



COMMONWEALTH GRANTS COMMISSION

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IMPLEMENTING HORIZONTAL FISCAL EQUALISATION A BACKGROUND PAPER

PRIORITIES ISSUES CONFERENCE

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1. This paper describes how the Commission implements horizontal fiscal equalisation (HFE). Its purpose is to provide background material.

2. The Commission has implemented HFE on the basis that the objective is equalising the capacity of State governments to provide services. This follows from the definition of HFE which is:

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 standard¹.

3. In implementing this principle, the Commission has decided:

- (i) what services and revenues are relevant to equalisation;
- (ii) what the words ‘same effort to raise revenue’ and ‘services at the same standard’ mean — that is, what the equalisation benchmarks are;
- (iii) whether there are circumstances beyond their control which influence whether States can achieve the benchmarks — that is, what circumstances beyond the control of States affect their capacity to raise revenues and their costs of providing services; and
- (iv) how to measure the advantages and disadvantages faced by States — what we term disabilities.

4. In implementing these decisions, the Commission aims to achieve:

- (i) comprehensiveness in the scope of revenues and services assessed;
- (ii) comprehensiveness in the advantages and disadvantages assessed; and
- (iii) policy neutrality in both the benchmarks and measures of advantage or disadvantage it uses.

5. The Commission consults extensively with Commonwealth and State Treasuries, the parties with a keen interest in its results. It checks that the arithmetic outcomes are consistent with what it knows about States policies and budgetary circumstances, using information obtained from the States through workplace discussions with State service providers, conferences with Treasury officers, State publications, special data requests and a wide range of economic and demographic information. Commission members draw on their experience to make judgements about the appropriateness of the outcomes.

¹ Commonwealth Grants Commission, Report on General Revenue Grant Relativities 1999, Volume 1, Main Report, p4.

Activities Relevant to Equalisation

6. In principle, the achievement of equalisation requires that the full budgetary circumstances of the States are recognised. Thus the capacities to raise all State government revenues and the costs of providing all services are taken into account. The existing scope of equalisation is:

all functions on which States spend money or from which States raise revenue — in practice, this means that Commonwealth and local government responsibilities are excluded.

7. Because the revenue provided by the Commonwealth is intended to enable States to provide government services, the Commission limits the scope to:

- (i) transactions of a recurrent or operating nature — in practice, this means that the operating impacts of capital transactions are included (through the Depreciation and Debt Charges assessments) but not the capital transactions themselves or most financing transactions; and
- (ii) general budget sector activities — activities of a private or commercial nature are not considered relevant to equalisation, except to the extent that governments subsidise or tax such activities.

8. The Commission defines relevant activities in terms of a standard budget based on State accounting information. This provides an independent measure of the importance of various activities in State budgets. Because of differences in the way States present their accounts, the Commission has always made adjustments to State budgets to ensure consistency between the States in coverage and definition of the activities included.

The Benchmarks

9. ‘Same’ effort to raise revenues, ‘same’ standard of efficiency and ‘same’ standard of services are measured as the national average². Thus the financial benchmarks are the average per capita for each revenue source States access or expenditure on each service States provide. The Commission assumes that all States can operate at this level unless there are special circumstances that mean States must, or can, operate at a different level³.

10. The financial average per capita levels of activity, or financial standards:

- (i) represent the national average revenue effort or level of service;
- (ii) represent the population weighted average of State policy;

² National averages are calculated as the sum of the revenue raised or funds spent by all States and Territories, divided by the sum of their populations — that is, they are population weighted averages.

³ States with revenue raising disadvantages operate below the average and those with revenue raising advantages operate above it. States with cost disadvantages operate at above the average level and those with cost advantages operate below it.

- (iii) capture an average level of efficiency; and
- (iv) are used as a weight to reflect the relative importance of each revenue source or service in the activities of the States and thus their requirement for general revenue assistance.

11. The use of an average standard means the Commission does not make judgements on matters that impinge on State sovereignty. In arriving at a distribution of untied funds, it does not make assumptions about what States should, or could, be doing.

12. Furthermore, the current financial standard is policy neutral and neither encourages nor discourages efficiency. If a State spends less than the average due to its efficiency, it benefits from that relative efficiency. It is given the capacity to operate at the standard level, after taking account of its disabilities. Its above-average level of efficiency does not affect its grant and it can use its savings elsewhere. Similarly, where a State operates at below the average level of efficiency, its grant is not increased as a result. It is given the capacity to provide services at the standard level, allowing for its disabilities, and its inefficiency is a real cost to its budget.

