REFORM OF THE COMMONWEALTH GRANTS COMMISSION: IT'S ALL IN THE DETAIL

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I WHY THE CGC?

The Commonwealth Grants Commission ('CGC') was established by the federal government ('Commonwealth') in July 1933, at a time when there was concern from States and Territories in the Australian federation about whether the Commonwealth could be relied upon to provide funding which acknowledged their differing needs. These concerns were most evident amongst the small States such as Queensland, Western Australia, South Australia and Tasmania. The CGC was therefore designed to operate as an independent arbiter in the area of intergovernmental financial relations, initially between the Commonwealth and the States, but also in the late 1970s with the Territories.

The objective of the CGC has been to maintain financial equality in a diverse federation and, while it has not always found universal support, its impartiality and objectivity are widely acknowledged. As a statutory authority (under the *Commonwealth Grants Commission Act 1973* (Cth)), its role is to provide advice to the Commonwealth in response to terms of reference ('TOR') from the Treasurer. These TOR (see Attachment A) are decided by the Commonwealth in consultation with the States and the advice provided by the CGC is based on the principle of horizontal fiscal equalisation ('HFE'), which states that

> each State should be given the capacity to provide the average standard of State-type public services, assuming it does so at an average level of operational efficiency and makes an average effort to raise revenue from its own sources.[1]

This process of HFE is focused on equalising each State's capacity to provide services – not how actual services are provided. This focus on the inputs rather than the outputs of States' service delivery is designed to provide States with the capacity to provide services while leaving each State free to determine its own specific priorities when expending their untied general revenue grants.

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1 See Commonwealth Grants Commission, *About CGC* <http://www.cgc.gov.au/about_cgc> at 22 July 2008.

The objective of this paper is not to focus on how the TOR are decided[2] but rather on how the CGC goes about responding to them. The intention of this paper is to focus on three basic issues:

1. The CGC methodology.
2. The broad limitations of the CGC approach.
3. Possible constructive reforms to the CGC approach – both incremental and more fundamental.

II FUNDING THE AUSTRALIAN FEDERATION

In 2006–07, the Commonwealth received 46.4% of its tax revenue from taxes on personal income, 25.8% from company income, 15.7% from the Goods and Services Tax ('GST') and 9% from excise duties. The States in contrast received 29.4% of their revenue from a tax on payrolls, 26.7% from taxes on property transfers, 12.1% from taxes on motor vehicles, 11% from land taxes and 9.8% from gambling taxes.[3] However, the Commonwealth raised considerably more revenue than it required for its own-purpose outlays, collecting 81.9% of all taxation revenue while being responsible for only 54.5% of total general government outlays.[4] This contrasts with States which collected only 15.3% of taxation revenue and were responsible for 40.5% of all general government outlays. A high level of vertical fiscal imbalance ('VFI') therefore characterises the Australian federation.[5]

Five basic strategies have been adopted to address this VFI:

1. Re-assignment of taxing powers.
2. Re-assignment of expenditure responsibilities.
3. Revenue sharing arrangements.
4. A system of specific purpose payments ('SPPs') to the States from the Commonwealth.
5. A system of general revenue (untied) grants to the States from the Commonwealth.

Table 1 details how these different sources of revenue funded general government expenditure in the various States in 2006–07. What is clear is that

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2 For discussion on this aspect of the issue, see Neil Warren, *Fiscal Equalisation in Australia: High Level VFI and Equity Focused HFE* (2008) CESifo DICE Report 1/2008 <http://www.cesifo-group.de/portal/page/portal/ifoHome/b-publ/b2journal/40publdice> at 23 July 2008; Neil Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements – Final Report* (2006) 82 <www.treasury.nsw.gov.au/__data/assets/pdf_file/0006/5793/fin-bench-rep.pdf> at 23 July 2008.

3 Australian Bureau of Statistics, *Taxation Revenue 2006–07* (Cat No 5506.0) Tables 1, 3, 15.

4 Ibid. See also Australian Bureau of Statistics, *Government Finance Statistics 2006–07* (Cat No 5512.0) Tables 1, 10, 19.

5 See ibid and above n 3.

the States depend on Commonwealth funding for over 40% of their operating budgets. The remainder of this Part will provide a brief overview of these different funding sources for States from both current and historical perspectives.

Table 1: State Government, Operating Statement – General Government: 2006–07

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	All
Taxation Revenue	38%	34%	27%	33%	28%	20%	32%	11%	32%
GST Revenue Grant to States	23%	25%	25%	23%	31%	43%	26%	62%	26%
SPPs to the States	14%	13%	13%	15%	14%	13%	10%	10%	14%
SPPs through the States	4%	4%	5%	3%	4%	3%	4%	2%	4%
Other Revenue	18%	23%	21%	25%	23%	19%	24%	13%	21%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%
Taxation Revenue	36%	24%	17%	12%	7%	2%	2%	1%	100%
GST Revenue Grant to States	28%	22%	20%	10%	9%	4%	2%	5%	100%
SPPs to the States	32%	23%	19%	13%	8%	2%	1%	2%	100%
SPPs through the States	30%	24%	25%	9%	8%	2%	2%	1%	100%
Other Revenue	26%	23%	26%	12%	7%	2%	2%	1%	100%
Total	31%	23%	21%	11%	8%	2%	2%	2%	100%
Population	33%	25%	20%	10%	8%	2%	2%	1%	100%

Source: Commonwealth, *Budget Paper No 3: Federal Financial Relations 2007–08* <www.budget.gov.au/2007-08/bp3/html/index.htm> at 27 June 2008; Australian Bureau of Statistics, *Government Finance Statistics, 2006–07* (Cat No 5512.0) Table 19.

A Tax Re-Assignment

The Commonwealth has, in the past, made some effort to address VFI through changes in tax assignment. Three instances stand out. In 1971, Commonwealth payroll tax was transferred to States, with States then significantly increasing the rate and base of this tax.

In the second instance, the Commonwealth introduced, in 1976–77, a two-stage system of personal income tax sharing. Stage 1 involved a system of income tax revenue sharing grants and Stage 2, a system where each State could legislate to impose its own surcharge (or rebate) on the Commonwealth personal income tax collected in that State with the Commonwealth authorised to collect it for that State.

Stage 1 was initially set as a per centage of personal income tax, but in the early 1980s it was set as a per centage of total tax receipts of the Commonwealth in the preceding year. By 1985, the Commonwealth had abandoned this revenue sharing arrangement as it sought to rein in its budget outlays at a time when tax sharing grants were 15% of total Commonwealth budget outlays and unstable, varying in line with fluctuations in income tax revenue. This arrangement was replaced with a return to the former system of general revenue funded Financial Assistance Grants ('FAGs').

