Specific Purpose Payments and the Commonwealth Grants Commission*

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The Commonwealth Grants Commission has, over the past ten years, been concerned with assessing the per capita relativities to be applied to the distribution of general revenue grants to the States in Australia to achieve fiscal equalization. In arriving at these assessments, the Commission has developed a number of approaches to the treatment of specific purpose payments. It is argued that one of these approaches—the inclusion approach—has an overriding effect which may place fiscal equalization in conflict with other objectives of Commonwealth policy. The nature of this conflict and its management are then explored.

I Introduction

In the past ten years, the Commonwealth Grants Commission (CGC) has had its role in Australian federalism expanded considerably. From its original task of assessing special grants for claimant States, it has been asked four times since 1978 to assess the per capita relativities to be applied to the distribution of the total general revenue grants to all States so as to achieve fiscal equalization.[1] Following its 1988 Report, the Premiers' Conference agreed that

> the triennial process of reviews of State relativities should be replaced by arrangements whereby the Commission prepares annual updates of relativities . . . with methodological issues being reviewed separately at five-yearly intervals [CGC, 1989, p.xii].

The first two such annual updates have now appeared (CGC, 1989, 1990a).

It seems likely, therefore, that the CGC will be an integral part of fiscal federalism arrangements in Australia for some time. As such, its methodology is of particular interest, for its expanded role means that the financial stakes for all States have increased considerably. Changes in the CGC's methodology may have a substantial impact on the assessed relativities and hence on the distribution of the general revenue grants to the States.

This paper is concerned with one particular aspect of the CGC's methodology—the treatment of specific purpose payments. Since the objective of the CGC's assessments is fiscal equalization, the CGC is concerned with assessing the total amount of financial assistance required by each State to achieve this objective. This assistance, however, can take the form of either general revenue grants or specific purpose payments and the assessed relativities are calculated only with respect to the former of these. The CGC must then decide how to treat assistance provided to each

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[1] The four resulting reports are CGC (1981, 1982, 1985, 1988a). For a review of the first three of these see Thomson (1986).

TABLE 1

Commonwealth Payments to the States and Territories, 1988-89 to 1990-91[a]

	1988-89		1989-90		1990-91[b]	
	$m	%	$m	%	$m	%
General Purpose						
Revenue	12 543	51.43	12 905	50.41	13 211	48.24
Capital	621	2.55	311	1.21	297	1.08
Specific Purpose						
Revenue	8 512	34.90	9 272	36.22	10 468	38.22
Capital	2 711	11.12	3 113	12.16	3 410	12.45
Total	24 387	100.00	25 601	100.00	27 386	100.00

Notes:
(a) Excludes the Australian Capital Territory
(b) Budget estimates
Source: Australian Treasury (1990, Table 1)

State by way of specific purpose payments in assessing general revenue grant relativities.

The importance of specific purpose payments relative to general revenue grants in Australia is indicated by the data in Table 1. Specific purpose payments (both revenue and capital) accounted for nearly half of all Commonwealth payments to the States and Territories in 1988-89 and 1989-90. This proportion is expected to exceed 50 per cent in 1990-91, with specific purpose revenue payments accounting for 38 per cent of the total. Specific purpose payments are, therefore, a major form of Commonwealth assistance to the States and Territories. The CGC's recommendations relate to the per capita relativities to be applied to the distribution of the 'General Purpose—Revenue' payments. The focus of this paper is on the CGC's treatment of 'Specific Purpose—Revenue' payments in assessing these per capita relativities.[2]

The following section of the paper provides a discussion of the CGC's methodology. It contains four sub-sections which deal respectively with the principle of fiscal equalization, the distribution model, the approaches to specific purpose payments, and the comparative effects of the deduction and inclusion approaches. This last aspect is then demonstrated in Section III with reference to the treatment of Medicare compensation payments to the States, and in Section IV with some results from a recent CGC review of methodological issues.

A particular aspect of the inclusion approach known as the overriding effect may bring the objective of fiscal equalization into conflict with other Commonwealth objectives. Section V provides a discussion of this possible conflict and suggests some ways in which it may be managed more explicitly should it arise. The conclusions are summarized in Section VI.

