CHAPTER 8: FINANCIAL ARRANGEMENTS WITH THE COMMONWEALTH

- Gross payments from the Commonwealth to New South Wales will increase from $9,557 million in 1999-2000 to $12,888 million in 2000-01.
- Specific Purpose Payments will increase by 4.6 percent to $4,569 million, and General Purpose Payments by 60.3 percent to $8,319 million.
- The increase in General Purpose Payments is not a structural improvement. It reflects (1) the substitution of the GST revenue pool ($24.1 billion for all States) for the current Financial Assistance Grants pool ($17.3 billion), and (2) compensation to New South Wales for taxes abolished under tax reform and for additional State expenditure responsibilities under the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*.
- In fact, according to current estimates, New South Wales will not begin to see the net revenue benefits of a GST until late in this decade.
- New South Wales will receive $7,180.3 million in GST revenue grants (out of a total of $24.1 billion for all States) and $982.1 million in Budget Balancing Assistance (out of a total of $2,692.6 million for all States).
- The new Commonwealth-State funding arrangements leave in place the NSW cross-subsidy to other States under horizontal fiscal equalisation. The new arrangements also considerably aggravate the problem of vertical fiscal imbalance because the GST is a Commonwealth tax.

8.1 INTRODUCTION

Commonwealth-State[1] financial relations in Australia have traditionally been characterised by the following:

- A high degree of *vertical fiscal imbalance* (VFI), referring to the mismatch between tax powers and expenditure responsibilities of the Commonwealth and State Governments. The Commonwealth collects significantly more tax revenue than it requires for its own purposes. Consequently, it transfers funds to the States in the form of general purpose payments (GPPs)[2] and specific purpose payments (SPPs)[3]; and

- An extensive system of *horizontal fiscal equalisation* (HFE) which governs the interstate distribution of GPPs (the largest component of which is Financial Assistance Grants (FAGs) in 1999-2000 and GST Revenue Grants in 2000-01), and which is overseen by the Commonwealth Grants Commission (CGC). This has historically resulted in the transfer of over $2 billion annually from donor States (New South Wales, Victoria, Western Australia and the ACT) to other States.

New South Wales, along with all other States, signed the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (the IGA) in June 1999. Although all States signed the IGA, some States including New South Wales had indicated at the outset that this did not imply their endorsement of a GST, and that their participation in the discussions was for the purpose of safeguarding the interests of their citizens.

The budget year 2000-01 will be the first year of implementation of major changes in Commonwealth-State finance under national tax reform. Key elements include the introduction of a Goods and Services Tax (GST) from 1 July 2000 and the abolition of a number of State indirect taxes and the Commonwealth's wholesale sales tax; the passing-on by the Commonwealth of GST revenues to States to replace FAGs and abolished State taxes; and the provision by the Commonwealth of guarantee payments to ensure that no State is worse off financially during the transition to a GST regime.

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1 *All references to 'States' in this chapter should be interpreted as referring to States and Territories.*

2 *GPPs are unconditional grants originally intended to compensate the States for losses on tariff revenue at Federation and the Commonwealth's takeover of income taxing powers after 1942. GPPs have traditionally consisted of financial assistance grants (FAGs) and special revenue assistance. With the introduction of national tax reform, FAGs will be abolished and replaced with GST Revenue Grants. During the transition period, GPPs (for purposes of this chapter) also include Budget Balancing Assistance (these are transitional payments from the Commonwealth to ensure that States are no worse off financially under the new arrangements).*

3 *SPPs are grants contingent on the States' compliance with certain conditions - for example, the purposes for which the funds may be used; specific monitoring and review arrangements; annual increases in funding; and/or maintenance of expenditure requirements. SPPs generally have a duration of one to five years depending on the terms of the individual SPP agreements, which are separately negotiated between the Commonwealth and States.*

Although the new arrangements give States access to revenue from a broad-based tax, the fundamental structure of Commonwealth-State finance has effectively changed little. The GST is a Commonwealth tax, and the pass-on of GST revenue is a revenue sharing rather than a tax base sharing arrangement.

On current estimates, New South Wales will not begin to see the revenue benefits of the reforms until 2007-08. That date could be brought forward if GST revenue were higher than projected, but in the first instance any higher-than-expected GST revenue will benefit the Commonwealth (through a reduction in guarantee payments) rather than the States.

The distribution of GST revenues on a fiscal equalisation basis ensures that the substantial cross-subsidies from donor to recipient States will continue in the foreseeable future.

General purpose grant shares on the new GST basis in 2000-01 cannot be compared with the old FAG shares of the previous year because the two reflect different policy environments. The increase in NSW total GPPs from $5,189.9 million in 1999-2000 to $8,318.9 million in 2000-01 is not a structural improvement, but a ‘pool size’ effect reflecting the substitution of the GST revenue pool (totalling $24.1 billion for all States) for the current FAGs pool ($17.3 billion).

The increase in general purpose payments merely compensates New South Wales for taxes abolished under tax reform, and for additional State expenditure responsibilities under the IGA. If FAGs had been retained in 2000-01, New South Wales' increase in GPPs would have been 3.5 percent in nominal terms (or about 0.9 percent in real terms).