In the case of Stage 2, the relevant Commonwealth legislation was enacted in 1978 and enabled the Commonwealth to collect any income tax surcharges (or grant rebates) introduced by States. With the Commonwealth unwilling to make room for such a State surcharge, no State was willing to impose such a 'piggyback' or perceived 'double' income tax (or to give an income tax rebate). The Commonwealth enabling legislation was ultimately repealed in 1989. Throughout the 1990s, States continued their calls for the introduction of income tax sharing[6] but the Commonwealth was unwilling to revisit such an arrangement.

The third instance arose in 1997 when the High Court of Australia decided that the New South Wales ('NSW') tobacco business franchise fee was in contravention of section 90 of the *Australian Constitution*, effectively excluding all States from imposing any form of sales tax.[7] The Commonwealth immediately stepped in and under a safety net arrangement agreed to collect the tax on behalf of the States and make Revenue Replacement Payments ('RRPs') to them equal to the revenue they would have collected from all their business franchise fees.

States have also acted in a way which has worsened VFI through their relinquishing particular taxes. Two prominent examples of the 'race to the bottom' are the abolition of death and gift duties in the late 1970s and the abolition of taxes on share transactions in the 1990s. However, in the case of payroll tax, when it was taken over from the Commonwealth at an initial rate of 2.5%, the States immediately and in unison increased the rate to 3.5%, then to 4.5% in September 1973 and to 5% in September 1974. Today the rates vary from 4.75% in Queensland to 6.85% in the Australian Capital Territory ('ACT').[8]

B Effective Expenditure Re-Assignment

Re-assigning expenditure responsibilities has also occurred – indirectly if not directly. Table 1 draws a distinction between SPPs which are 'to' States and those that pass 'through' States. SPPs 'through' States have grown in importance in recent years with the Commonwealth assuming direct funding responsibility for initiatives by States, with or without their agreement. Examples include funding for non-government schools, a first home owners purchase support scheme and financial assistance grants for local government. In recent years, there has also been considerable discussion about the Commonwealth taking over responsibility for health and increased direct funding of secondary schools. In this case, these SPPs remove the State governments from having an expenditure (and therefore funding) commitment.

C Tax Revenue Sharing

Tax revenue sharing is a common practice in federations and can occur when more than one jurisdiction taxes the same base through common tax legislation or

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6 See Neil Warren (ed), *Reshaping Fiscal Federalism in Australia* (1997) Australian Tax Research Foundation (ATRF Conference Series 20).

7 *Ha v New South Wales* (1997) 189 CLR 465.

8 New South Wales Treasury, *Interstate Comparison of Taxes 2007–08* (2007) <http://www.treasury.nsw.gov.au/__data/assets/pdf_file/0010/10171/trp07-2.pdf> at 23 July 2008.

tax administration. This is not the same as tax assignment, where different jurisdictions tax under their own legislation the same base and administer the tax through their own administration (as in Part II A above).

In Australia, tax revenue sharing has taken two forms – the sharing of tax revenue from a particular tax with, in the case of the personal income tax in the 1980s and early 1990s, scope for an additional State surcharge (which they did not implement). Since July 2000, the Commonwealth has shared its GST revenue with the States (Table 1). In contrast, in Canada the central government levies a GST and the Provinces piggyback their own sales taxes on the national GST, with the combined tax called a Harmonized Sales Tax.

Like Canadian provincial sales tax revenue, which returns to the Province from which it was collected, the State Personal Income Tax Surcharge available to the States in the 1980s was to have its revenue returned to those States from which it was collected. In contrast, the GST revenue sharing arrangements introduced in 2000 did not allocate the GST revenue to the State of origin. Rather, the revenue collected is pooled and forms the basis of the general revenue grant to States.

D SPPs

Grants from the Commonwealth to the States take two basic forms as shown in Table 1 – GST Revenue Grants and SPPs. The CGC is responsible for advising the Commonwealth on GST Revenue Grants in terms of its allocation between the States (using *assessed per capita relativities* as defined below).

SPPs 'to' States have also been designed to fund the expenditure obligations of States in a way which the Commonwealth seeks to encourage. These tied SPPs have a disproportionate impact on States' fiscal autonomy through the matching and maintenance conditions attached by the Commonwealth to these grants. In the case of NSW, these tied SPPs provide around 15% of NSW's total budget revenues, but effectively lock-in around 30% of NSW's budget outlays.[9] Table 1 shows that in 2006–07, SPPs constituted some 40% of all State grants received while some 21% of SPPs passed straight through the States.

In the case of tied (and untied) SPPs to States designed to fund expenditures which are the responsibilities of States, the CGC treats these grants as just another revenue source for States and effectively disregards any agreement between the Commonwealth and a particular State about the related goals and the lock-in effect on that State's expenditure programs. This issue is examined further in Parts IV and V.

E General Revenue Payments

While General Revenue Payments ('GRPs') to States are currently linked to revenue from the GST and have been linked to the personal income tax in the past, this is not the normal case. Moreover, in the current case with the GST, not

9 New South Wales, *Budget Paper No 2: 2006*–07, 8–14.

all the revenue is in effect passed on to the States. This is because the revenue from the 10% GST was assigned to the States in return for their repeal of some nine State taxes[10] and to fund the loss by States of Commonwealth FAGs and RRPs, both of which were abolished.

At the Commonwealth level, the abolition of FAGs helped to fund the repeal of the multi-rate narrow-based Wholesale Sales Tax ('WST') on 1 July 2000 when the GST was introduced. As a consequence, while the Commonwealth has made much of the assignment of *all* GST revenue to States, in effect in 2006–07, 58.5% of the GST revenue funded the loss by States of FAGs, 22.5% the abolition of RRPs, 14.1% the repeal of selected State taxes and the remainder their funding of changes to other Commonwealth GST implementation related tax and expenditures. As a consequence, the current arrangement with the GST is less genuine revenue sharing with States and more an alternative to the previous FAGs and RRPs.

The effect of these State tax reforms was that while in 1998–99, States collected 19.5% of all taxes, by 2006–07, this share had fallen to 15.3%. Over the same period, tax revenue as a proportion of total State general government operating revenue fell from 39% to 32%. In contrast, for the same period, the contribution to total State general government operating revenue by Commonwealth grants increased from 35% in 1998–99 to 43% in 2006–07.[11]

The remainder of this paper will focus on critiquing how Australia goes about allocating GRP amongst the States in the Australian federation.

III THE CHALLENGE FOR THE CGC

The challenge for the CGC has been deciding how to respond to its TOR requiring it to advise the Commonwealth on how to distribute GRP to States. In particular, in the case of the *Report on State Revenue Sharing Relativities: 2008 Update* ('*2008 Update*' – see Attachment A), the TOR to the CGC requested it to undertake an

> inquiry into and report upon, by 29 February 2008, the question of the per capita relativities to be used to distribute the combined pool of GST revenue and health care grants among the States, the Northern Territory and the Australian Capital Territory (collectively referred to as the States) in 2008–09,

10 While some of these nine State taxes were abolished within a year of introducing the GST, others were to be reviewed by at least 2005 with the ultimate goal of their abolition being funded from GST revenue receipts. By 2005, all States had either repealed the nine taxes or set dates for their repeal or review. For a list of the nine State taxes, see Commonwealth Treasury, *Tax Reform: Not a New Tax, a New Tax System – The Howard Government's Plan for a New Tax System* (1998) 22 <http://www.treasury.gov.au/contentitem.asp?NavId=022&ContentID=167> at 23 July 2008. For a discussion of the gradual repeal of these taxes, see David Collins and Neil Warren, *The States and the GST: Demystifying Australian Federal/State financial arrangements* (2007) Australian Tax Research Foundation (Information Paper No 4) Table 1.