II The CGC Methodology

(i) The Principle of Fiscal Equalization

Since its inception in 1933, the rationale for the CGC's assessments of special grants for claimant States (until 1978) and of the per capita relativities for distributing general revenue grants to all States (since 1978) has been the pursuit of fiscal equalization or horizontal fiscal balance. It has long been recognized that, in a federal system of government, differing fiscal capacities between States can result in a violation of the principle of horizontal equity in taxation (Buchanan, 1950; Oates, 1972). On the revenue-raising side of the

[2] Two points should be noted here. First, the CGC does not make recommendations concerning the *absolute* amounts of general revenue grants to be distributed to the States and Territories. Second, the CGC is concerned only with the distribution of revenue grants and not capital grants.

budget, differences in income distributions between States generally imply that, in order to raise a given amount of revenue, wealthier States will be able to levy taxes at lower rates than poorer States. Under these circumstances, people in equal economic positions may pay different amounts of tax depending on the State in which they live. On the expenditure side of the budget, interstate differences in the cost of providing public services which are outside the control of the States also imply that, in order to provide a comparable standard of public services, the more costly States will need to levy taxes at higher rates than less costly states with the same distribution of income.

The provision of equalization grants from richer to poorer States is one means by which the problem of horizontal fiscal imbalance between governments can be tackled. However, because they are provided to the *governments* of poorer regions and not to the *individuals* within those regions, they will not necessarily result in the achievement of interpersonal horizontal equity (Oates, 1972; Walsh, 1989). But it is also true that without equalization grants, States would not be in a position to achieve horizontal equity. Equalization grants place States in a position whereby horizontal equity *can* be achieved but do not obligate States to adopt uniform taxing and spending policies. Fiscal equalization, then, can be viewed as a necessary but not sufficient condition for the attainment of interpersonal horizontal equity.[3]

It is not the purpose of this paper to discuss the theoretical basis for the use of intergovernmental grants to achieve fiscal equalization. Rather, the purpose is to discuss the way in which Commonwealth/State specific purpose payments are handled by the CGC in assessing the per capita relativities to be applied to the distribution of the general revenue grants so as to achieve fiscal equalization between the States. In other words, it is not the *rationale* for the existence of the CGC or *what* it attempts to achieve which is the subject matter of this paper so much as *how* it pursues its objective.

Having said this, however, three general points will be made about intergovernmental equalization grants before proceeding. First, the return of taxing powers to the States will not eliminate the problem of *horizontal* fiscal imbalance. Such a policy might address the problem of *vertical* fiscal imbalance (conceived generally as a mismatch between States' expenditure responsibilities and the revenue sources to which they have access) but could not be expected to achieve fiscal equalization.[4]

Second, the principle underlying the procedures of the CGC is fiscal *capacity* equalization and not fiscal *performance* equalization. Fiscal capacity has been defined as 'a government's capacity to provide services, having regard to its revenue base and the cost of providing those services' (Mathews, 1980, p.270). As such, with fiscal capacity equalization, each State is placed in a position where it has the fiscal capacity to provide the same level of public services and levy taxes at the same rates as all other States (although it may choose not to do so). Under fiscal capacity equalization, the discretion which States have as to how their equalization grants are used can result in a failure to achieve interpersonal horizontal equity as noted above.[5]

Third, the principle of fiscal equalization requires that the assessment of a State's equalization grant be unaffected by that State's actual taxation and expenditure policies or by the relative efficiency with which that State carries out its taxation and expenditure functions. While the CGC is, of course, aware of these requirements, in practice their fulfilment can be problematic because of the difficulty of empirically separating the effects of policy and efficiency differences between the States from the effects of horizontal imbalance.

[3] Wiseman (1987, pp.389-90) argues that interpreting horizontal equity solely in terms of the fiscal treatment of individuals postulates a weak or centralist form of federalism in which the Federal government would use its powers to offset different regional notions of fiscal equity. However, his suggestion that equity may be interpreted 'as a matter of the relative treatment of different regions as well as of individuals' seems to indicate that achieving equity between regions is an objective in and of itself.

[4] Indeed, to the extent that intergovernmental grants designed to reimburse States for tax revenues collected on their behalf embody some element of horizontal equalization, the return of taxing powers to the States would exacerbate horizontal fiscal imbalance. For an indication of the magnitude of the redistributional component embedded in current general revenue grants to the States, see Walsh (1990).

