

CHAPTER 8: FINANCIAL ARRANGEMENTS WITH THE COMMONWEALTH

- ◆ Fiscal federalism in Australia is characterised by very high vertical fiscal imbalance and overly complex horizontal fiscal equalisation according to the Warren report.
- ◆ New South Wales expects to receive \$10.9 billion in GST grants in 2006-07, which is less than expected when the GST was introduced in 2000-01.
- ◆ New South Wales will abolish the taxes listed for review in the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, commencing with the abolition of rental duty in 2007-08.
- ◆ New South Wales continues to cross subsidise the other States by almost \$3 billion per year or almost \$11 billion over four years.
- ◆ New South Wales believes that the current horizontal fiscal equalisation system needs fundamental reform, but will continue to contribute to the Grants Commission's 2010 review.

8.1 INTRODUCTION

The Australian system of Commonwealth funding has two significant aspects: Vertical Fiscal Imbalance and Horizontal Fiscal Equalisation.

The NSW Government now depends on Commonwealth grants for around 40 per cent of its revenue, compared with around 30 per cent of its revenue before the introduction of the GST. Consequently, financial relations with the Commonwealth significantly influence the financial position of the State. The high degree of vertical fiscal imbalance in Australia compared with other federations, inevitably results in conflict over fiscal matters between the levels of government and results in confused accountability among the community.

VERTICAL FISCAL IMBALANCE

Vertical fiscal imbalance refers to the mismatch between the revenue-raising capacity and spending responsibilities between the States and the Commonwealth.

State governments have access to only a small number of taxes which constrains their revenue raising capacity relative to their expenditure responsibilities. In contrast, the Commonwealth Government collects much more revenue than it needs for its own purposes. The States rely on grants from the Commonwealth to fund their expenditure responsibilities.

The introduction of the GST worsened this imbalance because States were then required to abolish a number of their own taxes. The Commonwealth collects around 80 per cent of total national taxation revenue (including the GST), but is responsible for around only 54 per cent of own-purpose expenses. The States collect around 16 per cent of taxation revenue and account for around 40 per cent of own-purpose expenses. Commonwealth grants now account for around 40 per cent of New South Wales' revenues, compared with around 30 per cent before the introduction of the GST.

HORIZONTAL FISCAL EQUALISATION

GST revenue grants are allocated among the States according to the principle of horizontal fiscal equalisation currently defined by the Commonwealth Grants Commission as:

- ◆ State governments should receive funding from the pool of goods and services tax revenue and health care grants such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.¹

Under the current system the share of funding allocated to each State is recommended by the Commonwealth Grants Commission to the Commonwealth Treasurer. The Commonwealth Treasurer can accept or reject the Grants Commission's recommendations and therefore has the ultimate responsibility to determine the grants to the States.

¹ *Commonwealth Grants Commission Report on State Revenue Sharing Relativities 2006 Update, page 4.*

The factors that determine the distribution of the GST revenue among the States matter if Australia is to convert potential efficiency improvements into actual efficiency gains. It makes little sense for New South Wales to be subsidising Queensland and Western Australia in the current environment when those States are booming with revenue well in excess of their expenditure needs.

8.2 THE NEED FOR REFORM – THE WARREN REPORT

New South Wales commissioned an independent review by Associate Professor Neil Warren of the University of New South Wales comparing and benchmarking Australian and international arrangements for the allocation of taxation powers and expenditure responsibilities between central and subnational governments, and mechanisms for fiscal transfers between governments.²

Warren found that, *“Australia performs comparatively poorly in international comparisons of intergovernmental fiscal arrangements. A review in the national interest is overdue and essential if Australia is to adequately meet the challenges of an ageing population. International experience shows that comprehensive reform to intergovernmental fiscal arrangements is being undertaken in many federations.*

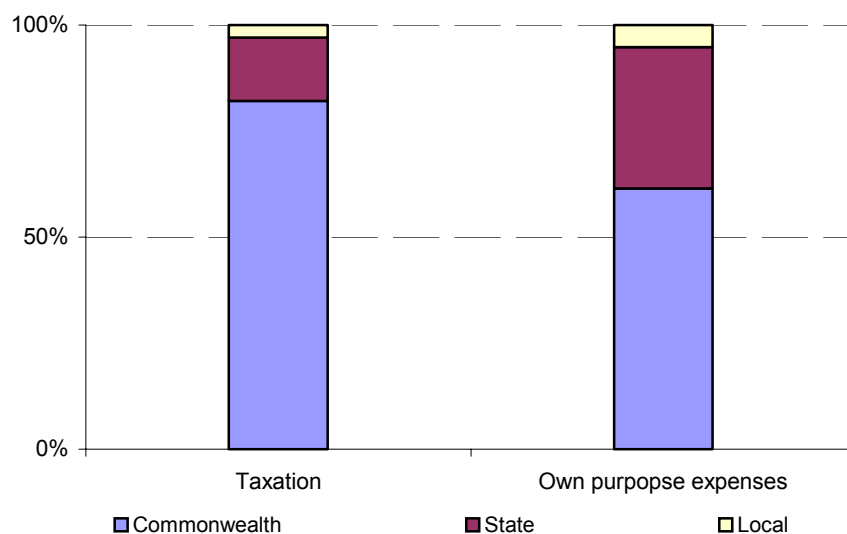
Australia’s system of intergovernmental fiscal arrangements is characterised by very high vertical fiscal imbalance (VFI) due to inadequate State tax powers, and complex and high level equalisation. These arrangements hinder adjustments in the economy that are essential for the economy to develop and grow, as it must if Australia is to meet future challenges.” (page xix)

The range of reforms associated with the introduction of the GST increased the degree of vertical fiscal imbalance (VFI) in Australia. There has been a trend towards greater concentration of taxing powers in the hands of the Commonwealth since Federation.