11 Warren, *Fiscal Equalisation in Australia*, above n 2.

where '[t]he Commission's assessments of per capita relativities should be based on the review period 2002–2003 to 2006–2007 inclusive'.[12]

The methodology to be applied requires that:

- fiscal equalisation (HFE) principles be applied to the 'pool';
- SPPs are variously treated by inclusion, exclusion, absorption or out-of-scope (as directed by the TOR or decided by the CGC) (as discussed later in Figure 3 and Table 4);
- both revenue and expenditure disabilities measured are considered (in consultation with the States and the Commonwealth); and
- all taxes and expenditures are included.

Just how the CGC responds to the TOR and how the Commonwealth utilises this '2002–2003 to 2006–2007 inclusive' data on relativities as reported in Table 2 for the *2008 Update*, distinguishes the Australian federation from all other federations, and it will be to how these relativities are derived and used that we now turn our attention.

Table 2: Per Capita Relativities: 2008–09

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
2002-03	0.83886	0.91954	1.05771	0.98839	1.19644	1.57482	1.12542	4.29672
2003-04	0.86417	0.90434	1.00657	1.02872	1.20851	1.54675	1.13842	4.34956
2004-05	0.92362	0.91437	0.95084	0.91946	1.18589	1.47332	1.19940	4.51074
2005-06	0.96314	0.93197	0.90715	0.75899	1.22953	1.51564	1.23183	4.72137
2006-07	0.96321	0.95677	0.90315	0.71883	1.22244	1.53918	1.16517	4.71336
Assessed Relativities (Unweighted Average) (1)	0.91060	0.92540	0.96508	0.88288	1.20856	1.52994	1.17205	4.51835
3 Year Weighted Ave (50%,25%,25% as in Canada) (2)	0.95330	0.93997	0.91607	0.77903	1.21508	1.51683	1.19039	4.66471
Difference between (1) and (2)	4.7%	1.6%	-5.1%	-11.8%	0.5%	-0.9%	1.6%	3.2%

Source: Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities: 2008 Update* (2008) Tables 6.2 and B-12 <www.cgc.gov.au/__data/assets/file/0004/9850/U2008_FINAL_REPORT_REVISED_VERSION.pdf> at 23 July 2008.

12 Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities: 2008 Update* (2008) <www.cgc.gov.au/__data/assets/file/0004/9850/U2008_FINAL_REPORT_REVISED_VERSION.pdf> at 23 July 2008.

IV UNDERSTANDING THE GRP ALLOCATION PRINCIPLE APPLIED IN AUSTRALIA

What do we want from the GRP allocation mechanism applied in Australia? Essentially, we want to address VFI through the allocation of GRP in a way that ensures any *horizontal fiscal imbalance* is redressed. Such an imbalance can arise when States experience expenditure disabilities (due to their relatively high per capita costs when providing public services) and revenue-raising disabilities (when having relatively small per capita tax bases). The objective of HFE in Australia is therefore focused on compensating States for their expenditure and revenue disabilities (but not for inefficiencies due to their own discretionary policies) based on the principle of *capacity equalisation*, not *performance equalisation*. This is achieved through equalising per capita capacities of the States, but not in a way which forces the adoption of uniform policies.

The actual approach adopted by the CGC in its response to the TOR from the Commonwealth warrants elaboration because a sound appreciation of the detail is fundamental to understanding the ensuing critique of the HFE approach adopted in Australia.

At the outset, it is important to acknowledge that the CGC is an independent statutory authority operating only under a directive from the Commonwealth. This Commonwealth directive arises from the consultation process between the Commonwealth and the States detailed in Figure 1. The ultimate advice sought from the CGC by the Commonwealth Treasurer is the per capita relativities (W_i in Figure 2) for each State *(i)* which is used to determine Australia's 'adjusted population' of which a State's share determines its share of total GRPs (G_i).

