all above-average revenue generating capacity from economically successful States to others, and that there should be some fiscal return from growth promoting policy at the State level. There is a widely held view in Australia that State Governments should receive some support in times of fiscal stress. In Australian approaches to reform, it is also accepted that major changes in policy affecting income distribution should be introduced gradually, giving affected citizens time to adjust.

All these conceptions of equity need to be considered when proposing reform to Commonwealth–State financial relations. But, in our opinions, most Australians share the view that reducing extremes in inequality in the distribution of income among individuals and households (vertical equity) is of primary concern.

Many ways to raise revenue

The redistribution of incomes towards high income States produced by the current system can be traced back to what we regard as a misconstrued approach to assessing their ability to raise revenue. Under the CGC methodology, revenue raising capacity is assessed in terms of revenues a State would collect if it applied the average tax rate to each of a large number of detailed tax bases and other revenue sources, as currently used by the States. This approach effectively assumes that there is no substitutability among different ways of raising revenue. This results in smaller States, notably the Australian Capital Territory, being assessed as having low revenue raising ability when they have relatively high household incomes and, in some cases, strong tax bases. This anomaly is discussed further in Chapter 11.

CHAPTER 10: Efficiency and Economic Growth

- Australia's system of Commonwealth–State financial relations has inherent problems that lead to inefficiencies and lost opportunities for increasing national welfare:
  - States with higher grants overspend relative to their community needs and demands.
  - Commonwealth and State Government roles and responsibilities are duplicated.
  - There is no focus on national outcomes.
  - There are disincentives for State Governments to seek long-term efficiency improvements in service delivery, and to invest in economic growth.
  - In States that receive higher grants, there is an anti-growth bias associated with artificial contraction of private economic activity.
  - There is reduced incentive to attract and retain international investment and high-value migrants to Australia because there is under-investment in public goods in the main migrant cities.
- Commonwealth–State funding arrangements should be reformed to achieve an optimal level of equity and efficiency, and remove disincentives for good economic performance.
- The static resource allocation costs of these factors is between $150 million and $280 million, plus a larger cost of administering the system. In our view, the dynamic costs are much larger.

10.1 Introduction

Chapter 1 identified how the system of Commonwealth–State funding transfers affects national economic efficiency and economic growth. This chapter assesses the efficiency effects within that system.

Concepts of efficiency

An economic arrangement is considered efficient when there can be no rearrangement of resources which will leave someone better off without worsening the position of others (Musgrave and Musgrave 1989, p. 60).

As with equity, efficiency has a number of meanings. The most readily understood is *productive* or *technical efficiency*, the use of resources in producing goods or services to conform with best practice (i.e. not using resources wastefully). *Allocative efficiency* refers to using resources available to produce the highest possible value of products for the overall community. The importance of allocative efficiency is demonstrated when the application of technical efficiency alone results in a product of less value to the community than the resources could produce if used elsewhere.

Dynamic (versus static) *efficiency* can apply to both productive and allocative efficiency. It is present when particular arrangements promoting innovation and improvement that may not produce immediate productivity gains do so over time. Some arrangements are superior to others in the dynamic sense of promoting more productive resource use over time.

The ten effects on economic efficiency introduced in Chapter 1 are described in more detail below.

(1) The tendency for equalising transfers to reduce the incentives for resources to locate in higher rather than lower productivity locations. Conventionally this is the dominant economic efficiency consideration in assessing horizontal fiscal equalisation (HFE) arrangements. This is one of the effects discussed in the paper *Effects of Changes in Commonwealth Grants to the States: An Applied General Equilibrium Analysis* by Monash University's Centre of Policy Studies (CoPS) (Dixon et al. 2002), presented at the National Forum. One form of this effect arises if transfers compensate for exceptionally high costs of providing services in some locations, as they are in Australia. People face reduced incentives to locate where public services can be provided at lower rather than higher costs.

(2) *The capacity for investment in human resources development in low productivity regions to enhance national economic potential.* Relatively fast population growth in regions where marginal productivity is higher, may be more productive for national society, as well as the individual, if it is preceded by transfers to slower-growing regions that allow adequate provision of services affecting labour market value. The obvious candidate is education, but health and other services may also be relevant. The Commonwealth Grants Commission (CGC) approach of assessing the quantum of transfers by reference to cost disabilities in service delivery, but without any requirement for funds to be spent on the particular services, would appear to be a source of inefficiency.

(3) *Incentives for people to stay in locations where their marginal social product is high.* This is the converse of the effects in (1). It could arise where a lower *fiscal residuum* or other cause of divergence between private and public benefits of emigration causes some people to move out of lower income regions when their marginal social product is higher than in the higher-income region to which they are moving. This is an insight of James M. Buchanan (1950), frequently cited in debates on these issues. A version of this effect does not depend on the geographical distribution of public services; this is also incorporated into the CoPS analysis cited in (2), in the form of 'congestion' costs of emigration to larger centres of population.

(4) *Attraction of high-value mobile resources in an international market.* International immigration plays an important role in Australian economic development. Migrants arrive disproportionately in large cities, especially Sydney, Melbourne and Perth. This raises land rents, and housing and other prices, generating incentives for established Australians to migrate elsewhere. The costs of services associated with immigration tend to be high. If resources are transferred from these cities on interstate equalisation grounds, it may reduce these cities' capacity or preparedness to accept the costs of large-scale immigration. This would consequently reduce rates of growth throughout Australia. The redistribution of fiscal capacity from parts of Australia most intrinsically engaged in attracting mobile human and other capital from overseas, and retaining these assets, may reduce Australia's capacity to attract and retain high-value mobile resources. To the extent that it does so, it may restrict growth across Australia, including in the States that are recipients of transfers.

(5) *Overhead and transaction costs of managing the system.* In the case of untied transfers, these include the cost of the CGC and the cost of State (and to a much smaller extent Federal) bureaucracies that serve and seek to persuade the CGC. Here, of greatest importance may be the time spent by many of the most talented officers of the State public services on what is an extraordinarily detailed and administratively cumbersome process. The task of these officials is to maximise CGC assessments of their own jurisdictions' expenditure disabilities, and minimise assessments of their revenue raising abilities – and to criticise other jurisdictions' assessments. Less transparent and larger are the SPP transaction costs, with continuous negotiation over conditions and guidelines, boundaries, administration, performance, reporting and accountabilities.

(6) *Duplication, lack of coordination and game playing.* Separate from the overhead and transaction costs of administering SPPs, is the duplication, imperfect coordination and game playing to assert control by both Commonwealth and State officials engaged in funding closely related services in areas where the States have Constitutional responsibility through SPPs and directly through State budgets, a source of potentially large inefficiencies. These inefficiencies may involve cost shifting and re-labelling, exploitation of weaknesses in criteria, and matching requirements and reporting arrangements. As well as causing inefficiency, accountability is diminished. There are also potential costs of distortion of priorities at the State Government level, through matching funding requirements and specific conditions in SPPs. The same issues arise in Indigenous affairs, where the Commonwealth has had an overriding responsibility since the 1967 Constitutional Amendment.

(7) *Enlarged role of the public sector.* Interstate transfers leads to the public sector playing a larger role in recipient than in donor States, independent of citizens' own preferences for public relative to private goods. This distortion appears in the CoPS analysis as the 'sticky paper' or 'flypaper' effect. This does not include the effect of a disproportionately large public sector on the political economy of growth policies, which is discussed in (10).

(8) *Grant seeking behaviour.* The 'averaging' methodology in the CGC calculation of revenue and expenditure disabilities when assessing each State's share of the GST revenue provides States with the opportunity to influence outcomes by increasing taxation or expenditure effort in areas where its own disabilities are large. The CGC has been concerned about grant seeking fiscal policy for a long time. It is generally thought to be present but not a large effect.

(9) *Diluted incentives for cost reducing reforms.* The emphasis on disabilities in costs of delivering services in assessment of a State's share in the GST revenues, and the need for a State to demonstrate continuously that its costs are higher than those of other States, can be expected to reduce emphasis on cost reducing reform. These tendencies may be strengthened by the CGC's consistent use of delivery costs compared with State average practice – rather than costs under best practice in assessing disabilities. This conflicts with the general focus on best practice through the public sector over the past two decades of cost-reducing reform in Australia. A good deal of information is available now to assist in identifying best practice costs.

(10) *Impact on the political economy.* The dominance of transfers from the Commonwealth in a framework of HFE could be expected to have a significant effect on the political economy of policy and development strategy affecting growth in both recipient and donor States. This is partly a matter of incentives, where both recipient and donor States are discouraged from growth-promoting policies if the fiscal benefits of stronger growth are mostly transferred to others. In addition, the political economy of some recipient States is distorted by the presence of an exceptionally large public and exceptionally small private sector. This has not been much discussed in Australia, although in international literature it has been interpreted as making a case against the late 20th century Australian approach to HFE (Buchanan 2001).

Effects (1) to (4) relate to various national externalities, or costs and benefits to the national economy that are external to the recipients and donors of the transfers themselves. This chapter explores these effects, some other measurable costs, and concludes with observations about less tangible, but potentially important, effects on the growth process.

Of these effects:

- (1) dominated early discussion of Federal financial relations
- (2) is a dynamic version of (1)
- (3) is the converse of (1), is prominent in Australian defence of HFE, and emerged from a seminal article by James Buchanan (1950)
- (4) qualifies (3), concerns international migration, and was noted by Buchanan in 2001.

10.2 Externalities

Buchanan (1950) suggested that a system of transfers was needed to ensure that the public sector in Federations provided ‘equal treatment for equals’ across the nation, and therefore to discourage anti-productive movements of people.

Equals are ‘individuals [who are] equal in those objective economic circumstances traditionally employed in the calculation of national government tax burdens’ (Buchanan 1950, p. 587). Equal treatment meant that equals should receive a similar fiscal residuum from government services: ‘The balance between the contributions made and the value of public services returned’ (Buchanan 1950, p. 588). Buchanan states that without these transfers, national resource allocation would be distorted and provide incentives for people to migrate to areas of ‘least fiscal pressures’ (in terms of taxation levels and/or value of public services) (2001, p. 589).

Buchanan (1950) believed that, in principle, HFE was best achieved by a central Government administering a geographically discriminatory personal income taxation.

> Any method of adjustment which involves…specific or block grants is inferior to the tax adjustment method…States could be placed in a position to treat citizens in the same manner…But States would not necessarily, or probably, choose to do so. (p. 596)

Buchanan (1950) noted that geographically discriminatory taxation had certain problems – it faced constitutional hurdles, and:

> …individuals probably respond more quickly to tax burden differentials (especially direct taxes) than to differentials in public service standards. Therefore…there might still be distortionary resource allocative effects due to…‘tax illusion’. (p. 595)

One problem Buchanan did not note is that much of the complexity of this approach is concealed by the example he used, involving State personal income taxes and equal per capita services. In the Australian context of stamp duties, payroll tax, other direct or business imposts, and needs-based service provision, achieving HFE through a central system of transfers to individuals faces additional hurdles. It would be easier if the States had accepted the Fraser Government’s offer to facilitate State-determined variations in rates of income tax, but contemporary Australia is not close to re-examining the decisions of two decades ago.

In 1950 Buchanan thought untied cash grants were second best to geographically discriminatory taxation. Fifty years later, he placed them much lower in the list of possibilities. Addressing the Montreal Economic Institute in October 2001, Buchanan was more concerned about how States use their grants. He suggested that a poor State might use its grant disproportionately to assist the poor or rich in that State, so that allocation distortions persist after equalisation. Accordingly, ‘The central government must, in effect, adopt a hands-on policy with respect to the ultimate distribution of the equalising funds within the poorer regions’.

Boadway and Flatters (1982) recognise the same problem but reach a different conclusion. They argue:

> being small economies in a world of mobile labour and capital, the extent to which provinces can pursue widely differing policies of redistribution is fairly limited…To devise a scheme that is perfectly equitable from a nationwide point of view would…amount to the federal government imposing upon the provinces its own norms of equity and behaviour. Apart from the unfeasibility of such a scheme, it strikes us as being contrary to the spirit of the Canadian Federation. (p. 48)

This debate shows a clash of values, very obvious from Buchanan's statement that 'Equality in terms of States is difficult to comprehend, and it carries with it little ethical force for its policy implementation' (1950, p. 586).

What is important to this chapter is the 'efficiency' issue: to what extent are the efficiency gains from central government intervention offset by efficiency losses through constraining States to act in accordance with central directions? Chapters 5, 11 and 12 include more extensive discussion about the desirability (or otherwise) of central government direction in the use of grants.

Buchanan's views on the potential for equalising transfers to enhance efficiency were contested by Scott (1950), who argued that, by helping to provide amenities to poor people in resource-poor States, assistance grants may impede labour mobility and perpetuate allocative inefficiency. Different analytical perspectives underlie Buchanan and Scott's conclusions. Buchanan and Wagner (1970) noted later that Scott assumed an economy out of long-run equilibrium, whereas Buchanan's implicit model was one of comparative statics. As discussed later, this issue is still very relevant to the debate about the efficiency effects of equalisation.

Another area of debate centred on whether the fiscal residuum should be defined in terms of marginal or total benefits (the latter incorporating the taxpayers' surplus from the willingness of others to pay for public services), and whether it is inefficient for equals in different States to have different fiscal residua. Musgrave (1961) argued that the higher taxpayer surplus available in richer communities should not be classified as distorting the regional allocation of resources, but as constituting 'a given datum for location, just as does the geographical distribution of natural resource deposits…efficiency is not served by erasing this feature of the map' (p. 133).

More precise analytic methods were developed to deal with these issues (Buchanan and Wagner 1970; Buchanan and Goetz 1972; Flatters, Henderson and Mieszkowski 1974). In these papers, inefficient resource allocation was seen as a result of potential migrants between States not considering the possible benefits or costs of their decisions on the rest of the population. In other words, potential inefficiencies in resource allocation arise because of the externalities associated with migration.

Important examples of externalities include:

- At small population sizes, there may be economies of scale in production, or improved social amenities.
- At large population sizes, there may be congestion costs – diseconomies of scale in production or increased social dysfunction.
- There may be rents (e.g. good public services, good environment, wages above the long run marginal product of labour due to low capital mobility or non-competitive labour markets) to which State residency provides access.

- Fiscal externalities may arise from State tax and expenditure policies (e.g. low income migrants to a State are likely to use more public services than they pay for in taxes, imposing a cost on the State to which they migrate, and generating a benefit for the State they leave).

The first three also include some fiscal externalities, for example:

- economies of scale may apply to publicly provided goods
- social dysfunction may require a public response (e.g. more police and welfare services)
- States may fund services through taxes with a rent component (e.g. royalties, land tax, conveyance duties and wages to the extent that these differ from long run marginal product of labour).

The theory of externalities suggests that inefficient migration outcomes (i.e. too much or too little migration) may occur in the absence of offsetting fiscal transfers between States.

It is, however, not possible to use untied fiscal transfers to eliminate inefficient migration in a Federation. As an extreme example of the problem, where one State has a progressive tax structure and another State has a regressive tax structure, inefficient migration will generally occur for all choices (and directions) of fiscal transfers.

Is the CGC process justified by fiscal externalities?

The literature on fiscal externalities is often used to justify the CGC's fiscal equalisation process. However, the real picture is more complex. The literature suggests there is an efficiency case for and against transfers, depending on circumstances. The case for transfers does not say unequivocally that a central authority should mandate them. Myers (1990) and Shapiro and Petchey (2000) argue that States will provide transfers that are optimal from an efficiency perspective if they wish to optimise their residents' welfare. This raises the question of whether the States would agree voluntarily on the current pattern of CGC subsidies.

The externality analysis provides some support for elements of the CGC process (equalisation for revenue capacity, administrative scale and demand). However there are important differences.

- The CGC considers the public sector, whereas efficiency optimal transfers need to consider all externalities – not just those involved in the public sector's provision of services.

- Many elements of the CGC's calculations are not fully warranted on the basis of externalities. Cost factors for dispersion and input costs provide examples, to the extent that these costs are proportionately borne by all State residents. In this case, cost subsidies encourage people to locate in higher cost regions, with a loss in national welfare. On the other hand, to the extent that State Governments decide that the rich will bear a disproportionately high share of these costs, subsidies may reduce the incidence of these costs on the rich, and hence reduce fiscal incentives for the rich to migrate to low cost States.[12]
- Some elements of the CGC's calculations work are directly against efficiency. For example, the CGC provides additional money to States with higher congestion costs (e.g. for law and order and public transport), whereas an efficiency optimal calculation would provide less money to these States (to encourage more migration to less congested States).

While the analysis of fiscal externalities provides some support for (as well as arguments against) transfers between the States, these transfers would look rather different from the CGC's recommendations.

10.3 Previous analyses of the efficiency of the CGC process

Previous analyses of the efficiency of the CGC process have focused on two aspects – policy neutrality and the effect of State subsidies on national resource allocation.

Policy neutrality

The CGC process is designed to be policy neutral, that is, to maintain a position in which States cannot affect their grants through spending and taxing policies, except through their ability to modify the standard taxing and spending policies that form the basis of the CGC's assessments.

It has often been pointed out that a State's grant allocation under the CGC process can be affected by the State's policy choices. States can increase their grant share by:

- shifting expenditures to areas where their assessed disabilities are higher
- shifting revenue raising to areas where their assessed capacities are lower
- reducing (or increasing) tax effort if the State's differential per capita expenditure requirement is less than (respectively greater than) its differential per capita revenue raising requirement.

In practice, these incentives to increase grant share are probably small, as the grant change is usually only a small fraction of the change in expenditure or revenue settings required to achieve the grant change. In addition, the five-year data averaging process and the lags in data availability reduce incentives for grant seeking behaviour, as there is a risk that the predicted grant benefit will not materialise due to method changes.

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[12] Some factor allowances may correlate with externalities not explicitly considered by the CGC and consequently by accident act to improve efficiency. However, such correlations remain to be established, and inverse correlations are equally possible.

Swan and Garvey (1996) calculated that such incentives could reduce national welfare by between $13 million and $54 million per year (1996 dollars).

There are likely to be much more important efficiency issues around whether the disability and capacity measures are policy neutral as discussed in Sections 10.4 and 10.5. Irrespective of the existence of deliberate grant-seeking behaviour, a process that encourages States continually to demonstrate that they have higher costs of service delivery than other States will inevitably have negative effects on the search for and implementation of more cost effective means of service delivery.

Effect on national resource allocation

A number of studies have attempted to examine the effect that Commonwealth–State transfers have on the efficiency of national resource allocation, with varying attention paid to the effects of externalities.

A study by Dixon, Madden and Peter (1993) (commissioned by the CGC) examined the migration effects and production impacts associated with the CGC's assessment of cost factors. The study did not examine the impact of demand factors and revenue capacity factors (reflecting the more obvious externality issues associated with these factors).

The study concluded that fiscal equalisation led to national production losses of about $30 million per year (1990 dollars and economic scale) using particular assumptions and modelling the impact on a State's employment of shifting resources to another State. More than 90 per cent of this was attributable to the cost factor allowances provided to the Northern Territory. Allowing for economic growth over the last twelve years, this now equates to about $50 million per year (about 0.01 per cent of gross domestic product).

From time to time, studies have revealed welfare losses from the CGC process ranging into hundreds of millions of dollars. Too much weight should not be placed on these attempts at quantification, except to note that – Buchanan's arguments of 1950 notwithstanding – all studies point to net economic efficiency costs and none to net benefits.

10.4 General equilibrium models: the CoPS analysis

Computable general equilibrium models have been used increasingly over the last two decades to model the Australian economy and the individual States. While they seem to be a natural candidate for modelling the efficiency effects of equalisation, they have not provided definite answers to the main questions.

The current models do not have sufficient sophistication. Key issues such as scale economies, congestion, long run factor productivity, public good benefits and non-homogeneous populations are not well reflected, or not reflected at all. Attempts have been made only recently (Giesecke and Madden 2001) to incorporate a simple form of Government decision making into large-scale models.

For the time being, the efficiency analysis of equalisation must rely on simplified models and qualitative assessments of important issues.

Monash University's Centre of Policy Studies (CoPS) was commissioned by the Review to undertake an efficiency analysis of the CGC equalisation process. The result is the most detailed and sophisticated study undertaken on a range of quantifiable economic efficiency effects. CoPS examined the impact on Australian welfare of the current system against alternative grant distributions. The CoPS report provides full documentation (Dixon et al. 2002). Some of the main features of the CoPS modelling, the major results and some qualifications are reported here.

Features of the CoPS model

The model was a stylised computable general equilibrium model of the Australian States, with welfare maximising individuals, profit maximising firms, and State Governments that attempt to maximise the welfare of their communities. The model was not designed as a realistic simulation of State economies, but to represent some key features of Commonwealth–State funding arrangements. Interesting aspects include:

- To facilitate long-run analysis, capital is not represented as an independent factor, but as part of (i.e. carried and owned by) the units of labour. Labour is, in effect, a labour–capital composite.
- Production has constant returns to scale, apart from mining (where mining resources are fixed) and for some alternative modelling exercises.
- Households can move between States to improve their utility, but there is a stay-at-home bias so that changes to current grant distribution will not result in as much population movement as would occur if household utilities were to be fully equalised across States.
- The CGC formula for allocating Commonwealth grants according to expenditure and revenue needs has been explicitly incorporated in the model.
- Taxes and rents (from minerals and land) accrued by the State public sector have been modelled separately. This captures the externality effects associated with using these revenue raising instruments to fund general public services.
- Externalities from public sector expenditures have been accounted for indirectly by taking a base level of expenditures in each State as a given. The base level of expenditures incorporates judgements about which spending categories are unavoidable, the CGC's demand and cost factors for those areas and the minimum standard of service provided by any State in those areas.
- While State Governments aim to maximise the welfare of their communities, the model does not assume that State Governments' perceptions of household demand for their goods necessarily match the reality. The model actually calculates the deviation between State Government perceptions in each State, and the actual demand for State Government goods (assumed to be the same across the nation, other things being equal).

The CoPS results

The CoPS analysis concludes that replacing the CGC allocation with an equal per capita grant distribution would increase national welfare by $169 million. Replacing current distribution with state of origin grant distribution would increase it by $279 million each year. These gains mainly reflect the ‘flypaper’ effect indicated by the model – Governments in subsidised States spend too much on public services compared with the wishes of their communities. The alternative funding distributions give more money to Governments that spend it according to community preferences.

The importance of the flypaper effect in determining the outcome of the modelling is shown by an alternative modelling exercise. Household demands for public goods are not assumed to be uniform across the nation, but rather that State Governments do correctly read the preferences of their communities. In this case, there is no welfare gain from the changed grant distribution. It is also shown by the fact that large changes in the assumed population mobility (even the extreme assumption of zero mobility) have little effect on the welfare gain.

The basic welfare gains modelled by CoPS would be even larger if it were assumed that the grant reductions to subsidised States force their Governments to provide services more in line with community preferences. For example, if the Northern Territory Government moved its spending in line with the next most out-of-line jurisdiction, the welfare gain from an equal per capita funding distribution would rise from $169 million to $248 million.

The modelling also shows that most of the welfare benefit from changing the grant distribution to equal per capita shares can be achieved fairly quickly, even if the movement to equal per capita funding shares is moderated by a real per capita guarantee. After ten years, a welfare gain of $157 million is achieved (i.e. 93 per cent of the gain from full equal per capita shares), even though the grant cut for the Northern Territory is only 27 per cent of the final cut. This reflects that as grants to the Northern Territory are cut, the benefits of directing grants to States where the money is more effectively spent are increasingly offset by productivity losses as labour migrates from the Northern Territory to lower wage States.