[5] In contrast to this concept of fiscal equalization, fiscal performance equalization involves an explicit attempt by the government making the equalization payments to affect the policies of the recipient governments with respect to the actual levels of taxation and public expenditure. Fiscal performance equalization implies the specification and enforcement of performance criteria for recipient governments.

(ii) An Overview of the Distribution Model

The translation of the principle of fiscal equalization into practice by the CGC is by means of its distribution model, a simplified sketch of which will be provided here.[6] Generally, the procedure involves two main steps. First, a State's total financial assistance requirement (TFAR), i.e. the total amount of financial assistance which a State requires in order to achieve complete fiscal equalization, is calculated. Second, assistance provided by the Commonwealth to the State in various other forms is then deducted from the TFAR so as to arrive at the assessed equalization grant. Since specific purpose payments are a major form of 'other Commonwealth assistance' (see Table 1), their treatment in the model is of considerable importance as it has a direct bearing on the value of the assessed equalization grant.

Considering first the calculation of the TFAR, in its 1988 Report (CGC, 1988a) the CGC presents its assessments of each State's TFAR defined in terms of standardized expenditure, standardized revenue and the standard budget result. For the i^{th} State the relationship between these can be expressed in per capita terms as follows:

$$TFAR_i/P_i = E_s^i/P_i - R_s^i/P_i + B_s/P_s \qquad (1)$$

where P_i is the population of the i^{th} State, P_s is the standard population, E_s^i is standardized expenditure for the i^{th} State, R_s^i is the standardized revenue for State i and B_s is the standard budget result. As an example, the CGC's assessments for the terms in equation (1) for Queensland for 1986-87 give the following numerical analogue for that equation[7]:

$$\$1119.21 = \$1937.23 - \$822.15 + \$4.13 \qquad (1a)$$

A State's standardized expenditure is the expenditure which it would have to incur in order to provide services comparable to those in the standard State(s). The 'standard' used as the basis for the calculation of States' standardized expenditures, in per capita terms, is the population-weighted mean per capita expenditure of the States. A State's standardized expenditure can be expressed in per capita terms as

$$E_s^i/P_i = (E_s/P_s)(1 + e_i) \qquad (2)$$

where E_s/P_s is standard per capita expenditure, and e_i is the i^{th} State's cost disability factor or differential cost of providing standard services. Again, using the assessments for Queensland for 1986-87, the numerical analogue for equation (2) is

$$\$1937.23 = \$1865.62 \times 1.03838. \qquad (2a)$$

This indicates that, over all expenditure categories, Queensland is assessed as having on average a cost disability factor of just under 4 per cent ($e_i = 3.8\%$).

A State's standardized revenue is the revenue which it would raise by applying standard tax rates to its revenue bases.[8] To the extent that a State is fiscally poorer than standard, it can be expected to raise less than standard revenue (allowing for population differences) by applying standard tax rates. If a State is assessed as having a revenue-raising disability this will give rise to a positive value for r_i (State i's differential revenue raising capacity) in the following expression for per capita standardized revenue:

$$R_s^i/P_i = (R_s/P_s)(1 - r_i). \qquad (3)$$

The assessments for Queensland for 1986-87 give the following numerical analogue for equation (3):

$$\$822.15 = \$831.92 \times 0.98826. \qquad (3a)$$

The assessed value for r_i is then 0.01174 indicating that the application of standard tax rates in Queensland would on average raise about 1.2 per cent less revenue per capita than standard.

The standard per capita budget result (B_s/P_s) is the budget result which each State could achieve if it received financial assistance equal to its TFAR, i.e. if its equalization grant was such as to achieve complete fiscal capacity equalization.

[6] A more detailed discussion of the model can be found in CGC (1990c, Vol.II, Appendix B).

[7] These data have been extracted from CGC (1988a, Vol.I, Table 1-10) and pertain to the assessments for distributing general revenue grants among the States and the Northern Territory with Medicare compensation grants treated as specific purpose payments distributed as per the existing basis of distribution. The positive sign for the standard budget result indicates a surplus. The data on Queensland presented below are also taken from this source.