Figure 1: Consultative Framework in the Australian Federation

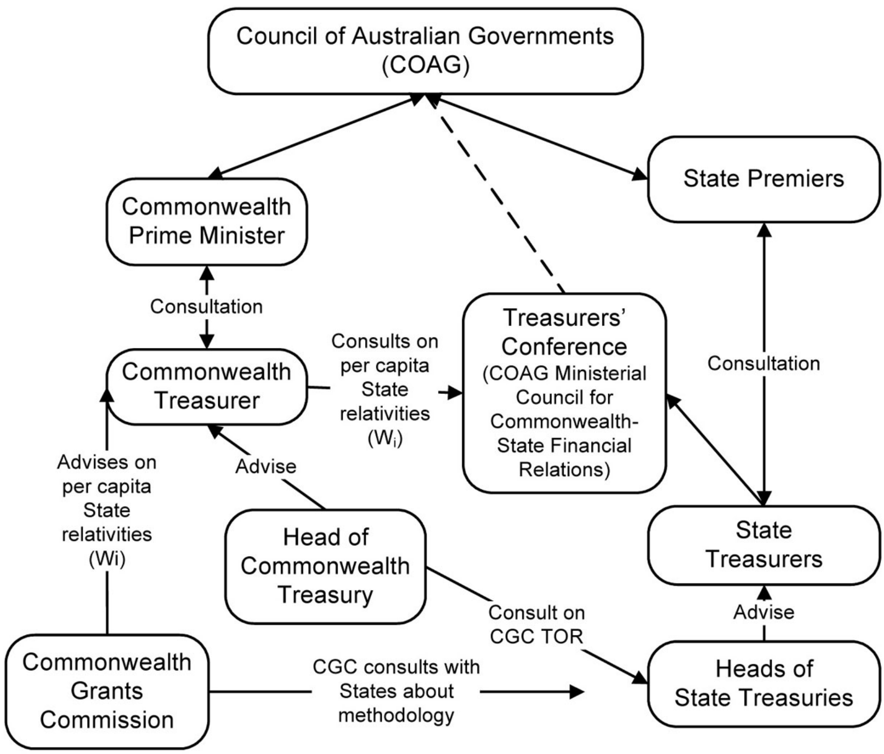
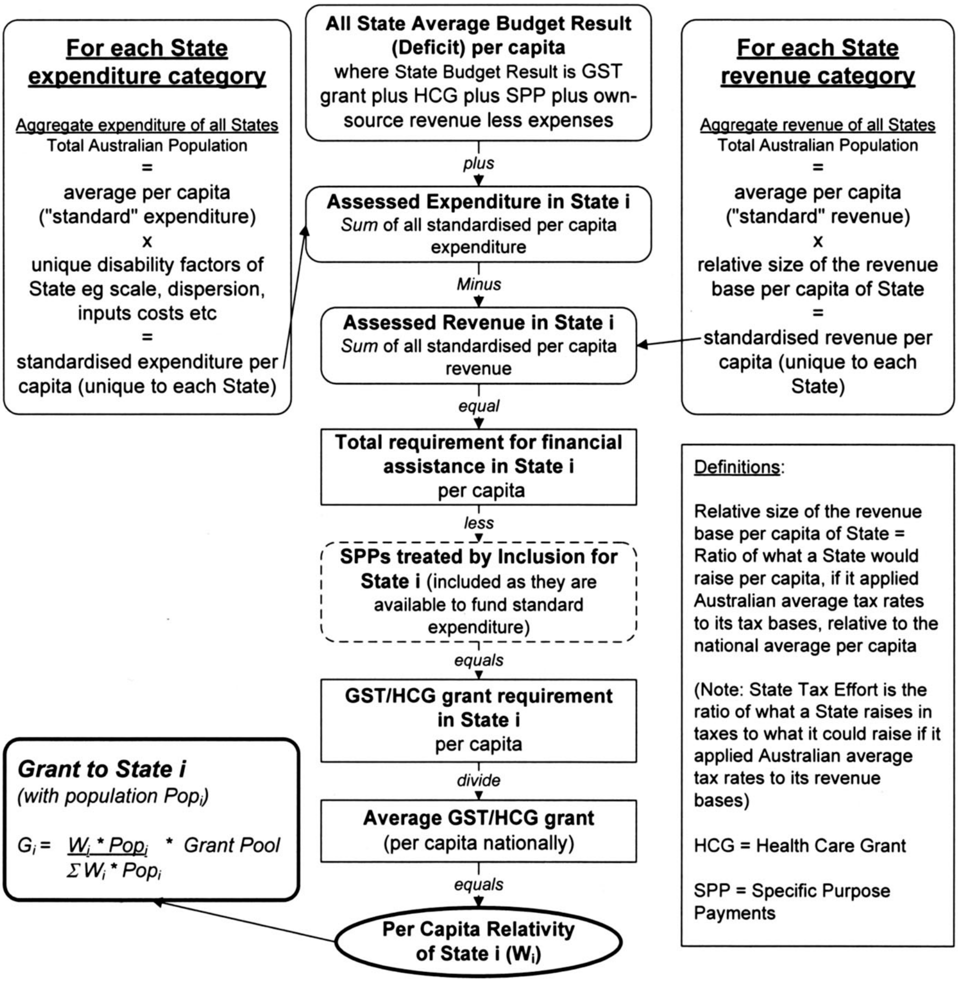


Figure 2: Estimating Per Capita Relativities in Australia



A key distinguishing feature of the Australian federation is how the CGC goes about estimating per capita State relativities for each year (W_i). This is achieved by first estimating a State's equalising requirement which is its requirement for funds from the GST and unquarantined Health Care Grants ('HCG') pool. This is measured as its average all State budget result plus assessed expenses less its assessed revenue less *actual* specific purpose payments treated by inclusion.[13] Table 3 details the CGC findings for 2006–07 for each State.

13 Commonwealth Grants Commission, *Commission Terminology* (2008) <www.cgc.gov.au/__data/assets/pdf_file/0015/10824/20_U2008_Commission_terminology.pdf> at 23 July 2008.

The derivation of assessed expenses and assessed revenue in Table 3 is outlined in Figure 2. At its simplest, assessed revenue reflects the distribution of the base of each tax and assessed expenditure reflects the disability States confront in providing services to residents when compared to the experience across all States.

Table 3: Per Capita GST Relativities: 2006-07

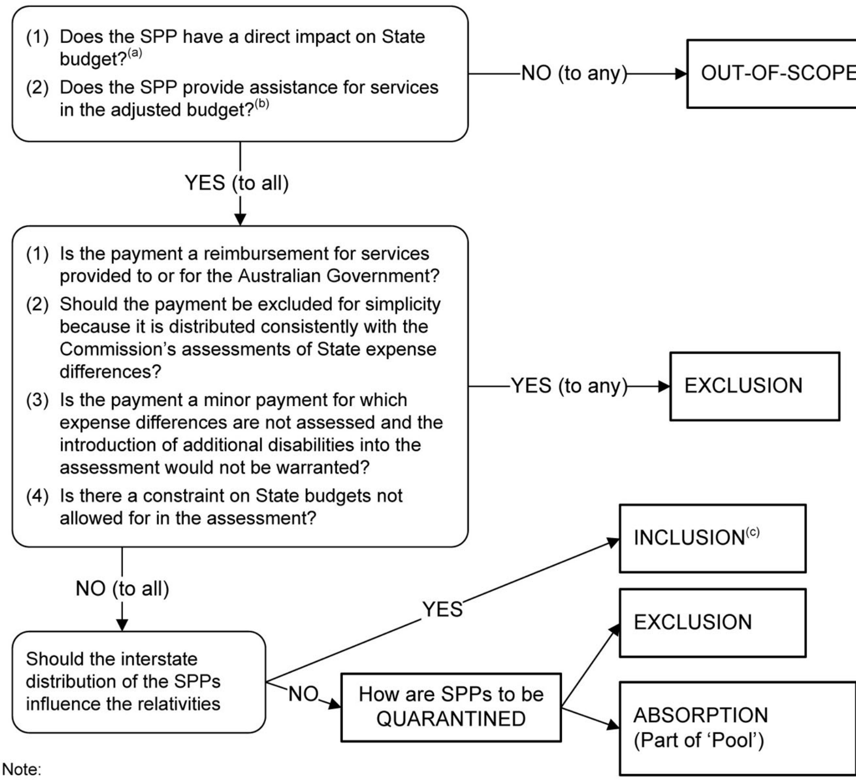
	NSW	Vic	Qld	WA	SA	Tas	ACT	NT
	$	$	$	$	$	$	$	$
Average State budget result	- 202.85	- 202.85	- 202.85	- 202.85	- 202.85	- 202.85	- 202.85	- 202.85
plus: Assessed expenses	5 657.16	5 226.92	5 734.56	6 212.44	5 634.26	6 109.48	5 595.92	14 534.65
	5 454.31	5 024.06	5 531.71	6 009.58	5 431.40	5 906.63	5 393.07	14 331.80
less: Assessed revenue	2 753.89	2 385.40	2 961.62	3 852.11	2 119.43	1 847.73	2 327.14	2 450.49
Total requirement for financial assistance	2 700.42	2 638.66	2 570.09	2 157.47	3 311.98	4 058.91	3 065.92	11 881.31
less: SPPs treated by inclusion	472.45	425.59	481.05	494.77	484.40	498.67	370.80	978.99
GST and HCGs requirement	2 227.96	2 213.07	2 089.04	1 662.70	2 827.58	3 560.23	2 695.13	10 902.32
Per capita relativity[(a)]	0.96321	0.95677	0.90315	0.71883	1.22244	1.53918	1.16517	4.71336

Source: Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities: 2008 Update* (2008) Table B.10 <www.cgc.gov.au/__data/assets/file/0004/9850/U2008_FINAL_REPORT_REVISED_VERSION.pdf> at 23 July 2008.