NSW GPPs in 2000-01 will consist of GST revenue grants ($7,180.3 million), Budget Balancing Assistance ($982.1 million) and competition payments ($156.5 million). Specific Purpose Payments (excluding the Gun Buyback Scheme in 1999-2000) for New South Wales' own purposes are expected to grow by 4.6 percent in nominal terms (or about 1.9 percent in real terms).

Data on 2000-01 Commonwealth payments to New South Wales and measures of VFI and HFE are provided in the tables at the end of this chapter. The remainder of the chapter describes developments during the past year, and canvasses issues in intergovernmental financial relations which are likely to remain of concern in the immediate future.

8.2 RECENT DEVELOPMENTS

NATIONAL TAX REFORM

The IGA, including amendments as a result of negotiations between the Commonwealth and the Australian Democrats, was signed by all States in June 1999. The IGA outlines major changes to Commonwealth-State financial arrangements.

Key features of the final agreement which will affect State budgets are summarised below, while progress in implementing IGA commitments is reported later in this chapter.

- A 10 percent GST, with the proceeds to be distributed to States. GST revenue grants to replace: (1) Commonwealth FAGs and Revenue Replacement Payments[4] (RRPs) to States, which will cease on 1 July 2000; and (2) a number of State taxes to be abolished (bed taxes from 1 July 2000; Financial Institutions Duty from 1 July 2001; stamp duty on quoted marketable securities from 1 July 2001; and Debits Tax by 1 July 2005, subject to review by the Ministerial Council).

- Adjustments to gambling tax arrangements taking into account the impact of the GST to apply from 1 July 2000.

- The removal of a number of remaining State taxes (stamp duty on non-residential conveyances; leases; mortgages, debentures, bonds and other loan securities; credit arrangements, instalment purchase arrangements and rental arrangements; cheques, bills of exchange, promissory notes; and unquoted marketable securities) to be reviewed by the Ministerial Council in light of State fiscal circumstances by 2005.

- The Commonwealth to make transitional assistance payments to States where necessary so that no State will be worse off. The IGA provides for an initial transition period to 30 June 2003, to be extended by regulation should the States require transitional assistance payments beyond that date.

- From 1 July 2000, States will fund and administer a new First Home Owners' Scheme to mitigate the impact of the GST on the price of homes for first home owners, entailing a lump sum payment to eligible home owners of $7,000.

- States to finance the Australian Taxation Office's costs of GST administration.

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[4] *Revenue Replacement Payments are payments which are made by the Commonwealth to States under the temporary safety net arrangements agreed between governments following the August 1997 High Court decision invalidating State business franchise fees.*

- The Commonwealth amended the *Trade Practices Act 1974* to enable the Australian Competition and Consumer Commission (ACCC) to ensure no overpricing due to the introduction of a GST. States are applying mirror legislation and extending the coverage of the ACCC to those areas outside the Commonwealth's constitutional power.

- Government entities to be subject to a GST, except for specified government taxes and charges determined to be GST-free by the Commonwealth Treasurer.

- A Ministerial Council, comprising Treasurers of the Commonwealth, States and Territories, was established from 1 July 1999 to oversee the operation of the IGA. The Council has a wide-ranging brief which includes "ongoing reform of Commonwealth-State financial relations".

Outcomes of First Ministerial Council Meeting

The inaugural meeting of the Council was held on 17 March 2000. The meeting covered a number of administrative and financial issues associated with the introduction of the GST and the commencement of GST Revenue Grants to the States. The Council endorsed a Statement of Estimated Payments specifying the amounts that each State will receive in 2000-01 under the new arrangements. The Statement of Estimated Payments was updated by estimates in the Commonwealth Budget issued on 9 May 2000, which sets out:

- The ***Guaranteed Minimum Amount (GMA***) to States in 2000-01 to ensure that each State is no worse off than under existing arrangements. The GMA for New South Wales is estimated at $8,162.4 million. The GMA is the sum of:

  - State revenues foregone from: the abolition of FAGs, bed taxes, RRPs and wholesale sales tax equivalent payments from public trading enterprises and the reduction in gambling taxes; and

  - Additional expenditure responsibilities for funding the new First Home Owners' Scheme and GST administration costs to be incurred by the Australian Taxation Office (ATO); and reduced State expenditures associated with off-road diesel subsidies and savings from the reduction in indirect taxes embedded in government purchases.

- The amount of ***GST Revenue Grants***. New South Wales will receive $7,180.3 million out of a total pool of $24.1 billion.

- Transitional payments by the Commonwealth to States, called ***Budget Balancing Assistance*** (BBA). This is calculated as the difference between the GMA and GST revenue grants.

  BBA in 2000-01 will consist of an interest-free loan component of $674.3 million (repayable the following year from the proceeds of that year's BBA) and a grant component of $307.8 million. Notwithstanding the fact that the Commonwealth 2000-01 Budget treats the loan component as an advance to States, for purposes of this chapter both components are treated as general purpose payments. Of the aggregate BBA to all States of $2,692.6 million, New South Wales will receive $982.1 million. BBA will be paid to States on 4 July 2000.