New South Wales believes the current Commonwealth-State financial arrangements (including the GST arrangements which see revenues raised by one level of government allocated to a different level of government) to be unstable in the longer term. It is for this reason that the NSW Treasurer has called for a summit of Commonwealth and State leaders.

² Warren, N, *“Benchmarking Australia’s Intergovernmental Fiscal Arrangements”, Final Report, May 2006.*

Chart 8.1: Vertical Fiscal Imbalance in Australia

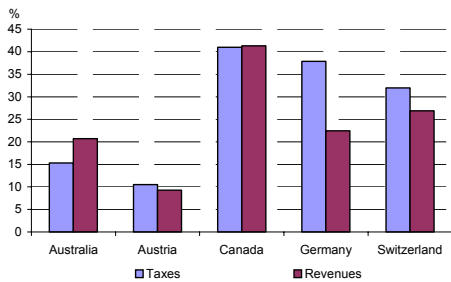


Australia has very high VFI compared to other developed federations. Australian States collect a low proportion of total taxes compared to Canadian, German and Swiss State governments. This means that State governments in Canada, Germany and Switzerland have the financial capacity to fund a much higher proportion of their expenditure from their own revenue sources than in Australia.

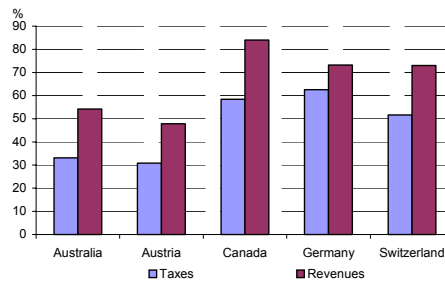
In Australia, States' own-source revenue accounts for around 54 per cent of their expenditures. State governments in Australia are much more dependent on fiscal transfers from the central government than most of the other federations studied in the Report (Chart 8.2).

Chart 8.2: International Indicators of Vertical Fiscal Imbalance

State Government own source taxes / revenues as a percentage of total Government taxes / revenues



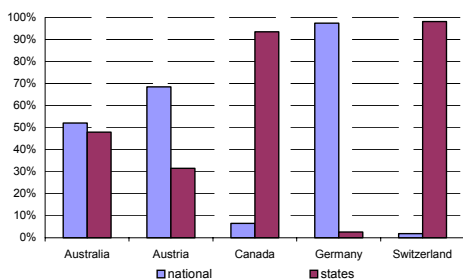
State Government own source taxes and revenues as a proportion of State Government expenditures



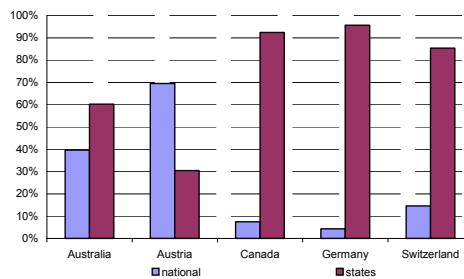
Warren found that expenditure responsibilities are generally allocated between the different levels of government in a relatively consistent fashion in the federations studied. The main points of difference between Australia and the other federations are in health and education. Health and education funding is shared almost evenly between the Commonwealth and the States. In most other federations those responsibilities are allocated almost exclusively to one level of Government. This is illustrated in Chart 8.3.

Chart 8.3: Health and Education Funding by Level of Government

Health



Education



This division of expenditure responsibilities can result in inefficiency and avoidance of accountability by blaming the involvement of the other level of government.

The high degree of VFI in Australia means that the States are very dependent on the Commonwealth for fiscal transfers. High VFI can lead to reduced public accountability and can hinder the pursuit of economic efficiency.

Warren also found that Australia's system for distributing grants among the States rated poorly when compared to other developed federations.

Warren stated that, *“In relation to domestic and international arrangements for transfers from national to subnational governments, Australia’s equalisation mechanism is the most complex and comprehensive of the comparator countries, despite Australia having relatively small economic differences across the States. For example, while Australia attempts to equalise both revenues and expenditures, Canada and Germany equalise on the revenue capacity side only.*

What makes Australia’s horizontal fiscal equalisation (HFE) system unique is the degree to which the equalisation objective is pursued at the expense of efficiency. In fact, the system fails to strike a balance in that it strives to achieve full horizontal equalisation without regard to the efficiency costs. Furthermore, there is no objective benchmark to assess whether Australia achieves interstate equity. It would appear that other federations acknowledge more fully than does Australia a likely trade-off between the interjurisdictional equity benchmark and achievement of other benchmarks such as efficiency, transparency and simplicity.” (page xxii)

According to Warren, *“Australia arguably has the most complex transfer mechanism of any comparator federation.”* There is no evidence that the complex and data intensive nature of the Grants Commission’s processes lead to any more reliable outcomes than the less complex and more transparent arrangements of other developed federations.

The key conclusions of Warren’s Report are that Australia performs comparatively poorly against many of the criteria which define best practice fiscal federalism. International experience shows that:

- ◆ Australia’s federal financial system is clearly in need of review in the national interest;
- ◆ comprehensive reform of intergovernmental financial arrangements has been recently undertaken in many federations; and
- ◆ if reform is necessary this should be possible without significantly disadvantaging any individual jurisdictions.