Not only does the CGC include consideration of State taxes and expenditures in its assessments of States but it also includes some SPPs. Figure 3 outlines the different ways in which the CGC can treat SPPs which, as Table 1 indicates, are nearly three-quarters the size of GST revenue. The treatment adopted by the CGC can be a result of the TOR, as is the case with HCG, which are required to be treated by absorption into the grant pool. Table 4 indicates that in addition to HCG which form 'part of the pool', the CGC decides how other SPPs are to be treated and, in the majority of cases, the remaining SPPs are treated by inclusion. This effectively means that SPPs are treated as not just another revenue source to the States, but as an advanced payment on any 'total requirement for financial assistance' from the Commonwealth (as defined in Table 3). This means that any Commonwealth intended purpose incorporated in the design of SPPs – such as encouraging greater expenditure by a particular State in areas to achieve some national objective – is countered by the CGC treating an SPP (tied or untied) by inclusion.

SPPs treated as out-of-scope are those services which are not part of the adjusted budget, such as services normally provided by the Commonwealth or where they did not have a direct impact on State budgets as with Commonwealth payments through the States. In this case, both the SPP and the related expenditure are excluded from the CGC equalisation analysis when deriving relativities. With SPPs treated by exclusion[14] – which includes reimbursement for services provided for the Commonwealth by States – not included in the CGC analysis (nor its related expenditure), the practical effect is that SPPs treated by exclusion have a similar effect to those defined as out-of-scope, both having no effect on State per capita relativities.

Figure 3: SPP Guidelines



Note:

(a) Under this criterion, other Australian Government payments made to non-government organisations and SPPs paid through the States were treated as out of scope because they did not have a direct impact on State budgets.

(b) Under this criterion, payments made for services which are the responsibilities of the Australian Government and local governments were treated as out of scope.

(c) When inclusion was used, the expense financed by the SPP was included in the adjusted budget and needs assessed in the relevant expense category. The SPP was treated as revenue, available to the recipient State to meet part of its assessed differences.

Source: Adaption of Commonwealth Grants Commission, *Treatment of Australian Government Revenue Payments* (2008), Figure 1 <www.cgc.gov.au/__data/assets/file/0019/10558/06_U2008_Treatment_of_Australian_Government_Revenue_Payments.pdf> at 23 July 2008.

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14 Commonwealth Grants Commission, *Treatment of Australian Government Revenue Payments* (2008) <www.cgc.gov.au/__data/assets/file/0019/10549/06_U2008_Treatment_of_Australian_Government_Revenue_Payments.zip> at 23 July 2008.

Table 4: Treatment of SPPs: 2002–03 to 2006–07 – Method of Treatment (a)

	2002-03	2003-04	2004-05	2005-06	2006-07	2002-03	2003-04	2004-05	2005-06	2006-07
	$m	$m	$m	$m	$m	%	%	%	%	%
Methods required by the terms of reference										
Part of pool	7 076.543	7 410.275	7 800.654	8 199.467	8 687.744	33.5	33.2	32.4	31.5	31.4
Inclusion	0.000	0.000	0.000	0.000	0.000	0.0	0.0	0.0	0.0	0.0
Exclusion	394.015	243.718	347.652	287.888	319.019	1.9	1.1	1.4	1.1	1.2
Out of scope	151.753	155.852	159.748	163.742	170.292	0.7	0.7	0.7	0.6	0.6
Total	7 622.311	7 809.845	8 308.054	8 651.097	9 177.055	36.1	35.0	34.5	33.2	33.2
Methods decided by the Commission										
Part of pool	0.000	0.000	0.000	0.000	0.000	0.0	0.0	0.0	0.0	0.0
Inclusion	7 413.263	7 479.745	8 181.775	8 969.492	9 799.979	35.1	33.6	34.0	34.4	35.4
Exclusion	700.668	985.495	993.028	1 490.966	1 424.782	3.3	4.4	4.1	5.7	5.2
Out of scope	5 385.031	6 018.606	6 580.558	6 926.707	7 244.334	25.5	27.0	27.3	26.6	26.2
Total	13 498.962	14 483.846	15 755.361	17 387.165	18 469.094	63.9	65.0	65.5	66.8	66.8
Total										
Part of pool	7 076.543	7 410.275	7 800.654	8 199.467	8 687.744	33.5	33.2	32.4	31.5	31.4
Inclusion	7 413.263	7 479.745	8 181.775	8 969.492	9 799.979	35.1	33.6	34.0	34.4	35.4
Exclusion	1 094.683	1 229.213	1 340.680	1 778.854	1 743.801	5.2	5.5	5.6	6.8	6.3
Out of scope	5 536.784	6 174.458	6 740.306	7 090.449	7 414.626	26.2	27.7	28.0	27.2	26.8
Total	21 121.273	22 293.690	24 063.415	26 038.262	27 646.149	100.0	100.0	100.0	100.0	100.0

(a) Excludes SPPs treated as State revenue

Source: Commonwealth Grants Commission, *Treatment of Australian Government Revenue Payments* (2008) Table 6 <www.cgc.gov.au/__data/assets/file/0019/10558/06_U2008_Treatment_of_Australian_Government_Revenue_Payments.pdf> at 23 July 2008.

The data for each year – as for 2006–07 in Table 3 – is then used to calculate the assessed relativities (as required by the TOR provided to the CGC by the Commonwealth) which is the unweighted average of the relativities derived over a five year period – as reported in Table 2 in the case of the 2008–09 allocation of the GRP 'pool' in Australia.

The CGC approach has been cited as 'best practice' by other federations, but despite these accolades the Australian approach has not gained acceptance in jurisdictions such as Canada, Germany and Switzerland, each of which have recently undertaken major reviews of their respective systems.[15] Why then have other federations not adopted Australia's approach? And if not, what can Australia learn from recent changes made in other countries to their intergovernmental fiscal arrangements?

15 Bev Dahlby, *The Canadian Federal–Provincial Fiscal Equalisation System* (2008) CESifo DICE Report 1/2008 <www.cesifo-group.de/DocCIDL/dicereport108-forum1.pdf> at 23 July 2008; Rene Frey and Gerard Wettstein, *Reform of the Swiss Fiscal Equalisation System* (2008) CESifo DICE Report 1/2008 <www.cesifo-group.de/DocCIDL/dicereport108-forum4.pdf> at 23 July 2008; Thiess Buettner and Federic Holm-Hadulla, *Fiscal Equalization: The Case of German Municipalities* (2008) CESifo DICE Report 1/2008 <www.cesifo-group.de/DocCIDL/dicereport108-forum3.pdf> at 23 July 2008.