Impact of the New Arrangements on New South Wales

Contrary to some claims, the GST does not constitute a 'windfall' for States and Territories including New South Wales. Box 8.1 indicates the reasons for this, while Table 8.1 provides estimates of New South Wales' need for transitional payments. These are based on assumptions agreed between the Commonwealth and States for the calculation of GMAs and BBA.

The losses from tax reform arise from abolished FAGs and taxes and net additional expenditure responsibilities. The estimates assume for working purposes that debits tax is removed from 1 July 2005, but that States retain business stamp duties beyond 2005. The estimates are only broadly indicative, and will be subject to further revision.

Table 8.1: Estimated Financial Impact of National Tax Reform on New South Wales: 2000-01 to 2007-08 [(a)]

Year	*GST revenue*	*Losses*	*Net Impact = Need for Transitional Assistance*
	$m	*$m*	*$m*
2000-01	7,180	(8,162)	(982)
2001-02	8,594	(9,352) [(b)]	(759) [(b)]
2002-03	8,863	(9,671)	(808)
2003-04	9,320	(9,913)	(594)
2004-05	9,937	(10,287)	(350)
2005-06	10,565	(10,948)	(383)
2006-07	11,159	(11,321)	(162)
2007-08	11,783	(11,669)	114

(a) Estimates for 2000-01 to 2003-04 are from the Commonwealth 2000-01 Budget issued 9 May 2000. Estimates thereafter are those presented to the Ministerial Council meeting on 17 March 2000.

(b) Excludes $674m to repay the Budget Balancing loan the previous year.

Box 8.1: Why the GST does not represent a revenue windfall for New South Wales

Contrary to some claims, States will not gain from tax reform a revenue windfall which they can immediately apply towards reducing their reliance on gambling taxes and other State revenue sources or to increase outlays.

Current projections suggest that net revenue benefits to New South Wales will not occur until 2007-08, assuming no reduction to the GST rate or erosion of the GST base in the meantime. (See details in Table 8.1.) This is despite the fact that the Commonwealth will meet the State's losses due to tax reform via guarantee payments during a transitional period.

In the absence of Commonwealth transitional assistance, the NSW Budget would be worse off by about $4 billion in total over the next seven years. On current estimates, only Queensland is expected to begin to benefit from the new arrangements within the first three years.

The estimates are premised on real economic growth of the order of 3.5 percent per annum after 2003-04, yielding an expected increase in GST revenues from $24 billion in 2000-01 to $39 billion in 2007-08. Benefits from the new arrangements would be pushed further back in the event that this growth does not occur.

To the extent that GST revenues exceed the estimates underlying the guarantee calculations, and that gain is not offset by unanticipated costs to States not covered by the guarantee arrangements, there is a possibility that States could begin to benefit earlier.

In order for New South Wales not to require Budget Balancing Assistance, GST revenues would have to be larger than estimated by about 13.7 percent in 2000-01, 8.8 percent in 2001-02, 9.1 percent in 2002-03 and 6.4 percent in 2003-04.

GST revenue above the current estimates but within these margins will not benefit New South Wales because the surplus GST revenues will be offset by a reduction in Commonwealth transitional assistance, thereby leaving the NSW Budget no better off on a net basis.

For the NSW Budget to obtain any net gain, GST revenue would need to exceed current estimates by even wider margins than indicated above. GST revenue is unlikely to have been underestimated to such an extent, at least in the early years.

Progress in NSW Implementation of IGA Commitments

In most cases, State legislation is required to implement NSW commitments under the IGA. The following provides an overview of progress to date on New South Wales' implementation of its obligations.

Legislation has been passed in respect of the following:

- Abolishing bed taxes from 1 July 2000. This was accomplished in Sec. 3 of the *State Revenue Legislation Further Amendment Act 1999*, which amended the *Accommodation Levy Act 1997 No 32*. The former Act was assented to on 24 November 1999.

- Extending the coverage of the ACCC to those areas outside the Commonwealth's constitutional power. The *Price Exploitation Code (New South Wales) Act 1999* was passed by the Parliament and given assent on 22 November 1999. It commenced on 10 December 1999.

Appropriate legislation on the remaining matters requiring State legislation will be introduced in the Budget Session 2000 which began in April. It is intended that the package will include legislation to effect the following:

- Appending the IGA to appropriate State legislation, mirroring the approach of the Commonwealth;

- Abolition of FID and stamp duty on quoted marketable securities from 1 July 2001;

- Adjusting gambling tax arrangements to take account of the application of the GST to gambling (see Chapter 3 for further details); and

- Allowing State and Territory entities and local governments to pay GST or make voluntary payments where necessary.

In regard to establishing a First Home Owners Scheme, States have agreed to a framework for its operation, and separate legislation (the *First Home Owner Grant Bill 2000*) has been introduced in the NSW Parliament.

In regard to Ministerial determinations, the Commonwealth and States and Territories including New South Wales have developed an initial list of taxes and charges to be excluded from the GST via a Commonwealth Treasurer's Determination. The Commonwealth Treasurer made the initial determination on 1 March 2000. It is intended to update the list on an ongoing basis.