CoPS also explored the possible influence of public sector scale economies, and economy-wide congestion costs.

- CoPS found that introducing substantial scale economies in State Government production did not reduce the welfare gain from moving to equal per capita grants – in fact the welfare gain was slightly increased.
- CoPS found that introducing congestion costs into State economies reduced the welfare gain from moving to equal per capita grants. Using the CoPS model of congestion – where congestion is modelled in terms of travel times alone – a new entrant generates a travel cost for the State twice as large as his or her own private travel cost. As a result, the welfare gain was reduced from $169 million to $43 million.

While the CoPS model provides important insights on the efficiency impact of fiscal equalisation, it does not provide a fully comprehensive analysis. Some significant limitations in the analysis are identified below.

- The analysis assumes that the States' current economic circumstances reflect a long-run equilibrium – i.e. the distribution of capital and labour across States is presently optimised for the current grant distribution arrangements. It is far from clear that this is the case (see below). This issue goes back to the debate between Buchanan and Scott about the efficiency of grant subsidies (see Section 10.1).
- The labour–capital composite CoPS used implies a closer link between labour and capital than is actually the case. In practice, often the owner of capital does not reside in the same State (or even the same country) as the owner of labour. However, the household and State Government welfare maximising strategies in the CoPS model are based on capital within the State being owned by households within the State.
- The CoPS model pays little attention to the production side of the economy. There is a fixed constant relationship between production and the labour-capital composite in each State (apart from a scarcity factor for minerals). There are no scale economies, no export sector and no role for Governments to influence production functions.
- The CoPS model's treatment of expenditure externalities is inevitably provisional and approximate. This treatment is necessitated by the fact that populations in the CoPS model are undifferentiated, and the benefits of many publicly provided goods are not easy to capture. CoPS assumed that 12 per cent of State Government expenditures were unavoidable. This is intended to reflect the cross-subsidy between taxpayers who pay more tax than they receive in expenditure benefits, and taxpayers who receive more in expenditure benefits than they pay in tax. All other expenditures can, in principle, be paid from benefit taxes. If this were increased to 24 per cent, the welfare gain from equal per capita funding would be halved. More likely, however, the 12 per cent figure is about right, but its distribution between the States is not as assumed by CoPS.

10.5 Political economy of the flypaper effect

Recipient States that receive large transfers relative to their economies have public sectors proportionately much larger than other States due to the flypaper effect. The corollary is that private employment and incomes are relatively less important in recipient economies.

Recipient States generally have much smaller private sectors, regardless of their citizens' preferences for private and public goods (Table 10.1). The CoPS study (Dixon et al. 2002) observes there is no reason to expect that residents of recipient States have stronger preferences for public rather than private services than residents of other States.

TABLE 10.1: Private full-time employment as a percentage of population 15+

	1983	1986	1991	1996	2001
NSW	31.5	33.3	34.4	35.6	36.3
VIC	33.2	34.6	33.4	36.5	37.2
QLD	32.2	33.5	33.5	35.4	34.5
SA	29.8	31.4	31.1	31.7	32.1
WA	32.7	35.1	33.2	37.2	37.1
TAS	28.5	29.7	29.7	29.6	28.1
NT	37.4	36.7	40.4	37.3	37.0
ACT	17.8	20.6	21.1	21.7	25.5
AUSTRALIA	31.8	33.4	33.3	35.3	35.6

Source: ABS (unpub.)

In Victoria the ratio of private full-time employment to population over fifteen years is almost one-third higher than in Tasmania. The failure of the private employment ratio to rise in Tasmania over the past two decades and the small increase in South Australia contrasts with large increases in the rest of Australia.

Such artificial expansion of public relative to private sector employment and income inevitably affects the political economy of policy making. A State in which relatively few people draw their main household income from private employment is likely to be:

- less sensitive to the policy and regulatory requirements of a market economy
- less supportive of growth-oriented taxation and regulatory policies
- over time, in danger of generating low levels of private investment, leading to low growth rates and, under current Commonwealth–State funding arrangements, larger transfers.

There is anecdotal evidence that these factors have influenced poor economic performance in Tasmania and South Australia in recent years.

The New Zealand Business Roundtable commissioned a report on Tasmania's economic performance in the last decade and the lessons to be learned for New Zealand. It describes the Tasmanian economy as:

> a cause for considerable concern not only for those Australians who happen to live there but also to those in the rest of the country who are called to underwrite the State's living standards (Rae 2002).

The State's poor economic performance is mainly attributed to poor policy decisions, including Government inaction in adopting recommendations to relieve adverse impacts of its anti-business and narrow-base taxation regime. Tasmanian policy has been greatly influenced by Commonwealth transfers over the decades, and, most strongly, in recent years. Under current arrangements, improved economic performance would not increase the fiscal resources available for use in the State. In the future, higher levels of successful, growth-promoting public investment may lead to less – not more – State Government funds being available for other activities.

The fact that recipient States have much smaller proportions of the population receiving their employment and incomes in the private sector than the donor States seems likely, over time, to influence the political economy of policy unfavourably for economic development.

10.6 Other aspects of efficiency

Overheads

In any system, an unambiguous source of inefficiency is the overhead cost of running the system.

In the case of HFE, costs include the running of the CGC and the State bureaucracies that serve and seek to persuade the CGC. These costs may total around $10 million per year, reflecting the extraordinarily detailed and administratively cumbersome nature of the process. Many of the most talented officers in the State public services are engaged in the task of marshalling evidence to maximise their States' expenditure disabilities, minimise their revenue disabilities and criticise other jurisdictions' arguments.

Less transparent, and larger, are the overhead costs of the 120 SPPs. In a recent audit of seventy-one SPPs, the Australian National Audit Office (1999, p. 136) estimated the cost of administering these to be $68.8 million (over 550 full-time staff) for the Commonwealth alone. The Australian National Audit Office also stated that the Commonwealth funded $77 million of State/Territory administration costs. This would be only part of the administration costs borne by the States. There is continuous negotiation over conditions, funding levels, guidelines, boundaries, administration, performance, reporting and accountabilities. Governments also need substantial administrative apparatus to provide information and policy expertise to support these negotiations. Administrative apparatus is also needed to support agreements on these issues and provide reports.

In addition, overhead costs for people and organisations seeking to utilise services funded by two levels of government are often overlooked. Business and community welfare groups have made this point in representations to the Review. The complexity of the system requires significant investment in information seeking, lobbying or applying for funds, and meeting accountability requirements.

Imperfect coordination and game playing

Apart from the direct overhead cost of the SPP system, potentially large inefficiencies arise from poorly designed and managed programs, and game playing by Governments.

The system of SPPs has come under strong and consistent criticism for not allowing States sufficient flexibility to employ resources to meet their different circumstances, or to use funds in the most efficient way. Too often the Commonwealth has micro-managed the design, management and required outputs and inputs of SPP programs. While the Commonwealth has a national perspective, it is also remote from practical considerations and particular circumstances affecting needs, which may require different approaches.

States far from Canberra are concerned that the Commonwealth is not a good arbiter of their needs. Canberra is remote from these States, and political representation in Canberra is strongly influenced by the interests of the southeastern States in numbers of politicians and access by interest groups.

The potential for State priorities to be distorted by poorly designed SPPs is increased through the Commonwealth's imposition of matching and maintenance of effort requirements which allow the Commonwealth to dictate the use of States' own revenues.

SPPs have also led to inefficiency by blurring accountability for providing services. Both levels of government have engaged in blame shifting. There has also been a plethora of 'dirty tricks', such as cost shifting, re-labelling, and exploitation of weaknesses in conditions and reporting requirements.

Despite these problems, SPPs are, in principle, an instrument capable of improving national welfare where States may give insufficient weight to national benefits. To achieve this potential, the two levels of government need to contribute jointly to development of national approaches on the basis of their respective comparative advantages.

States' freedom to depart from CGC 'standard policy'

The CGC approach is underlined by grant allocation based on States' average policy settings. States can decide on their policy settings without directly having an impact on their grant entitlement. There are a number of issues around whether a State should pursue a non-standard policy (e.g. spending more or less than the standard in particular areas).

- Are States' average policy settings appropriate from a national development perspective? 'Myopic' States may give no (or insufficient) consideration to national (i.e. inter–State) benefits or costs. If these effects are systematic across States, the average policy settings of States may be suboptimal from a national perspective.

- Even if the average policy setting is correct from a national perspective, is it so for all States (in terms of maximising national welfare)?
- How can we tell if a 'myopic' State policy (which may or may not match the States' average) is appropriate from a national development perspective?

It is not possible to give simple answers to these questions. The conditions imposed on States to receive Commonwealth SPPs may help correct for myopic perspectives that may be inconsistent with the long-term national interest. However some argue that the Commonwealth has paid insufficient attention to broad national objectives for SPPs and has allowed the system to be drawn into micro-issues of little national significance.

Tendency for equalising transfers to shift resources to lower productivity locations

As emphasised by Scott (1950), it should not be assumed that regions are in a long run equilibrium where labour is potentially equally productive wherever it works. Over the long term, there have been significant differences in economic growth between States (although less than in other Federations as shown in chapter 7). While some of this is due to adjustment costs as old industries have lost value and new industries have emerged, these trends are probably indicative of underlying differences in long-term productivity. Equalisation has put more resources into the two lowest productivity States, discouraging the flow of population to more productive regions. More generally flows from equalisation are not correlated with higher productivity (Table 10.2).

Similar conclusions can be drawn from the broader analysis of the regional distributional impact of Commonwealth fiscal policies in Chapter 8.

TABLE 10.2: GST productions subsidies compared to gross state product and population growth

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
GST subsidy ($ per capita, 2001)	-168	-348	166	116	198	922	549	5 330
Growth from 1990–91 to 2000–01 (%)								
GSP	70	60	84	85	47	37	67	85
Population	11	9	23	17	4	1	9	19
GSP per capita	53	47	50	58	41	36	53	55

International migration

International capital flows are a well-recognised feature of the global economy. Any reduction in Australian productivity will make Australia a less attractive place for capital investment (both foreign and domestic) and further reduce national welfare.

There is a global marketplace for skilled (high-value) labour. Expert labour seeks out locations around the world where its talents yield the greatest returns. High-value labour and capital from overseas flow to a few cities disproportionately, notably Sydney, Melbourne and Perth in the case of skilled migrants, and these cities plus Brisbane in the case of capital. The systematic transfer of resources from these regions, which are competitive in the global market for capital and high-value labour, reduces Australia's attractiveness as a national economy within a global system. The slower growth of the places that are globally attractive for capital and labour will reduce resources movement to, as well as purchases of goods and services from, other parts of Australia. The net result could be that growth in States receiving transfers is slower than if the transfers had never been made.

International flows of capital and quality labour can be cumulative, resulting in successively larger losses in national per capita output. In the long term, this international leakage is likely to be at least as important as the direct loss of productivity through non-optimal resource allocation within Australia.

Incentives for cost reducing reform

The CGC's assessment of expenditure disabilities aims to reflect underlying factors that lead to cost differentials, rather than policy factors. However all disabilities are affected by policy, at least in the medium to long term, as pointed out by Tasman Economics in its submission to the Review. There is a spectrum of policy impacts that ranges from least to most policy affected.

- Factors such as geography, climate and demography are inherent disabilities, although the cost effects of these disabilities may be affected by policy.
- Commonwealth policy can affect expenditure factors, but is amenable to change over the long term.
- State policy can indirectly affect expenditure disabilities in the longer term by affecting the behaviour of State populations (e.g. degree of self-reliance, mobility, risk-taking).
- State policy can affect expenditure disabilities directly through longer-term effects (e.g. policies may have longer-term effects on the location, health, social or economic circumstances of communities).
- States may choose different organisational and managerial structures.
- States may choose between taxation and user charging.

While the CGC's assessments of cost and demand factors can usually be considered policy-independent in the short term, they are unlikely to be independent in the long term.

Funding disability factors reduces the incentive for State Governments to reduce these disabilities. To maintain their share of GST revenue, States need to demonstrate the continuing relevance of these disabilities to the CGC. The CGC process effectively reduces the benefits States would receive from overcoming disabilities, because their grant share is reduced. This applies to cost factors such as scale, dispersion and congestion, and demand factors such as population age structure and socio-economic status.

The problem is more severe because disability factors are generally driven by States with the relevant disabilities – for example, scale assessments are based on the costs of the small States, and congestion costs are based on the costs of the large States. Likewise, Indigenous service demands are driven disproportionately by the experience of States with large Indigenous communities, and ageing demands are driven by the experience of States with older populations.

Some of these efficiency disincentives could be overcome if the CGC adopted 'best practice' expenditure assessments or discounted expenditure assessments. However best practice principles can lead to arguments about how to define efficient spending. There are many efficiency indicators, but their usefulness is often questioned because of their short-term focus and tendency to include a mixture of underlying efficiency and quality of service. A blanket discounting measure is a blunt instrument – it may encourage cost cutting, but could impede long-term efficiency if States reduce investment in measures to contain or reduce disabilities over time. More radical reform is needed (see Chapters 12 and 13).

Some indicators of the importance of this issue are:

- Tasman Economics (2002) has estimated that a 1 per cent improvement in public administration would increase national income by around $300 million per year.
- A 1 per cent reduction in all costs facing State Governments through improved long-term policy settings would save around $1 billion per year.
- A 33 per cent reduction in each of the disabilities (relative to the national average costs) assessed by the CGC would also save around $1 billion per year.

Incentives for economic development

Similar to the expenditure side, CGC assessments of revenue capacity aim to reflect the underlying capacity of States to raise revenue, rather than the policies of States. However, the CGC precludes only the first order effects of policy (e.g. differences in current tax rates, exemptions). It does not attempt to standardise revenue bases for different policies over time that may have improved or diminished the revenue base.

The CGC's funding of revenue disabilities reduces incentives for all States to get the best performance from their economies. States that increase their revenue capacity will receive a lower share of GST from the CGC. They also receive only a per capita share of any additional GST they generate. Of course, States have other incentives (i.e. voter approval) to improve their economies, or the CGC process would effectively remove all incentives.

To get a better feel for the importance of this issue, some basic calculations on the effect of government taxing on the community are presented.

The Commonwealth and State Governments together receive around 38 per cent of gross domestic product (24 per cent Commonwealth and 14 per cent State). Almost all is distributed on some equity basis. Accordingly, the value to each State of every additional dollar generated is much less than a dollar – about 75 cents for New South Wales and around 65 cents for the smaller population jurisdictions.

- State own source revenues equalised by the CGC accounts for around 6 per cent of gross domestic product. If this component were not equalised, the value to each community of a dollar generated would increase by around 4 cents for New South Wales, and nearly 6 cents for smaller population jurisdictions. In effect, equalisation of own source revenues is reducing the return to New South Wales by around 5 per cent (i.e. $^{4}/_{75}$) and 9 per cent for the smaller population jurisdictions.
- The effects would be even higher (by around two-thirds) if the implicit equalisation of GST revenues were included (i.e. sharing these revenues on an equal per capita basis).
- These effects are price signals for the community, whose consequent work–leisure choices are reflected in comparative static analyses such as the CoPS analysis.
- However, they are also price signals for State Governments in setting policy to maximise community income as opposed to other community objectives (e.g. equity, security).
- Where the risks and benefits are borne mainly by the public sector, the effects on price signals become much greater. For every dollar of tax/royalty generated by economic development, the CGC process redistributes all but a population share to other States (assuming a reasonably similar tax effort across all States). New South Wales would keep around 64 per cent of its revenues, while smaller jurisdictions lose 90 per cent or more of the revenues they generate.

These revenue losses are not significantly offset by gains on the expenditure side of the CGC process (although there is recognition of regulatory costs of industries). Economic development costs are not shared around the nation in the same way as the benefits.

A number of submissions to the Review identified the discouraging effect of equalising away revenue gains from projects without equalising the associated costs.

Many of these costs are not readily identifiable or distributable (e.g. cost to amenity, equity and security of business friendly regulation). However a number of expenditure pressures faced by Governments can be directly related to development (expansion of social and economic infrastructure, and economic subsidies) and are not assessed by the CGC.

The price signals for State policy from the CGC process are sufficiently substantial to generate large efficiency losses. Depending on the State Governments' capacities to influence economic growth, losses in the order of 1 to 2 per cent of gross domestic product (i.e. $6.5 billion to $13 billion) are not inconceivable.

An important question is: to what extent can State Government policy influence economic development?

Rae (2002) suggests that State Governments play a substantial role in the economic health of their States:

> While size and location factors are likely to have some bearing on a country's economic performance, the quality of its institutions and policies are vastly more important in explaining the performance of peripheral economies.
>
> Tasmania's unsatisfactory institutions have contributed to its dismal performance. The electoral system of proportional representation, for instance, has tended to deliver minority Government. This, and the independent character of Tasmania's upper house, resulted in a reluctance by governments to address issues no matter how urgent they became.
>
> Poor public policy also contributed to the dismal performance by creating an economic environment unattractive to business.
>
> - Government spending and borrowing have been excessive, and there have been poor returns on investment in state-owned enterprises.
> - Tasmania has the second most severe taxation system of the Australian states and the burden falls heavily on business
> - Excessive regulation has stifled innovation and competition. This is most pronounced in the environmental areas where there has been a perception that Tasmania is opposed to economic development. (p. vii)

The report also states:

> A confluence of institutions and public policy can be profoundly anti-business in its effects, even if that result is not what was intended. Tasmania's experience shows what can happen to an economy when policy develops a consistent anti-business character in each of the three key public policy areas – public expenditure, taxation and regulation...Tasmania has dissipated a significant part of the potential benefits from membership of the Commonwealth through a combination of poor institutional arrangements and policies. (p. 54)

Western Australia stands in many ways as a contrast to Tasmania. Western Australia's submission to the CGC (2002) puts forward the case that successive State Governments have helped industry development by:

- providing a stable and pro-development economic, legal and regulatory framework, encompassing issues such as industrial relations, property rights and environmental management
- acting as facilitator in securing land access, development agreements and timely development of necessary support infrastructure
- providing research and information dissemination services (e.g. geological surveys)
- providing support for social and economic infrastructure (sometimes directly, sometimes by obtaining developer agreement to provide this infrastructure in return for royalty concessions)
- providing investment attraction measures.

Western Australia is not the only example of what State Government initiative can achieve. This suggests that the equalisation framework has not discouraged State Government initiatives to develop their economies. However there can always be great leaders and extreme circumstances that generate the best from a State. In how many more cases has that effort been discouraged because of the disincentive effects of the CGC process? Pro-development policy is politically risky – the community may not welcome policies (e.g. maintaining incentives for development while managing environmental concerns, or freeing up labour markets, or maintaining balance between spending on industrial infrastructure and social welfare). Governments need to show that there are benefits from such policies.

10.7 Conclusions

The survey of the efficiency effects of HFE and SPPs has provided strong evidence that the current system of Commonwealth payments to the States has a number of features that reduce national welfare. This adds up to significant losses for the Australian economy. The problems identified are:

- The CGC process is significantly different from what would be required to deal with migration externalities in the Australian Federation.
- There are modest incentives for State Governments to increase their grants by increasing taxation or expenditure effort in areas where their disabilities are large.
- The CoPS modelling indicates a significant welfare loss through the flypaper effect – States with higher grants are overspending on publicly provided goods and services, relative to underlying community demands.
- The Commonwealth and States incur large expenditure overheads in running the complex system of HFE and SPPs, as does the community in accessing services funded by the two levels of government.
- The SPP system is not performing well due to poor design and management (especially a lack of flexibility for States) and blurring of responsibility between the two levels of government (leading to unproductive game playing).
- Insufficient attention is paid to the achievement of broad national outcomes – the system focuses disproportionate effort on detail, both for HFE and SPPs.
- The HFE system (and Commonwealth fiscal policies more generally) has a tendency to shift more resources to regions where long-term growth potential is lower.
- HFE provides disincentives for long-term efficiency in the provision of government services.
- HFE provides disincentives for Governments to get the best out of their economies.
- HFE has led to artificial contraction of the proportion of private economic activity and employment in recipient economies, with an associated anti-growth bias in policy.
- HFE is reducing the capacity of State Governments to provide adequate infrastructure in the Australian locations that are most important for the attraction of capital and labour in the world market.

To help overcome these problems, design parameters for a new, efficient and equitable system of Commonwealth–State funding arrangements should include:

- simplicity
- freedom for States to manage in their areas of competence
- attention to broad national outcomes
- removing disincentives and political biases against good economic performance.

CHAPTER 11: Simplicity, Transparency and Accountability – Anomalies and Unintended Consequences

- Australia's system of Commonwealth–State financial arrangements is a 'black box' which is a barrier to rigorous, open analysis and debate on ways to improve it.
- There are substantial and unnecessary costs involved in administering the system, and it has a number of inherent irregularities and anomalies.
- The concepts used by the Commonwealth Grants Commission to determine States' expenditure needs and revenue capacities – policy neutrality and average State policy benchmarks – are flawed.
- Commonwealth–State funding arrangements need to be simple and transparent.
- Australian electorates cannot properly evaluate Commonwealth and State Government performance in service delivery, because responsibilities are blurred and general purpose grants are used for purposes other than the ones they are allocated for.

11.1 Introduction

The commitment to fiscal equalisation across States, and the complexity of the process designed to achieve it, have become much greater in the late 20th century (Chapter 2). The evolutionary development of general purpose grants and specific purpose payments (SPPs) has led to a complex, opaque set of arrangements. One obvious consequence is significant problems of accountability to the electorate and other stakeholders at Commonwealth and State levels. The problem is manifested in numerous methodological approaches that make sense within the internal logic of the allocation process, but which appear anomalous to those who are not specialists within the system.

11.2 Simplicity, transparency and accountability

Horizontal fiscal equalisation

Australia's system of horizontal fiscal equalisation (HFE) has become increasingly comprehensive over recent decades. It is now more than ever the most comprehensive and complex of comparable Federations (see Chapter 7). This complexity means that the Commonwealth Grants Commission (CGC) frequently finds itself short of the data necessary to address every possible cost implication for State service provision. Consequently a degree of judgement is used to estimate particular disabilities. By seeking an impossible degree of equalisation, the CGC increases the possibility that judgement will determine outcomes.

The CGC makes its calculations available to the States annually in a 2 000-page report that requires a detailed understanding of CGC methodologies.

The system's complexity makes it inaccessible to the Australian public, while the lack of transparency in the CGC methods inhibits informed debate and, consequently, limits opportunities for improvement. This inaccessibility raises the important issue of accountability. The CGC is ultimately accountable to the Commonwealth Government. However, few Commonwealth officers and probably no Ministers are able to understand and challenge the CGC's workings. The CGC is also, in principle, accountable to the States. Every five years the States have the opportunity to question the CGC methods, but the costs involved are high and the outcomes uncertain.

Overall, the system encourages game playing between the States, which continually compete with each other to seek a greater share of grants.

Specific purpose payments

Administration of SPPs is even more costly. SPPs are usually managed and accounted for individually by the Commonwealth and the States. Commonwealth officials often monitor the activities of State officials, who then oversee service delivery programs in their State. This results in blurred accountability and generates additional costs. In addition, SPPs often require project approval and consultation mechanisms, with multileveled advisory systems and joint Ministerial approvals (e.g. the National Highways System). Even in areas of shared responsibility where there is a natural role for both levels of government (with the addition of local government in some cases), not all current arrangements are models of efficiency and cooperation.