V REFORMING AUSTRALIA'S APPROACH TO FISCAL EQUALISATION

While the CGC methodology is impressive, it has come under increasing scrutiny. This is in part due to a greater proportion of State revenue now coming from GST revenue grants than from the FAGs received prior to the introduction of the GST. Between 1998–99 and 2005–06, State tax revenue rose by 25%, while grants increased 100% (and total revenue by 57%). As a consequence, a far greater proportion of States' revenue is subject to the HFE process so it is not surprising that there has been increasing dissent in recent years over the CGC HFE methodology. This has been led by States such as NSW which in 2005–06 contributed some $2.5 billion per annum of NSW-sourced GST revenue ($366 per head) to other States (excluding Victoria and the ACT). Even on a per capita distribution basis, HFE results in $2 billion per annum ($293 per head) being distributed away from NSW.[16]

Of most concern are those aspects of the CGC methodology that distort State decision-making which, amongst many, include distortions as to whether a State should:

- build its tax base or not (as building a base could benefit lesser States through its impact on grant share);
- accept Commonwealth SPPs being treated by inclusion or absorption rather than being treated by exclusion or out-of-scope or excluded;
- receive SPPs as tied grants;
- manage data flows to the CGC in such a way as to maximise grants;
- influence CGC methodology during reviews to maximise own-grants; and/or
- argue for a complex system which yields opportunities to manipulate grants through:
    a. data integrity issues;
    b. questionable accompanying theoretical assumptions; and
    c. increased scope to manipulate the tax rate on the base (especially where a State has the lowest share).

The remainder of this Part will focus on some of the CGC HFE design attributes which result in these distortions, with Part VI going on to consider potential areas for future reform.

16 Warren, *Fiscal Equalisation in Australia*, above n 2.

A Coverage of Expenditures and Taxes

1 *All Expenditures AND Taxes AND SPPs*

The CGC approach to determining relativities is comprehensive in several respects. First, it involves examining some 37 taxes and 359 expenditure responsibilities. There is considerable dispute as to whether this sophistication is successful in achieving equalisation or whether in fact there is overcompensation for some States.[17]

As noted previously, when determining relativities, the CGC also treats by inclusion (Table 4) many SPPs provided to States by the Commonwealth without any regard as to how effectively either the SPPs or GRP are spent, such as whether service delivery goals are achieved. In the case of the HCGs – which is an SPP allocated to individual States following Commonwealth–State negotiations – this grant is treated by absorption by the CGC (as directed in its TOR). This means that it is effectively added to the GRP 'pool' and distributed using the CGC relativities, thus undermining any associated negotiation or particular purpose surrounding the original allocation of HCGs.

2 *Few Broad Categories or Many Detailed Categories*

The scope of the CGC TOR are all-encompassing and there is no real parallel to the Australian approach. For example, Canada does not include expenditure in its analysis and has only five broad tax classifications. There is a real need to review whether the Australian sophistication yields benefits that could not be achieved by an alternative simpler, more transparent, efficient and equitable approach. This is particularly so since the level of detail applied in Australia is so data intensive that the CGC itself has indicated that it confronts data integrity issues.

3 *Selected Taxes or all Taxes*

While one solution to Australia's focus on detail is to aggregate taxes into a limited number of categories (as noted above), another is to simply exclude some taxes in part or in full. This might be justified because they are minor; because they pose data and methodological problems; or because, if included, they would create unnecessary disincentive effects distorting State resource allocation.

Canada has moved to include only 50% of resource-based tax revenue as, amongst other reasons, to offer an incentive for resource-rich provinces to invest in the infrastructure needed to support such an industry. In the case of Australia, the resource-rich States of Western Australia and Queensland find their revenue from resources, cycling with resource prices and grant revenue cycling as a consequence. Putting incentive back into its federation was a key goal of the recently implemented Canadian review and Australia should consider this issue more closely.

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17 Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements*, above n 2.

B Treatment of SPPs

As noted in Figure 3 (and Table 4), the CGC, whether directed by the TOR or by decision, treats the majority of SPPs by either inclusion or absorption. There is a real need to review why this is the case and whether a better approach is possible. For example, HCGs are treated by absorption while other SPPs are treated by inclusion. Each has a different impact on relativities and on how the 'pool' is allocated which in turn can influence State policies such as whether to receive funding, say for health care, through non-HCGs or HCGs. These differences can result in equalisation grant 'gaming' opportunities for States as they exploit the way their taxation, SPPs and expenditures interact with how their equalisation relativities are determined.

C Distribution of Equalisation Grants and Cash Grants

One area of particular debate has been whether all of the 'pool' should be distributed on the basis of the HFE principle. The Australian debate[18] has been over whether it would be preferable to distribute part according to HFE principles designed to achieve some agreed minimum standard for States and then to distributed the remainder according to some other principle such as on a per capita basis or according to some agreement about program funding (as currently with SPPs). In the case of Canada, in 2007–08, 27% of total cash transfers to provinces were equalisation grants, the remainder being cash transfer. In the case of Canada Health Transfers, these were distributed on an agreed basis while Canada Social Transfers were distributed on a per capita basis.[19]

While Australia's SPPs (including HCG) do have much in common with Canada's cash transfers, two facts distinguish Australia. First, the equalisation pool is considerably larger in Australia. Second, Canada's cash transfers are not taken into consideration when determining equalisation grants whereas most SPPs are treated as just another State revenue source.

Australia must engage in a debate about the merits of reducing the size of equalisation grants, increasing SPPs by a commensurate amount and removing SPPs from consideration when determining equalisation grants.

D Some or All States

Related to the issue of whether the 'pool' should be distributed entirely according to equalisation principles is whether some States should be removed from the CGC TOR such that they receive no equalisation grants, only cash transfers (such as SPPs) allocated on some basis such as per capita or as agreed with the Commonwealth (as with HCG). For example, in Canada some provinces, such as Ontario, Saskatchewan, British Columbia and resource-rich

18 See Ross Garnaut and Vince Fitzgerald, *Review of Commonwealth–State Funding: Final Report – A Review of the Allocation of Commonwealth Grants to the States and Territories* (2002). The Report was produced for the Governments of NSW, Victoria and Western Australia.

19 Dahlby, above n 15. Canada Health Transfers in 2007–08 were 45.5% of total cash transfers to provinces and Canada Social Transfers were 21%.

Alberta, do not receive equalisation grants.[20] Australia needs to consider whether there is a case for States such as NSW, Victoria and Western Australia to be explicitly removed from the CGC HFE deliberations. This would give greater transparency to the role and actions of the CGC; it would also remove from the debate over HFE those States who in effect now receive negative equalisation grants.

The result would be an approach to HFE which 'equalises' recipient States 'up' to some agreed standards without simultaneously equalising non-recipient States 'down'. This would mean that any 'contribution' to the pool by a non-recipient State is capped at a level determined by the equalisation grant pool, so that these States have an incentive to make decisions largely independent of any (negative) equalising grant.