COMMONWEALTH GRANTS COMMISSION 2000 UPDATE

Apart from the quantum of payments to States for 2000-01, the inaugural Ministerial Council meeting also dealt with other issues previously handled by the annual Premiers Conference, including the 2000 Update Report by the Commonwealth Grants Commission on the distribution of untied grants.

The CGC has historically recommended, for each financial year, the appropriate distribution of FAGs between the States on the basis of horizontal fiscal equalisation (HFE). This principle is intended to ensure that Commonwealth general purpose payments are distributed among States so as to allow each State to provide government services at a level not appreciably different from that of other States, without having to impose taxes and charges at levels appreciably different from those in other States.

The CGC uses a complex revenue and expenditure model to determine how to distribute untied grants in accordance with the HFE principle. The CGC revises its methodology for calculating interstate relativities every five years (the last Review was completed in 1999) and updates its relativities every year on the basis of a five-year rolling average of data.

GST revenue grants, which will replace FAGs and abolished State taxes from 1 July 2000, will continue to be distributed among States on the basis of HFE. The CGC's most recent Update Report was released in February 2000, and its recommendations were endorsed at the inaugural Ministerial Council meeting.

Highlights of the 2000 Update include:

- The calculation of two sets of relativities for 2000-01: one GST based, the other FAGs based. The two sets of relativities were necessary for the calculation of the GMAs and BBA payments.

- The FAG relativities calculate the shares that States would have received in the absence of national tax reform. On this basis, FAGS would have risen for New South Wales in absolute dollar terms due to the normal expansion in the FAG pool (due to inflation and population growth). However, on a system-neutral basis (i.e., based on changes in the relativities alone), New South Wales would have lost $22.8 million. This mainly reflects the above-average level of revenue growth in New South Wales relative to other States in the five years to 1998-99.

- The GST relativities reflect the abolition of some State taxes and additional State expenditure responsibilities under the new arrangements. The shift from FAG relativities to GST relativities will yield a loss to New South Wales of the order of $90 million due mainly to two factors - the abolition of safety net payments for tobacco and petroleum (negative $59.2 million), on which New South Wales currently makes gains; and the introduction of the First Home Owners Scheme (negative $38.7 million), since New South Wales has a lower proportion of first home buyers to total population relative to other States.

NSW GST revenue grant receipts will be about $2 billion greater as compared with the old FAG-based arrangements, solely due to an increase in the size of the grants pool (by about $6 billion) arising from tax reform arrangements.

General Purpose Payments and Loan Council Allocations

General purpose grant shares on a GST basis for 2000-01 and the old FAG basis for 1999-2000 are not comparable because they reflect different Commonwealth-State financial environments. For this reason, this section merely reports the amounts which New South Wales expects to receive in 2000-01 without reference to growth from the preceding year.

The Commonwealth Statement of Estimated Payments, which was endorsed by the Ministerial Council, was subsequently updated. More recently, the Commonwealth Budget 2000-01 provided for funding to all States of $27,222.0 million in general purpose payments in 2000-01, of which the NSW share is $8,318.9 million.

GST Revenue Grants are the single largest component of total general purpose payments. GST Revenue Grants in 2000-01 will amount to $24,052.6 million for all States and $7,180.3 million for New South Wales. The remainder of general purpose payments to New South Wales consists of Budget Balancing assistance of $982.1 million and competition payments totalling $156.5 million.

In the three years to 1999-2000, New South Wales received its full competition payment. In its second tranche assessment as at 30 June 1999, the National Competition Council - which assesses compliance with the *Agreement to Implement National Competition Policy and Related Reforms* signed by Heads of Government in April 1995 – acknowledged New South Wales' accomplishments particularly in respect of energy reforms, reform of government businesses and comprehensive legislative review. New South Wales expects no constraints to receiving its full competition payment in 2000-01.

The NCC has indicated that continuing payments to States will be subject to supplementary assessments. The National Competition Policy agreements of April 1995 are subject to five-yearly reviews, the first due to be completed in May 2000.

At the 139th meeting of the Australian Loan Council held on 17 March 2000, the Council endorsed the Loan Council Allocation (LCA) nominations for 2000-01. The 2000-01 LCA of New South Wales[5] endorsed at the meeting was negative $329 million. The negative LCA bid of New South Wales indicates that the State expects to contribute to (rather than make demands on) national savings in 2000-01. Chapter 9 of this budget paper provides an estimate of the NSW LCA at Budget time.

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[5] *Consistent with the current Commonwealth treatment of LCAs, the LCA for New South Wales is expressed in ABS "headline" terms, whereby advances paid are treated as part of capital outlays rather than as a financing transaction.*

DEVELOPMENTS IN SPECIFIC PURPOSE PAYMENTS

The IGA commits the Commonwealth to not reducing SPPs as part of the tax reform process. Total SPPs to New South Wales are expected to increase by 4.6 percent in 2000-01 following an increase of 4.3 percent the previous year.