[8] Standardized revenue refers to a State's revenue raisings from its own revenue bases only and hence excludes any revenue from Commonwealth grants. The 'standard' used as the basis for calculating States' standardized revenues is analogous to that used for calculating standardized expenditures.

The second main step in calculating the equalizing grant is to deduct other Commonwealth revenue payments received by a State from its TFAR so as to determine the net amount outstanding which it needs to receive in order to achieve full fiscal capacity equalization. This step can be expressed in per capita terms for the i^{th} State as

$$TFAR_i/P_i - O_i/P_i = G_i/P_i \tag{4}$$

where O_i is other Commonwealth assistance received by State i and G_i is the resulting equalization grant required by State i. The assessed equalization grant is also referred to by the CGC as the State's standardized deficit or its adjusted TFAR. It is this per capita standardized deficit expressed as a proportion of that for Victoria which gives a State's unadjusted per capita relativity (or general revenue grant factor) for a particular year. For Queensland for 1986-87, the relevant data for equation (4) are as follows:

$$\$1119.21 - \$158.25 = \$960.96. \tag{4a}$$

Expressing the standardized per capita deficit of \$960.96 as a proportion of that for Victoria (\$713.37) gives an unadjusted per capita relativity for Queensland for 1986-87 of 1.3471 (see CGC, 1988a, Vol.I, Table 1-13).[9]

It is evident from equation (4) that, to the extent that funds received by a State from the Commonwealth are included in 'other Commonwealth assistance' (O_i), this will result in a dollar-for-dollar reduction in a State's assessed equalization grant. The CGC's treatment of specific purpose payments received by a State is then an important determinant of a State's assessed equalization grant.

(iii) The CGC's Approach to Specific Purpose Payments

What criteria are used by the CGC to determine whether a specific purpose payment is included as 'other Commonwealth assistance' and hence subtracted from a State's TFAR? The CGC has devised four approaches to the treatment of specific purpose payments in its model—the exclusion approach, the deduction approach, the inclusion approach and the hybrid-inclusion or absorption approach. The last of these is a variant of the inclusion approach which, in terms of the issues addressed in this paper, has the same effect as the inclusion approach. It will not therefore be discussed any further here. Each of the remaining three approaches will be outlined in turn.[10]

The exclusion approach completely excludes from the calculations all funds obtained by a State through the specific purpose payment. In addition, any expenditures on the program financed from a State's own funds are excluded as well as the proceeds of any earmarked State taxes or charges. This approach is applied to programs which are constitutionally the responsibility of the Commonwealth or programs for which the Commonwealth has accepted full financial responsibility. To the extent that specific purpose payments are made to States for these programs, this approach effectively regards the State as being a 'conduit' for the expenditure of Commonwealth funds in an area of Commonwealth responsibility. As such, any change in the distribution of specific purpose payments treated by the exclusion approach will have no impact on a State's assessed equalization grant. Specific purpose payments for universities and colleges of advanced education are an example of payments treated by this approach.

If a specific purpose payment is made in an expenditure category relevant to the CGC's assessments, the CGC will treat that payment by either the deduction or the inclusion approach. The deduction approach involves subtracting from a State's standardized expenditure an amount equal to the average per capita amount of the specific purpose payment distributed in the particular expenditure category adjusted for that particular State's cost disability factor in that particular expenditure category.[11] This deduction occurs in calculating a State's TFAR and hence requires that this specific purpose payment *not* be included in 'other Commonwealth assistance' which is deducted from the TFAR in calculating the assessed equalization grant as per equation (4).

If a specific purpose payment is treated by deduction, equation (1) must be modified to reflect

[9] These relativities are subsequently adjusted to distribute the gap which arises when the sum of the standardized deficits is not equal to the total general revenue assistance included in the standard budget.

[10] A discussion of each approach with numerical examples of the effects of each can be found in CGC (1990c, Vol.II, Appendix B).