8.3 COMMONWEALTH GRANTS

The *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (IGA) sets out the current Commonwealth-State financial arrangements. The Agreement was signed in June 1999 and the arrangements took effect from July 2000. Details of the Agreement were provided in the 2003-04 Budget Paper No 2.

It is a myth that the GST based funding arrangements have brought a large funding windfall to all of the States and Territories.

New South Wales has fared poorly from the GST, worst of all the States and Territories. To 2005-06, New South Wales will have received just \$209 million more in total over the six years the GST has been in place than under the former funding arrangements. That equates to just \$31 per capita in six years, or \$5 per capita per year. In contrast, the other States and Territories have in total received \$305 per capita in additional funding from the GST over the six years, almost ten times as much as New South Wales.

Furthermore, the GST has delivered New South Wales less funding from the Commonwealth than was expected when the new arrangements were implemented in 2000. In the six years to 2005-06, New South Wales has received around \$750 million less than was expected in 2000. Again New South Wales has fared worst by far, being the only State to have received less than was initially expected.

Table 8.1 provides estimates of Commonwealth payments to New South Wales for the period to 2009-10.

Table 8.1: Commonwealth Grants

	<i>Actual</i>	<i>Budget</i>	<i>Revised</i>	<i>Budget</i>	<i>Forward Estimates</i>		
	<i>2004-05</i>	<i>2005-06</i>	<i>2005-06</i>	<i>2006-07</i>	<i>2007-08</i>	<i>2008-09</i>	<i>2009-10</i>
	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>
GST Revenue Grants	9,884	10,373	10,244	10,941	11,728	12,513	13,233
Budget Balancing Assistance							
Payments	...	...	44	...	...	...	...
Compensation for GST Deferral	64	37	37	5	5	6	6
Guaranteed Minimum Amount/GST	9,948	10,410	10,325	10,946	11,733	12,519	13,239
National Competition Policy Payments	233	265	292	...	...	...	...
Total General Purpose Payments	10,181	10,675	10,617	10,946	11,733	12,519	13,239
Total Specific Purpose Payments	6,011	6,121	6,410	6,679	6,811	7,016	6,958
Total Grants	16,192	16,796	17,027	17,625	18,544	19,535	20,197

GST REVENUE GRANTS AND BUDGET BALANCING ASSISTANCE

In 2004-05, for the first time, New South Wales received GST revenue grants in excess of what would have been received under the previous set of funding arrangements, the Guaranteed Minimum Amount (GMA). New South Wales was the last State to receive top-up payments under the GMA arrangements.

However, in 2005-06 New South Wales' GST revenue grants were again less than the GMA, requiring payment of Budget Balancing Assistance (BBA). No other State required BBA in 2005-06.

New South Wales' general purpose grants (GST plus BBA where applicable) have grown much more slowly than grants to the other States. In nominal terms, GST grants to New South Wales in 2006-07 are estimated to be around 13 per cent higher than in 2001-02, compared to growth of around 34 per cent to the other States in aggregate.

In real per capita terms, grants to New South Wales are estimated to be around 5 per cent lower in 2006-07 than in 2001-02; grants to the other States in real per capita terms have risen by around 10 per cent over this period.

This significantly lower growth in grants to New South Wales reflects movements in the two components of general purpose grants i.e. the GMA, and any amount in excess of the GMA.

The Guaranteed Minimum Amount

The GMA represents what the States would have received under the previous financial arrangements. However, the GMA itself is not an unchanging baseline because it is affected by the Grants Commission's relativities.

New South Wales' GMA has been revised downwards over time as the relativities have declined.

Since 2003-04, New South Wales has been receiving significantly less in grants than was expected when the IGA was implemented in 2000. New South Wales is the only State that has received less than originally expected. Table 8.2 provides details of the differences across the States.

Table 8.2: Difference between Initial Grants Estimates and Outcomes, \$m ^(a)

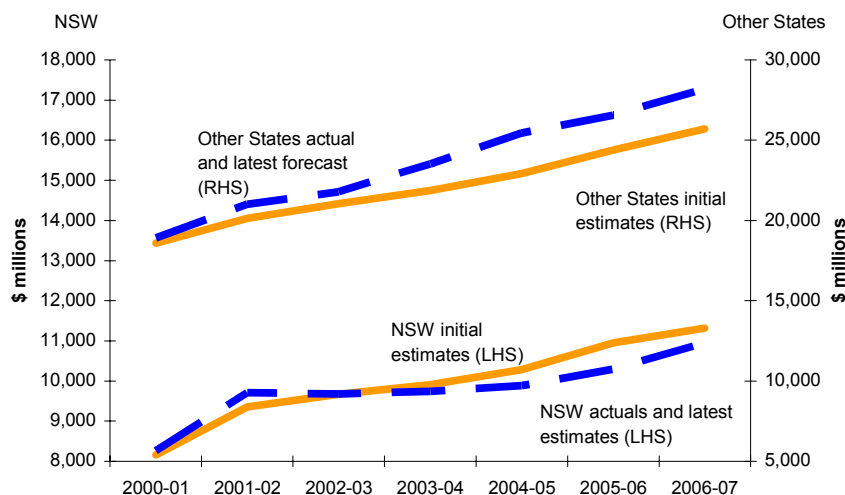
	<i>NSW</i>	<i>VIC</i>	<i>QLD</i>	<i>WA</i>	<i>SA</i>	<i>TAS</i>	<i>ACT</i>	<i>NT</i>
	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>
2000-01	103	79	148	3	63	24	6	3
2001-02	356	191	350	80	144	68	28	23
2002-03	8	12	383	75	113	98	10	60
2003-04	-174	188	647	249	219	180	29	134
2004-05	-403	422	1,050	523	261	174	11	86
2005-06	-646	383	926	470	214	149	5	26
2006-07	-380	885	823	412	190	156	3	11

(a) Defined as the difference between the initial estimates for State and Territory general purpose grants (GST and BBA) and the actual outcomes and latest estimates.