Administrative duplication is greatest where Commonwealth funds are provided to the States through many small SPPs, requiring details to be submitted for every program or requiring the Commonwealth to consider and approve individual projects. Detailed progress reports on each program's inputs, and prescriptive accounting and audit requirements, increase the administrative burden. For example, the Commonwealth funds hundreds of community-based projects in the Natural Heritage Trust program. Input details for each of these projects have to be certified by independent accountants each year. If administrative costs increase, it is at the expense of the delivery of the intended service.

High administrative overheads also result from a lack of clarity and distorted objectives caused by the complexity of many SPP arrangements. The Australian National Audit Office (1999) has previously estimated the cost to the Commonwealth of administering seventy-one SPPs – slightly more than half all SPPs – at $68.8 million. This did not include State costs or Commonwealth contributions to State costs, which would be substantially higher than the Commonwealth costs.

11.3 Horizontal fiscal equalisation and the creation of perverse incentives

The States have adjusted to the increased importance of interstate redistribution through the CGC in recent years by allocating more resources to it. The CGC's definition of HFE creates a strong incentive for a State to prove to the CGC that the cost of providing services to its residents is higher than in other States. Financial rewards for this are substantial, which consequently discourages pursuit of best practice in public administration. For the small States, nothing a Government does is more likely to affect its economic performance in the electorally decisive short term than persuading the CGC that its disabilities are greater than previously determined.

Revenue policy has corresponding disincentive effects. A State is not significantly penalised for altering a tax rate on a base that all States utilise in comparable ways. However if it extends its tax base (e.g. by promoting economic growth), most of the revenue gains are redistributed away from it. This is a clear disincentive for States to pursue policies that promote growth (see Chapter 10).

11.4 The impossible task of separating policy

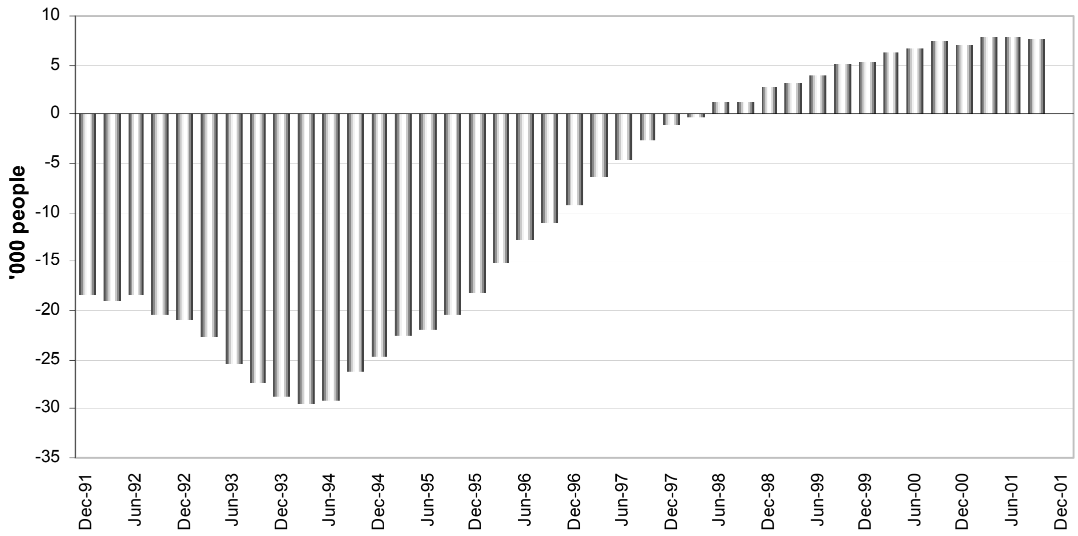
The CGC prides itself on a methodology that is intended to be neutral in relation to policies chosen by the States. However neutrality is not achieved and it could never be.

At the National Forum, CGC Chairman Alan Morris acknowledged that it is very difficult to assess States' disabilities independently of State policy. In essence, he said the CGC tries to contain only first-round policy effects.

Most of a State's disabilities are affected by its policy. The full range of CGC-measured disabilities can be placed within a continuum. At one end, disabilities such as climate, geography and geology are invariant to State policy in the long and short term. At the other end are disabilities that are directly influenced by State policy, such as revenue from almost all tax bases. In between are disabilities over which States have varying degrees of control.

It is virtually impossible to separate State policy from State disabilities. Population, a heavily used proxy for scale when determining State costs, is affected by State policies on economic development, labour market and taxation, yet the CGC sees it as being independent of policy decisions. For example, the huge swing in net migration away from and back to Victoria over the past decade is undoubtedly related to policy effects (Figure 11.1).

FIGURE 11.1: Victorian net interstate migration 1991–2001



Source: ABS cat. no. 3101.0

There are disincentives to adopting policies that encourage development for donor States and for States shifting from being a recipient to a donor State. Advantages a State enjoys from providing a service are effectively redistributed to supposedly disadvantaged States. Western Australia loses substantial revenues from mining royalties when these funds are shared between States with smaller resource sectors. Western Australia argues that while it has valuable natural resource endowments, revenue sharing is not based on the rents generated from these endowments (i.e. profits in excess of returns commensurate with capital invested in exploration and development). Moreover, the return of royalties to the State needs to be seen in relation to the State's extensive efforts to promote development and provide supporting infrastructure and services. This demonstrates the difficulty facing States that attempt to promote growth and reduce the cost of service delivery. Whatever other benefits might be derived by a State from successful, growth-oriented policies, fiscal benefits are largely redistributed.

11.5 Influencing the 'standard'

Critical to the methods employed by the CGC to determine States' relative disabilities is the establishment of average State policy in service provision, and average expenditure. The CGC describes this as the 'internal standard'. However because the standard is the average policy and expenditure and not a set benchmark, equalisation can still be influenced, intentionally or otherwise, by States' actions. (This would still be the case, but with a very different dynamic, if the internal standard were best practice among the States.)

Modifying a State's revenue collection and expenditure patterns will alter the standard, and the CGC's annual revision of State disabilities recognises this. The relatively small number of States in the Australian Federation means the effects of modification on a State are more severe, and less likely to be counterbalanced by the actions of another State. This can be likened to the effects of altering a single piece of data in a limited sample size. This is noticeable in areas of expenditure where one State dominates the total amount spent. Moreover, as the CGC applies the internal standard concept separately over many different and relatively narrow areas of public expenditure, even a small State can dominate one. For example:

- New South Wales is responsible for 61 per cent of States' total expenditure on non-urban passenger transport services
- Queensland is responsible for 48 per cent of States' total expenditure on regulatory and other services
- the Northern Territory is responsible for 47 per cent of States' total expenditure on Indigenous community services.

11.6 Consequences of focusing on capacity

The current system focuses on a State's capacity to provide a standard level of service in each area, rather than on actual outcomes of that State's expenditure. There is no guarantee that the outcomes will ensure individuals have equitable access to services important to their welfare, which is the underlying rationale for equalisation payments. This is because States are free to spend untied Goods and Services Tax (GST) grants as they see fit, and because capacity equalisation extends to all areas of State Government spending, however remote from the welfare of individuals and households.

It seems strange to an observer from outside the allocation system that a State receiving substantial grant shares enabling it to provide the same level of services as other States is not obligated to provide those services within its borders or to a particular standard.

CGC expenditure data show clear anomalies between the amounts provided to States to give them equal capacity to provide a standard level of service, and what States actually spend on those services. For example, in 1999–2000 the Northern Territory was deemed to have the most severe disability in terms of providing family and child welfare services. Consequently it was allocated over $250 per person for these services, compared to the national standard of $69 per person. However the Northern Territory Government spent $65 per person on family and child welfare services, which is even less than the standard. The Northern Territory Council of Social Services identified this apparent underspending of allocated funds in its submission to the Review (2002).

This highlights a significant problem with the CGC's current methodology. For a system that is so focused on high-level principles, it displays an extraordinary disregard to accounting for the money it redistributes.

The problem was identified by the CGC in a recent *Indigenous Funding Inquiry Final Report*:

> The Commonwealth has limited influence on the extent to which the distribution of mainstream programs reflects the relative needs of Indigenous people in different regions. Most service provision is under State control.
>
> Similarly, it has limited influence over the regional allocation of mainstream SPP funds, apart from the effects of any conditions it has attached to the payments under the agreements negotiated with the States (2001b).

This raises the interesting issue of the States' responsibility to address the disabilities identified by the CGC. There is no formal mechanism to track State disabilities over time while simultaneously considering levels of grant payments to the States concerned. There is an informal understanding between the States and the Commonwealth that funds provided to address a State's disability in the provision of education services will be spent on improving education services. However in the absence of any formal monitoring, incentives are weak for States to achieve standard levels.

11.7 Glaring anomalies in expenditure disabilities

The operation of the CGC's system of HFE includes numerous aspects that appear irrational and difficult to comprehend. This section provides examples on the expenditure side that we, and we think most Australians when introduced to them, have difficulty in understanding.

Education retention rates

The CGC methodology for the Government Schools category assumes that post-compulsory participation rates are mostly driven by State policies, with minimal non-policy influences. Accordingly, the CGC calculates post-compulsory enrolments for each State by adjusting the Australian average post-compulsory participation rate for the influence that different levels of socioeconomic status and urbanisation have on enrolments.

This approach is inconsistent with the CGC approach to the Non-Government Schools category (where it uses unadjusted actual participation rates), and does not reflect the determinants of post-compulsory participation in schooling.

All States adhere to national policy prescriptions that aim for almost all people to complete secondary school, most recently defined in the Adelaide *Declaration of Education Ministers on National Goals for Schooling in the 21st Century* (1999). The CGC methodology penalises some States for being relatively more successful than others in implementing the national policy.

The CGC identifies many other non-policy factors affecting post-compulsory participation rates:

- Language background: Other things being equal, students from a non-English speaking background are more likely to complete post-compulsory schooling than students from a predominantly English speaking background. This is linked to the higher educational and career aspirations of many migrants.
- Sector: One of the strongest positive influences on post-compulsory participation in schooling is attendance at a non-government school. Attendance at government and non-government schools varies significantly by State.
- Other factors: The labour market structure may affect post-compulsory participation in schooling. There is some evidence to suggest that States with strong labour market conditions have low rates of post-compulsory participation; however, the same is true for some States with weak youth labour markets.

Actual post-compulsory enrolments would seem to provide a better indicator of education needs than the CGC's calculations. This approach would support and not undermine the national policy goals jointly agreed by the Commonwealth and all States. Under current arrangements, the States receive no support for implementing agreed national policy goals.

The CGC approach to assessing needs for government schools contrasts with the approach for assessing corrective services disabilities. Here the cost of providing prisons is assumed to be largely dependent on the actual number of offenders in each State system, with these numbers presumed not to be influenced by State policies.

Such an assumption is curious. For example, a State's relative policing effort will largely determine the numbers of criminals brought to trial, along with differing approaches to public safety and attitudes towards diversion and rehabilitation programs. Assuming that prisoner numbers are beyond a State Government's influence is simply incorrect.

Superannuation

The current CGC methodology for equalising superannuation is an unsystematic blend of cash and accrual accounting that penalises some States for prudent management of their liabilities.

In 2001 the CGC (CGC 2001c) decided that it would:

- retain a cash standard for all assessments up to 1997-98
- use accrual data for all assessments thereafter.

However, the CGC decided that the accrual assessment of superannuation would have some special features. There would be:

- an assessment of accruing expenses for the concurrent cost of superannuation, using current labour cost disabilities
- a transitional assessment for ten years (commencing in 1998–99) comprising:
  - equalisation of one-tenth of the outstanding liability existing at the commencement of 1998–99, assessed using historical labour cost disabilities
  - equalisation of nominal interest on the unequalised portion of the outstanding liability existing at the commencement of 1998–99, assessed using historical labour cost disabilities and an interest rate disability.

Unfunded liabilities have arisen across most States because the States' share of superannuation costs has generally not been contributed as benefits accrue, but only when a benefit is actually paid – known as the emerging cost approach.

The CGC's assessment of unfunded liabilities over a ten-year period is inconsistent with States' policies on paying down these liabilities. Thirty-five years more closely resembles the timeframe by which States have committed to fully fund superannuation schemes (excluding the Northern Territory and Western Australia, which have not yet set a target date for full funding).

The CGC is therefore equalising unfunded liabilities in advance of States' payments to meet these liabilities. This is inconsistent with the old cash assessment approach and should therefore not have any place in the new accrual transition provisions.

Equalising special paydowns of unfunded superannuation liabilities (made from either privatisation proceeds, or issuing debt) is also inappropriate under either cash or accrual frameworks. These transactions have no impact on States' operating statements or net worth. They are balance sheet transactions, and capital in nature. Including such transactions is fundamentally against the CGC's principles of equalising or applying equalisation to recurrent operating expenses occurred in providing services (CGC 1999a).

It is only in the superannuation methodology that the CGC equalises balance sheet transactions.

By artificially including these balance sheet items into an assessment of operating results, the importance of superannuation within State budgets is overstated. States with low labour costs (as assessed by the CGC) that have in the past prudently managed their superannuation liabilities (by funding them concurrently or paying them down) are penalised by a large negative assessment from the CGC, based on a standard level of unfunded superannuation liabilities generated by other States that have allowed their liabilities to balloon over time. Similarly, States with high labour costs that have allowed their liabilities to grow are rewarded by the CGC process.

Big cities and urban transit demands

The CGC's current assessments do not adequately, in our view, account for the higher costs faced by larger cities due to increased urban density and greater congestion. These costs are particularly apparent in three areas: transport, social welfare and law and order. (This issue is separate from the one raised in Chapter 10, of whether it makes sense to compensate States for externalities associated with large city sizes.)

Transport

Congested cities rely heavily on efficient private (road) and public transport networks.

Road networks in congested cities typically operate very close to their absolute capacity. A minor breakdown or burst water main can cause traffic jams and delays for hours. To overcome this problem the Governments of larger cities attempt to build additional capacity. Typically there is no room at surface level, so overpasses and tunnels must be built at high costs. Expensive monitoring systems are also needed to supervise and divert traffic flows when necessary. While the CGC makes some allowance for these costs, it is far less than these cities are required to spend.

While all cities provide a public transport network, it becomes an essential part of the economic and environmental infrastructure in the largest and most heavily congested cities. While public transport systems generally only account for a small number of total trips, most of these trips occur in peak periods. Governments are therefore led to subsidise public transport, since the cost of these subsidies is less than the prohibitively high cost of expanding the road network to accommodate additional cars. The environmental costs of additional cars in already polluted cities are further reason that these cities subsidise public transport.

Social welfare

Larger and congested cities typically have higher property values, which creates particular pressure on people on social welfare or earning low incomes. State housing authorities accommodate some of these people, although most have long waiting lists. It is more expensive for State housing authorities in congested cities to buy or rent housing for their tenants. Commonwealth rent assistance to tenants also has far less purchasing power. For people who are able to find accommodation, the rent or mortgage payments consume a disproportionate amount of their income, increasing their vulnerability to other social problems.

The CGC's current assessments do not consider higher costs faced by government housing authorities in congested cities. They also do not consider additional costs to community service departments created by people who are forced to over-extend themselves in order to gain a foothold in an expensive housing market.

It might be argued that higher property values are associated with greater taxation capacity that, if utilised effectively, could fund the higher costs of housing services. Under the current HFE system, however, the greater revenue capacity is equalised away.

Inadequate recognition of the costs of social and physical infrastructure in large cities by the CGC has affected State Government capacity to maintain the quality of urban services. In Sydney at least, this seems to have some causal relationship to resistance to high levels of international migration, which, if it were to the influential in Commonwealth immigration policy, would be seriously damaging to development, nationally and in all States.

Law and order

International studies have demonstrated the positive correlation between crime rates and town size (International Crime Victims Survey Working Group 2000). The CGC's current assessments of State spending on law and order do not properly reflect this influence. A small allowance is made for extra demands on police, but none for extra demands on courts and the prison system.

Equal treatment of Indigenous Australians

The CGC assumes that Indigenous people, identified in the five-yearly census, are comparable in terms of their needs for State services if they are comparable in terms of characteristics such as age, location, income and English fluency. This approach is questionable.

The Census populations are based on self-enumeration, and show significantly different trends over time across States.

Table 11.1: Census counts of Indigenous people (by place of enumeration)

Census	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
1971	23 873	6 371	31 922	22 181	7 299	671	255	23 381
1976	40 450	14 760	41 345	26 126	10 714	2 942	827	23 751
Increase %	69	132	30	18	47	338	224	2
1981	35 367	6 057	44 698	31 351	9 825	2 688	823	29 088
Increase %	-13	-59	8	20	-8	-9	0	22
1986	58 999	12 600	61 250	37 786	14 285	6 716	1 059	34 738
Increase %	67	108	37	21	45	150	29	19
1991	69 999	16 729	70 102	41 769	16 223	8 882	1 592	39 893
Increase %	19	33	14	11	14	32	50	15
1996	101 485	21 474	95 518	50 793	20 444	13 873	2 899	46 277
Increase %	45	28	36	22	26	56	82	16
2001	119 865	25 078	112 772	58 496	23 425	15 773	3 576	50 785
Increase %	18	17	18	15	15	14	23	10

Source: ABS cat. no. 3105.0.65.001

The actual utilisation of services by Indigenous people varies widely across States. This is seen in the utilisation rates for hospital services (Table 11.2).

Table 11.2: Hospital utilisation rates

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	AUST
Indigenous	238.0	220.2	408.1	537.6	471.5	70.0	254.9	554.7	378.4
Non-Indigenous	167.7	186.4	168.9	162.9	207.0	142.7	134.9	142.6	173.9

Source: CGC 2002b

While differences in utilisation of health services could reflect policy, the differences are sufficiently large that other factors at least need to be considered – differences in the extent of self-enumeration and different needs for services.

Anecdotal evidence suggests that Indigenous people's willingness to self-identify varies across Australia. Similarly anecdotal evidence suggests that some of the differences in utilisation of health services reflect different needs. For example, some capital cities have significant Indigenous populations that have only relatively recently moved into the city from dispersed areas, and have generally lower health status.

Experimental Australian Bureau of Statistics Socioeconomic Indexes for Areas (SEIFA) data for Indigenous populations also suggests significant differences across States (Table 11.3).

Table 11.3: Experimental SEIFA indexes for ATSIC regions containing capital cities (based on the 1996 Census)

City	Index
Sydney	895.2
Wangaratta (includes part of Melbourne)	882.8
Ballarat (includes part of Melbourne)	897.7
Brisbane	897.9
Perth	911.6
Adelaide	908.2
Hobart	874.6
Queanbeyan (includes Canberra)	898.5
Darwin	915.0

Source: CGC 2001b

It is anomalous that the CGC has not examined these issues.

Scope of expenditure equalisation

The current CGC method attempts to consider States' needs to fund almost every area of expenditure. This ranges from bread and butter services such as education and health, to barbeque facilities, tourism promotion, land clearing, fish farming and nuclear energy research.

There is no sensible reason for taxpayers in one State to be forced to subsidise golf courses in another. Yet the CGC earnestly attempts to assess the differences between various States' costs for, for example, golf course funding programs, on the basis that they all should have equal capacity to supply from the public purse 'average' amounts of golf courses.

An alternative to the CGC's all-encompassing approach rests on the notion of merit goods, which are important goods and services provided by government (e.g. health and education). Merit goods are critical for equality of opportunity among Australians and necessary on public policy grounds, rather than being closely substitutable for private consumption.

Assessing States' relative abilities to provide merit goods is a more reasonable basis for some interstate transfers than equalising States' abilities to fund programs to provide tennis courts and subsidies to industry.

11.8 Anomalies in revenue disabilities

Two examples illustrate anomalies in the CGC's assessment of revenue disabilities.

Scope of revenue equalisation

The CGC's current approach to revenue assessment – focusing on what States do – does not reflect States' revenue raising capacities. The mechanics of State taxation systems is not a measure of taxpayers ability to pay, which is the commonly recognised principle used for achieving fairness in any tax system.

A State's revenue base is measured by the transactions it taxes, with adjustments to account for instances where the transactions it taxes differ from those taxed in most other States.

In some cases, the effects of differences between individual State taxation policies cannot be excluded when measuring their respective revenue bases. When this happens the CGC uses proxy or sub-global measures to reflect the activity that States are taxing.

Under the CGC methodology, revenue raising capacity is assessed in terms of revenues a State would collect if it applied the average tax rate to each of a large number of detailed tax bases and other revenue sources, as currently used by the States. This approach effectively assumes that there is no substitutability among different ways of raising revenue. While many taxes appear to be different, from an economic point of view they are equivalent. For example, the value of national income and output must be the same, consequently income and output (or uniform sales tax) must provide similar bases for taxation. All of the typically used tax bases are more or less close substitutes in terms of their incidence. Smaller States, notably the Australian Capital Territory, are assessed as having low revenue raising ability when they have relatively high household incomes and, in some cases, strong tax bases, because they cannot access all State tax bases, or some bases are of below-average size.

The States' ability to raise taxes is linked to gross state product. Different taxes are highly substitutable as they have similar incidence among households. There are two obvious options for a small jurisdiction such as the Australian Capital Territory to raise a typical level of revenue:

(1) Constitutionally, any State can apply an income tax surcharge or provide a rebate to be collected or distributed by the State, or by the Australian Tax Office with the Commonwealth's consent. While this option is generally considered politically difficult, it is available.

(2) States could raise more revenue by increasing land tax or conveyancing duty, or reducing concessions. In short, it is possible for every State to raise more revenue with essentially neutral impact on income distribution. Indeed, as the current system of grant allocation appears actually to have a regressive effect on vertical income distribution, partly because it does not properly capture the ability of all higher-income States to raise revenues, there are probably alternatives that would improve vertical equity.

The CGC's current revenue assessment focuses too narrowly on the detail of what States do. This narrow focus does not adequately reflect a State's revenue raising capacity. A broader assessment of each State's citizens' ability to pay would be more appropriate.

Fairness is an essential characteristic of any tax system, and the principles of horizontal and vertical equity are central to the concept of fairness. Horizontal equity is based on the notion that like individuals are treated equally. Vertical equity requires that if individuals are to experience unequal burdens, an individual should pay more than another if he or she has greater capacity to pay.

The 'ability to pay' principle is widely accepted as an equity rule that can guide tax policy. Income and wealth are the most common measures of ability to pay. A person's economic capacity is increased when income accrues in the form of money income, such as wages, interest and dividends, or imputed rent from owner-occupied housing, or from appreciation of assets.

A more appropriate approach would be to measure the revenue raising capacity of States according to the widely accepted taxation principle of ability to pay. A State's revenue raising capacity would be measured according to its overall levels of income and wealth, as a reflection of ability to pay. In these terms there are not major disparities in the States' abilities to raise revenues of a moderate proportion of gross state product (i.e. around 8 to 10 per cent which is typically raised now).

Mining revenue and economic rent revenues

The CGC assesses each State's capacity to raise mining royalties on the basis of its mining industry's 'adjusted value added'. This measures total turnover less a range of expenditures incurred in production, but excludes important costs faced by the industry. Consequently it is not a measure of economic rent generated by the mining industry in each State.

The CGC's methodology is anomalous in not being based on mineral rent, as this is ultimately the amount available for States to tax. In the short term, States can actually take more than the rent generated (reflecting the sunk costs of existing producers). In the long term, attempts to take more than the rent will reduce production below economic levels, as producers will no longer be generating the returns they need to continue investing in exploration and mine development. In effect, the CGC methods penalise States that maximise the economic value of their mining industries by allowing companies to earn normal profits before applying State royalties and taxation.

