FISCAL EQUALISATION IN AUSTRALIA: SOME TECHNICAL ISSUES

A PAPER PRESENTED TO THE EXPERT MEETING ON EXPENDITURE NEEDS, MINISTRY OF INTERIOR AND HEALTH, COPENHAGEN, DENMARK

BY JOHN SPASOJEVIC, SECRETARY

COMMONWEALTH GRANTS COMMISSION

13-14 SEPTEMBER 2007

CONTENTS

INTRODUCTION

1 This paper has been prepared for a meeting of technical experts on fiscal equalisation. It does not necessarily represent the views of the Commonwealth Grants Commission (the Commission) though it draws on the position of the Commission in the 2004 review of fiscal equalisation and on the position of the Commission in its current methodology review which is designed to deliver equalisation methodology to be used after 2010.

2 The Commission deals primarily with the fiscal equalisation of the Australian states[1]. Comments in this paper deal with state fiscal equalisation.

3 The Commission deals comprehensively with the fiscal capacity of the states covering all areas of revenue and expense. While many of the comments and observations below deal with expense issues, reflecting the emphasis in the session outline on those issues, they also apply to revenue assessments.

4 As with all country specific comments, how well they might inform the views of others depends on how similar their economic and political environments are to those in Australia. Some of the salient features of the Australian system are:

- **Sovereign states.** The Australian states are sovereign in their own right and are not legal constructs of the national government. Relations between the state and national governments are conditioned by that fact the constitution provides separate spheres of responsibility and within those the respective governments can exercise their own policy discretion. In areas of state responsibility the national government cannot direct the states, though it can and does exert influence through funding arrangements in specific policy areas, for example, for public hospitals.
- **Fixed pool.** Since 2000 by agreement between the states and the national governments, the pool of funds available for distribution in a year has been predetermined to equal the actual collections from the national goods and services (VAT) tax in that year and the funding provided though health care agreement payments. This means that distributions are a zero sum game as far as the states are concerned and have no impact on national fiscal policy.
- **Untied grants.** By agreement between the states and the national government, and reflecting their sovereign status, the funds distributed to the states can be allocated at the discretion of the state government.

THE ORGANISATION OF EQUALISATION

5 The Australian system of equalisation has evolved over some 75 years. In that time it has established principles and ways of working which suit our political and legal circumstances.

---

[1] In this paper, the words ‘state’ and ‘states’ include the Australian Capital Territory and the Northern Territory unless the context indicates otherwise.

6 The equalisation system is comprised of two elements. There is a Ministerial Council comprising the Treasurers (Minister for Finance) of the national and state governments, and an independent statutory Commission (Commonwealth Grants Commission).

7 The Ministerial Council meets and considers terms of reference for the Commission and its recommendations. The final decision on the distribution of GST revenue is the prerogative of the national Treasurer. In recent years, in the absence of an alternative distribution which has the unanimous support of the states, his decision has been to accept the advice of the Commission.

8 The Commission provides advice to the national and state governments on how equalisation could be achieved, but plays no role in the actual distribution of funds to the states. That advice is based on data and analysis guided by a set of public principles and to achieve an objective which has been agreed by all affected Governments. That body is supported by an office of public servants which undertakes the data collection, perform the analysis and make recommendations to the Commission.

In undertaking its work the Commission first defines its aim. By agreement between the national and state governments the pool of available funds is to be distributed among the states to achieve horizontal fiscal equalisation. The Commission has interpreted this to mean that in making its recommendations it should, consistent with the capacity of available data, recognise all inherent differences between the states and recommend equalising transfers of GST revenue to offset their impact on individual states' fiscal capacity. In simple terms,

If states levied comparable taxes, then with their GST revenue they would have the same capacity to provide comparable services.

In more precise operational language:

State governments should receive funding from the pool of Goods and Services Tax revenue and Health Care Grants such that, after allowing for material factors affecting expenses and revenues, 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 fiscal capacity to provide services at the same standard.

Secondly, it establishes methodology to deliver its aim. In its current review the Commission will develop methodology consistent with the above definition with the aid of a set of implementation principles. These implementing principles require that the methodology should:

- reflect what states collectively do;
- be policy neutrality;
- be practical; and
- deliver relativities most appropriate to the application year.

9 This two tier process allows for a separation between setting the policy objective and making decisions, the prerogative of Ministers and its technical implementation, the role of the advisory body. The mechanism for linking these two is through formal terms of reference provided to the Commission and through its formal advice to governments.

10 Terms of reference are determined by the national government in consultation with the states. They provide direction to the Commission in its annual update process and during its regular methodology reviews. For example, the terms of reference for the current methodology review direct the Commission to develop simpler assessment methods for achieving fiscal equalisation.

11 There has been an important change in the equalisation environment in recent years. Before 2000 the equalisation pool was predetermined in that it increased with inflation and population growth and formed part of the national budget, being funded out of general national revenues.