[11] The following exposition of the deduction approach is based upon that provided in CGC (1987). In practice, the CGC does not actually use the procedures which are now to be discussed in implementing the deduction approach but its calculations give the same results. See Mathews (1988).

this treatment. In particular, the per capita TFAR for the i^{th} State would now be expressed as

$$TFAR_i'/P_i = E_s^i/P_i - O_{ki}'/P_i - R_s^i/P_i + B_s/P_s \quad (5)$$

where O_{ki}' is the standardized specific purpose payment for the i^{th} State in the k^{th} expenditure category. This, in turn, can be expressed in per capita terms as

$$O_{ki}'/P_i = (\Sigma O_{kj}/P_s)(1 + e_{ki}) \quad (6)$$

where $\Sigma O_{kj}/P_s$ gives the average per capita amount of the specific purpose payment which has been distributed and e_{ki} is the i^{th} State's cost disability factor for the k^{th} expenditure category.

In its 1985 and 1988 Reports (CGC, 1985, 1988a), the CGC applied the deduction approach to specific purpose payments 'which could be construed as payments for services rendered; and payments made to a State, or a group of States, but not to all States, to meet a need which was particular to that State or group of States' (CGC, 1987, p.3). Examples of payments treated by deduction include natural disaster relief and financial assistance for local government.[12]

The inclusion approach is applied where the CGC considers that the specific purpose payments are 'similar in their effects to general purpose payments' (CGC, 1987, p.2). Examples of specific purpose payments treated by the inclusion approach are schools grants, grants for technical and further education, and welfare grants such as those under the Home and Community Care (HACC) program and the Supported Accommodation Assistance Program (SAAP). Inclusion results in the specific purpose payment being included in 'other Commonwealth assistance' in equation (4) and hence being deducted from the TFAR to determine the assessed equalization grant.

(iv) *Comparative Effects of Deduction and Inclusion*

What difference does treatment of a specific purpose payment by deduction or inclusion make to a State's assessed equalization grant? The answer is that it depends on whether the actual distribution of that specific purpose payment is the same as the distribution which would be dictated by the principle of fiscal equalization. If these are identical, treatment of the payment by either deduction or inclusion will make no difference to the assessed equalization grants or the relativities. If they differ, then the two approaches will give different results.

To demonstrate this, equations (5) and (6) are first of all carried through to the calculation of a State's assessed equalization grant with deduction. In per capita terms this gives

$$TFAR_i'/P_i - (O_i - O_{ki})/P_i = G_i/P_i \quad (7)$$

where O_{ki} is the *actual* amount of the specific purpose payment received by the i^{th} State for expenditure category k. From equations (4) and (7) the assessed equalization grants will be equal under deduction and inclusion if

$$(TFAR_i - O_i)/P_i = (TFAR_i' - O_i + O_{ki})/P_i. \quad (8)$$

Now from equations (4) and (5),

$$TFAR_i' = TFAR_i - O_{ki}'.$$

Therefore equation (8) can be rewritten as

$$(TFAR_i - O_i)/P_i = (TFAR_i - O_i - O_{ki}' + O_{ki})/P_i \quad (9)$$

which will hold if, and only if, $O_{ki}' = O_{ki}$, i.e. if the actual specific purpose payment to State i in expenditure category k (given by O_{ki}) *equals* the amount it would have received under equal per capita distribution allowing for the State's cost disability factor (given by O_{ki}'). Under this condition, treatment by deduction or inclusion gives the same assessed equalization grant.

If the actual distribution of the specific purpose payment *differs* from equal per capita distribution adjusted for cost disabilities, the deduction and inclusion approaches will give different results. In particular, the equalization grants assessed under deduction will be *insensitive* to the *actual* distribution of any given total of the specific purpose payment between the States. Recall from equations (5) and (6) that what is deducted is the equal per capita amount of the specific purpose payment adjusted for cost disability and this will be the same regardless of the actual distribution of the given total.[13] Hence the assessed equalization

[12] In the 1981 and 1982 relativities inquiries, the deduction approach was used where a State could influence the amount of Commonwealth assistance it received by varying its own policies.

[13] As Mathews (1988, pp.40–1) says: '. . . under the deduction method, the actual distribution of the specific purpose grants and of the expenditures they finance is regarded as irrelevant and outside the equalisation process'.

grants will also be the same regardless of the actual distribution of the specific purpose payment. In this way, treatment of a specific purpose payment by deduction gives rise to assessed equalization grants which do not offset or counter any 'unequalizing' influence of the actual distribution of the specific purpose payment. That is, the assessed equalization grants will not override the actual distribution of the specific purpose payment.[14]

The opposite conclusion applies if the specific purpose payment is treated by inclusion. Any disparity between the actual distribution of the payment and equal per capita distribution adjusted for cost disabilities will be completely offset or overridden by a compensating change in the assessed equalization grant. Under inclusion such grants fully compensate, on a dollar-for-dollar basis, for any change in the actual distribution of the specific purpose payment. Full fiscal equalization is achieved by neutralizing any unequalizing differences in the actual interstate distribution of the payment.