The cumulative loss to New South Wales between the introduction of the GST in 2000-01 and 2006-07 is estimated at around \$1.1 billion. Every other State has received more in grants than was initially expected.

New South Wales is again expected to be the only State to receive less than originally expected in 2006-07. Based on current estimates, New South Wales should begin to receive grants that are above the original estimates in 2008-09.

Chart 8.4: GST Revenue – Initial Estimates and Outcomes



GST in excess of the Guaranteed Minimum Amount

New South Wales received GST revenue in excess of the GMA for the first time in 2004-05 (refer to Table 8.3), making it the last State to not require top-up funding. In 2005-06, New South Wales again received its GMA, that is, New South Wales received no net GST gains.

This reflects the fact that New South Wales lost significantly more revenue from abolished State taxes and abolished Commonwealth grants (in addition to facing new costs) than the GST revenue grants which replaced these revenue sources.

Table 8.3: Amount of GST above GMA, \$m

	NSW \$m	VIC \$m	QLD \$m	WA \$m	SA \$m	TAS \$m	ACT \$m	NT \$m	Total \$m
2000-01	nil	nil	nil	nil	nil	nil	nil	nil	nil
2001-02	nil	nil	nil	nil	nil	nil	nil	nil	nil
2002-03	nil	nil	76	nil	nil	nil	nil	10	86
2003-04	nil	112	502	150	95	70	39	110	1078
2004-05	209	296	769	250	175	106	56	141	2002
2005-06	nil	103	525	185	140	86	47	117	1203
TOTAL	209	511	1872	585	410	262	142	378	4369
Expected									
2006-07	160	298	665	270	193	102	61	123	1873

National Competition Policy Payments

The Commonwealth announced its unilateral abolition of National Competition Policy (NCP) payments from 2006-07 during the 2004 federal election campaign.

The Commonwealth Government makes NCP payments to the States for implementation of agreed competition policy reforms, such as applying principles of competitive neutrality to government-owned businesses, reform of public monopolies, and assessment of legislation that restricts competition against net community benefits.

The National Competition Council (NCC) assesses each State's performance against these reform commitments and makes recommendations to the Commonwealth regarding NCP payments. These payments recognise that the States are responsible for significant elements of NCP, but most of the direct financial return accrues to the Commonwealth Government via its broader taxation powers.

In response to the NCC's recommendations for its 2004 NCP Assessment, the Commonwealth imposed a \$26 million penalty on New South Wales (in the form of suspended payments) for failing to reform restrictions in rice marketing and poultry meat legislation. In addition, the Commonwealth imposed a further \$26 million suspended payment penalty on New South Wales for its water sharing plan.

For the 2005 NCP assessment, responsibility for assessing jurisdictions' progress in relation to their water reform obligations under the National Water Initiative was transferred from the NCC to the National Water Commission (NWC). This represents the NCC's final assessment and final tranche of competition payments under the current NCP arrangements.

In 2005-06, New South Wales received a net total of \$291.9 million in competition payments. This amount takes into account:

- ◆ the NCC's recommendation that New South Wales be fully reimbursed \$26 million (in suspended payment penalties levied in the 2004 NCP Assessment) for completing reforms to rice marketing and poultry meat legislation.
- ◆ the NWC's recommendations for New South Wales:
 - reimbursement of \$13 million (of the \$26 million in suspended payment penalties levied in the 2004 NCP Assessment) in recognition of the progress made in the past 12 months in complying with water planning processes;
 - a continuing suspended payment of the remaining \$13 million (from the 2004 NCP Assessment) on the basis that New South Wales' current water planning processes continued some of the shortcomings identified in previous NCP assessments; and
 - a new suspended payment penalty of around \$13.3 million (representing 5 per cent of New South Wales' maximum available NCP payments for 2005-06) for not opening up water trading in the southern Murray Darling Basin.
- ◆ Both suspended amounts are recoverable upon demonstration of compliance to the NWC:
 - the continuing \$13 million suspended payment penalty is recoverable by 1 July 2007 upon demonstrating certain improvements in current/future water planning processes; and
 - the new \$13.3 million suspended payment penalty is recoverable by 1 January 2007 upon demonstrating satisfactory joint progress in opening up interstate water trading in the southern Murray Darling Basin.

At no stage was there any agreed decision between the Commonwealth and State Governments for the NWC to be able to recommend the imposition of further suspended payment penalties on jurisdictions' 2005-06 competition payments as part of the NWC's 2005 Assessment.

NEW NATIONAL REFORM AGENDA

The Council of Australian Governments (COAG) recently endorsed a new National Reform Agenda (NRA) comprising competition and regulation reforms, and human capital reforms in its 10 February 2006 Communiqué. The NRA will replace the current NCP agreement when it expires.

