

## AUSTRALIA'S EQUALIZATION SYSTEM

Philippe Le Goff  
Economics Division

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## AUSTRALIA'S EQUALIZATION SYSTEM

### INTRODUCTION

On 23 November 2004, the federal Minister of Finance tabled Bill C-24,<sup>(1)</sup> implementing the new framework for equalization and territorial formula financing (TFF) announced at the First Ministers' meeting of 26 October 2004. The bill received Royal Assent on 10 March 2005. Even before its adoption, however, the new framework was destined to have a very short life.

At the October First Ministers' meeting, the premiers of receiving provinces had expressed some disappointment at the federal equalization proposals. In the end they accepted them in exchange for the promise of an in-depth review of the program, which pays out more than \$10 billion. When Bill C-24 was introduced, the federal government appointed a panel of experts to undertake a public review of the equalization program and the TFF and make recommendations. The panel is due to table its report by the end of 2005, in time to provide advice on how equalization and the TFF should be allocated among the provinces and territories in 2006-2007. The Canadian government is committed to having any changes to equalization and TFF allocation in place by 1 April 2006.

When a review of a far-reaching program or public policy is undertaken, one of the first steps is normally to see what is being done elsewhere. In the case of the equalization program, the experience of other federations could be very informative; and for reasons of history, politics and geography, Australia's equalization system is particularly relevant.

The Commonwealth of Australia is a federation of six states (New South Wales, Victoria, Western Australia, Queensland, South Australia and Tasmania) and two territories (the Australian Capital Territory and the Northern Territory).

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(1) An Act to amend the Federal-Provincial Fiscal Arrangements Act and to make consequential amendments to other Acts (fiscal equalization payments to the provinces and funding to the territories).

The Australian Constitution defines in detail the areas of jurisdiction that are exclusive to the states or the federal government, and those that are shared by them. While the role of government in the broader sense has evolved considerably over the past century, its main responsibilities (education, public health, security, land and natural resources, and transportation) remain the responsibility of the states, at any rate in constitutional terms.

This paper provides an overview of the Australian system of transfer payments, with a particular focus on equalization, and notes certain aspects of interest in the context of a review of Canada's equalization program. It does not describe every detail of the Australian system, but rather provides basic information enabling the reader to compare the major features of the systems in place in the two countries. Lastly, it summarizes the main criticisms expressed by the Australian states about their country's equalization system.

## **THE AUSTRALIAN TRANSFER SYSTEM**

In 2004-2005, Commonwealth grants to state and territorial governments totalled \$60.1 billion,<sup>(2)</sup> or 31% of total Commonwealth expenditures. The majority of these grants (around \$35.5 billion) are "General Purpose Payments" (GPP); i.e., they can be used by states for any purpose. The remainder, called "Specific Purpose Payments" (SPP) are earmarked for specific services such as health, education, roads and housing.

### **A. General Purpose Payments**

The Australian government's GPP can be seen as the equivalent of equalization payments in Canada. The main component of the GPP (97%) is funded by the Goods and Services Tax (GST) revenues collected by the Australian government (\$34.5 billion in 2004-2005). When the GST was introduced by the Commonwealth in 2000,<sup>(3)</sup> the federal government and the states agreed that the proceeds should become the base or pool for general purpose grants to the states, and be divided among the states through the same mechanisms that had long been used to allocate such grants.

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(2) All funds in this paper are in Australian dollars; CAN\$1 = AUS\$1.04.

(3) The 10% GST went into effect on 1 July 2000.

The GST revenue pool is distributed among all states on the basis of recommendations by the Commonwealth Grants Commission (CGC). The CGC's recommendations are based on principles of horizontal fiscal equalization, which it describes as follows: "each State should be given the capacity to provide the average standard of State-type public services, assuming that it does so at an average level of operational efficiency and makes an average effort to raise revenue from its own sources."<sup>(4)</sup>

Equalization therefore means that there are no "have" and "have not" states per se in Australia. In 2004-2005, the richer states of New South Wales and Victoria received less than the Australian average per capita share of GST revenues. The poorer states – Queensland, South Australia, Tasmania, Western Australia and the territories – received more than the Australian average per capita share.

## **B. Specific Purpose Payments**

SPP constitute a significant portion of Australian government funding to the states. They amounted to \$24.6 billion in 2004-2005, or almost 13% of total Australian government expenditures in that year.