12 After 2000 the situation has changed. In 2000 tax reform led to the introduction of a Goods and Services tax (GST) — a VAT — with all the revenues collected in a year to be returned to the states through a fiscal equalisation payment. Now the pool is predetermined (although unknown until the end of a financial year) and has no impact on the national budget. This means that the equalisation process is much more a process among the states.

13 The primary purpose of the provision of GST revenue to the states is to fund state expenses and deal with vertical fiscal imbalance. Horizontal fiscal equalisation is a secondary objective. In 2007-08 the total pool (comprising GST ($41.9b) and Health Care Grants ($8.7b)) was some $50.6 b. The vast bulk of the pool was distributed on an equal per capita basis. Those states with an above average fiscal capacity in total received some $3.3b less than equal per capita, with that amount distributed to states with a below average capacity. Fiscal equalisation can easily be accommodated within the current pool and it is difficult to imagine circumstances where that would not hold in the future.

14 The Australian system centralises the calculation of an appropriate distribution of the pool and there is no involvement in that process by line departments. Those departments, to the extent they are interested in state service delivery, further that interest through inter-governmental agreements often supported by service specific funding. Those departments and state governments are often interested in how those specific purpose payments interact with the equalisation system — an issue taken up later in this paper.

15 Even if there were to be distributions determined by line departments, that would not lead to expenditure pressures in the national budget because the total pool is predetermined and more than adequate to deal with prospective divergent fiscal capacities. Nor would it change state budgetary flexibility because all revenue from the pool is untied.

16 While the Commission presents a single recommended distribution of the pool, it supports that with detailed calculations for a wide range of expense and revenue categories showing how cost drivers influence its assessments. States have access to a simulator of the assessment system to aid their understanding of how the Commission's recommendations are compiled. In this sense no transparency is lost through a central calculation of a fiscal equalisation distribution.

THE ROLE OF POLITICS

17 The transfer of the pool to state budgets is important to all states. On average it represents about 43 percent of total state revenue. Equalisation components — the differences from an equal per capita distribution — matter for some state budgets. For the two largest states their equalisation component represent about 6 percent of their total revenue. For the Northern Territory the equalisation component represents some 56 percent of its total revenue.

18 Given this financial impact, equalisation is a political issue. Political leaders from states that believe the outcome is unfair or unreasonable are vocal in their concerns while those who have their fiscal capacities increased are vocal in their support. Some have advocated a change to the untied nature of transfers, claiming that there is a moral obligation on states which receive above average transfers to actually use those funds to provide average service levels. The political process between national and state governments is the forum for addressing these concerns.

19 That happens in three distinct ways.

- The objective governing the distribution of the pool was settled as part of the 2000 tax reform process and included in an intergovernmental agreement attached to relevant national and state implementing legislation.
- The national and state governments consult on the terms of reference governing the work of the Commission. Those terms of reference reflect the political views of governments. For example in the current methodology review the Commission is directed to achieve equalisation using simpler methods, reflecting a concern of some states (and the Commission) that too much was being asked of the data in previous reviews. Further, at times the Commission is directed to exclude certain specific payments to the states from its calculations because not to do so would undermine the policy intent of those payments.
- It is national and state Ministers who jointly consider the Commission's recommended distribution of the pool, with the national Treasurer as the final decision maker.

20 The political process plays no direct role in the day to day operation of the Commission. The Commission performs its functions based on analysis and data rather than on political considerations. It is not just that the Commission would reject political interference in its recommendations, but there is no attempt to sway the views of the Commission for political ends.

21 There appears to be a broad consensus that the current arrangements of seeking independent advice, within an agreed policy framework, is a better way of making a decision than attempting to derive equalisation transfers through political negotiations.

22 However the work of the Commission does interact with the political process in several ways. For example,

- the equalisation process centres on the average policies of states, revealed through their average expenditures and revenues. As state political policies evolve and their expenditure and revenue priorities change so too do equalisation transfers. For example with no change to the inherent characteristics of states, if states on average, were to decide to remove a particular tax, then the state with the lowest capacity to raise revenue from that tax would see its equalisation transfer fall. So while individual state political processes have no effect on equalisation, the equalisation process tracks the average political concerns of the states and gives states the same fiscal capacity to deliver on the average policy agenda of the states.
- in addition to equalisation transfers to the states, the national government also provides funds to support specific state expenditures, for example, for public hospitals. These funds usually address specific policy objectives and their distribution reflects a negotiated outcome conditioned by the relative size of the policy problem in different states. They are the outcome of a political process between the national and state governments. In general and unless specifically excluded in terms of reference to the Commission, these transfers are incorporated into the equalisation process. This has the effect of overriding any differential distribution of these funds with the equalisation objective. How these payments should be treated by the Commission is sometimes part of the political process which determines their size and distribution and subsequently reflected in the Commission's terms of reference.
- the process followed by the Commission in a methodology review consists of two broad steps, the first to settle issues of principle and then to use those principles to develop methodology that can be used to derive equalisation transfers. Both those steps involve consultation with the national and state governments. The Commission raises issues, seeks reactions and then comes to conclusions. This process is designed to capture and weigh the concerns of the affected parties as the review progresses. It would be incorrect to assert that the Commission undertakes its work without reference to the collective views of the state and national governments, just as it would be incorrect to assert that it was directed by the views of any one or group of those parties.