Competition and Regulation Reforms

These reforms are a substantial addition to the NCP reforms and are expected to further boost competition, productivity, and the efficient functioning of markets. COAG agreed to:

- ◆ recommit to the principles contained in the Competition Principles Agreement;
- ◆ continue and strengthen gate-keeping arrangements to prevent the introduction of unwarranted competition restrictions in new and amended legislation and regulations;
- ◆ complete outstanding legislation reviews from the current NCP Legislation Review Program;
- ◆ energy market reforms (e.g. strengthen electricity transmission systems);
- ◆ freight transport reforms (e.g. harmonise and reform rail and road regulation);
- ◆ infrastructure regulation reforms (e.g. ensuring more timely regulatory decisions);
- ◆ infrastructure planning reforms, including various commitments to improve nationally significant transport corridors under the AusLink program;
- ◆ adopt a new Climate Change Plan of Action and to establish a high-level interjurisdictional Climate Change Group to oversee implementation of the Plan; and
- ◆ reduce the regulatory burden.

Human Capital Reforms

COAG agreed that these reforms should be based on an overarching theme of enhancing productivity and participation, with human capital as a key component. Key elements of these reforms include:

- ◆ health reforms that increase the effectiveness of the health system in achieving health outcomes and increasing workforce participation;
- ◆ education and training reforms including improving early childhood development outcomes; and
- ◆ encouraging and supporting increased workforce participation among key groups.

Funding Arrangements

In its 10 February 2006 Communiqué, COAG agreed that the Commonwealth:

“will provide funding to the States and Territories on a case-by-case basis once specific implementation plans have been developed if funding is needed to ensure a fair sharing of the costs and benefits of reform. Payments to the States and Territories and, where appropriate, to local government, would be linked to achieving agreed actions or progress measures and to demonstrable economic benefits, and would take into account the relative costs and proportional financial benefits to the Commonwealth, the States and Territories and local government of specific reform proposals.

Any funding could take the form of Commonwealth and/or shared funding for specific initiatives, and/or payments from the Commonwealth linked to results. Any funding would be in addition to other Commonwealth funding”.

The Productivity Commission has been asked to undertake some modelling of the expected economic benefits flowing from the NRA, which it expects to complete around late 2006. The outcomes of this modelling are expected to assist the Commonwealth and States/Territories to negotiate funding arrangements for the NRA.

SPECIFIC PURPOSE PAYMENTS

Specific purpose payments (SPPs) from the Commonwealth to the States are grants that are tied to specific types of expenditures and which usually include conditions attached to their use.

The Commonwealth offers SPPs for a variety of reasons, including:

- ◆ financial contributions to areas of State service delivery (e.g. health and education);
- ◆ implementing national priorities in areas that cross state borders (e.g. national land transport, salinity and water quality);
- ◆ complying with international obligations (e.g. world heritage properties); and
- ◆ compensating States for policies in areas of Commonwealth constitutional responsibility that adversely impact State finances (e.g. liberalising access to Commonwealth pensioner concessions).

In 2006-07, New South Wales will receive SPPs totalling \$6.7 billion, for more than 50 different specific purposes. In total, SPPs are estimated to record growth of around 4.2 per cent in 2006-07. Table 3.8 in Chapter 3 includes a list of the major payments to New South Wales.

SPPs provide about 15 per cent of NSW total Budget revenues. The conditions under which the grants are paid to States are documented in agreements that are typically renegotiated every three to five years. Because these agreements each have a limited duration, New South Wales does not have long-term certainty over this significant portion of total Budget revenues.

While SPPs constitute around 15 per cent of Budget revenues, through their matching and maintenance of effort requirements, SPP arrangements can control around 30 per cent of Budget outlays. This has a significant impact on Budget flexibility.

Many SPPs are indexed, typically by reference to movements in consumer prices and the minimum wage. Such indexation falls short of the rate of increase in costs experienced in services such as health care, creating a structural problem for State Budgets as the ageing of the population increases the proportion of the population requiring such services. Budget Paper No. 6 considers the impact of ageing on the Budget in detail.

New South Wales participated in negotiations for the following SPPs during 2005-06:

- ◆ national land transport (AusLink)
- ◆ supported accommodation assistance
- ◆ vocational education and training
- ◆ disability services.

The reviews of service delivery by the Council of Australian Governments have the potential to change some SPPs.

In particular, the review of health sector SPPs being conducted by the Australian Heads of Treasuries' SPP Working Group is to identify any elements of SPPs that, if changed, could increase the effectiveness of the health system in achieving health outcomes.

The following SPP agreements are due for renegotiation over the forward estimates period:

- ◆ public housing (expires 30 June 2008)
- ◆ health care (expires 30 June 2008)
- ◆ government schools (expires 31 December 2008)
- ◆ vocational education and training (expires 31 December 2008)
- ◆ national land transport (AusLink) (expires 30 June 2009).

8.4 IGA REVIEW OF CERTAIN STATE TAXES

The original *Intergovernmental Agreement (IGA) on the Reform of Commonwealth-State Financial Relations* was signed by all the States and Territories in April 1999.

Under this IGA, the Commonwealth and States agreed to a substantial list of taxes to be abolished. However, the list of taxes to be abolished had to be amended when a number of exemptions were introduced to the GST base in order to secure its passage through the Senate, which led to a significant reduction in GST revenue.

The revised Agreement signed in June 1999, included the following provisions:

- ◆ Bed taxes to be abolished from 1 July 2000;
- ◆ Financial Institutions Duty to be abolished from 1 July 2001;
- ◆ Stamp duty on quoted marketable securities to be abolished from 1 July 2001;
- ◆ Debits tax to be abolished by 1 July 2005, subject to review by the Ministerial Council for Commonwealth-State Financial Relations (the Treasurers' Conference).