Can States Operate at the Benchmark?

13. The present approach accepts that States need different per capita amounts of equalisation grants if, for reasons beyond their control such as their economic, social, demographic and physical circumstances (disabilities), they:

- need to spend more or less than the benchmark;
- can raise more or less than the benchmark; and
- receive more or less in specific purpose payments (the issue of how SPPs are treated is not covered in this paper).

14. The Commission calls the difference between the amounts that a State needs to spend, or can raise in revenue, and the benchmark, its 'needs'. They can be either positive or negative; that is, positive needs arise from revenue raising or service cost disadvantages and negative needs arise from revenue raising or service cost advantages.

15. Once needs are measured for each revenue and expenditure function, they are totalled to measure the relative requirements of each State for GST revenue. States receive a grant share which is above or below the benchmark share (equal per capita), depending on the overall impact of their revenue and cost advantages and disadvantages.

How are Needs Measured?

16. ***Structure of the assessments.*** To facilitate the measurement of needs, State government activities are broken into categories (different expenditure and revenue raising functions) based on what services States are actually providing and the revenues they are

raising. This is because the nature and extent of disabilities differ for different types of services and revenues.

17. In general, expenditure and revenue items are classified into separate categories when the disabilities relating to that expenditure or revenue differ from disabilities for all other types of functions. For example, government primary education expenditures are separately identified because it is believed that they are influenced by different disabilities from those which influence expenditure needs for government secondary education.

18. In practice, the choice of the number and nature of separate categories depends also on the availability of data to estimate the financial standards and disabilities. In addition, the Commission does not consider it worthwhile to have separate categories where the standards and/or disabilities have no material effect on State revenue shares.

19. While the actual expenditures and revenues differ between States due to disabilities and policy choices, the needs reflect disabilities only. Different approaches are used to assess expenditure and revenue needs. This is because it is easier to identify policy differences in revenue collection than in service provision.

20. *Expenditure assessments.* Expenditure assessments start with an assumption that equal per capita costs would provide the same service, except for the effects of explicitly identified disabilities. Thus, the Commission first identifies and then measures the influences beyond a State's control which require it to spend more (or less) per capita than the Australian average. Because some influences affect only part of the total cost, the Commission estimates the proportion of total costs affected. For example, the dispersion disability recognises the differences in communication and travel costs faced by States because of the geographic spread of their populations. However, because these costs are a relatively small proportion of the total costs of providing a service, the disability is applied so that it reflects only the relevant proportion of total costs.

21. About 15 types of expenditure disabilities are currently assessed. The core disabilities have remained unchanged for several reviews. They can be grouped into two types: demand disabilities and cost disabilities. Demand disabilities reflect the level of use of services due to such things as population characteristics and the availability of private services. Cost disabilities reflect influences that affect the unit costs of services, such as input costs (wage levels, accommodation costs, power costs) and dispersion.

22. Differences between a State's policy choice and the average policy should not increase or decrease the assessment of its needs. For example, States transport children in rural areas to centrally located schools. States with relatively more children in rural areas have an above-average demand disability. States with longer than average distances over which to transport children have a cost disability from extra fuel costs per student carried. Their expenditure requirements would be calculated by increasing the average cost by these disabilities. However, if a State chooses to provide a more generous transport scheme than others, the higher costs it incurs for that policy choice are not included as needs. Needs are only determined for activities reflecting the average policy choice.

23. There is no intrinsic limit to the number of disability assessments that can be made. However, in practice there are limits because the Commission has decided (after consultation with the States) that it is inappropriate to assess disabilities for some functions because:

- all differences in per capita costs are considered to be due to policy differences (for example, this view has been taken with expenditures to promote industry development);
- there may be insufficient information and data to assess disabilities with any confidence; or
- some disabilities may be too small to have a material effect on equalisation outcomes.

24. **Revenue assessments.** Capacities to raise revenues are not the same across States and the nature of revenue raising disabilities tends to be unique to each category. Information on policy differences is readily available from legislation and regulations. Revenue assessments focus on the choice of a revenue base that best measures the capacity of each State to raise that revenue, and to enable the Commission to identify and allow for policy differences. This is easier and more transparent than assuming equal capacity and seeking to identify and measure the effects of disabilities.

25. If policy differences are negligible, as they are for stamp duty on shares, the actual revenues reported by each State are used as the measure of capacity to raise revenue.