The CGC measures each State's mining revenue capacity using the following formula:

- a version of value added (i.e. turnover, plus increase in the value of stocks, less purchases and selected expenses)
- less wages and salaries and related on-costs (payroll tax, workers' compensation and superannuation)
- less a ten-year average of capital expenditure
- less a five-year average of 'on lease' exploration expenditures (about 23 per cent of total exploration expenditures)
- multiplied by an elasticity adjustment to recognise the impact of royalty rates on production levels.

This formula fails to measure economic rent in the following ways:

- The rate of return on investment that is required for all investment in the mining industry is not allowed as a cost of production.
- Most exploration expenditures (and associated rate of return requirements) are not recognised, although these are the crucial first step in developing the mineral resource. These exploration expenditures are high risk and can have long lead times to final development of the resource.

The CGC's current revenue capacity measure treats major industry costs as part of the industry's capacity to pay. The elasticity adjustment is not a solution – if State royalties do not allow even normal profits to be achieved, investment and future production is lost. In these circumstances, attempts to raise an additional annual quantum of royalties could cause, in the long term, a loss of annual revenue capacity many times greater than assumed in the CGC's elasticity adjustment. Some valuable mineral deposits may be able to support taxation at several times the standard level, without any adverse effect in current or future production, while others would never be developed at tax rates well below the standard (Garnaut and Clunies Ross 1983).

The CGC's method was motivated by an attempt to reflect some form of average of States' actual royalty systems (which vary from production royalties to full economic profit taxes). However in doing this, the CGC appears to be confusing the mechanics and intents of State royalty systems. While State Governments often do not tax rent directly, they are usually aware of the importance of rent (e.g. reflected in royalty concessions and often low rates of production royalties). Where they are not, the effects on the industry are likely to be significant.

The CGC's reports suggest some uncertainty in its own thinking. In Volume 2 of the 1999 *Review Working Papers*, it states: 'even if the opportunity cost of capital were regarded as a cost that reduced capacity, it would not follow that the introduction of a rate of return adjustment would increase the accuracy of the assessment or the degree of fiscal equalisation' (CGC 1999b). It is difficult to understand what lies behind this statement.

Apart from not recognising all the costs faced by the mining industry, a more general problem with the CGC's method is the lack of analysis of historical actions by the States that have enlarged or hurt the mining industry. State policies that may have affected industry development include industrial relations, property rights, environmental management, facilitation roles, development of supporting infrastructure, geological surveys, investment attraction measures and development-friendly royalty regimes.

These are not trivial issues. The rent value per unit value of production varies greatly across types of minerals, the nature of a mineral deposit, the location of a deposit in relation to markets, management, labour skills, and commercial, social, transport and communications infrastructure. The rent value of some natural resources, as revealed by operating rent tax systems in jurisdictions around the world with functioning mining industries, range from 0 per cent of the CGC's assessed State mining revenue base, to over 75 per cent. The CGC assesses a mine's contribution to a State's revenue capacity as the 'average' ratio for all States of mining revenue to the CGC calculation of the mining revenue base. Inevitably, this will be much larger than the rent value of the mine in some cases, and much smaller in others. In the former case, if a new mine is established with an economic value similar to any new investment of similar size in the manufacturing or service industries, but with little rent value and therefore little or no contribution to State mining revenue, the State's grants from the Commonwealth will fall. The mine's contribution to State finances will be negative, perhaps by a large amount. The negative State fiscal effect is compounded if, as is commonly the case, mine development requires the State to provide some infrastructure – and the capital component of this infrastructure is not assessed in calculating the State's expenditure needs.

11.9 Growth and infrastructure demands

A number of aspects of the CGC's process give insufficient and distorted consideration to expenditures States incur to service growing populations and economies, and to help foster conditions for growth.

Capital needs

The CGC assesses capital needs indirectly through recognition of costs in States' recurrent budgets (i.e. depreciation and interest charges).

The details of the CGC approach are complex. Important elements of the calculation include:

- depreciation allowances which recognise the quantity of capital stock needed to service the State population, and the rate of depreciation of the stock
- additional funding for States receiving higher per capita levels of capital grants
- additional funding for States with higher per capita annual expenditure requirements. States' relative annual expenditure requirements are assumed to be partly in line with relative depreciation allowances on total stocks, and partly in line with the relative cost of providing recurrent services.

In the last two cases, costs are recognised through the impact on State interest charges, based on at least a forty-year accumulation of capital outlays.

Setting aside more detailed methodology issues (such as the appropriateness of using factors for recurrent services in a capital context), the CGC's current approach fails in the following fundamental ways:

- The impact of population growth on the per capita level of State assets and liabilities is not accounted for. States with higher growth will see a greater per capita reduction in net assets.
- The impact on capital expenditure requirements of growing demand for services (e.g. due to growth in population and economic activity) is not accounted for. States with higher growth will need to augment their capital stock to a greater degree (in per capita terms) to cater for this additional demand. The CGC's capital expenditure factors are based on comparisons of total demand for services between States (i.e. depreciation of the total stock, and recurrent services provided to the total population). These are relevant to capital expenditure requirements resulting from stock depreciation and improved community-wide services, but not for capital expenditure to meet demand growth.

11.10 General subsidies to public corporations

The CGC's assessments of economic subsidies reward some types of economic support over others.

The CGC has paid a great deal of attention to the equalisation of general subsidies for urban public transport, although, as discussed in Section 11.2, the additional costs in big cities are not adequately recognised. However much less attention is paid to equalisation of general subsidies for transport, power and water in dispersed areas.

Subsidies for urban public transport are assessed by the CGC because it is standard policy for States. The assessment is based on elaborate calculations of the demand for and cost of delivering urban public transport services, and the capacity to raise revenue (based on a standard fare structure). Demand reflects the detailed characteristics of each city.

The CGC currently assesses economic subsidies in other areas as follows:

- Electricity: based on a 'one size fits all' measure of demand for concessions (the number of pensioners plus persons in remote areas). No assessment of costs and revenue capacity.
- Water: based on a 'one size fits all' measure of demand for concessions (the number of pensioners plus persons in non-urban centres). Costs are assumed to reflect the availability of water relative to demand in each major region of Australia (with a weighting for groundwater) and arbitrarily discounted by 50 per cent. There is no explanation as to why costs should be linked to water availability. Transport costs and scale diseconomies are ignored. There is no assessment of revenue capacity.
- Freight transport: there is no assessment of cost disabilities.
- Passenger country transport: the CGC's assessments are based on a 'one size fits all' measure of demand for concessions (number of pensioners, plus persons aged eleven to eighteen, plus other persons with 50 per cent weight, plus a double weighting for non-metropolitan populations). There is no substantive assessment of costs and no assessment of revenue capacity.

11.11 Equalising States versus regions

The HFE principle used by the CGC requires all States to be given the capacity to provide the same standard of services. In interpreting this general principle, the CGC takes into account the different level of services States provide to different types of localities and regions. In practice, practical data considerations limit the extent to which the CGC can do this. Examples include:

- Vocational education and training: the CGC allows for more demand in larger urban centres (compared with smaller urban centres and rural areas).
- Health: the CGC reflects the lower access to services in rural and remote areas as a cost saving for Governments.

- Hospital services: the CGC allows for a higher capital cost in larger population centres (even to the extent of higher costs in Sydney and Melbourne compared to other capital cities), reflecting the greater sophistication of services in larger cities.
- Urban transit: the CGC allows for the greater use of subsidised public transport by commuters in large capital cities.

As a result, States with a higher proportion of population in regions receiving higher service levels will, in effect, receive funding to sustain a higher average level of services across the State. This gives an unexpected outcome to the CGC's general equalisation principle.

11.12 Problems despite detailed CGC work

We do not see the many problems of administration, anomalies and unintended consequences in the current Commonwealth–State funding arrangements as a criticism of the people and organisations with the difficult responsibility of administering the system. Most of the work done to implement Commonwealth–State financial arrangements is of high professional quality. In fact, the quality and inventiveness of the CGC's people and work have so far prevented a dysfunctional system from collapsing. In reality, the CGC and agencies administering SPPs have been given an impossible job. Genius in implementation has postponed, but cannot avoid, realisation of the need for fundamental reform.

CHAPTER 12: Overall Assessment and the Need for Reform

- Australia's system of Commonwealth–State funding arrangements has been assessed on the basis of its efficiency, equity, and simplicity and transparency.
- There are deficiencies on all criteria.
- The only justification for a system that has large deadweight costs of resource misallocation and administrative overheads, and reduces incentives to improve efficiency would be that it increased equity.
- The Review has shown that the current system has a negligible, or perhaps an adverse, effect on equity at the levels of individuals and households.
- The current arrangements are complex, opaque and diminish the accountability of Commonwealth and State Governments for delivery of services and for fiscal policy.
- Uncertainty about future SPP funding, and about responsibility for health and aged care in Commonwealth–State financial arrangements, is a barrier to Governments planning their financial futures better in the face of demographic change.

12.1 Assessment criteria

The Terms of Reference for the Review (see Section 1.3) define three major criteria for assessing the Commonwealth's current system of allocating grants to the States:

(1) efficiency

(2) equity

(3) simplicity and transparency.

The Terms of Reference also require the Review Committee to consider the budgetary circumstances of the various Governments and the social and economic characteristics of their residents.

This chapter draws together the conclusions of Chapters 9, 10 and 11, which examined the current system against each of the three major criteria, and sets out the Review Committee's overall assessment of the current system.

12.2 General considerations

The Review Committee considered it important to assess current grant allocation arrangements against the relationships between the Commonwealth and the States envisaged at the time of Federation, and to examine how the arrangements have changed over time. This was done in Chapter 2.

When reviewing Australian systems and structures, it is standard practice to compare them against relevant overseas benchmarks. Arrangements in other Federations were examined in Chapter 7.

Australia versus other Federations

Two major conclusions emerged when comparing Australian arrangements with those of the most similar Federations – Canada, Germany and the United States.

(1) Despite having the smallest inherent disparities of economic circumstances among its States, Australia has the most comprehensive approach to horizontal fiscal equalisation (HFE). It fully equalises both expenditure and revenue factors, down as well as up, whereas others equalise partially (Canada and Germany) or little at all (the United States).

(2) The Australian system of fiscal equalisation is notable for overriding the allocation of almost all specific purpose payments (SPPs).

While the Review did not analyse arrangements in unitary States such as the United Kingdom, France or Japan, these countries do not appear to apply fiscal equalisation across provinces or regions to the same extent as Australia. In the United Kingdom, and most other unitary States, most Government expenditure programs with significant implications for equity are distributed by local area according to the location and circumstances of the intended individual beneficiaries – regardless of region. While some unitary States provide region-specific assistance programs at times, these appear to be exceptional and to address the circumstances of economically depressed regions.

Australia is not a unitary State, either constitutionally or in the mind of the Australian community. While there is a strong sense of national unity, there is an equally strong sense of freedom to be distinctive and to do things differently in each State, but within a national framework (e.g. the recent agreement on stem cell research). With only moderate inherent differences in economic circumstances and opportunities among jurisdictions, Australia's extreme approach to HFE is striking – as is the extent of its vertical fiscal imbalance. While these facts are clearly related, high vertical fiscal imbalance does not require an extreme form of HFE, particularly given the relatively small intrinsic economic differences between the Australian States.

Australia's grants history

The founders of the Australian Constitution appear to have envisaged that its grants power would enable the Commonwealth (which initially had very limited capacity to deliver services of any kind itself) to provide funds to a State:

- for development projects of national significance
- for other common objectives (e.g. major development projects)

  or

- to enter into an agency-type arrangement with a State whereby it performs some function for the Commonwealth.

Since World War II, and particularly since the Whitlam Government, SPPs have increased in number, scale and complexity (see Chapter 5). General purpose payments are also now at historically high levels as a proportion of State revenues, although they have grown less rapidly than SPPs over the last several decades.

The Commonwealth's taking over of exclusive powers over income tax during World War II (see Chapter 2) was the biggest contributor to this increase in vertical fiscal imbalance. More recently, vertical fiscal imbalance has been further increased by the High Court invalidation of State franchise fees and the States' voluntary withdrawal from certain other taxes (e.g. financial transactions taxes) as part of national tax reform.

Emergence of major areas of shared responsibility

Over the last half-century, with the increase in vertical fiscal imbalance and, in particular, the growth in SPPs, the Commonwealth has taken on more responsibility in areas that are assigned by the Constitution to the States, including education and health. These sectors are important for national economic development and equality of opportunity, and the reasons for an increased Commonwealth role in relation to them still seem compelling.

- The Commonwealth Government took on responsibility for public funding to non-government schools in response to political contention over public funding for private (church-related) schools, which was difficult to resolve completely at State level. The States continue to dominate the funding and operation of government schools.
- In response to shared national aspiration, the Menzies Government effectively established the Commonwealth as the main provider of higher education funding. This role is now entrenched at Commonwealth level, with wide State support.
- The Commonwealth has enlarged its role in vocational education and training over the past twenty years, although less so recently. This area is an example of a new type of federalism, where the two levels of government develop a shared national framework within which each State can apply its specific approaches. The Australian National Training Authority coordinates the national framework and reports to a Commonwealth–State Ministerial Council. Advantages of a national approach include national recognition of skills acquired within any State.

More recently the Commonwealth has become a major participant in the funding of public health services, despite this being primarily the States' constitutional responsibility. The Australian National Training Authority has no equivalent in this area, but a Ministerial Council develops broad priorities and a national framework. Even though the States have substantial discretion to determine the resources they apply, Commonwealth funding and associated mutual commitments influence outcomes. Health is now effectively an area of shared responsibility and appears certain to remain one.

Implications

The Review Committee believes these important changes in Federal arrangements must be considered in any assessment of the system of allocating Commonwealth grants to the States. Clearly the Commonwealth now has a large and permanent role in allocating financial resources to public service delivery in areas of great importance to the welfare of individual Australians, particularly education and health.

12.3 Equity assessment

For the reasons outlined in Section 9.3, the system should be assessed against equity criteria on the basis of the outcomes it achieves for Australian individuals and households – not States.

Vertical equity: the NATSEM findings

Work undertaken by the National Centre for Social and Economic Modelling (NATSEM) for this Review modelled the vertical equity effects of current Commonwealth–State funding and two benchmark alternatives – an equal per capita distribution of Commonwealth grants and a distribution based which returns revenues to the States from which they were collected. See Chapter 9 for more detailed analysis of the NATSEM study.

Most relevant to this Review, the two alternative scenarios do not significantly alter vertical income distribution relative to the status quo. A move from the present system to a system of equal per capita allocation would actually *reduce inequality* slightly, mainly because the current system redistributes income to the high income Territories (Chapter 9).

Horizontal equity

We believe there is no strong case for making large interstate transfers in the interests of horizontal equality in Australia. Australia has an inherently more even distribution of economic circumstances and household incomes across States before equalisation than other Federations (see Chapter 7). The costs of HFE would be much lower if its aim was to ensure that each State were able to provide a good standard of services, rather than to equalise all States – down as well as up.

The current system does nothing to address inequities in access to services within States, does not require funds to be used where needs were assessed, and overrides SPP allocations determined by the Commonwealth, often within explicit national (Commonwealth–State) arrangements.

Also, to the extent that the current HFE system equalises across all public services, it goes far beyond what is justifiable on grounds of equity. The case for HFE would be stronger if equalising access to public services were confined to the range of *merit goods* that most affect equity and in particular equality of opportunity (i.e. education, health and, because of special issues of equity, Indigenous community development).

12.4 Efficiency assessment

The CoPS study

The Centre of Policy Studies (CoPS) was commissioned to investigate the effects of the current system on Australia's economic efficiency (see Chapter 10). The study focused on quantifiable efficiency effects of current HFE arrangements. (Quantitative methods cannot, in the present state of economic science, be applied to all potential channels through which Commonwealth–State funding affects national economic efficiency – particularly dynamic efficiency.) The main effects investigated were:

- the tendency for the public sector to play a larger role in recipient States (the 'flypaper' effect)
- congestion effects
- migration effects.

The study found that a move from the present system to allocating Commonwealth grants among States on an equal per capita basis would increase the economic welfare of the Australian community by between $150 million and $250 million per year. It also concluded that these gains would not be seriously compromised if the move to equal per capita funding were phased in over ten or twenty years by freezing the real per capita grants of recipient States at their initial level.

Moving to a State of origin distribution would generate a welfare gain of about $280 million per year.

Other dimensions of efficiency

The high overhead costs of administering the current system of Federal financial relations adds to the state resource allocation effects identified by CoPS.

The CoPS study examines only a few of the current system's effects on efficiency and drivers of economic growth. The National Forum addressed a range of other potential effects. For example, Nick Morris of Tasman Economics argued that the CoPS study understated the efficiency costs of current arrangements by not considering the effects of grants on States' production functions. He argued that grants affect in major ways the choices made and methods used by some States to provide public services. He identified several other factors contributing to understatement of the welfare costs, including effects on infrastructure spending and the take-up of new technologies.

Several people argued strongly in submissions to the Review that the current arrangements significantly affect the political economy of development. While State Governments do not pursue development only for the impact on their budgets, the budgetary impact of the current system noticeably weakens incentives for making political decisions to pursue development.

Chapter 10 explained how the Commonwealth Grants Commission (CGC) redistributes the revenue benefits from economic development around the nation, without similarly sharing many of the costs of economic development borne by State Governments.

In addition, the artificial enlargement of the public sector and relative diminishing of the private sector in recipient economies may reduce the priority of economic development in policy making. The systematic transfer of resources away from the States that are most important in attracting and retaining high-value, internationally mobile capital and labour is likely to be damaging to economic growth in all States and Australia as a whole.

Efficiency arguments for horizontal fiscal equalisation

Efficiency arguments to support HFE have often been raised. It is said that fiscal equalisation redistributes windfall fiscal gains to avoid artificial attraction of migrants seeking out the more favourable fiscal residuum resulting from a windfall (e.g. a mineral find). However, revenue capacity in the resource sector is not in practice assessed on the basis of economic rents, no account is taken of the different efforts made by States to develop their resource bases or other advantages, and many of the costs associated with economic development are not taken into account by the CGC. Further, to effectively combat any tendency for counterproductive migration to advantaged regions State transfers should be spent in ways that leave equal fiscal residua for individuals contemplating movement.

Arguments that current HFE arrangements enhance efficiency in Australia are unconvincing. To the contrary, enlarged and/or high-cost public sectors in recipient States demonstrate allocative distortions of greater significance than the effects to which attention is drawn in defence of the current system.

Overall conclusions on efficiency

The system has negative resource allocation effects on efficiency, employment and economic growth which, as far as they are measurable, are moderate. These costs might be tolerable if the system contributed significantly to achieving equity among individual Australians. However, it does nothing for vertical equity and may even have small regressive effects. Efficiency could be better achieved by directly addressing outcomes for individuals and households.

Overall, the system has no equity advantages that justify:

- an annual $200 million cost from resource misallocation
- the deadweight costs of administering the system
- other efficiency costs of a dynamic kind, some related to the political economy of State development and growth policies, which are potentially larger but difficult to quantify.

12.5 Simplicity, transparency and accountability

A complex and little-understood system

One of the most striking features of the Australian system of HFE, whether viewed in isolation or compared to the systems of other Federations, is its extraordinary complexity. The methodology for calculating allocations has, over time, been elaborated in increasingly fine detail.

As observed in *Issues in Commonwealth–State Funding* (Garnaut and FitzGerald 2002), the system reflects what appears to be a particular Australian genius for almost infinite bureaucratic elaboration, usually in pursuit of a perceived concept of equity.

Complexity has a number of adverse effects, even if the principles on which arrangements are being elaborated are sound, including:

- increasing transaction costs in running the system
- difficulty in evaluating performance and efficiency
- weakening democratic accountability because it almost always limits public understanding of what is being done.

The CGC claims this complexity makes its calculations more precise, but in reality it generates increasing complexity that requires unavailable data to make the necessary calculations. Invariably, more weight is placed on the judgment of those making the assessments.

To its credit, the CGC has not generally been controversial and at times has acquired something of the status of an arbitrator. However, the CGC removes important national budgetary decisions from the accountable political process to officials acting with a great deal of autonomy. Donor States have questioned this recently in reaction to the CGC's increasingly extreme approach to equalisation.

Overall, the current system of HFE implemented by the CGC is a mystery to almost the entire Australian community.

Complexities in specific purpose payment allocation

The most important source of complexity in the SPP arrangements is in the interaction between Commonwealth and State Government responsibilities. The Commonwealth places conditions on funds it provides in areas of primary State responsibility, but the States in practice can exercise considerable discretion. With the SPPs, the Commonwealth is providing, to some extent, fungible money (Garnaut and FitzGerald 2002).

When both levels of government seek to influence spending and emphasise their own roles to the electorate, the public has understandable difficulty in allocating responsibility for good or poor performance. Federal election campaigns can be fought on issues that are primarily the States' responsibility (such as health) without the public being able to assess properly the extent of real Federal or State influence in these areas.

This dual government influence on spending also increases the complexity of public sector operations. Costs mount from duplicated guidelines, reporting arrangements and funding cycles, which affect individuals and households that are clients of the services involved, and organisations such as welfare groups seeking to gain Government support. This issue was a major theme of representations from both business and community welfare groups in the course of this Review.

Towards Cooperative Federalism

When considering simplicity, transparency and accountability, there is much to recommend the system originally envisaged in the Constitution. In core areas such as health and education, and social security, one level of government was responsible for service delivery and it was to raise and spend funds that were required. Given the high degree of vertical fiscal imbalance that is now permanent in Australia, it is inevitable that the Commonwealth will remain substantially involved in areas originally the domain of the States. Some consider this an unfortunate negation of the original Federal compact, and some an appropriate expression of heightened national perspectives in the provision of services most important to Australians.

The Commonwealth has an entrenched and important role in aspects of school education, vocational education and training and an almost exclusive role in higher education (see Chapter 5).

Coordinated approaches to setting broad objectives and priorities can be positive, and the Commonwealth has a valuable potential role in coordination and leadership. Where the two levels of government cooperate efficiently, the interaction can enhance outcomes for the community.

That being so, the present system of SPP allocation cannot be abolished and largely replaced by an enlarged system of untied grants – albeit that the CGC methodology is, in one view, seeking to do just that.

Instead, the principles elaborated in this assessment should be applied (i.e. the arrangements which are costly in efficiency terms and contribute nothing to equity should be replaced with arrangements that directly improve outcomes for individuals and households rather than States).

Some positive attributes of SPPs can be seen in the better functioning areas of SPP allocation, for example:

- the Commonwealth taking on a leadership role, articulating common strategies and national objectives, and coordinating State efforts
- well-functioning Ministerial-level forums working cooperatively rather than divisively
- agreements focusing on objectives and relevant performance measures rather than control of inputs
- a willingness to allocate service delivery to the level of government best placed to implement programs
- removing micromanagement and complex administrative overlap.

Arrangements work best when they are straightforward, transparent and have clear lines of accountability from political levels through to the electorate.

Reform of the processes for SPP allocation should be guided by these characteristics, with the allocation of untied grants not overriding those processes.

12.6 All States have potential for economic growth

Many Australians believe that substantial transfers to at least two States are justified on the grounds of their inferior economic prospects. This inferiority is thought to be a permanent feature of the Australian environment.

However, despite deep pessimism about growth prospects in South Australia and Tasmania, all Australian States have reasonable prospects for economic growth. In this, Australia is unlike comparable Federations. It is important that Commonwealth–State financial relations reward, rather than discourage, all States to maximise their opportunities.

South Australia

South Australia has considerable strengths for development in the modern global economy. Its low-cost, productive urban facilities make it a competitive location for footloose service industries. Its horticultural industries are well placed to take advantage of buoyant Australian and international demand for high-value products.