Indexation arrangements under the Australian Health Care Agreements (AHCA) remain an issue of contention between the Commonwealth and States. The AHCA provided for a default indexation rate of 0.5 percent per annum. However, failure to reach agreement on an appropriate index led to the Commonwealth nominating three possible independent arbiters.

The Commonwealth and States agreed to a terms of reference and selection of one arbiter in accordance with Clause 41 of the Agreement. The arbiter's advice suggested that a more appropriate index would be the sum of the increase in the CPI (in the range of 2 to 3 percent) and an additional 0.5 percent to account for the rise in the real cost of providing public hospital services.

The Commonwealth did not accept the arbiter's recommendation, and subsequently offered the States a compromise indexation rate of 1.5 percent, which is reflected in health funding levels in the Commonwealth 2000-01 Budget. Over the remaining life of the AHCA, adopting the Commonwealth alternative offer of 1.5 percent would yield a loss to New South Wales of the order of $200 million relative to the option recommended by the arbiter.

During the past year, New South Wales reached agreement with the Commonwealth over bilateral arrangements for the Commonwealth-State Housing Agreement (CSHA), a new four-year Supported Accommodation Assistance Program (SAAP), and a five-year Public Health Outcomes Funding Agreement (PHOFA). The SAAP arrangements incorporate an additional $15 million per annum in SAAP funding for all States (carrying no State matching requirements) as part of the tax reform package negotiated between the Prime Minister and the Australian Democrats in May 1999.

While these SPP agreements represent some improvement over previous agreements in respect to flexibility in the use of program funds, the agreements continue to require States to report to the Commonwealth against a large number of performance indicators.

New South Wales believes that there is room for further streamlining of SPP reporting requirements. More broadly, the issue of reform of SPPs remains a continuing concern to New South Wales and other States. In July 1999, States presented to the Commonwealth a discussion paper on SPPs outlining difficulties with the current system and suggesting areas for improvement.

In the wake of this development, and with the endorsement of Heads of Treasuries, an SPP Working Party was set up in October 1999. The Working Party consists of all States and the Commonwealth and is aimed at improving information exchange between all parties and facilitating the process of future SPP reform. Initial activities of the Working Group include the development of a comprehensive database of SPP information and the formulation of a set of guiding principles and desirable features of SPPs, including a possible template agreement to guide future SPP negotiations.

8.3 THE TASKS AHEAD

NATIONAL TAX REFORM

In New South Wales, the immediate priority for tax reform in the next year will be to introduce remaining required legislation and to complete and fine tune the operations of State public sector agencies following the implementation of the GST and business tax reforms.

In the longer term, the main task will be to review the need for Debits Tax and the other State taxes that were to be abolished under the original Commonwealth tax reform proposals.

Key tasks in the near term include the following:

- *Preparations for GST implementation*. NSW government agencies (including Public Trading Enterprises) have been preparing for the GST consistent with Treasury's *GST Compliance Plan for Public Sector Agencies*, which was issued in June 1999. The Plan sets out a phased approach to GST compliance, providing agencies with a series of key activities and target dates. Agencies have been reporting periodically to the Treasury on progress with their GST preparations.

- *Development of a GST Administration Performance Agreement with the ATO* to ensure accountability of the ATO to the States in the administration of the GST. It is currently envisaged that work on this agreement will commence at the beginning of 2001, taking advantage of the operational results and experience from 2000-01.

- *Initiating work on the implementation of a National Tax Equivalent Regime (NTER).* The Ministerial Council approved the deferment of implementation of the NTER by one year, to 1 July 2001, in view of the magnitude of work in preparing for GST implementation. The NTER will entail the imposition of income tax on State and Territory owned businesses, and will be administered by the ATO. Progress on the NTER will critically depend on the Commonwealth amending its income tax legislation to ensure that businesses established by local government bodies receive the same protection from the scope of income tax legislation as is provided to PTEs.

VERTICAL FISCAL IMBALANCE

The degree of imbalance between the Commonwealth and State Governments remains excessive compared with other federations.

VFI is not costless.

It undermines governmental accountability for taxing and spending decisions because governments responsible for providing services are not necessarily responsible for raising the revenue to finance those services. This encourages cost shifting between levels of government and results in costly duplication and overlap of services.

VFI hampers States' ability to respond to community needs in a timely and effective manner. Some Commonwealth conditions on tied grants introduce rigidities in service delivery (e.g., the form of service provision, purchasing arrangements, pricing or other restrictions on the use of Commonwealth grants). This can send the wrong market signals or incentives and can lead to implicit rationing and under- or over-utilisation of some services, thereby reducing allocative efficiency.

Where the Commonwealth imposes fund matching requirements on its payments to States, VFI produces a bias towards over-expenditure, distorts States' spending priorities, and serves as a disincentive for States to exercise fiscal discipline.

Reporting requirements for Commonwealth tied grants tend to be structured to meet the Commonwealth's need for information rather than to measure the efficiency or effectiveness of service delivery. Administrative changes at the Commonwealth level, such as changes to cash management procedures, may impose minimal cost at the Commonwealth level, but can lead to discontinuities and real disruptions in service delivery at the State level.