26. If policy differences are important and there is no indication that disabilities apply, as for interest earnings, the assumption is that each State has the same capacity to raise revenue. In this case, State population is used as the measure of the revenue base.

27. However, for most revenue categories, there is a mixture of policy differences and disabilities at work. In these cases:

- (i) if policy differences are relatively minor, as they are for stamp duties on conveyances, the approach is to measure tax bases and adjust them for differences in policy;
- (ii) if policy differences are large and their effect is large, as they are for gambling taxes, the approach is to use a broad measure of the underlying capacity, such as household disposable income.

28. **Measurement.** Quality data are available to measure many disabilities or revenue bases. These data are comparable across States and are available from independent sources, such as the ABS and the Institute of Health and Welfare. Considerable confidence is held in the accuracy of disabilities or revenue bases measured using these data. The schools education categories are characterised by such data.

29. The measurement of disabilities or revenue bases using information provided by the States usually produces satisfactory assessments, although, in some cases, the data are considered less reliable.

30. The measurement of some disabilities or revenue bases is more problematic. Where good quality data are not available, the Commission estimates disabilities based on partial information and knowledge gained from workplace discussions, conferences and other sources. It is the Commission's job to make these decisions on the trade-offs between diminished equalisation outcomes due to the non-assessment of disabilities and the increased uncertainty in the outcomes that accompanies the use of judgement.

Implementation Guidelines

31. In summary, the States' relative needs for funding from the Commonwealth are assessed as follows.

- (i) Decide on what State government activities are relevant to fiscal equalisation — the coverage is as comprehensive as possible.
- (ii) Identify activities for which the costs or revenue raising capacities are affected by similar influences and group them into expenditure or revenue categories — this closely reflects how States deliver services or raise revenues.
- (iii) Derive benchmarks for expenditure and revenue categories using the average level of expenditure or revenue on each function by all States.
- (iv) Start with the assumption that all States operate at the benchmark level. This is modified if we can observe:
 - differences beyond the control of the States in the demand for or cost of providing services; or
 - differences beyond the control of the States in size of tax bases or tax rates.
- (v) Use independent, comparable data sources to assess disabilities or tax bases, if possible.
- (vi) Include the disability/assessment only if it moves States closer to an HFE position — that is, ask whether the data are good enough to support the assessment, and whether the Commission is sufficiently confident of its judgements.

Checking Overall Results

32. The calculation of States' funding requirements is not done in abstraction from what States actually do. This is why an important part of the process is to ensure that

the results of needs assessments for each category meet expectations. The Commission reviews what it knows about States policies and circumstances for each category to check that the redistribution looks reasonable in relation to State advantages, disadvantages and policy differences.

33. Looking at the aggregated results, the total revenue redistribution is used as a further reality check. The Commission again reviews what it knows about States policies and budgetary circumstances to check that:

- (i) States receiving more than an equal per capita share face disadvantages in terms of their revenue raising capacities, costs of providing services, shares of SPPs, or all three; and
- (ii) States receiving less than an equal per capita share have advantages in terms of their revenue raising capacities, costs of providing services, shares of SPPs, or all three.

34. Table 1 provides a summary of the redistributions from an equal per capita share caused by the 2001 Update assessments for all revenue and expenditure categories and SPPs.

Table 1 CONTRIBUTIONS TO THE 2001 UPDATE — MOVEMENT FROM EQUAL PER CAPITA

Caused by assessments for:	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total ^(a)
	\$ million								
SPPs	166.7	101.6	89.2	-241.8	-8.7	-13.0	-5.0	-89.0	357.4
Revenue	-783.1	297.4	157.0	-400.8	408.1	219.9	79.6	22.0	1183.9
Expenditure	-239.4	-1384.9	-227.7	565.2	48.3	182.6	1.8	1054.1	1851.9
Total	-855.9	-985.9	18.5	-77.3	447.7	389.6	76.4	987.1	0.0
	\$ per capita								
SPPs	25.6	21.2	24.8	-126.8	-5.8	-27.7	-15.9	-451.1	18.5
Revenue	-120.1	62.0	43.6	-210.2	271.5	468.7	253.2	111.4	61.3
Expenditure	-36.7	-288.8	-63.3	296.5	32.1	389.2	5.6	5343.8	96.0
Total	-131.3	-205.6	5.1	-40.6	297.8	830.3	243.0	5004.1	0.0

(a) Total movement from EPC.