South Australia has overcome the short-term costs of adjusting to the 1992 State Bank collapse, which required over $3 billion in special funding and almost doubled State public debt. It underwent disproportionate structural adjustment out of highly protected, previously inward-looking industries with the liberalisation of Australian import barriers in the late 20th century. These challenges were compounded by a State political economy that has been influenced by a history of exceptional transfers through grants and protection from the rest of Australia – recognised by economists as the political economy of the rent-seeking society (Krueger 1974).

In the 1990s South Australian growth was damaged by structural challenges and, over a longer period, an overly cautious approach to competitive markets. This has generated excessive pessimism about South Australia's prospects for vigorous growth in a competitive environment. South Australia's employment, population and output growth was reasonably strong in the decade before the State Bank collapse, only moderately behind Australia as a whole. Stagnation after 1992 was associated with a widening of the gap between State and national performance. The adjustments to the State Bank disaster and trade liberalisation having been largely completed, there is no a priori reason to expect the exceptional gap between State and national growth to continue. A new Government in South Australia is emphasising the State's growth prospects, and has the opportunity through policy reorientation to place the State on a more favourable growth trajectory. In this context, the legacy of the rent-seeking society is a burden which could be eased by reform of Commonwealth–State relations.

Tasmania

Tasmania has almost completed a difficult structural change due to the decline of some traditional energy and capital-intensive industries that were once dominant in the economy. At the same time, Tasmania's high-value agricultural industries, and the footloose services industries servicing national and international markets, have now been growing strongly for long enough to significantly affect the State's economic aggregates. Tasmanian Chamber of Commerce and Industry Chief Executive Tim Abey commented recently: 'after a decade of being belted up unmercifully in the economic stakes, Tasmanians now have much to look forward to' (Tasmanian Chamber of Commerce and Industry 2000). The Tasmanian Chamber of Commerce and Industry (2001) has estimated that the Basslink project alone will inject over a billion dollars into the Tasmanian economy over the next decade and sustain almost 1 000 new jobs. Tasmanian Treasurer Dr David Crean reinforced this positive outlook recently, stating in the 2002–03 Budget Speech that the jobless rate has declined from '10.5 per cent to 8.6 per cent over the past three and a half years substantially due to jobs growth…the unemployment queue has reduced by more than 4 000 people' (2002).

The Territories

The Territories also have good growth prospects.

The Northern Territory's economy and population have grown far more strongly than the rest of Australia through the past two decades, and official projections by the ABS anticipate it will continue to do so. The gradual improvement in Darwin and State infrastructure – soon to be joined by completion of the Alice Springs to Darwin railway – have allowed the Territory to make increasing use of the advantages of proximity to Asia. After the interruption of the Asian financial crisis 1997–98, neighbouring Asia is again growing much more strongly than the rest of the world. Natural resource discoveries, most importantly offshore petroleum, provide exceptional prospects for a small economy.

The Australian Capital Territory has been expanding as a centre for private sector service industries, serving national and international markets. It has advantages from the strongest per capita education, research and skilled labour base of any State. Its competitiveness as a location for high-value service industries is enhanced by rising real estate and other costs in Sydney.

12.7 The need for reform

The Review of Commonwealth–State Funding has revealed large weaknesses in established arrangements. Around these weaknesses are intensely politicised differences among the States on the way untied grants are distributed, and between the Commonwealth and States on the levels and character of SPPs.

Identifying weaknesses – even major flaws – in the existing system, and recognising deep differences within the Australian community about them, does not in itself make a case for change. The case for reform also requires demonstration of an alternative that would work better in practice. It must be capable of being implemented with transitional arrangements that avoid costly dislocation, and generate overall benefits that exceed the costs of transition. It must be feasible within the Australian political framework.

There is a better model, and a path of implementation that would avoid dislocations in transition while retaining most of the net benefits of reform. This creates an attractive opportunity for reform to achieve greater equity, efficiency and transparency in an important area of public policy. Reform always requires political and community leaders to make the case for change once they have been convinced of its necessity or value. We hope that leaders on both sides of politics and at Commonwealth and State level will give thought to the alternative model, and weigh its merits.

The best model is not an improved version of the status quo, patched up to remove the most obvious flaws in methods of assessing untied grants to the States (see Chapters 4, 5 and 11), and of management of SPPs (see Chapters 2 and 5). It would be possible, for example, for the CGC's calculations to take sensible account of public investment needed by the States for relatively strong economic growth. Economic rent, rather than sales value, could be introduced as an indicator of taxation capacity in the natural resource industries. Inconsistencies in accrual and cash accounting that have introduced anomalies into assessment of superannuation-related expenditure disabilities can be resolved.

However, small improvements would not remove the biggest weaknesses in the CGC's current interpretation of HFE.

- It would continue to distort the size of the public sector, and therefore the political economy, of States that are the largest recipients of transfers via the Commonwealth.
- It would continue to drive a wedge between the effects of State policies on State economic performance, and the benefits enjoyed by the relevant State communities.
- It would continue to override Australians' preferences in relation to the availability of minimum levels of the most important merit services across the national community.
- Most importantly, a system that is already so complicated that only a few Australians understand it would become even more complicated and opaque to community interest and accountability – despite its relevance to delivery of services of great importance to all Australians.

Equally there is little merit in marginal reform of the established system of SPPs. In submissions and other representations to the Review, interested parties on both sides of Australian politics and in all States recognised the need for fundamental reform of funding through SPPs because of:

- blurred accountabilities derived from overlapping Commonwealth–State responsibility
- deadweight costs of game-playing over funding and responsibility
- resulting underperformance in areas that are most important to Australians.

Another important consideration is the potential benefits of a less adversarial environment for Commonwealth–State and State–State relations. The existing arrangements promote conflict. In the past, transfers to fiscally weak States have contributed to easier interstate and intergovernmental relations. However the same cannot be said of the system of transfers today. As a non-elected and apolitical independent body assigned by the Commonwealth to implement HFE, the CGC has become increasingly caught in conflicts between sovereign elected Governments. The application of an extreme version of HFE has institutionalised conflict among the States. The high importance and uncertainty over levels of SPPs, and dysfunctional conditions applied to them, has institutionalised conflict between the Commonwealth and the States.

The States are forced to play a game over distribution of GST revenues, with expensive consequences, tightly refereed by the CGC on behalf of the Commonwealth. State dissatisfaction with the process will inevitably filter through to other Commonwealth–State and interstate dealings, and the time and effort spent on game playing is costly and inefficient. Commonwealth–State relations will be tested even further in coming years if the level of funds transferred across States grows rapidly, as is expected if current arrangements continue (see Chapter 4).

12.8 Lessons from past attempts at reform

Major attempts to reform Commonwealth–State financial relations over the past several decades illuminate the difficulties of change and also shape the contemporary possibilities (see Chapter 2).

In the 1950s the larger States continued efforts to remove the vertical fiscal imbalance at the heart of Australia's problems of Commonwealth–State funding, by seeking revocation of the Commonwealth's wartime assumption of exclusive control over income taxation. The High Court's surprising constitutional interpretation in favour of the Commonwealth in 1959 made it clear that any major reform would require Commonwealth support. There were no longer ‘States’ rights’ in arrangements that, at the time the Constitution was accepted, were seen as providing a reasonable balance between expenditure responsibilities and revenue raising capacities at each level of Government. Alongside these developments in constitutional interpretation, during the Menzies Government the Commonwealth, with the support of the States, assumed responsibility for the funding of large areas of education.

The Whitlam Government sought to reduce the impact of vertical fiscal imbalance by expanding Commonwealth and contracting State expenditure responsibilities. The States’ resistance turned out to be politically effective: when called to adjudicate through electoral processes, Australians seemed to value the decentralisation of service delivery responsibility that is embodied in the Constitution. The permanent legacy of the Whitlam reforms was a major Commonwealth role in funding local government and in funding and shaping national standards in relation to the main merit services of health and education. The implications of this expansion of the Commonwealth’s role are not reflected fully in reforms to the funding arrangements, resulting in the unsatisfactory features of SPPs since the 1970s. Gough Whitlam, consistent with positions taken by Governments that he led, argued in a submission to the Review that vertical fiscal imbalance and the associated problems of SPPs should be reduced by the States giving responsibility for funding hospitals to the Commonwealth (2002).

The Fraser Government's *New Federalism* offered the States greater fiscal flexibility by giving them access to the Commonwealth's income tax base. The Fraser legislation enabled the States to vary tax rates to reduce or increase the taxation liabilities of their citizens, with their own Treasuries carrying the fiscal implications. This was potentially a path to restoring the balance between the two levels of governments' expenditure responsibilities and revenue opportunities. However, as Malcolm Fraser explained in his submission to the Review, the States' new opportunities were not politically acceptable to them in the absence of the Commonwealth 'making room' by simultaneously reducing rates of income tax (and, correspondingly, payments to the States) (2002).

The most comprehensive attempt at reforming Commonwealth–State relations was made in the last two years of the Hawke Government. This attempt was based on an unprecedented degree of cooperation between the Commonwealth and the States. It was politically possible because of the existence of effective reformist Governments in the Commonwealth and a number of States. Submissions to the Review from Bob Hawke, Mike Codd (former Secretary of the Department of Prime Minister and Cabinet), and Nick Greiner (former New South Wales premier) reflect this attempt at reform, as did the Review Committee's conversation with former Queensland premier Wayne Goss, and former South Australian premier John Bannon's presentation to the National Forum.

Reform objectives in the early 1990s included replacing the large number of dysfunctional SPPs with a smaller number of cooperative sectoral programs, for which the States would retain executive responsibilities without micro-interventions by the Commonwealth. Objectives, and approaches to monitoring of performance against objectives, would be agreed. They included agreement to implement efficiency-raising reform in areas of shared responsibility under competition policy, in relation to which the Commonwealth expanded the amount of unconditional funding. Sharing the Commonwealth taxation base as a means of reducing vertical fiscal imbalance was under discussion. Bob Hawke's submission observes that this promising attempt at cooperative reform conflicted with the internal Federal Parliamentary Labor Party struggle over leadership. Elements of cooperation over competition policy were kept alive under the Keating Government, but not the wider reform agenda. However ideas on reform of SPPs from that time continue to resonate among State Governments.

12.9 A new basis for Federal fiscal reform

The Howard Government's introduction of the *New Tax System* in 2000 changed Federal financial relations in ways that hold out promise of securing solutions to longstanding problems. The Commonwealth promised the States access to Goods and Services Tax (GST) revenues to replace the old system of untied general revenue grants, in return for cooperation in the general program of tax reform. In the early years, the Commonwealth is making additional payments to bring grants to individual States up to the levels of taxes and grants forgone, pending the anticipated expansion of the GST base. While the GST is a Commonwealth tax, and the political agreement to return all proceeds to the States is just that – a non-binding political agreement – the States now have firmer assurances on untied grants from the Commonwealth than they did previously. The GST gives the States as a whole a substantial part of what they had been seeking in earlier efforts to reform Commonwealth–State funding.

The Commonwealth's discretion in allocating GST revenue among the States is constrained by the Intergovernmental Agreement. It requires that the GST should be distributed in accordance with HFE principles. At least one State has sought to interpret this as HFE as presently defined by the CGC. This view was put forward by the current CGC Chairman at the National Forum. Several State Governments representing the large majority of the Australian population have, in submissions to the Review, expressed the view that the reference to HFE in the Intergovernmental Agreement is to some redistribution from fiscally strong to fiscally weak States, and not to the particular form of HFE currently favoured by the CGC. They argue that it is consistent with the Intergovernmental Agreement for HFE to be defined in the less absolutist manner in which it was applied in the CGC's first six and especially its first four decades.

The Intergovernmental Agreement will never be interpreted by the courts as it is not a legal document. Nevertheless, it is politically relevant that the records of negotiation show disagreement on the meaning of HFE among the States in 1999. Unhappiness over the way this aspect of the Intergovernmental Agreement has been applied in practice was part of the background to commissioning this independent Review of Commonwealth–State Funding. There is currently disagreement about the interpretation of the Commonwealth's guarantee of minimum levels of funding in replacement of taxes once raised by the States (in particular over the excise on petroleum products). This is currently of intense interest, but will cease to have importance for Commonwealth funding once budget balancing assistance has been made redundant by growing GST revenues.

The Intergovernmental Agreement provides the States with a general assurance on the level of SPPs – that the Commonwealth has no intention of reducing their amount. Intentions can change, and even if they do not, the Intergovernmental Agreement does not indicate if the assurance is in nominal, real or real per capita terms. As noted in *Issues in Commonwealth–State Funding* (Garnaut and FitzGerald 2002), much hangs on the distinction. If SPPs were held constant in nominal terms, and assuming that after the transition period GST revenue will rise more or less in line with gross domestic product, total Commonwealth payments to the States would in all circumstances (except of inflation well above the Reserve Bank of Australia's target range, or of recession) rise in real terms, but less rapidly than the population growth rate. If SPPs were held constant in real terms, total Commonwealth payments would stay fairly steady over time in real per capita terms. If SPPs were held constant in real per capita terms, total Commonwealth payments to the States would rise in real per capita terms at about three-fifths of the national rate of increase in labour productivity.

The GST replaced a number of State taxes, which were less elastic in relation to income growth, and State revenues (including Commonwealth GST grants but not SPPs) can now be expected to grow more closely in line with national income. The debate over whether guarantees over total amounts of SPPs should be firm (no reduction of real per capita amounts) or weak (no nominal reduction) feeds into a debate about whether legitimate demands for expenditures in areas of Commonwealth responsibility are likely to grow more strongly than legitimate demand for expenditures in areas of mainly State responsibility. Similarly, if there are to be tax cuts, should they be mainly cuts in Commonwealth or State taxes? Any effective assurance on total Commonwealth payments to the States will require a commitment by the Commonwealth on both SPP funding and untied grants.

The States now accept the practical reality that the Commonwealth Government has a significant role in shaping and setting national standards and objectives for the main merit services provided by SPPs, in particular health and education and more generally Indigenous community services since the 1967 referendum. The high profile of health and education in Federal election campaigns, despite these areas being the States' constitutional responsibilities, demonstrates this reality. All States have a continuing interest in rationalising SPPs to reduce Commonwealth micromanagement of the services they deliver, alongside acceptance that the Australian community now expects a Commonwealth role in setting standards and objectives.

Historically, Federal Labor Governments have pushed harder to expand the Commonwealth's role in service delivery through SPPs. State Governments of both political persuasions have been sensitive to costs and mismanagement inherent in the current system of SPPs. The current circumstances – a conservative Commonwealth Government and all Labor State Governments – seems to provide a rare, possibly uniquely favourable opportunity for productive reform of SPPs. The Commonwealth Government has the rare luxury of assessing the national interest in distribution among the States, unaffected by claims from loyal allies at a State level. The favourable step of allocating GST revenue to the States and unique political circumstances establish a positive environment for comprehensive reform of Commonwealth–State financial arrangements.

12.10 Context for reform: intergenerational issues

Public discussion in recent years has begun to focus on an issue with significant implications for Commonwealth–State funding – Australia's ageing population. Recent studies suggest that Australian Governments will be facing fiscal and other challenges as the baby boom generation retires from the workforce and moves into old age over coming decades. This demographic shift may make the financial positions of Australian Governments unsustainable in the long term without well thought out policy responses, including in the area of Commonwealth–State financial relations. A new order of intergovernmental financial relations will need to adapt and contribute to a changing and challenging policy environment.

Current long-term population projections provide reason for concern regarding demographic change. Population growth is projected to slow from 1.2 per cent to around 0.2 per cent by 2042 as a result of low, and possibly declining, fertility rates. The proportion of the population aged over 65 is projected to rise from 12.5 per cent to around 24.5 per cent over the next forty years, while over the same period the number of people over eighty-five years is projected to increase from around 300 000 to 1.1 million (Commonwealth Government, 2002b). Higher levels of immigration could moderately increase population growth rates and reduce the proportion of older people in the population, but this would only reduce and not remove the associated problems.

These demographic changes can be expected to place pressure on the future workforce as the ratio of people aged over sixty-five to people of working age (fifteen to sixty-four years) rises from 19 per cent to 41 per cent by 2042.

These demographic pressures are likely to be reflected in the form of increasing demand for many public services. The Government's capacity to respond to these demands may also be constrained by slowing revenue growth. A decline in the proportion of children will only partially offset the fiscal effects.

The Commonwealth's recently released *Intergenerational Report* (Commonwealth Government 2002b) highlights the budget pressures facing the Commonwealth Government in coming decades. For the Commonwealth, the gap between spending and revenue from the demographic change is projected to grow to 5 per cent of gross domestic product or around $87 billion in real terms by 2041–42. Most of this increase will be in the area of health care, where the Pharmaceutical Benefits Scheme accounts for over half of the gap. The age and service pensions will also show sharp increases.

However, focusing too narrowly on the *Intergenerational Report's* headline figures can obscure a number of features relevant to reform of Commonwealth–State financial relations.

(1) The *Intergenerational Report* projects that the Commonwealth's demographically-driven spending will fall by 0.6 per cent of gross domestic product, or around $5 billion in real terms, by 2006–07. It is not until 2017–18 that the demographic change will have a net negative impact on Commonwealth finances. Consequently, there is a long lead-time before the impacts highlighted in the *Intergenerational Report* begin to affect the Commonwealth adversely. This provides time to implement more robust fiscal arrangements in Commonwealth–State funding, which can contribute to an appropriate policy response to demographic change.

(2) Most of the pressure on Commonwealth health care spending arises not from demographic change, but from non-demographic factors such as new technology and increased use and costs of services. This is particularly the case with the Pharmaceutical Benefits Scheme, which has carried sharp cost increases in recent years. However, unlike demographic change, the long-term financial impacts of non-demographic factors (e.g. new technology) are highly speculative. Simple extrapolation of current trends can be misleading, particularly when a small change in the model assumptions can produce a significant change in the projection of the long-term impact.[13] The sensitivity of the fiscal position to uncertain future movements of non-demographic factors suggests the need to manage this risk in the relevant Government programs, rather than to respond now as if the projected outcomes were certain to occur.

(3) While the ageing of the community will slow economic growth, the living standards of Australians are likely to be significantly higher in 2042 than they are now. For example, Guest and McDonald estimate that living standards will be 76 per cent higher in 2042 than they are now. The community will have growing capacity to fund increased health care and other services either privately or publicly through Governments, raising the possibility of adopting new funding models for these services – possibly involving building up resources through some form of pre-funding.

All Australian Governments, not just the Commonwealth, will face pressures resulting from demographic and other developments, although these pressures will manifest themselves in different ways.

[13] For example, changing the real non-demographic growth by 0.5 percentage points (e.g. from 2.5 to 3.0) changes the projected value of Commonwealth health spending in 2041–42 by 2.0 percentage points of gross domestic product (Commonwealth Government 2002b p. 40).

Health care represents a major area of spending for States, with over 20 per cent of their expenditure committed to it. States are major providers of public hospitals and community health services and therefore will also be susceptible to uncertain health care costs with the introduction of new drugs and treatments and the impact of an ageing population.

An ageing population is also likely to place particular pressures on other State public services and infrastructure. An older and less mobile population may increasingly turn to public transport, seek special accommodation and require home-based services. This effect will be especially important in regional areas, which will generally experience greater levels of population ageing than cities.

State Governments are also major providers of education. An important conclusion of the *Intergenerational Report* is that State Government finances will benefit from falling education expenses as the proportion of people aged fifteen years and under declines. However this is a narrowly focused view of future education requirements. Knowledge and innovation appear to be increasingly important inputs to all stages of production, suggesting that the role of education in successful economies may become more critical in coming decades.

A broader perspective would consider education as part of the solution to the problems of an ageing population. Better utilising a labour force that is a smaller proportion of the population suggests the need for more intensive use of capital in the production process. This includes developing human capital through longer and better education, training and retraining the workforce and broader adoption of lifelong education. Education can also help maintain higher labour market participation rates and reduce long-term unemployment, especially in older age groups. This broader perspective of Australia's future education requirements suggests the potential for a growing rather than declining role for education in the economy.

Major components of State Government revenues may also face pressure as a result of population ageing. Consumption patterns of older people favour spending on health care and more basic foods. Both are largely exempt from the GST and may see GST revenue lag behind economic growth over time. The lower propensity of older people to change residence may also result in property conveyance duties declining as a component of State revenues.

These impacts on State finances need to be understood in the context of the widely varying revenue raising capacities of the different levels of government. The Commonwealth raises over 80 per cent of taxation in Australia, compared to approximately 15 per cent by the States combined. If GST revenue is excluded from the calculation the Commonwealth, largely through its broadly based income taxes, still raises over 4.5 times as much as all the States through their much more narrowly based taxes. The Commonwealth has much greater capacity to absorb the risks of population ageing than the States.

There is a fairly long lead-time – at least fifteen years – before the ageing population exerts significant pressures on the finances of Australian Governments. However reform of financial relations needs to recognise the long-term context in which it will be expected to operate.

In the lead up to these demographic and other changes, all Governments will need to manage their major programs and overall finances more closely to ensure they are in a sound financial position. Current financial arrangements blur the line between Commonwealth and State responsibilities, and force Governments – and particularly State Governments – to plan and manage in an uncertain environment.

Greater certainty in intergovernmental financial relations will allow Governments to plan their financial futures better in the face of demographic change. This will also provide incentives to Governments to manage their financial positions rather than offload their fiscal difficulties, while clearer lines of accountability for service provision will assist Governments in their consideration of the most appropriate funding models for public services in the future.

At the same time, a better system of financial relations needs to recognise that the future is uncertain and future developments will affect different Governments in different ways. It will need to be adaptable so that impacts arising from unforseen and unforeseeable changes can be absorbed in the most effective manner – such as the impact of new technology on health care and the knowledge economy on education requirements. To some extent, this means sharing fiscal risk between different levels of government, while recognising the capacity of different levels of government to bear this risk.

CHAPTER 13: Commonwealth–State Financial Relations for the 21st Century

- The new model for Australia's Commonwealth–State financial relations is based on efficient, simplified delivery of services that are most important for equality of opportunity among Australians.
- National programs would be established in Health and Aged Care, Education and Training and Indigenous Community Development.
- Commonwealth and State Governments would have joint responsibility for setting broad national objectives in each area.
- Administrative responsibility would be unambiguous – States would administer the Health and Aged Care and Education and Training programs, and the Commonwealth would administer the Indigenous Community Development Program.
- Most specific purpose payments would have their funds transferred to the three National Programs.
- Untied grants funded by the GST would be allocated on a simple basis of equal per capita, with an element of horizontal fiscal equalisation. The element of horizontal fiscal equalisation – favouring the smaller States – would be much closer to that originally applied by the Commonwealth Grants Commission. There would be guarantees on minimum untied payments to all States, which would ease adjustment in the main recipient States.
- The new model would provide Australia with a more efficient and equitable system of Commonwealth–State financial relations to match its modern, dynamic economy in the 21st century.

13.1 Outline of the new model

The model introduced in Chapter 1 recognises that there are certain areas of government service provision that are centrally important to both the Commonwealth and the States. It also recognises the importance of removing administrative inefficiencies associated with shared and overlapping administration in these core areas to eliminate duplication, cost shifting and a lack of coordination between closely related areas.

The key elements of the proposed model for providing services that are most important for equality of opportunity among Australians are:

- Joint responsibility at the strategic level for setting broad priorities. Outcome objectives and agreed measures to monitor results in the three key areas of health and aged care, education and training, and Indigenous community development.
- Administrative responsibility for each of these key areas residing with one level of government. Generally this would be the State level since in the relevant areas they are predominant in service delivery capacity. There would be a single integrated program for these areas and the administering level of government would be free of input controls and micromanagement from the other level of government.
- Rationalisation of existing functions and funding arrangements. Opportunities would be sought for rationalising functions within or closely related to the three areas between the levels of government.