ARE EXPENDITURE NEEDS AN OBJECTIVE REALITY?

23 There seem to be two broad approaches to determining 'expenditure needs':

- expenditure needs revealed by state governments; or
- expenditure needs decided by the national government.

24 The Australian equalisation system is based on the first approach.

25 This approach of the Commission is consistent with some of the core characteristics of the Australian environment:

- The states are sovereign. The Constitution delineates areas of state and national responsibility, and while the boundary changes with legal interpretation, where states are sovereign they cannot be directed to change their policies.
- Equalisation transfers are untied and can be spent as the states see fit. Even if equalisation transfers were based on external standards that would not necessarily influence the actual service delivery levels in the states. Their policies would need to change for this to occur. If funds were tied, then using an external standard would provide a national government with control to align state spending to the external standard.

26 The approach starts with what states spend, on average, on different state services. Methodology is then developed to determine how much more or less than that average a specific state would need to spend to provide the average service. That methodology centres on inherent differences between the states, for example, in their demography or population dispersion. It is these divergences in state spending from the average of all states that the equalisation system addresses.

27 It is a common misconception in Australia that the Commission attempts to provide states with the fiscal capacity to address ‘needs’ against some external standard. The most topical example relates to the impact of the Indigenous population on fiscal equalisation.

28 On average, Indigenous people use more state government services, and those services are more expensive to deliver (in part because many live in remove locations). As a consequence, those states with high concentrations of Indigenous people are assessed to need to spend more per capita of total state population to deliver the average service to their mix of Indigenous and non-Indigenous population.

- In parallel there is widespread recognition that against a range of outcome indicators, such as expected longevity or infant mortality, Indigenous outcomes are worse than those of the non-Indigenous population.

29 The common misconception is that, by addressing ‘Indigenous needs’, the Commission will provide states with the capacity to equalise those outcomes and that the persistence of different outcomes reflects a failure of states to use the available funds appropriately. That is not the case; the Commission’s process only provides all the states with the capacity to provide the same services to Indigenous people and the same, but possibly different, services to non-Indigenous people. The difference between these levels of service reflects the average policy choice of state governments.

30 There is no assurance that what, on average, states spend on Indigenous people will equalise outcomes with the non-Indigenous population.

31 The current approach has several advantages from an Australian perspective:

- it accepts the Constitutional reality and the untied nature of equalisation transfers;
- it tracks the average policies of the states; and

- using a rule to establish the standard of expenditure, rather than having the Commission set it on the basis of its own policy judgments, improves transparency and makes it easier for governments to accept the role of an independent Commission in recommending equalisation transfers.

32 However, alternatives have been suggested:

- basing the average on the 'middle group' of states so that outliers do not influence the average; or
- basing the standard on the expenditure policies of the donor states.

33 The Commission has preferred the weighted average approach because it reflects the policies of all state governments.

34 The approach of using the average policy of states to set the standard requires trade-offs between design principles. It reflects what states actually do, but at the margin states can influence the average through their policy choices and so influence the equalisation process. Ideally, the equalisation process should be neutral with respect to state policy.

35 The Commission has accepted that some non-neutrality might exist, but it would appear to be only marginal in practice (because the combination of weighting and lags in the equalisation methodology mitigates equalisation benefits, making them small compared to the day-to-day policy imperatives facing state governments).

36 The Commission has preferred the average approach for both conceptual and practical reasons. However, in making its recommendations it has had to address the issue that every state's spending is also affected by the efficiency of its administrative systems. The Commission's approach is not to reward states for inefficiencies that are policy-related. Ideally, the average expenditure of the states would be weighted to reflect their technical efficiency or inefficiency. In concept, the standard would reflect what would need to be spent if all states replicated the efficiency of the most efficient state. However, it is impossible to make this adjustment so the Commission uses the average technical efficiency as its benchmark. Because the weighted average of expenditures already reflects the average technical efficiency, no further adjustments are required.

37 Because states are sovereign and because the agreed objective is fiscal equalisation, the Commission covers all expenses and revenues of the states in its methodology. It makes no judgments as to what are essential services and what are voluntary. It accepts that if states on average allocate funding to a purpose then it falls within the scope of fiscal equalisation.

38 While all expenses are currently within scope it does not mean that all are individually assessed at the finest possible level of disaggregation. Assessments are usually undertaken at some aggregated level of expenses. Some expenses are assessed equal per capita and so have no influence on the distribution of the pool.