The treatment of specific purpose payments by deduction or inclusion by the CGC does have significant implications for the use of such payments as an element of Commonwealth government policy. To the extent that the policy being pursued by the Commonwealth requires an unequalizing distribution of the payment, this policy may be completely negated if the payment is treated by inclusion by the CGC. Before discussing this potential policy conflict in more detail, however, the effect of the inclusion approach will be demonstrated by reference to the CGC's treatment of the Medicare compensation payments in its 1988 Report, and by presenting some results from the 1990 review of methodological issues.

III Medicare Compensation Payments and the CGC

The Commonwealth's Medicare compensation payments to the States commenced on 1 February 1984. These were specific purpose payments designed primarily to compensate States for the loss of fee revenue and additional costs incurred as a result of the provision of inpatient and outpatient treatment free of charge to public patients in public hospitals. These payments were made in addition to the Identified Health Grants which were introduced in 1981-82 to replace the hospital cost-sharing agreements.[15]

In its 1988 Report, the CGC included the Identified Health Grants in the basic general revenue grants as required by its Terms of Reference (see CGC, 1988a, Vol.I, p.xix). The Medicare compensation payments, however, were specific purpose payments which were treated in the 1988 Report by the inclusion approach. This represented a significant change from their treatment by the deduction approach in the 1985 Report. The CGC noted this change in its 1988 Report in the following terms:

> The most important change in the treatment of specific purpose payments in the present review concerned Medicare grants, which the Commission decided to treat by the inclusion method instead of regarding them as compensation for States' own revenues forgone as it had done in the 1985 review [CGC, 1988a, Vol.I, p.40].

In illustrating the significance of this change, consider first of all Table 2 which presents data on the proportion of 'other Commonwealth assistance' (i.e. assistance treated by the inclusion approach) accounted for by Medicare payments for each State and the Northern Territory for 1986-87. It can be seen from column (4) of this Table that Medicare payments constituted from 18 to 36 per cent of such assistance.

The fact that the Medicare payments are relatively large sums of money, however, does not in and of itself signify that a change from deduction to inclusion is important. As was demonstrated in Section II, the differential effects of treating a payment by deduction or inclusion will arise only if the actual per capita distribution of the payment differs from the standardized per capita amount.

Table 3 presents the data contained in Table 2 in per capita terms and shows considerable

[14] In the words of the CGC (1987, p.7), '... the treatment of (a specific purpose payment) by the deduction approach maintains the agreed (specific purpose payment) distribution between States ...'.

[15] South Australia and Tasmania continued with their hospital cost-sharing agreements until 30 June 1985 as the original agreements with these States provided for their continuation until that date. For a history of hospital funding arrangements in Australia, see Commonwealth Department of the Treasury and Commonwealth Department of Health (1983). The Medicare compensation payments and the Identified Health Grants were replaced in 1988-89 with the new hospital funding grants (Australian Treasury, 1988, pp.60-2). A discussion of this change can be found in Butler (1991). Mathers and Moore (1989) provide some background on the calculation of these new grants.

TABLE 2

Total Medicare Payments and Other Commonwealth Revenue Payments, States and Northern Territory, 1986-87

	Other Commonwealth Revenue Payments (excl. Medicare) ($m) (1)	Medicare ($m) (2)	Total ($m) (3)=(1)+(2)	Medicare/Total (%) (4)=(2)/(3)
NSW	738	415	1 153	36.0
Vic.	591	267	858	31.1
Qld	341	79	420	18.8
WA	224	86	310	27.7
SA	215	109	324	33.6
Tas.	78	35	113	31.0
NT	41	12	53	22.6
Total	2 228	1 003	3 231	31.0

Source: CGC (1988a, Vol.II, Table C-11, p.258).