New South Wales has fulfilled all of its obligations under the IGA. New South Wales abolished debits tax on 1 January 2002, three and a half years ahead of schedule.

The IGA also stated that:

*“The Ministerial Council will by 2005 review the need for retention of stamp duty on non-residential conveyances; leases; mortgages, debentures, bonds and other loan securities; credit arrangements, instalment purchase arrangements and rental arrangements; and on cheques, bills of exchange, promissory notes; and unquoted marketable securities.”*³

These taxes were reviewed in 2005, as required by the IGA. This review concluded that sustainable taxation reform can only be achieved where such measures are consistent with sound fiscal policy. The review also concluded that the excess of GST over GMA is not a measure of the fiscal capacity of the States to implement tax cuts, as it does not take into account the broader fiscal pressures on state budgets.

Legal advice from Mr Bret Walker SC confirms that New South Wales has fulfilled its obligations under the IGA. This advice stated,

*“The fact that, as a result of the review, New South Wales perceived a need, for the time being, to retain the stamp duties in question cannot possibly on any legal view constitute a breach of the Agreement by New South Wales.”*⁴

Notwithstanding this legal advice, the Commonwealth has continued to insist that the States must abolish the IGA listed taxes or the Commonwealth would judge the States to be in breach of the IGA.

The implementation of the Commonwealth Government’s timetable would have cost New South Wales around \$2 billion over the current Budget period. New South Wales cannot afford to abolish these taxes according to this schedule given it loses nearly \$3 billion a year in net GST revenue.

Following discussions at the 2006 Treasurers’ Conference, New South Wales has put its own counter offer to the Commonwealth. The New South Wales timetable for the abolition of these taxes acknowledges the fiscal pressures on New South Wales and that New South Wales has benefited least from the GST, and delays the abolition of the taxes until New South Wales begins to see some financial benefit from the GST.

³ *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, Section 5(vii).*

⁴ *Legal advice prepared by Bret Walker SC for NSW, 4 May 2005, paragraph 28.*

The schedule is:

- ◆ 1 July 2007 – Abolish stamp duty on credit arrangements, instalment purchase arrangements and rental arrangements.
- ◆ 1 January 2008 - Abolish stamp duty on leases.
- ◆ 1 January 2009 – Abolish stamp duty on non-quotable marketable securities.
- ◆ 1 January 2010 – Abolish one half of stamp duty on mortgages, bonds, debentures and other loan securities.
- ◆ 1 January 2011 – Abolish remaining half of stamp duty on mortgages, bonds, debentures and other loan securities.
- ◆ 1 July 2012 – Abolish stamp duty on business conveyances other than real property.

New South Wales has always recognised the desirability of abolishing these inefficient taxes. However, the large shortfall that New South Wales incurred in its GST grants compared to the original expectations made abolition of the taxes in line with the Commonwealth timetable fiscally irresponsible.

8.5 COMMONWEALTH GRANTS COMMISSION'S 2006 UPDATE

The total GST pool size in 2006-07 is estimated to be \$39.1 billion. The distribution of this revenue among the States has significant implications for the States' ability to fund services.

The Commonwealth allocates the goods and services tax revenues between the States on a per capita basis adjusted for States' relative revenue capacities and relative expense needs. The Commonwealth Grants Commission recommends the relativities to be used in the distribution of the GST among the States. Under the terms of the IGA, the Commonwealth Treasurer determines the relativity factors after he has consulted with each State and Territory.⁵

The Commonwealth Grants Commission reviews its methods of assessing State relativities every five or six years and updates these relativities with new data annually.

⁵ *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, clause B2.

Table 8.4 shows for all States the impact of the 2006 annual data update on each States' GST grant. Table 8.4 isolates the impact of the 2006 data update on State relativities by assuming for the purpose of this calculation that the size of the total goods and services tax revenue pool is unchanged from 2005-06. Hence it does not measure the change in the actual goods and services tax revenue grants to States.

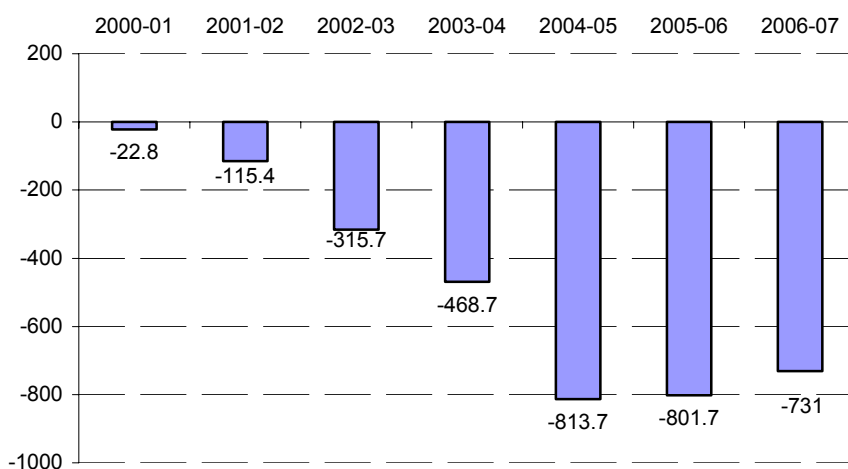
Table 8.4: Effect of 2006 data update on the States in 2006-07

	<i>NSW</i>	<i>VIC</i>	<i>QLD</i>	<i>WA</i>	<i>SA</i>	<i>TAS</i>	<i>ACT</i>	<i>NT</i>
\$ m	71	220	-176	-90	-50	-4	2	27
% of each State's GST grants	0.7	2.6	-2.2	-2.3	-1.4	-0.3	0.3	1.4

The small increase in New South Wales' relativity in the 2006 update follows significant losses in most of the years since the introduction of the GST. In 2006-07, New South Wales again expects to receive significantly less in GST grants than was expected when the GST was introduced.