Historically, VFI has also been a disincentive to the pursuit of microeconomic reform, since States must bear most of the implementation costs but cannot directly access the major increase in Commonwealth revenue resulting from these reforms.

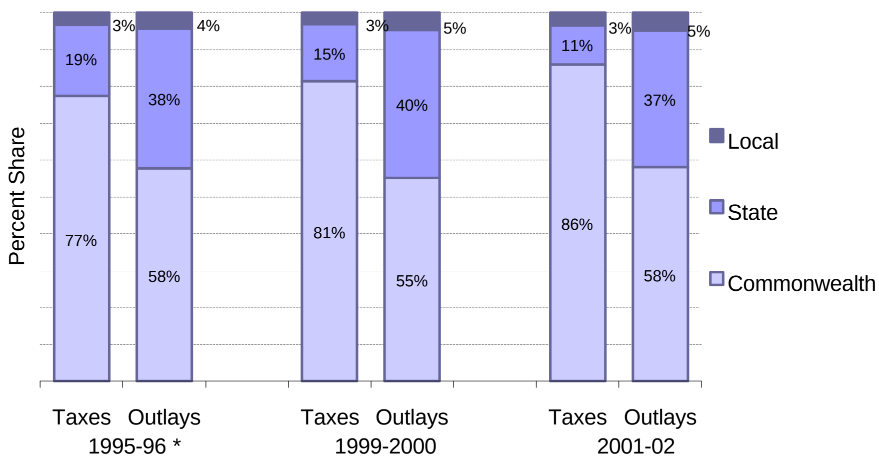
The reforms to Commonwealth-State financial relations leave in place, and in fact aggravate, the problem of VFI. Prior to tax reform, Commonwealth grants accounted for slightly over a third of total State revenues for all States in aggregate. Following the implementation of the GST, this proportion is expected to increase to close to 40 percent with the replacement of abolished State taxes by GST revenue grants.

The new arrangements considerably erode State revenue autonomy (i.e., the degree of State control over the tax rate and/or base), since the States will give up key revenue sources in exchange for a GST whose rate and base the States will not control. Irrespective of the commitment by the Commonwealth to turn over GST revenue to States, the GST clearly remains a Commonwealth tax. The Commonwealth has the constitutional power to unilaterally change GST revenue-sharing arrangements, including changes which could narrow the tax base and thereby erode GST revenue.

The chart below provides an indication of how VFI is expected to widen between 1999-2000 and 2001-02 (the first full year of GST implementation).

The VFI problem may be remedied through a redistribution of either taxation powers or expenditure responsibilities. New South Wales remains open to pursuing such options in future in cooperation with the Commonwealth and other States.

Chart 8.1: Vertical Fiscal Imbalance, Pre- and Post-Tax Reform (Percentage of Total General Government)



* Prior to the introduction of safety net taxes.

HORIZONTAL FISCAL EQUALISATION

NSW GST Revenue Grant in 2000-01 will be $1,101 per capita or about 26 percent less than the average of the six smallest States. The average for New South Wales and Victoria (traditional HFE donor States) is $1,079 per head compared with an average of $1,483 for the other jurisdictions.

The estimated GST Revenue Grant per capita by State for 2000-01 is given in the table below. Based on the 2000-01 GST equalisation relativities calculated by the CGC, New South Wales, Victoria, Western Australia and the ACT are net donors.

Table 8.2: GST Revenue Grants Per Capita, By State, 2000-01

State/Territory	*GST Revenue Grants (In $ Per Capita)*
New South Wales	1,101
Victoria	1,049
Queensland	1,280
Western Australia	1,226
South Australia	1,495
Tasmania	2,071
Northern Territory	6,148
Australian Capital Territory	1,497
Average, six smallest States	**1,483**
AUSTRALIAN AVERAGE	**1,246**

The level of transfers from donor States to recipient States can be measured in a number of ways.

One approach is to measure the difference between actual GST Revenue Grants and an equal per capita distribution of funding. This is called “CGC equalisation”. On this basis, New South Wales will be transferring to other States $944 million or $145 per capita in 2000-01. The combined transfer from New South Wales, Victoria and Western Australia is estimated at about $1.9 billion[6].

Another approach is to compare the GST revenue grant distribution with a benchmark based on State shares of a particular tax or tax base. Two possible benchmarks are personal income tax shares and personal consumption shares.

[6] *The estimated cross-subsidies in this chapter may differ from those in Commonwealth Budget papers because the latter calculates the cross-subsidy based on the sum of FAGS (or GST revenue grants) and unquarantined Health Care Grants. The estimates in this chapter are based solely on FAGs (or GST revenue grants).*

The Commonwealth originally intended FAGs as compensation to States for their loss of income taxing powers. Therefore the cross-subsidy is measured by calculating the difference between FAGs paid to each State and the level of Commonwealth ***personal income tax*** raised in that State. This is called "tax equalisation".

While GST Revenue Grants will replace FAGs in 2000-01, this should not be taken to imply an abrogation of States' historic claims to a fair share of income tax revenues. The use of personal income tax shares therefore provides a consistent benchmark against which one can measure the current distribution against the original intent to compensate States for the loss of income tax powers.