39 It has been proposed by some states that to facilitate a simpler approach the Commission should restrict its scope to core functions. However this does not have the support of all states and there

is no agreement on what would constitute core activities. While such an approach would be technically possible it would represent a significant change in the intent of equalisation as currently practised and would be a question for government rather than the Commission. In preparing the post 2010 methodology the Commission intends to retain a comprehensive approach, but to have less disaggregation of expense and revenue items, and to assess each of those in a simpler way. In keeping with the terms of reference the Commission has adopted a materiality threshold so that differences between the states which would only redistribute small amounts do not find their way into the methodology.

INCOME AND POLITICAL EFFECTS ON STATE SPENDING LEVELS

40 The national and state governments have agreed that the pool of available funds should be distributed to achieve fiscal equalisation. In the Australian context that means that differences in state tax bases and differential costs of service provision are removed and, policy choices aside, the states can deliver the same standard of services. Individual states are provided the same capacity to deliver services regardless of the relative size of their own tax bases. In this way differences in tax bases between the states do not translate into differences in service delivery capacities.

41 However state policy choices can still result in differences in tax rates and in service provisions. Some states choose to have lower than average tax rates and spend less than average while some choose the reverse. States are also perfectly free to allocate equalisation transfers to state expenditure priorities and this results in a wide spread of spending on specific services.

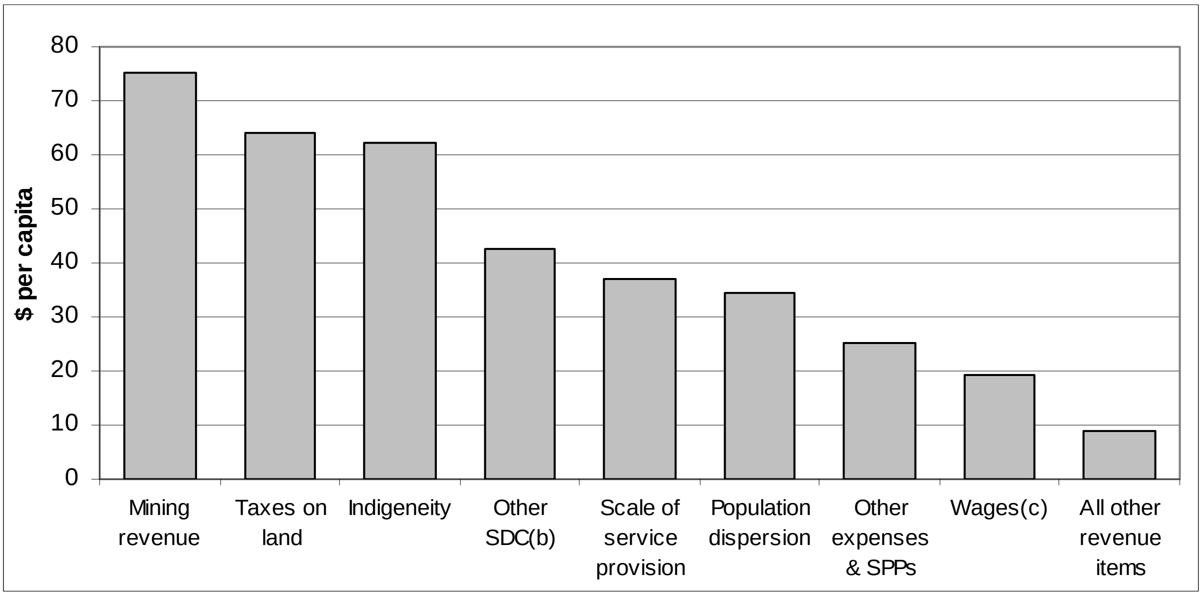
42 The sovereign nature of the states and the untied nature of equalisation payments mean that the equalisation process has evolved to focus on an objective of perfect equalisation — the provision of equal fiscal capacities, rather than one which attempts to model some differential capacity based on revealed or determined preferences for state expenditure at different state income levels.

43 However, during the current methodology review some states advocated a move to partial equalisation. This might mean that only 80 per cent of the differences between the initial fiscal capacities of the states were equalised. Proponents of such an approach argued that perfect equalisation weakened incentives for states to pursue economic efficiency and build their own tax bases and that a move to partial equalisation would represent a better mix between equalisation and efficiency (and economic growth). However, those proponents also recognised that any such decision was a matter for government, who would then provide appropriate guidance to the Commission on what degree of equalisation its recommendations should deliver. At this stage the only advice the Commission has received is to deliver equalisation.

MAIN DRIVERS OF EQUALISATION

44 The table below shows the main drivers of differential transfers to the states.

Table 1 Contribution of major drivers to the redistribution[(a)], 2007 Update



(a) The redistributions shown are the absolute value of all the positives or all the negatives for the states. They cannot be added as redistributions can be positive or negative for a particular state and potentially cancel one another.
(b) ‘Other SDC’ refers to socio-demographic contributions by drivers other than Indigeneity, such as age, sex, income levels and English fluency.
(c) Wages refers to the combined impact of the ability to raise revenue from wages and disabilities associated with the level of wages that states may need to pay their employees.