E Incomplete Precision

What this paper has not examined but is worthy of note is the great precision with which the CGC determines assessed revenue and assessed expenditure (in Table 3). For example, in the case of payroll tax, it assumes when estimating a State's share of this tax's base that the average threshold is $650 000 when in fact actual thresholds vary up to nearly twice this level.[21] In the case of land tax the actual tax rate schedule in each State is modelled when estimating assessed revenue from the land tax on commercial property; but in the case of the tax on residential land, only average tax rates are applied to the base.[22] At the same time, no account is taken of the effect land tax rate differentials may have on property prices. The fact is that the more precision the CGC methodology claims, the weaker the foundations become for its approach as it stretches the integrity of its data and the economic theory which underpins its methodology.

F Progressive Revision of Relativities

Each year the CGC responds to the TOR by updating its data for all the years covered by the assessment period of the TOR (such as for 2002–03 to 2006–07 in the *2008 Update*). Also, if a formal review of the methodology has led to a revision of the methodology then the relativities will change as a result, as will assessed relativities.[23] This will also be the case if current or future State policy changes mean that there will be changes to the data for current years that are not consistent with previous financial years in an assessment period. In this case the CGC undertakes 'backcasting' of the changes which will result in changes in past

20 Dahlby, above n 15, 4.

21 Australian Bureau of Statistics, *Taxation Revenue 2006–07* (Cat No 5506.0) Tables 1, 3, 15.

22 Commonwealth Grants Commission, *Land Tax* (2008) <www.cgc.gov.au/__data/assets/file/0019/10666/04_U2008_Land_Tax_Results.pdf> at 23 July 2008.

23 The assessed relativities for the allocation of the 'pool' in 2008–09 are the unweighted average of relativities from each of the years 2002–03 to 2006–07.

relativities. In some cases these can be significant, as with the 2004 CGC methodological review.[24]

As a result, not only are the relativities applied to the 'pool' in Australia up to six years out of date, the relativities for particular years will be varying over time. While revision of relativities are understandable in principle, in practice constant revision as a result of improved data and methodology reviews can lead to uncertainty for State budgeting. Some case exists therefore for fixing relativities once they are determined, as is now the case in Canada.

G Timeliness

An issue related to the revision of relativities is the approach taken when determining assessed relativities as shown in Table 2. In Australia's case, relativities used in one year are two to six years out of date. For example, assessed relativities for the 2008–09 allocation of the 'pool' is derived from the *un*weighted average relativities for the period 2002–03 to 2006–07. This can mean the relativities applied do not reflect the current situation confronting a State.

Table 2 highlights the impact in Australia of replacing the current unweighted approach with the recently introduced Canadian approach which seeks to reflect the current situation confronting provinces by considering only the past three years with the most recent year attracting a 50% weight and the second and third year each receiving a 25% weight. The difference in the results demonstrates that the Canadian approach better reflects the current tax revenue situation confronting States such as Western Australia and Queensland, than the current Australian approach of using an unweighted five year average. The benefit of this approach is that it delivers to States what they need closer to when it is needed. Having an approach which is not reflective of current budgetary pressures confronting a State can result in adverse budget planning and outcomes.

H Focus on Inputs not Outputs

No consideration is currently given to inefficiencies arising from a State's own discretionary policies as they relate to how GRP is expended. Rather than performance equalisation, the focus is on equalising per capita capacity equalisation in a way which does not force the adoption of uniform policies across States. In assessing that capacity, the CGC treats all SPPs from the Commonwealth to States as simply another revenue source (unless the CGC is directed to quarantine these grants, which is more the exception than the rule).[25]

This is being remedied in part because recent reforms will see SPPs moving to an output rather than an input focus. This is a result of the Commonwealth introducing performance requirements to SPPs through States being entitled to

24 Commonwealth Grants Commission, *2004 Review Report* (2004) <www.cgc.gov.au/method_review2/2004_review_report> at 23 July 2008.

25 'Quarantined' SPPs are a small proportion of total SPPs and have historically related to direct grants to non-government schools and local governments.

National Partnership Payments ('NPPs') from the Commonwealth following an independently assessed review of their performance in delivering on Commonwealth set goals for these SPPs. With NPPs being treated as out-of-scope in the TOR to the CGC, States will be encouraged to conform to Commonwealth performance targets, thus forcing SPPs (treated by inclusion by the CGC) to be output focused in practice. The contradiction in the CGC methodology is that with the CGC treating all SPPs by inclusion under the new SPP Guidelines from the Commonwealth, the Commonwealth goals are at odds with the CGC methodology which is claimed to be policy neutral. That is, CGC equalises capacity, not outputs. In contrast, the Commonwealth's action is seeking to equalise outputs, not capacity.

There is a good argument then for SPPs to be simply excluded and all made performance related. The alternative and more circuitous approach is to treat SPPs by inclusion and for NPPs to undo the GRP grant redistribution arising from the CGC methodology.

If it happens that all SPPs became renamed NPPs, then the CGC would invariably treat them by inclusion – the only advantage then being that they are delivered to States under independently reviewed performance agreements with the Commonwealth – which implies only the Commonwealth effectively benefits from such an outcome.

I Process Review

Another distinguishing characteristic of the Australian approach to distributing general revenue grants is the response of the Commonwealth Government to the CGC advice on State relativities. The Commonwealth, almost without exception, accepts the CGC advice and the Ministerial Council for Commonwealth–State Financial Relations does not exercise its option to dissent on the CGC advice. Moreover, the Commonwealth Treasurer allocates 100% of the GST revenue and HCG (the pool) between States using CGC relativities.

This Commonwealth response could be seen as anomalous given the CGC's decision to treat many SPPs by inclusion without being so directed by the TOR. This action could be interpreted as undermining the original Commonwealth objective for those SPPs, which is to support particular expenditure priorities and regions. While the Commonwealth can advise the CGC that certain SPPs be treated by exclusion or out-of-scope (as shown in Table 4), in practice those which are so defined are a small proportion of total SPPs and have historically related to direct grants to non-government schools and local governments.

VI TUNE-UP, OVERHAUL OR TRADE?

The above issues combine to raise the question whether a 'tune-up' of the CGC methodology is in order (as is currently being undertaken with the 2010

Method Review)[26] or if more fundamental root-and-branch reform is necessary to better reflect the needs and demands of our changing federation.

The basic fact is that it is not acceptable to have a grants allocation framework which distorts the growth of a State's tax base, its investment infrastructure or its budget planning practices. It is also questionable to have in place policies designed to make SPPs performance tested when the CGC is acting to undermine this action. It is likewise anomalous to claim precision with a methodology which cannot be supported by the data or economic theory.