The core of the model is the establishment of three national programs – in Health and Aged Care, Education and Training, and Indigenous Community Development. These are the areas of State responsibility in which the Commonwealth has come to be most heavily involved. In reality they are areas of shared Commonwealth–State responsibility. Each program would be overseen by a Ministerial Council, with the Commonwealth and the States agreeing on broad objectives, minimum performance criteria and the basis for shared funding distribution. Administration of service delivery would rest with one level of government. States would have administrative responsibility for the Health and Aged Care and Education and Training Programs. The Commonwealth would have administrative responsibility for the Indigenous Community Development Program, recognising the Commonwealth's special responsibility in this area. However, the Commonwealth would work in cooperation with the States, and the States may manage the delivery of the services funded by the Commonwealth under this program.

Linking Commonwealth payments to the national programs to outcomes, rather than inputs, is consistent with recent trends in thinking about specific purpose payments (SPPs) at both Commonwealth and State levels.

The level of government with executive responsibility for administering and delivering a particular program would have the freedom to manage a single integrated program without interference from the other level of government and without input controls. There are significant advantages in having closely related areas of service delivery under one management structure. It reduces the opportunity for cost shifting behaviour, and removes overlaps and gaps in service delivery. Inefficiencies generated by the division of responsibility for health and aged care between the Commonwealth and the States are well known, for example, with acute care facilities being occupied by older Australians who could be more appropriately cared for in a specialised aged care facility.

Within the areas covered by the national programs, functions best carried out by one level of government would continue in the same way. For example, the Commonwealth would maintain responsibility for the Pharmaceutical Benefits Scheme, the Medical Benefits Scheme and for higher education funding.

Central to the model is a comprehensive rationalisation of SPPs. A considerable number would be abolished and their funding would be redirected to the three new national programs. A limited number of SPPs would be unchanged, including:

- SPPs that relate to cross border programs such as national roads
- SPPs where the Commonwealth is entering into an agency-type agreement with a particular State or States (e.g. to provide security for a Commonwealth meeting)
- existing 'through' SPPs, where the States on-pass funding to private schools, universities, local governments and other organisations.

Most of the funding from the abolished SPPs would be pooled to provide increased funding to the Health and Aged Care and Education and Training Programs. This would represent a significant increase in Commonwealth expenditure in these key areas. To balance this, States would have more autonomy in areas such as social welfare and housing, and would need to provide additional funding from their own sources to maintain current levels of expenditure in these areas. They would have the capacity to do this because the Commonwealth would be meeting a greater share of costs in the health and aged care and education and training areas. The cessation of many SPPs outside the areas covered by the national programs would not imply any diminution of priority or funding for the activities funded by them. States may choose to make them larger priorities than they were under the old arrangements.

Where there are particular issues of national significance that cross State boundaries, such as natural heritage and other environmental issues, it is important that all State Governments and the Commonwealth Government continue to work cooperatively.

The model is premised on a commitment from the Commonwealth to at least maintain its funding for the two largest national programs in real per capita terms. Commonwealth funding to the States would be conditional on the States meeting the minimum performance criteria agreed (in outcome terms) by the relevant Ministerial Council. The States would carry the risk of increased demand for these services as the population ages, but would enjoy increased certainty in terms of future revenue streams. The Commonwealth's revenues rise broadly in line with gross domestic product, even if it returns 'bracket creep' from the personal income tax to taxpayers with indexation. Even a real per capita guarantee leaves the Commonwealth with discretion over an element of growth in the revenue that funds these SPPs, reflecting the national rate of increase in labour productivity.

Funding specifically delivering services to Indigenous people from abolished SPPs would be redirected to fund the Indigenous Community Development Program.

The relevant Ministerial Council would determine appropriate distribution of funding for each program, focusing on equitable access for all Australians, as well as the quality of outcomes. Allocation would be based on a simple and straightforward assessment of the pattern of requirements for the services in question across Australia. This does not necessarily mean equal access, recognising that access to services in rural and remote areas will not realistically be the same as access in cities – for example hospital services are not going to be the same in Barcaldine as in Toowoomba, and services in Toowoomba are not going to be the same as in Brisbane.

The notion of equitable (rather than equal) access to the relevant public services would be reflected in the agreed outcome objectives for each of the programs. Generally, resources required to achieve these outcomes would be allocated according to the distribution of numbers of potential recipients of the services (e.g. school education or acute health care) across the States – that is, on relevant demographic patterns. Other factors may be thought by the Ministerial Council to have become relevant as outcome priorities and objectives are established, but no general or systematic role for assessment of relative cost disabilities along Commonwealth Grants Commission (CGC) lines is envisaged. Systematically compensating for cost disabilities institutionalises and rewards inefficiency, both through costs of particular services and through location decisions. The new system should be focused on outcomes and not seek to constrain the inputs applied by the administering level of government. As a result, efficiency – not inefficiency – would be rewarded.

Appendices A, B and C provide more detail on how these programs might work. A straightforward demographic basis is used to distribute funding for the Health and Aged Care and Education and Training programs. Funding for the Health and Aged Care Program is distributed among States according to population shares, with a simple adjustment for differences in age profiles among the States. Funding for the Education and Training Program is distributed among States based on numbers of students in government schools and publicly funded vocational education and training programs. Other factors would also be taken into account where the Ministerial Council agrees that it is necessary to achieve agreed outcomes and objectives.

The core concept of the proposal for reform of SPPs around three national programs is that SPPs should become the vehicle for achieving equitable access to the public services that are most important for equity and equality of opportunity among individuals and households throughout Australia. Resources would be provided for these SPPs under the direct authority of Ministers responsible to the electorate, and allocated to achieve equitable outcomes in these areas, rather than to equalise the generalised fiscal capacity of jurisdictions.

This reform direction would remove any equity rationale for the equalisation calculations that the CGC presently undertakes for expenditure disabilities. On the expenditure side, the focus of equalisation would be on meeting the minimum overhead costs of government – the burdens of which are proportionately greater for the smaller jurisdictions.

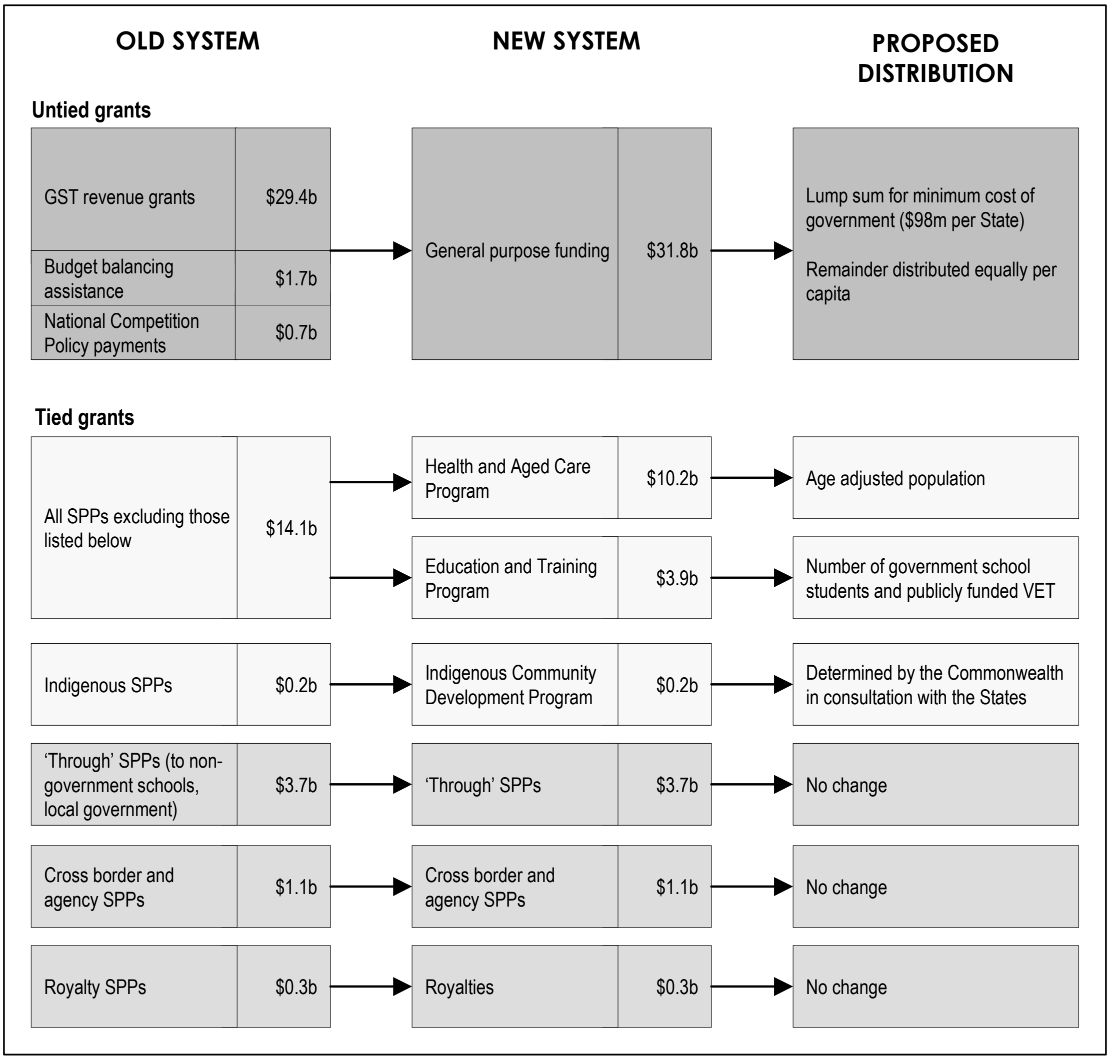
On the revenue side, there are no large intrinsic differences in the States' revenue raising abilities when it is realised that most of the alternative ways for States to raise revenues at the relevant overall level are substitutes (in incidence terms) of differing degrees of closeness. Moreover, it is constitutionally open to the high income Territories to access the income tax base (i.e. collect some small surcharge on income taxes paid by their individuals) – with Commonwealth facilitation being required for reasons of practicality.

Considerable simplification of existing arrangements for untied grants is recommended. Accordingly, the pool of funds to be allocated as untied grants (GST revenue, budget balancing assistance and national competition policy payments) would be allocated to the States on an equal per capita basis, after the allocation of minimum cost of government funding. Even this simple allocation embodies a very substantial degree of redistribution relative to where revenues are raised. Transitional arrangements (involving guarantees) would be required (see Section 13.2).

Most of the existing range of general purpose payments would be pooled. From this pool, all States would be provided with a fixed amount to cover the minimum cost of government, representing the cost of basic infrastructure needed to operate a government regardless of a State's population size. More work is needed to determine the appropriate funding for the minimum cost of government. For the purpose of this report, $98 million is taken as a reasonable estimate based on the work of the CGC. The remainder of the general purpose pool would be distributed on an equal per capita basis.

The total value of the minimum cost of government grant components across eight jurisdictions is approximately equal to the competition policy payments. Competition policy payments are currently maintained in real (not real per capita) terms, and minimum cost of government amounts would also be expected to remain approximately constant in real terms. The budget balancing assistance for which the Intergovernmental Agreement provides would be added to the pool of untied grants. This would be the first line of funding for extra payments under the guarantees to individual States on their amounts of untied funding. The budget balancing assistance amounts are transitional. Once they disappear from the pool, the amounts available for distribution over and above the minimum cost of government amounts will rise closely in line with GST revenues (i.e. approximately indexed to national income).

FIGURE 13.1: Funding arrangements under the proposed model



These are significant reforms, with considerable effects on total funding for some States – particularly in the short term. Transitional arrangements are discussed in Section 13.2.

13.2 Guarantee arrangements

The Terms of Reference ask the Review to recommend appropriate transitional arrangements where necessary. Recognising the importance of transitional arrangements, the model for reform includes a guarantee that the current level of funding for all States will be maintained in real per capita terms. The model provides for a simple real per capita guarantee to each State on the sum of general purpose payments and funding for the Health and Aged Care and Education and Training Programs. The guarantee ensures that each State's current level of funding will be maintained in real per capita terms. Funding for the guarantee would be provided by States with total grants from the formula exceeding the guarantee benchmark. As the budget balancing assistance funds are added to the untied grants pool, this established guarantee could be seen as the first source of funding for the new guarantees. The balance would be drawn from GST revenue allocations of States that are above the guarantee benchmark.

Table 13.1 summarises the way funding for a State is determined subject to the guarantee, using the Australian Capital Territory as an example.

TABLE 13.1: Calculating a State's funding: Australian Capital Territory, 2003–04

		$m
Base allocation for 2003–04		
Untied: minimum cost of Government		100
Untied: equal per capita share		514
Health and Aged Care Program		158
Education and Training Program		64
Total	**a**	**836**
Guaranteed minimum amount		
Previous year funding (2002–03)		
Untied: minimum cost of Government funding		98
Untied: equal per capita share		500
Health and Aged Care Program		152
Education and Training Program		62
Sub-total	b	812
Population growth factor	c	1.002
CPI factor	d	1.025
Total	**e = b*c*d**	**873**
Total funding		
Base allocation	a	836
Guarantee Adjustment	f = e-a	37
Total	**g = a+f**	**873**

Table 13.2 summarises the overall funding distribution before and after the application of the guarantee for 2002–03 (the base year) for all States. Table 13.3 shows projections of the distributions resulting from our model in 2007–08 (year 5) and Table 13.4 shows 2012–13 (year 10). Further details are provided in Appendix D, including parameters and assumptions used in the calculation of these projections.

TABLE 13.2: Projected distribution – base year ($ million)

2002–03	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	AUST
General purpose grants	10 549	7 849	5 960	3 167	2 481	841	598	415	31 861
Health and Aged Care Program	3 471	2 576	1 884	972	822	251	152	83	10 212
Education and Training Program	1 329	956	744	374	301	102	62	49	3 917
Sub-total	15 349	11 381	8 588	4 513	3 605	1 195	812	547	45 989
Guarantee benchmark	14 583	10 201	8 457	4 374	4 185	1 620	850	1 717	45 989
Adjustment	- 766	-1 180	- 130	- 139	581	426	38	1 170	0
Total	**14 583**	**10 201**	**8 458**	**4 374**	**4 185**	**1 620**	**850**	**1 717**	**45 989**

TABLE 13.3: Projected distribution – year 5 ($ million)

2007–08	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	AUST
General purpose grants	13 143	9 776	7 584	4 005	3 012	976	710	505	39 709
Health and Aged Care Program	4 300	3 200	2 391	1 234	999	296	184	103	12 707
Education and Training Program	1 657	1 181	952	468	364	116	74	61	4 874
Sub-total	19 100	14 157	10 928	5 706	4 375	1 387	969	669	57 290
Guarantee benchmark	17 262	12 074	10 235	5 269	4 836	1 789	967	2 025	54 456
Adjustment	- 807	- 915	- 304	- 192	461	403	- 1	1 356	0
Total	**18 293**	**13 242**	**10 623**	**5 514**	**4 836**	**1 789**	**968**	**2 025**	**57 290**

TABLE 13.4: Projected distribution – year 10 ($ million)

2012–13	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	AUST
General purpose grants	17 052	12 674	10 036	5 266	3 804	1 170	871	635	51 509
Health and Aged Care Program	5 299	3 949	3 021	1 555	1 209	346	221	126	15 725
Education and Training Program	2 063	1 452	1 197	591	436	129	88	76	6 032
Sub-total	24 413	18 075	14 255	7 412	5 448	1 645	1 181	838	73 266
Guarantee benchmark	20 325	14 212	12 306	6 306	5 560	1 960	1 090	2 376	64 135
Adjustment	- 724	- 684	- 345	- 196	111	315	- 16	1 538	0
Total	**23 689**	**17 391**	**13 910**	**7 216**	**5 560**	**1 960**	**1 165**	**2 376**	**73 266**

13.3 The new model and intergovernmental issues

The proposed model would be based on a new intergovernmental agreement, building on the 1999 Intergovernmental Agreement. The new intergovernmental agreement would set out the Commonwealth's commitment to maintain grants to the two largest national programs and total payments to each State in real per capita terms. It would lay down the basic principles for operation of the three cooperative national programs.

Ministerial Councils would develop specific agreements for the Health and Aged Care, Education and Training, and Indigenous Community Development Programs. They would specify multi-year objectives for the national programs and be reviewed annually. Multi-year rolling budgets and performance indicators would be identified, by which performance against objectives would be assessed.

The agreement for each national program would also specify minimum service outcomes and an estimated minimum level of real per capita expenditure necessary to deliver that level of service. Each State would be required to achieve the agreed outcomes, sometimes partially specified in terms of minimum levels of services. However the States would be free to achieve these outcomes and levels of service with the most cost-effective means available to them and without obligation to commit specified amounts of inputs. States would also be free to provide services above the agreed minimum standard.

The new approach would give effect to the objectives set out in the recent SPP Principles agreed by all the States.

In regard to education and training, existing bodies have roles in setting broad objectives to meet the needs of the community in areas such as access, choice, equity and excellence in schooling, and vocational preparation. The Australian National Training Authority is the Commonwealth statutory authority that currently provides a national focus for vocational education and training. The Australian National Training Authority administers national programs and the Commonwealth component of funding for the national vocational education and training system. It also plays an advisory role to the Ministerial Council of Commonwealth, State and Territory Ministers, which is responsible for vocational education and training. Under the new arrangements, the Ministerial Council for Education and Training would consider whether these established bodies would continue in the same or modified roles.

13.4 Advantages

The new model has a number of clear advantages.

It would establish, on an early timetable, a more cooperative pattern of conditional SPPs from the Commonwealth to the States. Cooperation in the special area of education, health and Indigenous community development would require large changes from established patterns. However the changed institutional arrangement should quickly reduce inherent tendencies for game playing over funding and conflicting responsibility between the Commonwealth and the States. Australians would have greater confidence that the public sector would provide a basic minimum level of services in areas that are widely accepted as being centrally important for equality of opportunity and equity more broadly. It would also remove dysfunctional Commonwealth micromanagement in other areas where conditional payments are less critical to equality of opportunity on a national basis.

Lines of responsibility to Commonwealth and State Governments would be much more transparent. Under the status quo, a political party competing for Government at a Commonwealth level can promise improvement in various aspects of education or health services, without clarity around the actual effect Commonwealth policy can have on outcomes. A political party competing for Government at State level may criticise the adequacy of education or health services, without clarity around how responsibility for any shortcomings is shared in practice between Commonwealth and State Governments.

Within the new model, the extent and limits of both Commonwealth and State Governments' responsibility for delivery of services in health, education and Indigenous community development will be clear. At Commonwealth level, the relative merits of raising guaranteed minimum levels of services in these areas on the one hand, and reducing rates of income taxation on the other could be debated. At State level, the relative merits of raising levels of service in health or education above minimum national levels, and reducing revenue from payroll or gambling or other taxes could be debated. The Commonwealth would be actively engaged in monitoring outcomes from the national programs, and have the means available to apply pressure on States that were under-performing in relation to minimum outcomes agreed in the Ministerial Council.

The model provides an appropriate balance between the States' responsibility for cost-effective delivery, and the Commonwealth's commitment to provide a substantial but not abundant guaranteed minimum level of funding. The Commonwealth's greater fiscal freedom under the proposed arrangements would give it the capacity to fund higher outcomes from the national programs in future if it chose to do so. It is unlikely to do so unless the States were performing at a high level of efficiency in delivering good outcomes in relation to commitments.

The Commonwealth's commitment not to reduce real per capita payments in relation to the Health and Aged Care and Education and Training Programs would complete a process that commenced with the allocation of GST revenues to the States. It would provide considerable certainty about total Commonwealth payments to the States, at a reasonable level. At this level, total per capita revenues available to the States would rise by about three-fifths of the growth rate of real per capita income in the absence of changes in taxation rates or bases. Total revenues available to the Commonwealth net of minimum payments to the States would grow slightly more rapidly than per capita income, if there were income tax indexation but no other change in tax rates or bases. The new system would provide greater certainty about payments to the States and remove the main remaining area of entrenched dispute on financial matters between Commonwealth and State Governments.

13.5 Timing and nature of gains

The proposed model embodies gradual change in the proportionate allocation of GST revenues among the States. The transitional arrangements entrench much of the favourable treatment afforded some States for many years and, in the case of the Northern Territory probably several decades. It also establishes an historically favourable starting point for South Australia, Tasmania and the Northern Territory. As a result, some of the efficiency advantages of the new system would take some time to filter through.

However, most of the efficiency gains would come quickly, including:

- removing the overhead costs of managing the system of untied payments including, at the State level, the need to persuade the CGC of each State's point of view
- restoring full economic incentives for reducing service delivery costs
- restoring full economic incentives for adopting policies that secure economic growth.

The CoPS modelling suggests that a high proportion of the static resource allocation gains from the new model would be realised long before the guarantees ceased to be effective. It suggests the static resource allocation gains from the new model would approximate those from a medium-sized microeconomic reform. However, the Review Committee believes the dynamic effects would be much larger than the static analysis suggests (e.g. through incentives for economising behaviour, including in government policy making). This is the general tendency with efficiency raising reform. Australian productivity increases following efficiency raising reform in the 1980s and 1990s have been much larger than static analysis suggested. The Australian experience is similar to that in many other countries.

Substantial gains from economic efficiency would come at no net cost to equitable distribution. There is no reason to expect the gap between the circumstances of relatively rich and relatively poor Australians to be wider in the new model. In fact, there could be greater confidence that a minimum level of important basic services would be made available to all Australians.

Recognising some economies of scale in State Government administration, an element of horizontal fiscal equalisation (HFE) has been embodied – favouring the smaller States – in the suggested formula for allocating GST revenue among the States. The proposed arrangements define HFE in a form much closer to that applied by the CGC in its earlier decades, than it has been since the 1990s. Guarantees on minimum untied payments would avoid disruption from reducing funding to any State.

The new model is much simpler than established arrangements. Commonwealth–State financial arrangements would be comprehensible to Australians in a way that they have not been for at least several decades. Democratic accountability of Commonwealth and State Governments would be greatly enhanced, and gains from greater simplicity, transparency and accountability would be realised quickly.

13.6 The road to reform

The new model is an extension of recent discussions and reform in Commonwealth–State funding. It builds upon ideas about cooperative sectoral programs that attracted wide support from all Governments in the early 1990s. It also builds on the introduction of the GST in 2000, and the historic decision to allocate the revenues to the States. It is formally consistent with the Intergovernmental Agreement of 1999 in all respects. The new model also restores a role for the CGC that is much closer to that of its formative decades. The Commonwealth and all State Governments have much to gain from the new model through improvements in national economic performance, simplicity and equity.

While all stakeholders will benefit from the new model, every State will be able to imagine an alternative that, if implemented, would generate even larger gains for itself. The two larger of the three States that commissioned this Review would gain more from allocation of GST revenues according to State of origin rather than equal per capita, which embodies large transfers from high-income to lower-income jurisdictions. These three States would gain more from more rapid movement to applying the new model, without constraint from the guarantees on minimum real per capita payments to each State. Victoria and New South Wales contest the extent of economies of administrative scale as assessed by the CGC and mostly incorporated into the new model. On the other hand, some States may hope to secure a continuing increase in their shares of the GST revenues under the established approach.