45 The table below shows the relative impact of expense, revenue and tied transfers (SPPs) on the overall redistribution by state.

Table 2 Difference between equalisation and equal per capita distributions, dissected by source

Difference in	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total[(a)]
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Revenue raising capacity	-1 148.0	986.2	- 115.1	-1 145.8	822.2	412.6	124.2	63.8	2 409.0
Expense requirements	- 627.1	-2 277.8	132.5	909.8	- 31.7	233.1	1.1	1 660.2	2 936.6
SPPs	46.8	124.5	36.5	- 15.4	- 47.7	- 32.3	- 1.9	- 110.4	207.8
Total difference from EPC	-1 728.5	-1 167.5	54.4	- 250.6	742.5	613.2	123.3	1 613.2	0.0

(a) Total movement from EPC, calculated as the sum of total positive (or negative) components.

46 In the Australian context it is a mixture of both inherent revenue and expense differences which are addressed by fiscal equalisation. They have about the same overall impact, though the patterns across states vary considerably. However, changes in relativities from year to year are much more a function of changes on the revenue side, reflecting their cyclical nature, than on the expenditure side.

47 Differences in demographic characteristics play an important role in equalisation. These relate to age, sex, income characteristics and linguistic capabilities. The table below provides some indication of their relative importance. It shows the redistribution arising from Indigeneity and other socio demographic characteristics as well as other important influences on state expenses.

Table 3 Contribution of expense disabilities to redistribution

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total[(a)]
	$m	$m	$m	$m	$m	$m	$m	$m	$m
Indigenous influences[(b)]	- 364.5	- 782.8	276.0	225.4	- 105.4	9.8	- 35.7	777.2	1 288.4
Other socio-demographic composition influences[(c)]	- 340.5	- 440.4	450.8	35.0	156.1	141.2	- 99.8	97.5	880.7
Wage levels	811.7	- 63.5	- 474.0	- 126.3	- 150.7	- 71.8	31.1	43.6	886.4
Other input costs[(d)]	- 2.0	- 191.2	- 77.0	56.0	- 8.9	22.1	- 19.6	220.6	298.7
Administrative scale of service provision	- 346.4	- 195.5	- 106.5	44.8	76.6	156.9	170.4	199.6	648.4
Delivery scale of service provision	- 70.0	- 48.2	- 1.9	15.0	15.1	14.9	- 8.7	83.7	128.8
Urban influences[(e)]	182.9	126.1	- 87.5	- 68.2	- 59.9	- 52.9	- 7.9	- 32.6	309.0
Population dispersion[(f)]	- 291.0	- 338.3	151.6	199.8	- 9.6	- 43.1	- 34.6	365.2	716.6
Economic environment[(g)]	- 165.1	- 68.7	- 23.1	185.8	8.4	25.2	- 6.1	43.6	263.0
Physical environment[(h)]	38.6	- 315.6	- 82.8	265.9	19.2	- 1.1	- 6.7	82.5	406.2
Expenses – others[(i)]	- 81.0	40.4	106.9	76.5	27.2	31.9	18.7	- 220.7	301.7
Total expenses	- 627.1	-2 277.8	132.5	909.8	- 31.7	233.1	1.1	1 660.2	2 936.6

(a) Total movement from EPC, calculated as the sum of total positive (or negative) components.
(b) Includes the effects of the use of services by Indigenous people and higher costs of servicing them, including the effects of land rights and native title legislation.
(c) Includes the effects of age, sex, cultural and linguistic diversity, income and the cross-border use of services.
(d) Includes costs of office rent and electricity, interest rates; the isolation of some states from major sources of supply in south-east Australia; and accrued expenses and historical costs of superannuation.
(e) Includes effects of urban complexity, urban traffic management, and urban transit capital and pricing subsidies.
(f) Includes the net effects of population dispersion and of geographic location on hospital costs and patient transport.
(g) Includes effects of structure and nature of state economies, road use, availability of private medical services, and the ACT's status as the national capital.
(h) Includes the effects of climate, natural hazards, conservation task, water availability, other aspects of the physical environment, and road and bridge length.
(i) Includes some miscellaneous small factors and interactions between factors.

48 The role of each of these characteristics differs depending on the type of state expenditure that is being considered. Methodology is developed for each individual expenditure category which allows the relevant demographic characteristics to be incorporated. For example in health areas the assessments take account of the different use and cost of patients of different ages and sex, as well as linguistic capability and whether they are Indigenous or not. A different set of demographic characteristics is used in assessing policing costs.