The Australian government makes SPP to the states as a contribution to important areas of state responsibility. In 2004-2005, there were over 90 different payments covering a broad range of policy areas such as education, health, social security, housing and transport.

SPP can be classified into three groups:

- those paid "to" the states – direct payments to state governments, totalling an estimated \$17.9 billion in 2004-2005;
- those paid "through" the states – payments that state governments pass on to local governments (for example, financial assistance grants to local governments) and to others (for example, to non-government schools); this category is estimated at \$6.4 billion in 2004-2005; and
- those paid directly to local governments to help fund roads, child-care programs and disability services administered by those governments; these payments are estimated at \$304.7 million in 2004-2005.

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(4) Commonwealth Grants Commission Web site, "The Commission and its History," [http://www.cgc.gov.au/CGCGeneralPages/history\\_of\\_cgc.htm](http://www.cgc.gov.au/CGCGeneralPages/history_of_cgc.htm).

SPP agreements often include agreed-upon national objectives, and generally contain conditions to help ensure those objectives are achieved. Such conditions may include:

- general policy requirements (for example, the provision of free public hospital access for Medicare patients);
- matching funding arrangements; and
- reporting on performance.

In making SPP payments, however, the Australian government does not seek to assume responsibility for state functions.

## **HOW EQUALIZATION PAYMENTS ARE DETERMINED**

As mentioned above, the Commonwealth Grants Commission determines the allocation of GST revenues among the states,<sup>(5)</sup> based on the principle of horizontal fiscal equalization.

A major goal of the CGC is to be policy neutral. States receive extra money if it can be demonstrated that they face higher costs in providing services or have a lower capacity, for reasons outside their control, to raise their own revenues. For example, states with a higher proportion of their population in remote and/or high-cost areas, or with a higher proportion of their population requiring higher service levels (e.g., indigenous people, seniors, students), receive a larger share of grants. Similarly, states with a smaller mining industry receive a larger share of grants in recognition of their lower capacity to raise revenue from royalties.

The allocation process thus includes two key steps. First, it aims to identify factors outside the states' control that affect their expenditure requirements or their ability to raise revenues. Second, it aims to quantify the impact of these factors.

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(5) The role of the CGC has grown substantially since its establishment in 1933. In the early years, the Commission's role was to make recommendations on applications for special assistance from states experiencing financial hardship; it now makes recommendations on the distribution of around \$35 billion of GST revenue to all states on a regular basis.

### **A. Analysis of Expenditure Requirements and Fiscal Capacity**

The CGC analyzes each area of state expenditure (e.g., hospitals, schools, security) and revenue (e.g., payroll tax, land tax, royalties).

States' relative expenditure requirements are based on many indicators of demand for services and cost of services, including: population size and age structure; income; size of the indigenous population; population's level of fluency in English; number of welfare recipients; community size and remoteness; isolation from other states; use of public versus private services; wage, rental and electricity costs; industry size; and road length.

States' relative fiscal capacities are based on the size of their revenue bases, such as wages and salaries (payroll tax), land values (land tax) and mining industry profits (royalties).

### **B. Calculation of Grant Entitlements**

After the CGC has determined states' expenditure requirements and fiscal capacities, it calculates grant entitlements using the following formula:

- a per capita share of the total pool of funds;
- plus "expenditure needs" to reflect differences between states in the demand for, or cost of, services (e.g., due to socio-demographic and location factors);
- plus "revenue needs" to offset differences in revenue-raising capacity between states (e.g., varying revenues from mining royalties);
- plus "needs for Specific Purpose Payments" to offset differences in the levels of SPP provided by the Commonwealth to the states.

As data to implement this formula are not available for the grant allocation year, the calculations are based on a rolling five-year average of states' relative circumstances prior to the grant allocation year. Notional equalization grants are assessed for each of the five years. These grants are then converted into "relativities," which express the per capita equalization grant for each state as a ratio of the national average per capita equalization grant. These relativities are then averaged over five years and used as the basis for distributing the pool of GST revenues in the grant allocation year.

The CGC undertakes a comprehensive review of its methods every five years (the latest review was published in 2004), as well as annual updates of its findings to roll forward the five-year data period.