TABLE 3

Per Capita Medicare Payments and Other Commonwealth Revenue Payments, States and Northern Territory, 1986-87

	Other Commonwealth Revenue Payments (excl. Medicare) ($) (1)	Medicare ($) (2)	Total ($) (3)=(1)+(2)
NSW	132.62	74.53	207.15
Vic.	141.38	63.78	205.16
Qld	128.60	29.65	158.25
WA	151.60	58.15	209.75
SA	154.63	78.51	233.14
Tas.	174.40	78.18	252.58
NT	258.50	79.14	337.64
States and NT	140.37	63.18	203.55

Source: CGC (1988a, Vol.II, Table C-12, p.259).

interstate variation in the actual per capita distribution of the Medicare payments.[16] Queensland received by far the lowest per capita Medicare grant, being only just over half that of the next lowest State (Western Australia). Queensland's position is explained by the fact noted earlier that the Medicare grants were designed primarily to compensate States for the revenue lost as a result of changing to a system of providing

[16] While Table 3 presents data only for the year 1986-87, similar variation exists in 1984-85 and 1985-86 also. See CGC (1988a, Vol.II, Tables C-8, C-10).

treatment free of charge to public patients in public hospitals. Since Queensland has maintained such a system for over four decades anyway, it had considerably less fee revenue to lose in comparison with the other States.

The data in Table 3 pertain to the actual per capita distribution of the Medicare grants. To obtain data on the standardized per capita distribution, the relative health needs factors assessed by the CGC have been applied to the 1986-87 Medicare grants (a total of $1003m) to generate a set of per capita payments which reflect those factors. These results, together with the actual per capita distribution and the percentage change in the per capita amounts implied by a shift to a distribution based on relative health needs, are presented in Table 4. The per capita distribution of the Medicare grants based on relative health needs factors (column (2) in Table 4) gives the per capita Medicare grants which would have to be made to achieve full fiscal capacity equalization in this expenditure category.

The differences between columns (1) and (2) in Table 4 indicate that there will be a significant difference in the assessed equalization grants for the States and the Northern Territory when Medicare grants are treated by inclusion rather than deduction. Since the deduction approach maintains the existing per capita distribution of a specific purpose payment and does not offset the unequalizing effects by adjusting the assessed equalization grants, treating the Medicare payments by deduction would preserve the existing distribution as given in column (1) of Table 4. Under inclusion, the unequalizing effect is completely neutralized or overridden so that the differences between columns (1) and (2) will be completely taken up in the assessed equalization grants. For example, Queensland's shortfall of $35.36 per capita in the Medicare grant will result in that State getting an additional $35.36 per capita (or $93.7m) in its assessed equalization grant.[17]

TABLE 4

Changes in Per Capita Medicare Compensation Payments Implied by CGC Relative Health Needs Factors, States and Northern Territory, 1986-87

	Actual Distribution[a] ($ per capita) (1)	Distribution based on Relative Health Needs Factors[b] ($ per capita) (2)	Change (%) (3)=((2)-(1))/(1)
NSW	74.53	60.44	-18.9
Vic.	63.78	60.09	-5.8
Qld	29.65	65.01	+119.3
WA	58.15	68.06	+17.0
SA	78.51	68.12	-13.2
Tas.	78.18	68.94	-11.8
NT	79.14	105.59	+33.4
States and NT	63.18	63.18	

Sources:
(a) See Table 3.
(b) Calculated using three-year average relative health needs factors for States and Northern Territory in CGC (1988a, Vol.I, Table 1-3, p.8), population data in CGC (1988b, Vol.3, p.359) and total Medicare grants for 1986-87 of $1,003m (see Table 2).

[17] Applying States' population figures to the data in Table 4 indicates that treatment of the Medicare compensation grants by inclusion results in the States' shares in such grants being redistributed by $112.5m. Of this, Queensland gains $93.7m.

The effects of treating the Medicare payments by inclusion are also manifest in the various scenarios which the CGC was required to consider in its 1988 Report regarding possible changes in the actual distribution of such payments. In particular, the CGC was required to calculate per capita relativities for distributing general revenue grants corresponding to each of the following three options for distributing Medicare payments. First, it was to be assumed that Medicare payments continued to be allocated to the States as specific purpose payments on the existing basis of distribution (such as in column (1) of Table 4). Second, a set of general grant relativities had to be calculated on the assumption that the Medicare payments continued as specific purpose payments but were distributed in accordance with relative health needs (such as in column (2) of Table 4). Third, the general grant relativities were to be calculated on the assumption that Medicare specific purpose payments were discontinued and absorbed into the general revenue grants pool.