Over the six years since the introduction of the GST, New South Wales' cumulative loss from changes in relativities now exceeds \$700 million annually (see Chart 8.5). Since the introduction of the GST in 2000-01, New South Wales has lost over \$3 billion due to the effects of relativity changes.

Chart 8.5: NSW' cumulative annual loss from changing relativities (\$m)



The Grants Commission uses a five year moving average in calculating the relativities; data from 2000-01 to 2004-05 was used in the 2006-07 update. As a result, revisions to historical data up to six years prior to the current year can affect the relativity. Revisions to historical data, particularly for compensation of employees, had a significant negative impact on New South Wales' 2006-07 relativity.

This negative impact on the relativity was offset by the inclusion of data for 2004-05 in place of data for 1999-2000 in the five year moving average calculation.

Table 8.5 lists the major changes in the Commonwealth Grants Commission's assessment for New South Wales in the 2006 update, compared to the 2005 update.

Table 8.5: Major changes in the 2006 data update

<i>Factor</i>	<i>\$ million</i>
Payroll taxation	- 208.2
Stamp duty on conveyances	165.8
Inpatient services	30.3
Wages input costs	50.2

The large negative effect relating to **payroll tax** reflected the impact of revisions to historical data. The Australian Bureau of Statistics (ABS) revised its data on compensation of employees, which is the source for the estimates of payroll tax. In particular, the ABS revised the way in which the national figure is allocated across the States, which resulted in a large increase in New South Wales' proportion of the national figure. This significantly increased New South Wales' assessed capacity to raise revenue and led to a reduction in grant share.

The impact on New South Wales' grant share in the 2006 data update is substantial because the revised estimates of compensation of employees affect all five years of the payroll tax assessment. It is one of the perversities of the present system that future grants can be influenced by revisions to data for periods as much as six years in the past.

The Grants Commission assessed that New South Wales' capacity to raise **transfer duty (stamp duty on conveyances)** has declined because growth in property market turnover in New South Wales between 1999-2000 and 2004-05 was lower than in Queensland, Western Australia and Tasmania.

New South Wales saw an increase in the **inpatient services** assessment because the proportion of people in New South Wales likely to use inpatient services rose.

The CGC recognises that public sector **wage costs** are higher in New South Wales than the Australian average. This is due to non-policy influences such as the cost of living and location where the work is performed. An increase in the underlying wage costs led to an increase in New South Wales' relative cost of providing services.

CROSS SUBSIDIES IN THE GST DISTRIBUTION

The current system for distributing the GST revenue among the States gives rise to a large cross subsidy from New South Wales and Victoria to the other six States. This cross subsidy is apparent when the GST grants are compared to either an equal per capita distribution or to the amount of GST generated in each State.

In 2006-07, New South Wales will receive \$10,941 million of the total GST pool of \$39,130 million. This is significantly less in GST revenue grants than if funding were based solely on population shares (see Table 8.6).

- ◆ New South Wales' GST revenue grants in 2006-07 will be \$1,594 per capita or 16 per cent less than the average of all the States;
- ◆ The average GST revenue grant in 2006-07 for New South Wales and Victoria (the donor States) will be \$1,621 per capita, compared with an average of \$2,260 per capita for the recipient States.

Table 8.6: GST Revenue Grants Per Capita, 2006-07

<i>State/Territory</i>	<i>GST Revenue Grants (In \$ per capita)</i>
New South Wales	1,594
Victoria	1,657
Western Australia	1,902
Queensland	1,951
South Australia	2,279
Australian Capital Territory	2,303
Tasmania	3,182
Northern Territory	9,461
Average, 2 donor States	1,621
Average, 6 recipient States	2,260
AUSTRALIAN AVERAGE	1,890

In 2006-07, New South Wales and Victoria will subsidise the recipient States by \$3,227 million, compared with an equal per capita distribution. New South Wales alone will transfer \$2,035 million, or \$296 per capita, to the recipient States.

Total cross subsidies for 2006-07 reflecting the 2006 Update relativities compared with an equal per capita distribution of GST revenue are in Table 8.7 (negative figures indicate donor States).

Table 8.7: Cross Subsidies, Equal per Capita Benchmark, 2006-07

	<i>NSW</i>	<i>VIC</i>	<i>QLD</i>	<i>WA</i>	<i>SA</i>	<i>TAS</i>	<i>ACT</i>	<i>NT</i>
Total, \$m	(2,035)	(1,192)	250	24	605	632	136	1,580
\$ per capita	(296)	(233)	61	11	389	1,292	413	7,571

The New South Wales cross subsidy is distributed to the subsidised States as shown in Table 8.8.

Table 8.8: NSW Cross Subsidy Distribution, Equal per Capita Benchmark, 2006-07

	<i>QLD</i>	<i>WA</i>	<i>SA</i>	<i>TAS</i>	<i>ACT</i>	<i>NT</i>	<i>Total</i>
Total, \$m	158	15	381	399	86	997	2,035
\$ per capita	23	2	56	58	12	145	296

COMPARISON WITH GST GENERATED BY STATES

An alternative method of measuring the level of transfers from donor to recipient States is to compare GST revenue grants with the amount of GST generated by activity in each State.⁶

Economic activity in New South Wales is estimated to generate around 34 per cent of GST revenue, but New South Wales receives only around 28 per cent of GST grants. This economic activity in New South Wales is estimated to generate around \$13.5 billion in GST revenue in 2006-07; significantly more than the GST grants of around \$10.9 billion.