## CRITICISMS OF THE SYSTEM

As in Canada, the equalization system is subject to criticisms in Australia, both on general grounds and more specifically on grounds of vertical fiscal imbalance.

### A. General Criticisms

Over the years, individual states have voiced various concerns about the principles underlying equalization and the way in which the concept is implemented.

New South Wales and Victoria (which receive lower payments than their demographic share) have argued that the existing approach to equalization promotes mediocrity rather than efficiency, and is inconsistent with the wider public policy framework. Victoria, for example, has claimed that the current approach stifles the evolution of competitive and dynamic state governments and does not adequately take account of changes in public administration using the best available measurement techniques. It further argued that, in assessing states' needs and "disabilities,"<sup>(6)</sup> the Commission should use standards that reflect best practices in service delivery and revenue collection.

According to Victoria, states that receive above-average per capita grants should be accountable to the broader Australian community for the use of the funds. This accountability could extend to some explanation of why the extra funds received have not led to reductions in disabilities over time. Describing the redistribution of funds to the smaller states as subsidies, Victoria emphasized that the recipient states had an obligation to make effective and efficient use of them.

Several states have also questioned whether the Commission's assessment of the differences between states' expenditure requirements and revenue-raising capacity is based too much on the effects of disabilities, and consequently understates the effects of policy differences.

Some states have argued that the scope of equalization should be extended to better reflect the role states play in developing their economies and enhancing their revenue bases. New South Wales, on the other hand, has proposed limiting the scope of equalization, on the expense side of the budget, to the provision of what it called "merit goods" (i.e., goods that are determined by government to be beneficial to citizens). New South Wales also encouraged the Commission to move to a global assessment of revenue capacities, rather than using the current tax-base approach.

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(6) In this Australian debate, the term "disabilities" is used to describe expenditure needs above the national average.

Finally, the Commonwealth Grants Commission's calculations of relativities have been criticized as being based on questionable and complex methodologies. The CGC's methodology documentation runs to nearly 2,000 pages of annual reports and working papers. The complexity reflects the CGC's attempts to take detailed account of the myriad of factors affecting states' expenditures and revenues. Many elements of the calculations reflect judgments by the CGC about the way to quantify factors, or the extent to which factors are important in affecting state expenditures and revenues. The basis for those judgments is not always clearly documented, and judgments can change significantly over time. Despite many years of close examination by the CGC and the states, the quantification of expenditure and revenue needs continues to generate intense debate and analysis.

As might be expected, the views of New South Wales and Victoria have been strongly contested by Queensland, South Australia, Tasmania and the two territories, all of which receive more than their demographic shares in equalization payments. They have expressed their support for the current system, arguing that it reflects the broad political consensus about the objectives of equalization, which constitute an integral part of the fabric of the federation.

## **B. Vertical Fiscal Imbalance**

States rely heavily on funding from the Australian government. About 50% of state revenue is provided by various Commonwealth grants. Over the last five years, the funds distributed under equalization arrangements were equivalent to 34% of the gross operating expenses of all states. The actual percentage varied from state to state, from 30% in Western Australia to 62% in the Northern Territory.