Within the new model, the Commonwealth would gain the States' acceptance of a possible decline in payments as a share of gross domestic product, and of sharing responsibility for health and aged care costs, which will rise due largely to the ageing population. However, within the status quo, the Commonwealth might hope to reduce payments to the States by larger amounts by retaining the discretion allowed under current approaches to SPPs.

Inevitably, in any reform process there will be some jockeying for advantage between the Commonwealth and the States, and among the States. Opening up the Review's recommendations to discussion and debate may identify improvements to the model. We hope, through this process, that all parties will keep in mind the shared interests of all Australians in a better model of Commonwealth–State funding.

Upon implementation of the new model, Australia would still be one of the most egalitarian of the world's Federations. The inequalities in incomes across States are smaller in Australia before payments to the States are considered. In addition, the new model would probably provide for proportionately larger net transfers across the States than in Canada, Germany or the United States. The smaller and poorer States are likely to continue to perform more strongly relative to the national average than in other Federations. There was no expectation at the time of Federation that Queensland and Western Australia would be the strongest economic performers of the 20th century. The new arrangements would strengthen the chances that the current recipient States would be among the strong performers of the 21st century. That would be a good outcome for all Australians.

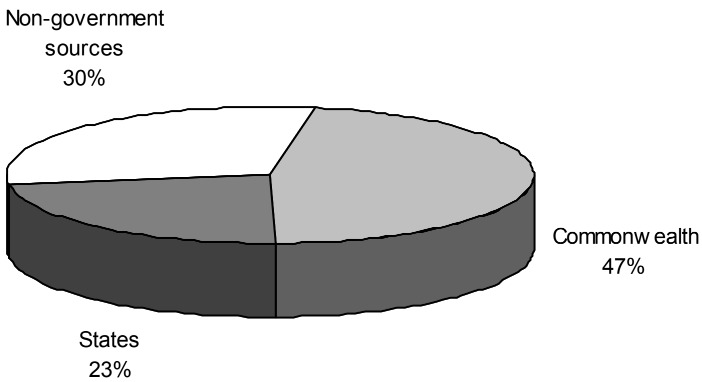
APPENDIX A: National Health and Aged Care Program

Australia's health system has many merits. However, the health system is under increasing financial pressure through the interaction of technological change, rising expectations and the ageing of the population. The development of biotechnology and information technology, and their reflection in new drugs, instruments and clinical practices, has stimulated rising expectations and demand for health services. The result is upward pressure on health expenditure, which will be further exacerbated over time by the ageing of the population.

Australia's health expenditure as a proportion of gross domestic product has increased gradually from 4.3 percent in 1960–61 to the current level of about 8.5 per cent. Australian health care expenditure as a proportion of gross domestic product is about average for OECD countries. The proportion ranges from 6.8 per cent for the United Kingdom to 13.9 per cent in the United States. It is expected that this figure will continue to rise. The National Commission of Audit has suggested that health expenditure as a proportion of gross domestic product could be as high as 17 percent by 2041.

Health care expenditure is a major component of public expenditure at both levels of government, accounting for 14 per cent of the Commonwealth budget and between 19 and 25 per cent of State budgets in 2000–01 (ABS 2002b). In 1998–99, $50 billion was spent on health services in Australia by the Commonwealth, States and non-government sources (private health insurance, individuals, motor vehicle third party insurance and workers compensation). Figure A.1 shows the relative contributions.

Figure A.1: Shares of health funding



Source: Australian Institute of Health and Welfare 2000b
Note: SPPs are treated as Commonwealth funding

Aged care is largely funded by the Commonwealth, with expenditure of $2 575 million and compared to State expenditure of $137 million in 1997–98 (Australian Institute of Health and Welfare 2000a).

The current system

In 2002–03 the Commonwealth Government will distribute $8.6 billion in SPPs to the States for health and aged care (Table A.1).

TABLE A.1: Estimated SPPs in Health and Aged Care, 2002–03

SPP	$m
Health	
Blood transfusion services	82.2
Health program grants	3.8
Health care grants	7 059.0
National health development fund	64.2
Highly specialised drugs	345.3
Youth health services	2.4
National public health	194.7
Essential vaccines	86.4
Repatriation general hospitals	13.8
Fringe benefits tax transitional grants for hospitals	64.6
Health total	7 916.4
Aged Care	
Aged care assessment	43.0
Home and community care	674.1
Aged care total	717.1
Health and Aged Care Total	**8 633.5**

Source: Commonwealth Government 2002a

Table A.2 shows the current distribution of funding to each State compared with an equal per capita benchmark. The current distribution is close to equal per capita for New South Wales, Victoria, Queensland and Western Australia. South Australia and the Northern Territory receive significantly more than their population shares, while the Australian Capital Territory receives significantly less.

TABLE A.2: Distribution of Health and Aged Care SPPs, 2002–03

		NSW	VIC	QLD	WA	SA	TAS	ACT	NT	TOTAL
2002–03 distribution	$m	2 889.8	2 175.4	1 584.0	848.6	742.1	190.6	110.3	92.7	8 633.5
	%	33.9	24.1	18.9	9.2	8.4	2.7	1.5	1.4	100.0
State population shares	%	33.6	24.9	18.9	9.9	7.7	2.4	1.6	1.0	100.0

Source: Commonwealth Government 2002a

Problems with the current system

Health and aged care funding arrangements in Australia are complex, distinguished by the complicated division of responsibilities between the Commonwealth and the States. The States retain the major responsibility for the public provision of health services, including public and psychiatric hospital systems, and for public and community health care. The Commonwealth Government funds Medicare, the Medical Benefits Scheme, the Pharmaceutical Benefits Scheme and the Private Health Insurance Rebate. It also contributes to State funding of public hospital services and provides funding to non-government organisations for services such as residential care, community care and Indigenous care.

The division of responsibility between the two levels of government is often ambiguous and overlapping. For example, the funding of private hospitals is shared, with the States providing 47 per cent of recurrent public funding and the Commonwealth providing 45 per cent. Another example is funding of community and public health, which is the responsibility of the States, whereas residential aged care is financed and regulated by the Commonwealth.

The overlap of funding responsibilities has led to lack of coordination and inefficiencies in the health care system. The poor links between different components of the health sector can make it difficult for patients to find the way between services and to readily obtain access to the most appropriate care.

Cost shifting and blame shifting from one level of government to another are consequences of the overlapping funding arrangements. This can have a significant impact on patients who are encouraged to choose their care based on the source of funding rather than what best suits their needs. Governments put considerable resources into shifting costs, and boundary disputes arise as a consequence.

Aged care is a particularly disconcerting example of cost shifting. Pressure on Commonwealth funding for nursing homes causes many older people to be treated unnecessarily in high-cost public acute hospitals funded by the States. Older people are not provided with the most suitable care and acute hospital beds are not put to their most efficient use. It is difficult for resources to be moved between different programs efficiently or in response to demand.

The basis for the current distribution of SPPs to the States is in some cases historical, with little consideration of differences in demand or need. In others, distribution follows assessment of demographic factors affecting underlying needs. Individual SPP arrangements can become an impediment to the achievement of policy objectives and effective service delivery. For example, detailed prescriptions and a focus on inputs rather than outcomes provide a disincentive to innovative policy and administrative solutions. Furthermore, administrative costs are high relative to the size of grants. There is much scope for simplification and standardisation.

The CGC's assessment of health creates even further complexity, overriding the current SPP arrangements with their own methodology.

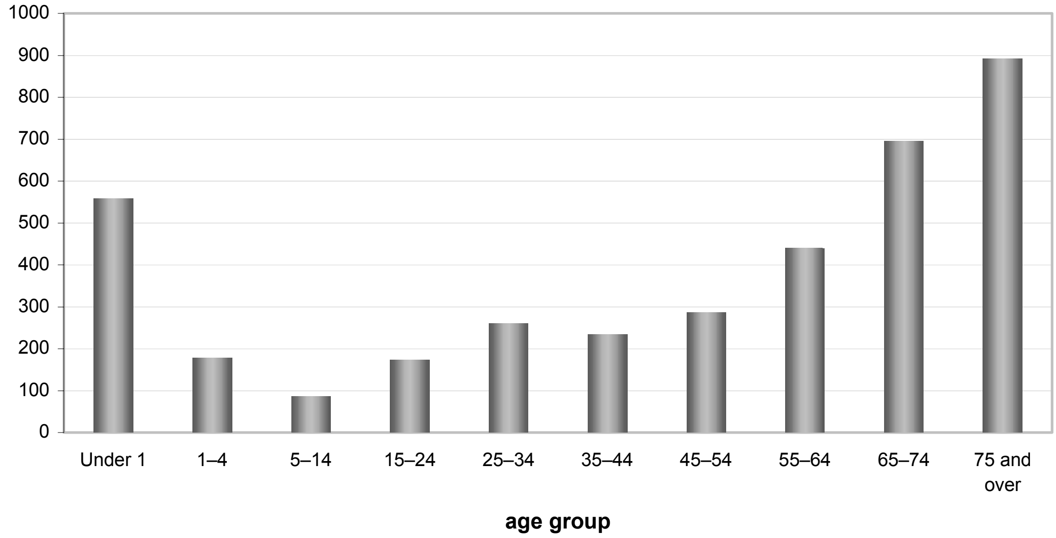
New approach

Funding for the new Health and Aged Care Program would total around $6.9 billion in 2002–03. This is about 50 per cent of the available pool for Health and Aged Care and Education and Training Programs.

Age is the most significant driver of demand for health related services, aside from Aboriginality. This issue has received significant attention with the release of the Commonwealth Government's *Intergenerational Report*.

Under the proposed model, Commonwealth funding would be based on simple indicators of need, mainly based on demographic factors, as agreed in the Ministerial Council. The projections of Commonwealth funding in Chapter 13 are based on population shares, adjusted to reflect the different age distributions of the States. The age adjustment is based on separations statistics (or hospital visits). Figure A.2 shows the number of hospital separations per 1 000 population by age group.

FIGURE A.2: Number of separations per 1 000 population



Source: Australian Institute of Health and Welfare 2000c

In the projections, distribution of Health and Aged Care Program funding is based on population shares re-weighted to reflect differences in the age distribution between States and the resulting additional demand for health related services. The resulting distribution is shown in Table A.3.

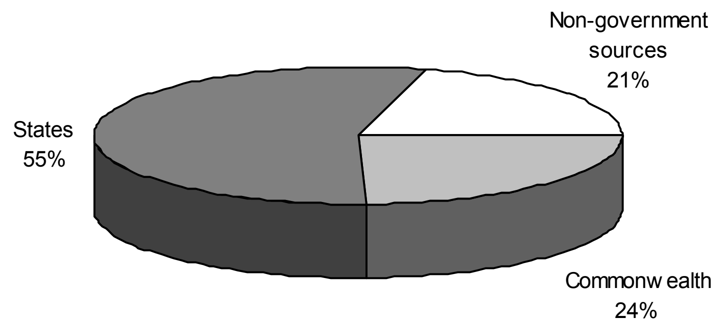
TABLE A.3: Indicative distribution based on weighted population, 2002–03

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	TOTAL
$ million	3 471	2 576	1 884	972	822	251	152	83	10 212
%	34.0	25.2	18.4	9.5	8.1	2.5	1.5	0.8	100.0

APPENDIX B: National Education and Training Program

In 1999–2000 expenses on education totalled $42.8 billion, or 6.8 per cent of gross domestic product. The relative contribution of the Commonwealth, States and the private sector is shown in the figure below. States account for more than 50 per cent of all education funding.

FIGURE B.1: Shares of education funding



Source: Steering Committee for the Review of Commonwealth/State Service Provision 2002

Notes: Excludes spending on universities; SPPs are treated as Commonwealth funding

The current system

In 2002–03 the Commonwealth Government will distribute $7.18 billion in SPPs to the States for education purposes. This funding is divided between nine separate SPP programs, and between allocations for current and capital purposes.

TABLE B.1: Estimated SPPs to the States for Education, 2002–03

SPPs	$m
Current	
Government schools	1 465 442
Non-government schools [a]	3 696 143
Vocational Education and Training Funding Act	1 032 527
Targeted programs aimed at both government and non-government schools	324 105
Targeted programs non-government schools [a]	170 638
Indigenous education strategic initiatives program – government [b]	114 247
Indigenous education strategic initiatives program – non-government [a]	52 663
Current total	6 855 765
Capital	
Government schools	230 847
Non-government schools [a]	90 755
Capital total	321 602
Education total	**7 177 367**

Source: Commonwealth Government 2002a
[a] SPPs 'through' the States
[b] To be included in Indigenous Community Development SPP

Government schools

Government school funding is specified in the Quadrennial Agreement with the Commonwealth under the *States Grant (Primary and Secondary Education Assistance) Act 2000* for 2001–2004. General recurrent grants are provided as block grants calculated on a per student basis and are subject to adjustments based on movements in Average Government School Recurrent Costs. Capital grants are provided as block grants and funds for each State are allocated on the basis of total government school enrolments. Commonwealth capital funding is supplemented annually using the Building Price Index.

Targeted programs aimed at both government and non-government schools

Targeted programs funding is appropriated in the Quadrennial Agreement with the Commonwealth under the *States Grant (Primary and Secondary Education Assistance) Act 2000* for 2001–2004. General grants are provided for programs on the basis of a composite mechanism of several factors, including ABS data on the number of students with English as a second language, the Index of Relative Socioeconomic Disadvantage, a fixed percentage of the former Special Education – School Support Program, and strategic assistance based on the number of eligible students with disabilities.

Vocational education and training

Vocational education and training funding is determined by the Australian National Training Authority Agreement Ministerial Council (including State and Commonwealth Vocational Education and Training Ministers), and guided by the Australian National Training Authority Agreement between the Commonwealth and the States for 2001–2003. Recurrent funding allocations are based on a population share (a mix of historical and current) and capital funding allocations are based on an historical breakdown.

Distribution

Table B.2 shows the current distribution of education funding to each State compared with equal per capita benchmark. The equal per capita results are not significantly different from those of the current system, despite the detailed analysis and methodologies currently applied.

TABLE B.2: Distribution of Education SPPs, 2002–03

		NSW	VIC	QLD	WA	SA	TAS	ACT	NT	TOTAL
2002–03 distribution	$m	1 034.8	736.0	577.1	280.6	257.4	81.3	44.4	41.4	3 052.9
	%	33.9	24.1	18.9	9.2	8.4	2.7	1.5	1.4	100.0
State population shares	%	33.6	24.9	18.9	9.9	7.7	2.4	1.6	1.0	100.0

Source: Commonwealth Government 2002a

Problems with the current system

There is no simple and transparent rationale for the current distribution of education funding to the States. The basis for each distribution appears to be largely historical. The historical basis is entrenched further each time an agreement is renewed, without due consideration to emerging service needs.

Other issues arise out of Commonwealth involvement in an area for which it has no constitutional responsibility. The States are responsible for delivering education services to all children of school age. Some of the States' core responsibilities include administration and funding of Technical and Further Education institutes, administration and delivery of vocational education and training, and education in government schools. The Commonwealth's role is to provide funding to the States for agreed priorities and strategies, provide funding to the States through the Australian National Training Authority for the delivery of vocational education and training programs, and provide funding for higher education and assistance for students.

This lack of flexibility removes the States' freedom to pursue education policies and programs to suit their own particular needs.

The CGC's assessment of education adds an even higher level of complexity to the existing SPP arrangements. Irrespective of the appropriateness of the current arrangements, they are effectively made obsolete by the CGC's overriding methodology.

New approach

Commonwealth funding for the new Education and Training Program would total around $7.2 billion in 2002–03. This is about 50 per cent of the available pool for the Health and Aged Care and Education and Training Programs.

Establishing a broad education SPP would result in significant advantages, including:

- improving effectiveness of service delivery
- reducing administrative complexity
- increased simplicity and transparency
- increasing the States' ownership of education issues, encouraging them to deliver education outcomes rather than focusing on inputs
- a more cooperative approach between the States and the Commonwealth.

Consolidating education SPPs will improve education outcomes. Increased policy flexibility will enable program requirements to be targeted at specific communities and allow policy choice to occur at community level, for example, by schools themselves. It will also improve efficiency, simplicity and transparency. In addition, equity outcomes could be targeted to suit local requirements.

'Through' SPPs, which are simply passed by the States to private institutions, will remain unchanged.

As in the Health and Aged Care Program, a simple approach is suggested for the distribution of the Education and Training Program. Under the model, the Ministerial Council would agree indicators of need. As with health, simple and objective criteria should be used. The projections in Chapter 13 are based on the number of government school and publicly funded vocational education and training students in each State.

Modification of a simple equal per capita distribution is recommended as there are important differences between States that have an impact on demand for government schools and vocational education and training, including:

- number of school-age children
- proportion of students in government and non-government schools
- participation rates in publicly funded vocational education and training courses.

In determining the appropriate distribution, the Ministerial Council would need to consider how differences in the structure and number of years of school education provided by each State should be taken into account. For example, Queensland and Western Australia have twelve years of formal schooling, while all other States have thirteen.

While State Government expenditure on education extends beyond government schools and vocational education and training, these segments account for more than 90 per cent of all government expenditure on education (ABS Australia Now Education and Training). For this reason, the distribution embodied in our projections is based on a simple composite of the number of school and vocational education and training students. Weightings have been applied to reflect the cost differential between school and vocational education and training education. On average the cost per vocational education and training student is only about one third of the cost per government school student. Much of this differential is due to the part time nature of many vocational education and training courses.

TABLE B.3: Government expenditure per student

Government expenditure per school student ($)	5 767.2
Government expenditure per VET student ($)	2 059.4
Cost of educating a VET student compared with a school student (%)	35.7

Source: ABS 1999–2000

The resulting distribution is shown in Table B.4.

TABLE B.4: Indicative distribution based on number of school and vocational education and training students, 2002–03

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	TOTAL
$ million	1 329	956	744	374	301	102	62	49	3 917
%	33.9	24.4	19.0	9.6	7.7	2.6	1.6	1.2	100.0

APPENDIX C: National Indigenous Community Development Program

The Commonwealth Government has accepted a special responsibility for Aborigines and Torres Strait Islanders following the amendment of the Australian Constitution pursuant to the referendum of 1967. The Commonwealth would continue to fund the special needs of Indigenous Australians in accord with this responsibility under the proposal.

Under the proposal, States would still be responsible for providing and improving services for Indigenous Australians (to be funded from their own sources, GST revenues and broad-banded education and health SPPs). The Commonwealth and States would take a cooperative approach in improving services for Indigenous Australians and meeting their specific needs. Commonwealth funding would include all existing SPPs and own purpose outlays currently targeted at Indigenous people, augmented at the Commonwealth's discretion. The Commonwealth would have ultimate control over the distribution of its funding. However, the Commonwealth would work in cooperation with the States in using this funding to improve outcomes for Indigenous people. In practice, the States, which have access to the bulk of service delivery mechanisms, would play a significant role.

Decision making and funding arrangements

States would determine their own policies on service provision, subject to intergovernmental agreements. The national Health and Aged Care and Education and Training Programs would include agreed objectives for Indigenous service delivery (and the distribution of these SPPs would reflect special factors in meeting the needs of Indigenous Australians especially in remote communities).

Agreements would also be made under other Commonwealth-funded programs directed to meeting special needs of Indigenous people. The Commonwealth would fund services through its own expenditures (e.g. through ATSIC), or by funding the States through the Indigenous Community Development Program. This Program would include the existing Indigenous Education Strategic Initiatives Program and Housing Assistance for Indigenous People SPPs. The Commonwealth would be able to increase funding from its own sources to improve outcomes for Indigenous people. Wherever practical, service recipients and all three levels of government should consult over service delivery to optimise service outcomes. In particular, for discrete Indigenous communities, collaborative decision making over the spending of a combined pool of funds from all sources is to be preferred (including decisions over how funds are to be distributed between different service functions). Direct management of service delivery for each function should be in the hands of the level of government that is best placed to deliver the services.

Where services are delivered to communities with Indigenous and non-Indigenous people, the States would be responsible for providing mainstream services (recognising agreed national objectives). This would not preclude the Commonwealth from also providing or funding Indigenous-specific services.

Local government

Governments would work towards ensuring that local government services are improved for Indigenous communities. In particular, Commonwealth general purpose assistance to local governments that is attributable to Indigenous persons (either directly through population numbers or special allowances, or indirectly through recognition of lower revenue capacity) would be fully spent on Indigenous services.

Where practical, Indigenous communities would be incorporated as a local government area, to gain direct access to Commonwealth funding for local governments and allow communities the opportunity to manage themselves.

Examples of how this model would work in practice

States would provide school services to Indigenous children. The Commonwealth could, if it wished, employ additional specially trained staff or take additional measures to increase student outcomes.

States would continue to provide access to health services for Indigenous and non–Indigenous persons on the basis of medical need and seek to improve Indigenous health outcomes. This means that the States would continue to fund the higher utilisation of hospital services by Indigenous persons. The Commonwealth would provide Indigenous-specific health services and assist the States in improving outcomes through special programs, particularly in remote locations where States typically do not provide more than basic access to health services.

States would provide public housing, on the basis of need as at present, and continue to fund special programs for improving Indigenous housing. The Commonwealth would provide additional housing assistance (e.g. community housing) and assistance for communities which are small or itinerant. Moves to use pooled funding arrangements to meet Indigenous housing needs would continue.

Implications of the proposed model

The proposed model aims to improve services for Indigenous people through:

- agreements on broad objectives in health and education
- cooperative arrangements between governments in areas of special need
- a recognition that programs should be managed flexibly against agreed outcomes by the level of government best placed to deliver services (usually the States)
- a recognition of the Commonwealth responsibility to help fund improvements in Indigenous outcomes
- a recognition that local government funding and service delivery for Indigenous outcomes needs to be improved.

APPENDIX D: Minimum Cost of Government

All States require basic infrastructure to operate a government regardless of their population sizes. The most obvious basic infrastructure includes the Parliament, the office of the Governor, the revenue collection authority and the judiciary. However, while these institutions are important to sustain the operation of government, they do not encompass the full range of services a Government must provide to maintain and enhance the welfare of its people. Two issues need to be considered in deciding a minimum cost of government. The first is what is the scope of government activities to be defined. The second is what are the resources required by government to provide that basic infrastructure.

Scope of government activities

The CGC approach to equalisation is a comprehensive assessment of revenues and services of the States that are classified under the activity of the general government sector, with a few exceptions. The problem with this approach is that the scope of the services provided by government often stretch beyond those that provide ‘public goods’ of direct importance to the welfare of citizens.

In our view, there is no merit in including the overheads of providing industry assistance in minimum costs of government. Expenditure on tourism, primary industry, resource development, and other industry assistance and facilitation would be excluded. Included in the core government services would be overheads, education, health and welfare, law and order, environmental management, public transport, roads and the basic functions that support the operation of government.

Resources required by government to provide core services

As implied, the definition of the minimum cost of government is not supposed to comprehensively include expenditure that States incur on core government functions generating utility. Instead, it should include the inescapable fixed costs that are required to facilitate the delivery of services.

A good approximation of this concept is the minimum expenditure States incur to provide a central office. The role of a central office is to provide corporate services and policy and planning (CGC 2001a). The CGC attempts to do this through a part of its assessment of the administrative scale disability factor.

CGC approach to measuring the fixed cost of government

The CGC's comprehensive approach to equalisation of recurrent State expenditure includes an assessment of the costs of basic administrative structures, whose role is to provide machinery of government, policy advice across the full range of services and to administer and implement policies (CGC 2001a).

In calculating an administrative scale disability factor, the CGC assumes that the basic structure of government refers to part of the function of head offices of departments (CGC 2001a). The CGC calculates the cost of this basic administrative structure as the fixed and scale affected variable cost of corporate services and policy and planning which they derive from expenditure of (the smallest) three States on the central office functions of education and police services. The results are extrapolated to cover the full range of State Government services.