The question then is whether the current approach to allocating the GST revenue (and not the 'pool') should be overhauled and whether SPPs in the form of HCG and other payments should be excluded given the move to performance testing of States in receipt of these payments. The answer must be 'yes' – but should we trade-up to the overhaul evident in the new Canadian model, more radically trade-up to a new model as did the Swiss (who have also associated their reforms with expenditure reassignment) or follow Germany in its push for major reform?[27]

What Australia seems incapable of doing is bringing about reform. While there is broad agreement that allocating 100% of the 'pool' according to HFE principles has adverse consequences as well as being too redistributive, reform has proven elusive. The reality is that such a review cannot be left to the States (collectively or individually). Rather, it would be best served though an independent review, as in Canada, which could consider issues such as:

- excluding some or all of selected taxes and expenditure;
- excluding some States from HFE;
- simplifying the tax/expenditure classifications (as with Canada's reduction from 33 taxes to five categories);
- distributing the grant 'pool' part by per capita and part on HFE principles;
- changing the treatment of SPPs (including allocating the majority of SPPs by per capita and treating these as out-of-scope and performance related);
- making assessed relativities more timely such as by using a three year weighted average (Canada) in place of the current five year unweighted average;
- reviewing expenditure and tax assignment (as in Switzerland and Germany) including revisiting the principle of subsidiarity;
- examining different tax assignments and tax sharing arrangements (as in Germany); and

26 Commonwealth Grants Commission, *2010 Review Documents* (2008) <www.cgc.gov.au/method_review2/2010_review_documents2> at 23 July 2008.

27 Commonwealth Grants Commission, *Treatment of Australian Government Revenue Payments* (2008) <www.cgc.gov.au/__data/assets/file/0019/10549/06_U2008_Treatment_of_Australian_Government_Revenue_Payments.zip> at 23 July 2008.

- reviewing (regularly) the consultative framework to reflect better the balance of national and regional interests.

In calling for change, this paper is not recommending the abandonment of the HFE principle. What is at issue is how best to ensure the HFE principle applied in the Australian federation works to address the challenges now confronting the nation in an increasingly competitive and integrated global economy. To this end, only a fundamental and independent review of intergovernmental fiscal arrangements will achieve this task. It is not enough to undertake another CGC methodology review as some of the issues which need to be addressed are beyond its immediate area of responsibility. Canada, Switzerland and Germany have been able to undertake such major reviews. If Australia wants to have a dynamic and vibrant federation capable of constructively responding to changing financial and economic needs and pressures into the future, it too must undertake a fundamental root-and-branch review of its intergovernmental fiscal arrangements.

ATTACHMENT A: TERMS OF REFERENCE FOR 2008 UPDATE

1. I, Lindsay Tanner, Minister for Finance and Deregulation, pursuant to sections 16, 16A and 16AA of the *Commonwealth Grants Commission Act 1973*, refer to the Commission for inquiry into and report upon, by 29 February 2008, the question of the per capita relativities to be used to distribute the combined pool of GST revenue and health care grants among the States, the Northern Territory and the Australian Capital Territory (collectively referred to as the States) in 2008-09. The Commission should provide the per capita relativities to the Australian Government and the States by 22 February 2008.
2. The Commission's assessments of per capita relativities should be based on the review period 2002-2003 to 2006-2007 inclusive. Where possible, the Commission should use the latest available data.
3. The Commission should provide per capita relativities for determining the distribution of:
   (a) a combined pool of GST revenue grants and health care grants; and
   (b) a combined pool of financial assistance grants and health care grants (based on the assumption of a continuation of the Commonwealth–State financial arrangements which applied in 1999-2000).
4. Subject to paragraphs 5 to 11, the Commission's assessments should be based on the application of the same:
   (a) principles;
   (b) items of revenue and government services;
   (c) methods of assessment of those items;
   (d) range and methods of measuring revenue and expenditure disabilities; and
   (e) range and methods of treatment of Australian Government revenue payments

   that the Commission used to calculate the per capita relativities in its *2007 Report on State Revenue Sharing Relativities*.

5. The Commission should prepare its assessments on a basis consistent with the Commonwealth's intention that the following matters should not directly influence the per capita relativities:
   (a) The following components of the Australian Health Care Agreements between the Commonwealth and a State:
      (i) payments in relation to mental health;
      (ii) payments in relation to the National Health Development Fund;
      (iii) payments in relation to the Pathways Home Initiative;
      (iv) all payments under an adjustment module, including those related to the Critical and Urgent Treatment (CUT) Waiting List Initiative;
      (v) compliance payment arrangements (in this case including the maximum available compliance payments in the assessments);
      (vi) payments to South Australia for the administration and management of the hospital at Woomera;
      (vii) payments to Queensland in recognition of the cost associated with the movement of Papua New Guinea's citizens across the Torres Strait;
   (b) the National Aboriginal Health Strategy component of the payment to the Northern Territory under the agreement for the Provision of Housing and Infrastructure for Indigenous People in the Northern Territory 2005-08;
   (c) the Commonwealth's purchase of the Mersey Campus of the North West Regional Hospital from Tasmania; and
   (d) the Commonwealth funding to deliver the Northern Territory Emergency Response to address the indigenous crisis in the Northern Territory.
6. The Commission's assessments should take into account the reforms under the *Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations* (the IGA) which was signed by Heads of Government in June 1999, including the agreed abolition of taxes listed for review in the IGA.
7. Where it is necessary to accommodate later budget developments, the Commission's assessments should be based on the principles, methods of measuring revenue and expenditure disabilities, and methods of treating Australian Government revenue payments that conform to those applied in similar circumstances in the *2007 Report on State Revenue Sharing Relativities*.
8. In preparing its assessments the Commission should have regard for the need to observe policy neutrality in relation to a reduction in the level of a Specific Purpose Payment resulting from non-compliance by a State or Territory with the conditions of the payment. Any such reductions should not directly influence the Commission's assessments of the per capita relativities. Given the complexity and variety of Specific Purpose Payment agreements, additional guidance in relation to any actual reductions for non-compliance will be provided to the Commission if and when the need arises.
9. Where investigations undertaken by the Commission indicate that data used in existing assessments are unsatisfactory, any changes in methods should be made in accordance with the *2010 Review of State Revenue Sharing Relativities Progress Report to Ministerial Council for Commonwealth–State Financial Relations, 2006*.

10 The Commission should take into account all relevant fiscal needs of the Australian Capital Territory, as for the other States and Territory.

11. The Commission should consult the Australian Government and the States before deciding on any changes in methods that arise as result of a significant change in arrangements which govern Commonwealth–State relations and which are considered appropriate for the Commission to fulfil its obligations in respect of these terms of reference.
12. To the extent possible, the Commission should, upon reporting, provide all parties with details underpinning its calculations and assessments, and endeavour to meet requests for supplementary calculations.

LINDSAY TANNER

Source: Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities: 2008 Update* (2008) 29-31, Box 2-1 <www.cgc.gov.au/__data/assets/file/0003/9849/U2008_FINAL_REPORT_REVISED_VERSION.zip> at 23 July 2008.