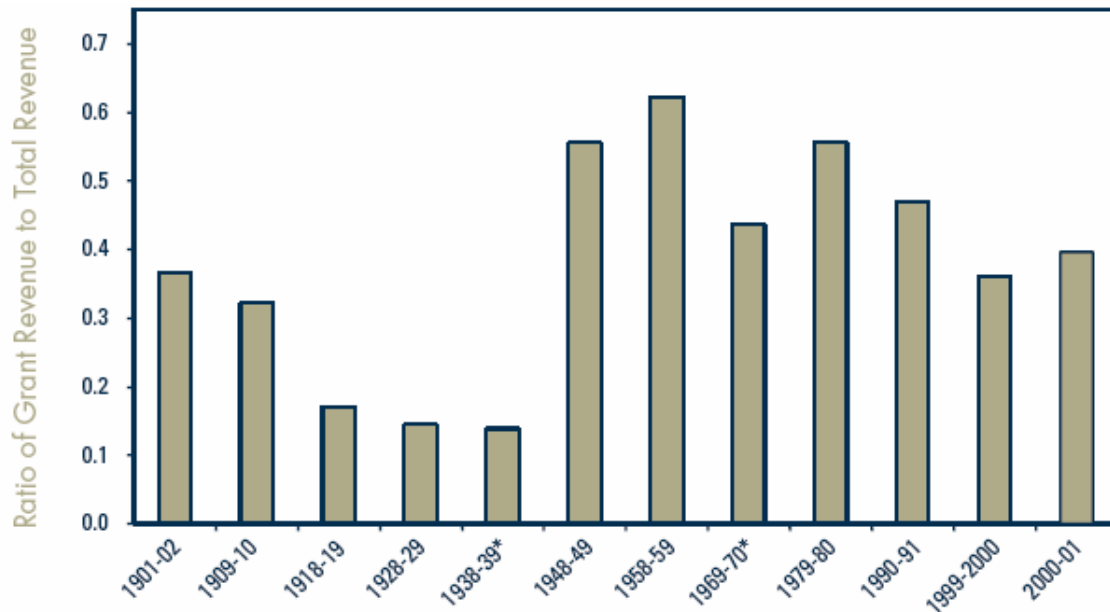
The states' heavy reliance on Australian government grants is driven by the Commonwealth's dominance in taxation collection and the states' responsibility for many of the major service delivery functions set out in the Constitution. According to the states, the Australian government's revenue-raising powers far outweigh its expenditure responsibilities. Conversely, the states' own revenue-raising powers are not sufficient to pay for the expenditures for which they are responsible. As a consequence, revenue sharing between the Commonwealth and the states has been required since federation. (Similarly, some Canadian analysts hold that the money is in Ottawa and the needs are in the provinces.)

During World War II, the Commonwealth took unilateral control over income taxation, a tax base that the Constitution had left open to both levels of government and that had been an important pre-war state tax. The Commonwealth did not make room for the states to re-enter this field after the war – a situation that generally increased the states' reliance on the Commonwealth for funding.

The vertical fiscal imbalance between revenue powers and expenditure responsibilities in the federation increased still further in 1997, when the states lost the capacity to impose business franchise fees on liquor, tobacco and petroleum products. This resulted from a High Court decision that held such fees to be excises and reserved to the Commonwealth. The Commonwealth compensated the states for their lost revenue by increasing its own excise on those products and returning the revenue to the states in the form of a new component of untied grants.

The imbalance between the central government and the states increased once more in 2000 with the Commonwealth's introduction of a 10% GST. It was agreed that all the proceeds would go to the states, with the proviso that the states would eliminate or phase out seven of their own taxes. This deal brought the states what they had long sought – access to a large growth tax. It also, however, made the states more dependent upon the Commonwealth for funding. As Figure 1 illustrates, their dependency ratio had fallen between 1979 and 1999, but is now climbing again.

**Figure 1**  
**Vertical Fiscal Imbalance Over 100 Years of Federation in Australia:**  
**Ratio of Grant Revenue to States' Total Revenue**



Note: Years marked \* include local government.

Source: Review of Commonwealth–State Funding, *A review of the allocation of Commonwealth Grants to the States and Territories*, Background Paper, Melbourne, 2001, p. 13.

## CONCLUSION

Australia's equalization system has certain characteristics of interest for Canada. First of all, Australia has an independent body responsible for allocating the equalization program's budget envelope among the states. Second, one of the key characteristics of the Australian system is the concept of the states' "expenditure requirements," which goes hand-in-hand with their "fiscal capacities." In Canada, this approach is for the moment confined to discussions among government experts and academics.

That being said, however, the Australian system may not offer a solution for those who criticize the Canadian equalization program as being too complex and lacking transparency. Because the Australian system takes expenditure requirements into account, it is as complex as the Canadian system, and perhaps even more so. In addition, it is more subject to arbitrary and subjective decisions. It is easy to imagine that, in the Canadian context, taking expenditure requirements into account could exacerbate tensions among various governments over the sharing of the budget envelope.

In light of the Australian experience with equalization, it seems obvious that increasing the number of factors and variables that are considered in calculating equalization payments (with a view to making them fairer and better reflecting the relative capacities of the various jurisdictions) does not reduce the level of dissatisfaction with the program.

A miracle solution to the ills of the Canadian equalization program is perhaps not to be found in the antipodes. Nonetheless, the Australian system certainly deserves to be studied, if only to reinforce certain working hypotheses and to rule out some other possible approaches to reform that would lead nowhere.