49 The decision on which characteristics to incorporate involves several steps. Initially, a conceptual case has to be developed that the characteristic does influence expenditure and that it

is expected that differences in the distribution of this characteristic among the states is likely to be significant. Secondly, there has to be a database which enables the influence of this characteristic to be reliably delineated. Most often this is an administrative data set collected by the service delivery agency. For example, there is a good data set collected from patients in public hospitals which records the demographic characteristics of patients, what treatment they received and the cost of that treatment.

50 An important technical issue in constructing assessment methodology is to ensure that there is no double counting of the impact of state characteristics. This is especially an issue with socio-demographic characteristics and perhaps illustrated in the incorporation of the Indigeneity influence. We observe that Indigenous residents cost more to service and make an allowance for that. We also observe that people with poor language skills cost more to service and allow for that. We then observe that many Indigenous people also have poor language skills. We need to ensure that we have properly accounted for the interaction between the impact of Indigeneity and language skills. This requires a data set which breaks down service cost for Indigenous residents according to their language skills. To ensure consistency for every new characteristic added we need a cross tabulation across all the other characteristics. This quickly adds to the size of the data matrix needed to calculate equalisation transfers.

51 The Commission includes in its analysis factors for scale effects (recognising that there is a minimum cost of state government services which increases per capita costs in small states), dispersion (recognising that states with more dispersed populations can face higher service delivery costs) and a wage cost factor (recognising that some states face higher wage costs).

52 There has been a debate about the inclusion of locational effects. Some have argued that their inclusion can lead to a distortion of locational decisions by individuals. However, it seems unlikely that locational decisions are heavily influenced by the ability to extract a fiscal premium and much more influenced by the ability to reap private benefits by responding to wage differentials or quality of life issues. We observe a large movement of population to Queensland, a state which enjoys a warmer climate than much of the rest of urban Australia. We also observe a large movement of people to the west in response to employment opportunities created by strong investment in mineral extraction. We see little evidence of a move to remote communities where the fiscal premium is highest.

53 It is also worth noting that the equalisation system does not remove all locational differences. On average, states deliver differing standards of service to residents in different locations. The equalisation process preserves this average policy and ensures that all states can deliver it to their residents. In simple terms state governments have the capacity to deliver similar services to residents in all urban areas, similar though different services to all rural residents and similar, though different, services to all residents in remote areas.

54 There is almost no debate about the inclusion of scale economies in the assessment methodology. These are recognised as costs outside the control of an individual government and having a measurable impact on the cost of service provision in smaller states.

55 The Commission also recognised that wage costs are higher in some states and incorporates this into its assessments. This has occurred even though state governments are parties, with their staff, to setting public sector wages in their states.

56 In undertaking this assessment the Commission has been careful to minimise the scope of states to influence the equalisation distribution through their own policy actions. It does this by basing its assessments on private sector wage costs, gathered by the national statistical agency through a survey which cross tabulates wages against a wide range of demographic and economic indicators. The Commission uses econometric techniques to estimate state specific wage influences, having controlled for other influences such as educational status and industrial structure. It is only these state specific influences which are seen as beyond the influence of state government that are used in the assessment methodology. It is likely that this will again be an area of great interest in the current methodology review.

57 One argument advanced for including differential wage costs may be particularly relevant to Australia and the equalisation of revenue as well as expenses. State governments raise a tax on the payrolls of private businesses. States with relatively high wages have an inherent advantage in raising this tax and receive a lower share of the equalisation pool as a result. Some states argued that, to preserve symmetry, the Commission needed to recognise that just as high wages might give a state a revenue advantage it would also force the state to incur higher costs in its own service delivery.

58 The Australian equalisation system copes with a wide range of state conditions. From the smallest state with 1 percent of the population spread over 1349 thousand sq kilometres to the largest with 33 percent of the population spread over 801 thousand sq kilometres. Those states all provide similar state services with largely similar tax bases. Fiscal equalisation is achieved not by separate streams of transfer for different conditions or different types of states, but rather through the identification of drivers of state costs and revenues, service by service and revenue by revenue. These are then combined into the determination of single transfer payment. In part this recognises that the transfer is completely untied. Even if separate transfers were made for each service they would be aggregated in the hands of state Treasuries and allocated according to state budget priorities.

59 There is however an ongoing debate about whether all appropriate cost drivers are recognised. Some states advocate the incorporation of drivers to recognise unavoidable costs of large cities such as Sydney and Melbourne. While these costs may exist, the states (who have access to the data in their administrations) have not demonstrated that in general service delivery costs rise per capita in the larger cities in Australia. Until some reliable evidence of these cost differences is available they can not be incorporated in the equalisation process.

60 Similarly some states argue that the current classifications dealing with the remoteness of some communities is inappropriate and that equalisation outcomes would be improved if new classifications — such as extremely remote — were included. Again this relies on the ability not just to apportion populations into different remoteness classes, but also to develop reliable use and cost indexes for each class. The ability to interrogate state administrative data sets using

nationally defined remoteness classifications places bounds on how many remoteness classes can be contemplated.