On this measure, the transfer from donor States (New South Wales, Victoria, Western Australia and the ACT)[7] is of the order of $2.8 billion in 2000-01, of which New South Wales will be contributing over half ($1.7 billion). This equates to a total cross-subsidy by New South Wales of $261 per head in 2000-01.

An alternative measure of cross-subsidy would be the difference between the GST revenues collected in a given State and the GST revenue grants returned to that State.

Since GST revenues have yet to be collected, State ***household final consumption expenditure*** has been used as a rough proxy[8] of interstate shares of GST revenue. On this basis, the total transfer from donor States (New South Wales and Victoria) is about $2.4 billion, of which New South Wales will contribute $1.3 billion or $202 per capita.

By any measure, the cross-subsidy from New South Wales to other States remains substantial. Over the long run, such sizeable cross-subsidies are not sustainable. The table at the end of this chapter indicates the amounts expected to be transferred from donor States to recipient States in 2000-01 based on CGC redistribution and the benchmark of personal income tax shares.

In relation to interstate competition, some jurisdictions which have historically been recipients of HFE transfers are in a position to offer incentives to private business or to build up fiscal surpluses, which they may not otherwise have been able to do in the absence of HFE. In this respect, the current HFE process remains an obstruction to the design of efficient State tax regimes and overall allocative efficiency.

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[7] *The ACT is a donor in terms of tax equalisation but a recipient in terms of CGC equalisation. Once these two opposing effects are taken into account, the ACT is a donor jurisdiction in net terms.*

[8] *Personal consumption is used as a benchmark here only for indicative purposes, on the premise that the GST is intended to be a tax on consumption and not on investment, production or transfers. Another option would be to use shares of State final demand (i.e., the sum of expenditure on final consumption and investment by both the public and private sectors). However, given that some components of public sector consumption expenditure constitute transfers to the household sector, the use of State final demand may distort the measure of cross-subsidy, particularly for small jurisdictions.*

New South Wales believes that with national tax reform now in place, attention should turn to the issue of fundamental changes to the system of fiscal equalisation in the future, including a re-examination of the rationale and mechanisms for HFE in light of the particular fiscal and economic circumstances of individual jurisdictions.

Cross-subsidies should be made only where justified, and fiscally strong and economically healthy States should not gratuitously derive benefits on the basis of the extreme disabilities suffered by the truly disadvantaged jurisdictions. Among other things, a revisiting and restructuring of the HFE process would allow States to engage in beneficial interstate tax competition without compensation for policy-driven inefficiencies being provided through the CGC process.

Thus, irrespective of the implementation of tax reform, New South Wales will continue to seek basic changes to HFE and remains committed to reformed arrangements. Ideally, these would put the fiscally stronger States (New South Wales, Victoria, the Australian Capital Territory, Queensland and Western Australia) on equal ground while preserving equalisation transfers to the three fiscally weakest jurisdictions.

Table 8.3: Inter-governmental Financial Relations, Selected Indicators, 1995-96 to 2000-01

Item	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01
COMMONWEALTH PAYMENTS TO NEW SOUTH WALES						
Million $, Nominal						
General Purpose(1)	4,517	4,464	4,591	4,705	5,189	8,319(3)
General Purpose (excluding Competition Payments)(1)	4,517	4,464	4,519	4,632	5,041	8,162(3)
Specific Purpose(2)	3,480	3,478	3,519	4,187	4,367	4,569
Gross Payments(1)	7,997	7,941	8,111	8,892	9,557	12,888(3)
Percentage Annual Change, Real (2000-01) Terms (2)						
General Purpose(1)	3.0	(-) 3.1	1.6	1.6	9.0	-- (8)
General Purpose (excluding Competition Payments)(1)	3.0	(-) 3.1	0.0	1.6	7.6	-- (8)
Of which: FAGs (excl FCPs) or GST Revenue Grants	2.7	(-) 3.4	2.8	6.0	7.6	--(3), (8)
Specific Purpose(2)	(-) 1.3	(-) 2.1	0.0	17.9(4)	3.1	1.9
Gross Payments(1)	1.0	(-) 2.6	0.9	8.7	6.2	-- (8)

Item	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01
Real Per Capita (2000-01 dollars)(2)						
General Purpose(1)	794	759	763	765	826	1,276
General Purpose (excluding Competition Payments)(1)	794	759	751	754	803	1,252
Of which: FAGs (excl FCPs) or GST Revenue Grants	742	707	719	754	803	1,101(3)
Specific Purpose(2)	611	591	585	681(4)	695	701
Gross Payments(1)	1,405	1,350	1,348	1,447	1,522	1,977
VERTICAL FINANCIAL RELATIONS						
Ratio of % share of own-source tax revenue to % share of own-purpose outlays (5), (6), (7)						
Commonwealth	1.34	1.36	1.39	1.45	1.41	1.44
States	0.51	0.50	0.48	0.41	0.42	0.32
Local Government	0.76	0.68	0.79	0.69	0.68	0.66

Sources: Commonwealth Budget Papers, various years; ABS Cat 5501.0; NSW Treasury estimates.