The CGC compares each State's capacity to provide the fixed cost component of the basic administrative structures on the basis that each State should be given the same dollar capacity to provide basic administrative structures.

The scale affected variable disabilities assumes that New South Wales, Victoria and Queensland have achieved full economies of scale, while the Northern Territory's disability is calculated to be three times that of the largest States. Disabilities for the other States have been interpolated to take account of their expenditure and population size (CGC 2001a).

The CGC's most recent calculation (1999a) of the fixed cost component incurred by States in providing the basic structure of government is in Table D.1. The shaded rows represent fixed costs the States incur in provision of services that do not directly impact upon the welfare of Australians and which are excluded from our definition of the minimum cost of government.

TABLE D.1: CGC calculation of fixed costs

	Fixed Cost ($m)
Education	**12.0**
Pre-school education	0.2
Government primary education	3.3
Non-government primary education	0.8
Government secondary education	2.8
Non-government secondary education	0.8
TAFE	4.0
Health (excluding public health)	**10.0**
Hospital services	5.4
Nursing home services	0.3
Mental health services	0.7
Community health services	1.7
Public health	2.0
Law and order	**13.0**
Police	5.0
Administration of justice	4.0
Corrective services	2.0
Public safety and emergency services	2.0
Welfare	**8.0**
Family and child welfare	1.2
Aged and disabled welfare	2.3
Other welfare services	0.5
Housing	4.0
Culture and recreation	**9.0**
Culture and recreation	7.0
National parks and wildlife services	2.0
Community development	**0.4**
Indigenous community services	0.4
General public services	**30.5**
Superannuation	0.5
Other general public services	30.0
Services to industry	**11.6**
Primary industry	2.8
Mining, fuel and energy	2.8
Tourism	3.0
Manufacturing and other industry	3.0
Transport	**4.0**
Road maintenance	4.0
Regulatory and other services	**15.0**
Regulatory and other services	15.0
Total	109.5
Total excluding Services to Industry	**97.9**

Source: CGC 2001a

Problems with the CGC methodology

There are several drawbacks of using the CGC method for measuring the minimum cost of government.

(1) The scale-affected variable cost does not relate to the central office function and as such, does not constitute a component of the minimum cost of government.

(2) States differ in their allocation of functions to departments, making comparisons across States inaccurate. In order for the CGC approach to accurately compare States, it would have to ensure a consistent allocation of each expenditure type to a department. This is problematic because two similar expenditure areas located in the same department may share corporate services, and achieve economies of scale. Grouping of expenditure types across departments will vary across States. In addition, in the Northern Territory, much of the central office type functions are undertaken by the Department of Corporate and Information Services, which is a share service organisation providing corporate services to all Government agencies in the areas of human resources, finance, contracts and procurement, superannuation, printing and information services (Department of Corporate and Information Services 2001).

(3) The timeframe on which the CGC constructs its central office costs is outdated when applied to current grant distribution. The CGC's estimates depend upon data from 1993–94 and 1997–98. Only current expenditure will adequately reflect the impact of microeconomic reform upon decisions to allocate resources between labour and capital. As technology becomes more advanced, the resourcing decision of States will move away from labour towards capital.

(4) The CGC estimate of the cost of the basic structure of government is unnecessarily narrow as the calculation is restricted to police and education. For the CGC methodology to accurately reflect the minimum cost of government it would need to measure the cost of each functional area of core government expenditure, rather than assuming that the head office structures for police and education are typical of all areas of State Government expenditure.

(5) The analysis only utilises data from three States. The CGC has constructed a typical head office for education based on information available for the Australian Capital Territory, Tasmania and the Northern Territory; and a typical head office for police, based on information for Tasmania and the Northern Territory. These three States were selected on the presumption that they would be operating the minimum sized central office, as they have the smallest populations. The use of three States is problematic.

An alternative methodology

An alternative methodology to measuring the minimum cost of government is sensibly based on the substantial work done to date by the CGC on the fixed cost of the basic structure of government.

The existence of economies of scale in provision of government services is fairly uncontentious. It is the minimum population size required to achieve efficiencies, and the population size at which diseconomies of scale occur, that are open to debate. This directly affects how many Australian States have achieved a population size sufficient to achieve economies of scale in provision of head office functions.

The CGC assumes that a States' ability to achieve efficiency in provision of a central office function is directly proportional to its population size. Further work needs to be done on determining at what point economies of scale in central office functions are achieved. It might be that a calculation of a precise population is impossible, and that economies of scale are achieved within an upper and lower population bound.

A minimum cost of government will exclude expenditure States incur on functions that do not maintain or enhance the delivery of services that are directly important to the welfare of citizens. These are included under the CGC's definition of 'services to industry'. The proposed minimum cost of government would exclude such expenditures.

The CGC approach to measuring the fixed cost of a central office is a good foundation on which to base the measurement of the minimum cost of government. In the absence of a definitive analysis surrounding economies of scale, the following modifications should be made to the CGC methodology of measuring administrative scale so that it more accurately measures the minimum cost of government.

(1) The data utilised by the CGC needs to reflect the period to which they apply. Outdated data will not be useful in determining the unavoidable expenditure that States incur in provision of central administration.

(2) The departmental coverage across States needs to be consistent. As much as possible, the calculation should reconcile functional expenditures consistently across States.

(3) The measurement of central office costs should encompass the functions areas in Table D.1 (excluding the 'Services to Industry') rather than measuring two areas of expenditure (police and education) and extrapolating them for the other areas.

(4) The analysis should utilise data from all States to ensure that bias and policy choice are not being entrenched in the calculation.

Calculating the minimum cost of government

Calculating the minimum cost of government is a role that the CGC could perform. The CGC's role would initially be to analyse the existence and boundaries of economies of scale. The minimum cost of government would need to be recalculated periodically to ensure it reflects the prevailing environment of central office expenditure in States.

For the purpose of this Report, the Review Committee utilises the work done to date by the CGC on measuring fixed costs. The minimum cost of government for a State is defined as the total fixed cost, subtracting the 'services to industry' expenditures, as they do not maintain or enhance the welfare of the residents. The minimum cost of Government for a State is calculated at $97.9 million per year.

As the minimum costs of government are not related to population, the revenue projections in Chapter 13 assume that nominal costs rise at the general inflation rate.

APPENDIX E: Consultation

The Final Report and the Review Committee's recommendations have been informed by experience, views and analysis from the Australian community. The Review's consultation process included calling for public submissions, holding a National Forum and meeting with interested parties in all States and Territories.

Submissions

All Australians were encouraged to make a submission to the Review. Fifty-five submissions were received from a range of organisations and individuals, including:

- Aboriginal and Torres Strait Islander Commission
- Aged and Community Services Australia
- Anglicare Tasmania
- Association of Mining and Exploration Companies
- Australian Institute of Health and Welfare
- Burke, Denis – Leader of Northern Territory Country Liberal Party Opposition
- Business Council of Australia
- Catholic Welfare Australia
- Centre for Economic Development of Australia
- Chamber of Commerce and Industry of Western Australia
- City of Sydney
- Codd, Mike – Secretary of the Department of Prime Minister and Cabinet 1986–1991
- Commerce Queensland
- Committee for Sydney
- Court, Sir Charles – Premier of Western Australia 1974–1982
- Craig, John – Centre for Policy Development Systems
- Davis, Professor Glyn – Vice Chancellor, Griffith University and Director-General, Queensland Department of Premier and Cabinet 1998–2001
- Drummond, Mark – University of Canberra
- Erskinomics Consulting
- Fraser, Malcolm – Prime Minister of Australia 1975–1983
- Government of New South Wales
- Government of Victoria
- Government of Western Australia
- Greens (Western Australia)
- Greiner, Nick – Premier of New South Wales 1988–1992
- Hancock, Jim – South Australian Centre for Economic Studies
- Hawke, Bob – Prime Minister of Australia 1983–1991
- Laird, Associate Professor Phillip – University of Wollongong
- Lewis, PS
- Local Government and Shires Association of New South Wales

- Local Government Association of South Australia
- Lynch, Toby
- Matthewson, Melanie – Conceptual Planners
- Melville, Sir Leslie – Record of Ross Garnaut's discussion with Sir Leslie Melville, Chairman of the Commonwealth Grants Commission 1966–1974 and 1979–1981
- Municipal Association of Victoria
- New South Wales Farmers' Association
- Northern Territory Council of Social Service
- Pincus, Professor Jonathan – University of Adelaide
- Productivity Commission
- RACV
- Real Estate Institute of Australia
- Real Estate Institute of South Australia
- Rigby, Ken
- Robinson, Associate Professor Marc – Queensland University of Technology
- Smith, Julie – Australian National University
- Stone, John – Secretary of the Commonwealth Treasury 1979–1984 and Federal Senator for Queensland 1987–1990
- Tasman Economics
- The Smith Family
- Uniting Care Australia
- Victorian Employers' Chamber of Commerce and Industry
- Victorian Local Governance Association
- Western Australia Local Government Association
- Western Australian Chamber of Minerals and Energy
- Whitlam, Gough – Prime Minister of Australia 1972–1975.

Submissions can be viewed in full on the Review's website.

National Forum

The National Forum on Commonwealth–State Funding was held at Old Parliament House on 14 March 2002. More than 75 people – including former politicians, leading business and community groups, public policy experts, academics and economists – gathered at Old Parliament House in Canberra to discuss the current system of Commonwealth grant allocation to the States and Territories. Old Parliament House was a symbolic location for the National Forum, as it is the venue where Australia's current system of Commonwealth–State financial arrangements started to take on its contemporary shape in 1933.

The National Forum provided an opportunity for public discussion of the issues at the core of the Review, and to test the academic rigour of research undertaken for the Review. The University of Canberra's National Centre for Social and Economic Research presented draft research on the equity effects of the current system, and Monash University's Centre of Policy Studies presented draft research on efficiency. The Committee also tabled an issues paper on current Federal financial arrangements, *Issues in Commonwealth–State Funding*.

Discussion on the papers was opened by:

- The Honourable John Bannon, Premier of South Australia 1982–92
- Professor Geoff Brennan, Australian National University and former Director of the Research School of Social Sciences at the Australian National University
- Emeritus Professor Cliff Walsh, Adelaide University and former Executive Director of the Federalism Research Centre
- Professor Nick Morris, Chief Executive, Tasman Economics
- Jim Hancock, Deputy Director, South Australian Centre for Economic Studies
- David Johnson, Associate Professor, Melbourne Institute of Applied Economic and Social Research.

The following people and organisations attended the National Forum:

- Aboriginal and Torres Strait Islander Commission
- Australian Council of Social Services
- Australian Health Care Agreement Taskforce, Department of Health and Ageing
- Australian Divisions of General Practice
- Committee for Sydney
- Commonwealth Grants Commission
- Commonwealth Treasury
- CPA Australia
- Department of Finance and Administration
- Department of Prime Minister and Cabinet
- Department of Treasury and Finance, Tasmania
- Department of Treasury and Finance, Victoria
- Department of Treasury and Finance, Western Australia
- Econtech
- Erskinomics Consulting
- Laird, Philip – University of Wollongong
- Mission Australia
- New South Wales Treasury
- Peloquin, David – Privy Council Office, Government of Canada
- Pincus, Jonathan – University of Adelaide
- Productivity Commission
- Property Owners' Association of New South Wales
- RACV Ltd
- Real Estate Institute of Australia
- Real Estate Institute of Victoria
- Salomon Smith Barney/Citibank Australia and New Zealand
- Sisters of Charity Education Council
- Smith, Julie – Australian National University
- South Australian Centre for Economic Studies
- Stone, John – Secretary of the Commonwealth Treasury 1979–1984 and Federal Senator for Queensland 1987–1990
- Tasman Economics
- The Salvation Army
- UnitingCare Australia

- VICRoads
- Wild, Philip – University of Queensland
- Williams, Ross – University of Melbourne
- A number of Australians in their capacities as private citizens.

Interstate visits

The Committee has consulted with interested people in every State, including former political leaders, business and community groups, public policy experts, academics, business economists and government officials. Meetings took place in person and by telephone.

- Australian Business Economists (Sydney)
- Banks, Gary – Chairman, Productivity Commission
- Court, Sir Charles – Premier of Western Australia 1974–1982
- Craig, Andrew – Chief Executive Officer, Commerce Queensland
- Davis, Professor Glyn – Vice Chancellor, Griffith University and Director-General, Queensland Department of Premier and Cabinet 1998–2001
- Fraser, Malcolm – Prime Minister of Australia 1975–1983
- Goss, Wayne – Premier of Queensland 1991–96
- Hawke, Bob – Prime Minister of Australia 1983–1991
- Henry, Ken – Secretary, Commonwealth Treasury
- Kennett, Jeff – Premier of Victoria 1994–1999
- Madden, John – Centre for Regional Economic Analysis, University of Tasmania
- Melville, Sir Leslie – Chairman of the Commonwealth Grants Commission 1966–74 and 1979–81
- Morris, Alan – Chairman of the Commonwealth Grants Commission
- Norris, Jon – Director of Policy, Commerce Queensland
- Pitkethly, Garth – First Assistant Commissioner, Productivity Commission
- Robinson, Associate Professor Marc – Queensland University of Technology
- Smith, Greg – Executive Director, Budgets Group, Commonwealth Treasury
- Walsh, Cliff – Emeritus Professor Adelaide University and former Executive Director Federalism Research Centre
- Senior Officers of the Commonwealth Department of Finance
- Senior Officers of the Governments of New South Wales, Victoria, Western Australia, Queensland, South Australia, the Australian Capital Territory and the Northern Territory.

GLOSSARY

Term	Definition
budget balancing assistance	Commonwealth guarantee under the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (1999) that the budgetary position of each individual State and Territory will be no worse off following the tax reforms introduced under *A New Tax System*. To meet this guarantee, the Commonwealth makes transitional assistance payments to each State and Territory until their shares of the GST revenue pool are enough to compensate for any losses from GST-related changes.
Commonwealth Grants Commission	Statutory body that advises the Commonwealth Government on per capita relativities for distributing among the States and Territories the pool of general revenue assistance made available by the Commonwealth.
consumer price index	An inflationary indicator that measures the change in the cost of a fixed basket of goods and services typically purchased by metropolitan wage earning households. The goods and services are divided into the following groups: food; clothing; housing; household equipment and operation; transportation; tobacco and alcohol; health and personal care; recreation and education. Indexes for each of these groups and for `All Groups' are published monthly for each of the State capitals, Canberra and Darwin and for the weighted average of the eight capital cities.
Deadweight cost	The cost to the economy over and above the amount of actual revenue collected or the excess burden.
disabilities:	
cost disabilities	*Cost disabilities* – when states face higher costs in providing services for reasons outside their control.
revenue disabilities	*Revenue disabilities* – when States have a lower capacity to raise their own revenues for reasons outside their control.
donor States	States and Territories that receive less than their per capita share of GST revenues.
economic growth	The persistent expansion of a country’s production possibilities.
economic rent	The amount a factor is earning over and above what it could be earning in its next best alternative use.
economies of scale	When larger firms are able to lower their unit costs. This may happen for a variety of reasons, for example, a larger firm may be able to buy in bulk, it may be able to organise production more efficiently, it may be able to raise capital cheaper and more efficiently.

Efficiency:

allocative efficiency	*Allocative efficiency* occurs when available resources are used to produce the highest possible value of products for the overall community. The importance of allocative efficiency is demonstrated when the application of technical efficiency alone results in a product of less value to the community than the resources could produce if used elsewhere.
dynamic efficiency	*Dynamic efficiency* (versus static efficiency) occurs when particular arrangements promoting innovation and improvement may not produce immediate productivity gains but may do so over time. Some arrangements are superior to others in the dynamic sense of promoting more productive resource use over time.
economic efficiency	*Economic efficiency* is a measure of the ability of an organization to produce and distribute its product at the lowest possible cost. This occurs when no rearrangement of resources will leave someone better off without worsening the position of others.
productive or technical efficiency	*Productive* or *technical efficiency* is the use of resources in producing goods or services to conform with best practice (i.e. not using resources wastefully).

equity:

horizontal	*Horizontal equity* refers to the equitable treatment of people who are equally well off, wherever they live in Australia.
vertical	*Vertical equity* refers to when a policy transfers income, purchasing power or access to services among Australians, and in doing so redistributes from richer to poorer individuals or households.

expenditure needs	Differences from average costs of providing and average demands for State services.
externalities	Where the actions of organisations and individuals have an effect on organisations and individuals other than themselves. In the case of negative externalities, the external effects are costs on other people, known as external costs. There may be external costs from both production and consumption. These can be added to the private costs to get the total social costs. An example is pollution, where people other than the firm may bear the health costs and other problems. In the case of positive externalities the external effects are benefits on other people, external benefits. There may be external benefits from both production and consumption. These can be added to the private benefits to get the total social benefits.
financial assistance grants	Tax reimbursement grants to the States distributed by the Commonwealth Grants Commission from 1942, following the Commonwealth's introduction of uniform income tax legislation. These grants became known as financial assistance grants in 1959. They were later replaced by general purpose grants under the 1999 *Intergovernmental Agreement on Reform of Commonwealth–State Financial Relations*.
fiscal residuum	The total level of Commonwealth public services and benefits received, less Commonwealth taxes paid (both directly and indirectly) by individuals in a region.
flypaper effect	When spending and tax decisions made by a government are not closely in line with the preferences of their households. Money 'thrown' at a State Government tends to stick, even though the welfare of households would be better served if the money were passed on to them through lower taxes.

fungibility of funds	When the Commonwealth purports to place conditions on the funds that it provides, while the states utilise the potential for money saved from one activity to be spent on others (fungibility) to retain a considerable degree of actual control.
general purpose grants	United grants provided by the Commonwealth to the states that can be used by the states for any purpose. Under the Intergovernmental Agreement, GST revenues are used for general purpose grants, replacing financial assistance grants and revenue replacement (of state franchise fees) payments.
gini coefficient	Measures the extent to which the distribution of income among individuals or households deviates from a perfectly equal distribution. Zero represents perfect equality, while one represent absolute inequality.
gross domestic product	A measure of national income. It is the total value of all goods and services produced over a given time period (usually a year) excluding net property income from abroad. It can be measured either as the total of income, expenditure or output.
gross state product	A measure of the total monetary value of goods and services produced in a state during a given period.
horizontal fiscal equalisation	Arrangements within a federation to reduce or eliminate differences in the fiscal ability of States to carry out the functions for which they are responsible.
horizontal fiscal imbalance	When the revenue capacities of State Governments vary so that they are not able to provide their citizens with services at the same level on the basis of comparable tax levels. In addition there can be imbalances on the expenditure side due to differences in the 'expenditure needs' of different states because of variation in sociodemographic characteristics of their populations and the cost of providing services.
inclusion approach	Approach used by the Commonwealth Grants Commission where specific purpose payments provide assistance for a function within the standard budget for which needs are assessed. Expenditure financed from the specific purpose payment and from State sources is included in the relevant expenditure standards while, on the revenue side, the specific purpose payment is assumed to meet part of the State's Total Financial Assistance Requirement.
Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations (IGA; 1999)	An agreement signed by all jurisdictions in mid-1999 that outlined the new arrangements for Commonwealth–State financial relations. It provided for GST to be allocated among the states by the Commonwealth Grants Commission on horizontal fiscal equalisation principles.
Länder	A state in Germany; the equivalent of an Australian State.
marginal income tax rate	The rate of tax paid on the next dollar earned. In the case of income tax this will increase as a person moves from one band to the next.
marginal productivity	The additional real gross domestic produced by one additional hour of labour input, holding all other inputs and technology constant.
marginal social product	The effect on social welfare of employing one additional unit of a factor of production (labour, land or capital).

merit goods (health, education and training)	Goods that would be under-provided in a pure free market economy. This is because they have external benefits that people would not take into account when they made their decisions about how much to consume. An example is vaccinations. As a result of people being vaccinated we keep disease out of the country, but if it was left just to the market many people might choose to take the risk and not pay for vaccinations. This could have negative effects for society.
mobile resources:	
mobile capital	*mobile capital* – the ability of investment funds to flow across international borders.
mobile labour	*mobile labour* – the extent to which workers are willing to move from one region or country to another (geographical mobility) or to change from one occupation to another (occupational mobility).
National Competition Policy	A wide-ranging reform program to develop a more open and integrated Australian market that limits anti-competitive conduct and removes the special advantages previously enjoyed by government business activities.
needs principle	To reflect above or below average revenue raising capacity or expenditure responsibilities, the equal per capita amount of the pool for each state is adjusted by adding its per capita expenditure, revenue and specific purpose payment needs, and expressing the result as a proportion of the per capita pool of Commonwealth funds.
on-passed funding	Payments from the Commonwealth through the Sstates, which are passed to other bodies, principally non-government schools and local governments.
outcomes	Government objectives in each portfolio area. Desired results, impacts or consequences for the Australian community influenced by the actions of the Commonwealth.
outputs	The goods and services produced by agencies on behalf of government for external organisations or individuals. Outputs also include goods and services for other areas of government external to the agency.
per capita	Per head of population.
performance measures	Dimensions of quality, quantity, timeliness and cost used to describe how many, how well, when or how frequently, and at what cost the outputs Governments intend to fund will be delivered.
policy neutrality	States are given the capacity to provide an average standard of services (at an average level of efficiency) regardless of whether those services are provided below or above that standard.
political economy	The social science that deals with political science and economics as a unified subject; the study of the interrelationships between political and economic processes.
real terms	A value or variation adjusted for inflation.
recipient states	States and Territories that receive more than their per capita share of GST revenues.
relativities	The per capita equalisation grant for each State expressed as a ratio of the national average per capita equalisation grant. Relativities are then averaged over five years and used to distribute the combined pool of GST revenues in the grant allocation year.

revenue need	Reflect above or below-average revenue raising capacities
revenue raising capacity	Determined by the size of States' revenue bases, such as wages and salaries (payroll tax), land values (land tax) and mining and industry profits (royalties).
revenue replacement payments	A form of compensation to the States for the loss of franchise fees. Subsequently replaced with general purpose grants.
royalties	A share of the profit or product reserved by the grantor, especially of an oil or mining lease.
specific purpose payments:	Commonwealth Grants to the States that must be spent in specific areas such as health or education. Specific purpose payments are subject to individual agreements which attach a variety of terms and conditions to the grants. They are also usually classified as:
SPPs 'through'	– payments 'to' the States, which are programs administered by the States
SPPs 'to'	– payments 'through' the States, which are on-passed to other bodies, principally non-government schools and local governments.
standard budget	The starting point in the calculation of relativities. It reflects the scope of state activities to be included in the assessment and puts them into a common framework.
standardised expenditure	The assessment of what a State would need to spend to provide a standard (average) service if it operated at an average level of efficiency.
standardised revenue	An estimate of what a State would raise from its own sources if it made a standard (average) revenue raising effort; that is, if it applied standard (average) tax rates to its tax bases and collected revenue at an average level of efficiency.
State of origin allocation	Returning proceeds of a tax to the States that generated the revenue.
unitary state	A system of government in which legislative responsibility is carried out by one set of elected parliamentarians, representing the entire population and fulfilling administrative and executive responsibilities.
vertical fiscal imbalance	When constitutionally assigned federal and state government revenues do not match their constitutionally assigned expenditure responsibilities.

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INDEX

A

B

C

D

E

F

G

H

I

J

K

L

M

N

O

P

Q

R

S

T

U

V

W

Review of
Commonwealth – State Funding