61 Both of these issues, among others, are being examined in the current review of equalisation methodology.

Special population groups

62 In the Australian context the Indigenous population is the special population group with the greatest impact on equalisation transfers. This arises because their use of state government services differs from that of the rest of the population, the cost of delivering services, especially for indigenous people in remote locations, differs markedly from the average cost and they represent very different proportions of total state population.

63 In making its assessments the Commission considers any programs which are directed at indigenous residents, but more importantly recognises the higher use made by Indigenous people of mainstream services in for example health areas, and their higher unit costs. This data is usually extracted from administrative data sets or through special data collections initiated by the states to inform submissions they make to the Commission.

CAPITAL SPENDING

64 In the 2004 review the measure of fiscal capacity that the Commission sought to equalise was the balance on the states' operating statement. It recognised all revenues and expenses, including interest costs and depreciation. This concept aligned with the intent to provide states with a common capacity to deliver state services.

65 The role of capital assessments might be very different if the objective of equalisation were to equalise the economic performance or potential of the states. However, this is not the objective of equalisation in Australia.

66 This approach recognised that states had differential capital needs and that this would lead to differential depreciation and to differential borrowing to finance capital acquisition.

67 There is no doubt that the methodology used to addresses these differential needs was complex and highly data intensive.

68 This approach necessarily encompassed the policy choice that states have in how to finance capital acquisition. States could either borrow or divest financial assets. In turn that raised issues of state management of financial assets, which is heavily policy determined. In an environment where states have no net debt, interest costs of financing capital are more than offset by interest earnings leading to a situation where any differential costs of acquiring capital through borrowing no longer influences equalising transfers.

69 As part of the 2010 review the Commission has indicated that it will look afresh at how best to incorporate capital needs into its assessments. The Commission has a range of options before it which it aims to discuss with the states in 2007 before reaching any conclusions. These include:

- retaining the current structure which looks at the impact of capital decisions on recurrent expense-though in a much simpler and more transparent fashion; or
- widening the measure of equalisation to net lending and bring the expenditure on new fixed assets into the equalisation process in the year that expenditure occurs.

70 These alternatives share some common features. Both require a way of assessing how a particular state's capital needs vary from the average due to the inherent characteristics of the state. Over the life of an asset both should provide the same equalisation outcome. However, in the short term they can provide different equalisation transfers, especially when states capital needs diverge, for example, due to divergent population growth. In the case of the net lending approach, divergent capital needs can immediately be reflected in differential equalisation transfers, while in the traditional approach that occurs with a lag as those differential capital needs impact on depreciation and borrowing costs.

71 The assessment of differential capital stocks will be complex, but one approach which holds some promise is to begin with existing annual estimates of the total value of all state assets and the assumption that this stock is, on average across the states, the stock needed to deliver the average level of services. There are some data on how this stock is distributed across expenditure categories, that is, we have capital stocks used to deliver education services. We could then use these ratios, applied to a state's assessed expenditures to derive its assessed capital stock.

72 This approach while appealing does not avoid some of the complex questions. On roads for example the difficulty would not be to estimate the stock but to make a reliable assessment of current expenditure needs. Those estimates are based on assessed road lengths and road use where compiling reliable, policy neutral estimates is very difficult. At present the Commission is exploring the use of a mapping algorithm to establish comparable road length data, which will then form the basis of road use data.

OVER WHAT TIME FRAME SHOULD EQUALISATION BE ACHIEVED?

73 The current Australian equalisation system uses a five year moving average with a one year lag, to determine equalisation transfers. In that system annual financial data is investigated for each of the five assessment years and relativities (population weights) determined for each year. Conceptually those weights would have achieved equalisation in the assessment years had they been applied to the pool of available funds in that year. Those weights are then averaged and used in the next financial year to determine equalisation transfers.

74 If those weights are stable and there has been no change in the relative fiscal capacities of the states between the assessment years and the application year then they form a good guide to equalising transfers in the application year.

- In the Australian system there is no revisiting a year to correct for over or under equalisation in the past. It is not an advances and completion system.
- Where data are revised, for example by the national statistical agency, those revisions flow into all the assessment years and change the population weights, but again there is no revisiting past equalisation distributions to make corrections.

75 In recent years the relative fiscal capacities of the states has changed rapidly, raising questions about the appropriateness of the current averaging methodology and a deeper consideration of when (as opposed to how) is equalisation to be achieved.

76 The current approach, with its averaging approach, slowly tracks what is happening to state fiscal capacities. If those changes are cyclical it tracks the average, but if changes are structural then the average will be always out of step with relative fiscal capacities in the application year.