Notes to Table 8.3:

1. *General purpose payments and total gross payments are after deducting Fiscal Contribution Payments to the Commonwealth in the three years to 1998-99. Identified Roads Grants to States were subsumed into FAGs as from 1997-98.*

2. *Specific and general purpose payments are adjusted for letterbox, extraordinary or reclassified items (listed below, this footnote). In the calculation of real growth rates, nominal amounts are deflated using the Gross Non Farm Product deflator adjusted for embedded wholesale sales tax. The following adjustments are made to the nominal amounts published in the Commonwealth Budget Papers in order to enable comparison across years:*

   (a) *exclusion of the recurrent/capital payments "through" States to third parties - Higher Education; Non Government Schools including cost escalation; Research at Universities; Financial Assistance to Local Government; and Local Government Identified Roads;*

   (b) *reclassification of Building Better Cities funding as a specific purpose payment rather than a general purpose capital payment;*

   (c) *exclusion of the Gun Buyback Scheme in specific purpose payments in the four years to 1999-2000; and*

   (d) *conversion of Higher Education and Research at Universities into a Commonwealth own-purpose payment from 1997-98.*

3. *Budget Balancing Assistance (BBA) from the Commonwealth to New South Wales in 2000-01 consists of two components: an interest-free "loan" of $674 million and a grant of $308 million. Notwithstanding the ABS decision to treat the loan component as an advance by the Commonwealth, for purposes of this chapter the Budget Balancing loan is accounted for as a revenue (grant) item. All references to BBA and total (gross or net) Commonwealth payments to New South Wales in the table above include both the loan and grant component as part of general purpose payments in 2000-01.*

4. *The unusually large increase in SPPs in 1998-99 is due to funding under the Australian Health Care Agreement.*

5. *Own purpose expenditures include payments to public trading enterprises.*

6. *The ABS classifies safety net revenues as State own-source revenue. Since the High Court decision invalidating State business franchise fees occurred in August 1997, for purposes of this table safety net revenues are attributed to the Commonwealth from 1998-99. Prior to this year, we adopt the ABS approach.*

7. *Data are on GFS cash basis up to 1998-99 and accrual basis for 1999-2000 and 2000-01.*

8. *Growth rates are not calculated for these items because general purpose payments in 1999-2000 and 2000-01 reflect different intergovernmental funding regimes.*

Table 8.4: Estimates of Cross-subsidies between States, 2000-01[(1), (2)]

DONOR STATES	RECIPIENT STATES QLD	SA	TAS	NT	Total (5)
	$m	$m	$m	$m	$m
CGC Redistribution					
NSW	62	192	198	493	944
VIC (3)	62	193	198	495	948
WA	3	8	8	20	38
TOTAL CGC EQUALISATION(5)	**127**	**390**	**404**	**1,008**	**1,929**
Tax Equalisation					
NSW	556	353	285	506	1,700
VIC (3)	62	192	198	495	938
ACT (4)	21	20	19	38	97
WA	40	20	15	21	95
TOTAL TAX EQUALISATION(5)	**679**	**585**	**516**	**1,060**	**2,841**
NSW PER CAPITA CONTRIBUTION (in $)					
CGC Redistribution	10	29	30	76	145
Tax Equalisation	85	54	44	78	261

SOURCE: NSW Treasury estimates

Notes to Table 8.4:

1. *This Table measures the amounts redistributed due to -*

   (a) *Commonwealth Grants Commission (CGC) equalisation; and*

   (b) *Tax equalisation.*

   CGC equalisation consists of revenue equalisation (i.e., taking into account the underlying revenue raising capacity of each State) and expenditure equalisation (ie., taking into account differential demand and supply factors which affect expenditure levels). 'Tax equalisation' in this table is defined as the difference between GST Revenue Grants paid to each State and the level of Commonwealth personal income tax raised in that State. As suggested in the text, a similar calculation can be done using State shares of Final Personal Consumption Expenditure.

2. *The following examples illustrate how to interpret the numbers in the Table. New South Wales contributes a total of $1,700 million to other States through tax equalisation, of which Queensland receives $556 million, South Australia receives $353 million and so on. On the part of recipient States, the Table shows that the Northern Territory receives a total of $1,060 million from all States through tax equalisation, of which New South Wales contributes $506 million.*

3. *The amounts of CGC Equalisation and Tax Equalisation are the same for Victoria for purposes of this table. A comparison of Victoria's estimated GST revenue with its personal income tax share suggests that this State is very marginally a recipient.*

4. *The ACT is a minor recipient in terms of CGC redistribution, but a net donor in terms of the total redistribution. To avoid showing the ACT as being simultaneously a donor and a recipient, there is no ACT column and no ACT row in the section of the table dealing with CGC redistribution. (The ACT's small share of CGC redistribution receipts has been proportionately allocated to the other four recipient jurisdictions.) The total redistribution reports only the ACT's net subsidy to other jurisdictions.*

5. *Some subtotals may not add up to totals due to rounding.*