⁶ State contributions to GST revenue are estimated by NSW Treasury based on the GST generating activity in each State. Data have been sourced from ABS Cat No 5220.0, Australian National Accounts: State Accounts 2004-05. The estimates are not based on the location of the businesses remitting GST revenue. On that basis, the cross-subsidy from NSW would be much larger.

This is a cross-subsidy to the other States (except Victoria) of around \$2.6 billion, or \$372 per capita. New South Wales receives around 81 cents for every \$1 in GST generated in this State.

Table 8.9: GST Generated and GST Grants, 2006-07

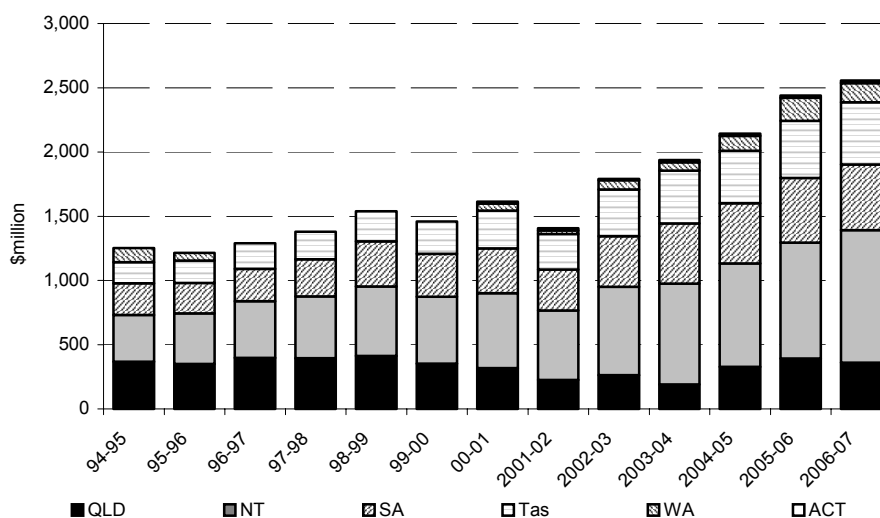
	<i>NSW</i>	<i>VIC</i>	<i>QLD</i>	<i>WA</i>	<i>SA</i>	<i>TAS</i>	<i>ACT</i>	<i>NT</i>
Generated \$b	13.5	9.9	7.4	3.7	2.7	0.8	0.7	0.4
Grants \$b	10.9	8.5	8.0	3.9	3.5	1.6	0.8	2.0
Cross Subsidy \$b	(2.6)	(1.4)	0.6	0.2	0.8	0.8	...	1.6
Cross Subsidy, \$pc	(372)	(283)	138	114	515	1,552	89	7,735

Table 8.10: NSW Cross Subsidy Distribution, GST Generated Benchmark, 2006-07

	<i>QLD</i>	<i>WA</i>	<i>SA</i>	<i>TAS</i>	<i>ACT</i>	<i>NT</i>	<i>Total</i>
Total, \$m	361	150	511	485	19	1,031	2,556
\$ per capita	53	22	74	71	3	150	372

This cross subsidy has been increasing over time. Chart 8.6 shows the growth in New South Wales' cross subsidy since 1994-95.

Chart 8.6: NSW Cross Subsidy to Recipient States



For the period prior to the introduction of the GST, 1994-95 to 1999-2000, the cross subsidy is based on the difference between financial assistance grants (FAGS) and a share of the combined FAG/unquarantined health care grant pool equivalent to New South Wales' share of income tax payments.⁷ The cross subsidy in the GST period is based on the difference between the amount of GST generated in New South Wales and GST grants received. Clearly, the cross subsidy paid by New South Wales to the recipient States has risen dramatically over the past ten years.

New South Wales has always recognised the need for cross subsidies to be paid to the small States, with narrow economic bases, that is, South Australia, Tasmania and the Northern Territory. However, there does not appear to be any good justification for the continuation of cross subsidies to the large, prosperous States of Queensland, Western Australia and the Australian Capital Territory.

8.6 COMMONWEALTH GRANTS COMMISSION'S 2010 REVIEW

The Grants Commission's next methodology review is due to report in February 2010.

The terms of reference for this review require the Grants Commission to simplify its assessments, including by:

- ◆ aggregating existing assessment categories;
- ◆ eliminating unreliable category assessments;
- ◆ applying a materiality threshold to assessments; and
- ◆ reviewing the scope for the use of broader indicators.

The terms of reference also require the Grants Commission to report:

- ◆ to the 2006 Treasurers' Conference on its conclusions concerning the elimination of unreliable assessments and the application of a materiality threshold; and
- ◆ to the 2007 Treasurers' Conference on its conclusions concerning the aggregation of assessments and issues relating to the quality and fitness for purpose of the data that it uses.

⁷ Sourced from Commonwealth Budget Paper No. 3 for each year.

The Grants Commission's report to the 2006 Treasurers' Conference proposed a number of measures designed to improve reliability as well as materiality thresholds for categories and disabilities.

New South Wales will continue to participate in this review despite the narrow terms of reference. However, New South Wales will also continue to argue for fundamental reform of the current system of horizontal fiscal equalisation. The need for this reform is clearly described in the Warren Report.