- The use of historical population weights to make future distributions also requires some technical assumptions. For historical weights to be a guide to the future, that future needs to be a scaled version of the past, where the scaling factor is the actual growth of the pool. State expenses and revenue need to grow at the rate of the pool otherwise the disabilities associated with those financial aggregates are inappropriately recognised in the application year.
- In the current review the Commission has adopted the aim of giving the states the same fiscal capacity in the application year, rather than a distribution which achieves equalisation over time. If states are to have the capacity to deliver equal services in a given year, then capacities need to be as equal as possible in that year.
- The Commission has however rejected an approach based on using economic forecasts of state fiscal capacities, or the budget forecasts of the states themselves. It will continue to rely on historical data, but adopt methodology which results in the population weights more closely tracking emerging state fiscal capacities. One option is to shorten the averaging process.
- These issues might be of most concern to equalisation systems which rely on observed standards of expenses and revenue. By definition they use historical data and their methodology needs to appropriately adjust for differences between the historical period and the year in which equalisation transfers are to be made. In systems with external standards they can be set to apply in the application year and so reduce the reliance on historical data.

DATA ISSUES

77 There is widespread recognition that data quality is a constraint on the equalisation system. While the Commission is well served by the national statistical agency, national administrative data and comprehensive state data there are stills issues with particular data sets and the overall data intensity of the equalisation system.

78 The Commission in its last report asked if the data were being asked to do too much given concerns about data quality

79 The terms of reference for the 2010 Methodology Review explicitly direct the Commission to have regard to the quality and fitness for purpose of data and to have a program of continuous improvement of data quality.

80 There has been an extensive process of reviewing data sets used in the current assessments to assess quality and fitness for purpose. In turn those reviews play an important part in shaping the thinking for the assessment methodology to be developed for the period post 2010. In that process questions of data quality have been embedded in the assessment guidelines which the Commission is using to guide its decision making.

81 For the Commission there are particular concerns relating to the comparability of data among the states. What is of particular interest to the Commission is how the underlying characteristics of the states differ. This requires that data be collected on a consistent basis across the states. Unfortunately much state data is primarily collected for a state's own policy purposes and that has lead to the evolution of separate data sets, which while covering similar areas differ at the margin. Much Commission staff time is devoted to bringing these data sets into alignment to make them fit for the Commission's purposes. This is an ongoing process because state data needs are constantly changing without attention to retaining comparability with other states. It is particular concern when the data collected is heavily influenced by state policy choices and difficult to adjust to reflect average state policy. For example, the Commission makes no elasticity adjustment for state tax base data, even though what is collected reflects the tax policies and different tax rates of individual states.

82 The Commission accepts that for much state data its needs are secondary to those of state government. That means that data collections will focus on individual states needs and that the Commission will need to work with the states to addresses questions of data comparability.

THE USE OF ASSESSMENTS

83 In Australia there are two distinct forms of transfers to the states. Equalisation transfers which are untied (worth some $41.8b) and a wide range of specific purpose payments which support specific areas of state expenditure (worth some $22.4b). The nexus between these two raises some interesting policy and design issues.

84 The general approach of the Commission is to treat these specific purpose payments as a revenue source for the state and to incorporate any expenditure financed by these payments into

the average service levels used for equalisation. (Indeed the largest SPP for public hospitals is explicitly included in the pool.) The effect of this treatment is that if the pattern of SPPs differs from the pattern of assessed relevant expenditure the difference is redistributed among the states. In a dynamic sense, if an SPP to one state increases, its relative fiscal capacity will increase and it will warrant a smaller equalisation transfer, while transfers to other states will rise. In net terms it will only retain its weighted population share of the increase. Most of the increase will be distributed to other states.

85 Some have expressed concern that this reallocation of SPPs gives fiscal equalisation primacy over the policy objectives underlying individual SPPs. However the intent of SPPs is usually preserved because they are conditional, as opposed to the unconditional nature of equalisation transfers. Further there is an option to have SPPs quarantined from the Commission's consideration through the terms of reference (and this occurs). Others are more relaxed about the interaction; they prefer the Commission's approach, based on data, to a distribution influenced by a negotiating process.

86 This becomes an especially topical issue when there are changes in the range and size of SPPs reflecting changes in the balance of financial responsibility for the financing of state services. There are similar issues raised when the national government directly funds services which are usually provided by the states.

87 The Commission is unaware of any situation where its assessments are used as a basis for the allocation of SPPs. SPPs are usually addressed at solving some specific policy issue rather than addressing some inherent differences between the states. There can be some common elements, for example, some demographic characteristics, but also significant different determinants.

88 The Commission publishes its estimates of assessed expenses and revenues and these sometimes find their way into other uses. Sometimes those uses are well founded and sometimes they are misused.

- A common misuse is to confuse assessed expenses with optimal expenses as discussed earlier.
- Another common misuse is to impute that when actual expenses exceed assessed, the Commission has reached a view that actual spending is excessive. However, that represents a decision by a state to spend more than average — perhaps to supply an above average quality service — which a state is free to do and on which the Commission makes no judgment.

89 The Commission's assessments are also often used by others to analyse state budgetary conditions. This analysis is a matter for individual state governments and is outside the mandate of the Commission.