Given that Medicare payments are treated by the inclusion approach, to the extent that their distribution changes in each of the three scenarios above there will be an offsetting change in the distribution of general revenue grants. The offsetting change will be such that the *combined* general revenue and specific purpose payment relativities will be maintained. This was demonstrated by the CGC in its 1988 Report. The relevant table is reproduced here as Table 5, and shows that the *combined* grants are the same under each of the three scenarios (see columns (1), (3) and (5) in Table 5).[18] In other words, any change in the distribution of the Medicare grants would be completely neutralized by an offsetting change in the assessed equalization grants so as to maintain full fiscal capacity equalization.[19]

[18] The minor discrepancies between the combined grants reflect the distribution of the gap referred to in footnote 9. See CGC (1988a, Vol.I, p.62) for a discussion. The figures are calculated using an estimated total financial assistance requirements pool (general revenue plus specific purpose) of $17 737.4m for distribution in 1987-88.

[19] Another important point also borne out by this analysis is that, where *any* specific purpose payments are treated by inclusion, the assessed general grant relativities will pertain to a particular distribution of those specific purpose payments. If the actual distribution of the specific purpose payments subsequently changes, so will the assessed general grant relativities required for full fiscal equalization. On this and other related points, see CGC (1988a, Vol.I, pp.63-4).

IV Results from the 1990 CGC Review

The 'suitability and consequences' of treating specific purpose payments by the inclusion approach was one of several matters addressed by the CGC in its recent review of some issues in fiscal equalization (CGC, 1990c). This matter, along with several other methodological issues, was referred to the CGC for review as a prelude to the formulation of the terms of reference for the next major (five-yearly) review of per capita relativities.[20]

In addressing the matter of 'consequences', the CGC investigated the effects of treating specific purpose payments by deduction rather than by inclusion on the distribution of the implied general revenue grants to the States. The results of this investigation are also useful in the context of the present paper for demonstrating the relative effects of the inclusion and deduction approaches.

Using data from the 1990 relativities update (CGC, 1990a), the CGC has calculated the results presented here in Table 6. Column (1) in that Table shows the implied shares of the 1989-90 pool of general revenue and hospital funding grants with specific purpose payments treated according to the usual CGC procedures.[21] Columns (2)-(4) show the changes in these implied shares when hospital funding grants,[22] education grants and welfare grants respectively are treated by deduction rather than by inclusion. If the actual distribution of these specific purpose payments was the same as that implied by the principle of fiscal equalization, treatment by deduction or inclusion would make no difference to the grants distribution and these changes in implied shares would all be zero.

The data in Table 6 indicate that the CGC's treatment of hospital funding grants by inclusion redistributes $114.8m of the implied grants between the States. This is comparable in absolute terms with the $112.5m redistributed because of the treatment of Medicare compensation grants by inclusion in 1986-87 (see Section III). In proportionate terms, however, it represents only 3.7 per cent of the total hospital funding grants

[20] It is anticipated that this major review will be referred to the CGC for completion in 1993.

[21] A complete statement of the CGC's treatment of each specific purpose payment can be found in CGC (1990b, Vol.3, Section 5).

[22] Hospital funding grants were introduced in 1988 to replace the Medicare compensation grants and Identified Health Grants (see footnote 15).

TABLE 5

Combined Implied General Revenue Grants and Specific Purpose Payments 1987-88: Differences from Equal Per Capita Distribution of Combined Grants under Alternative Arrangements for Medicare Compensation Grants

	With Medicare Compensation Grants Treated as Specific Purpose Payments				With Medicare Compensation Grants Absorbed into Pool	
	Implied Basis of Distribution 1988 Assessments		Distribution Reflecting Relative Health Needs			
	Combined Grants[a] ($ per capita) (1)	Differences from Equal Per Capita (%) (2)	Combined Grants ($ per capita) (3)	Differences from Equal Per Capita (%) (4)	Combined Grants ($ per capita) (5)	Differences from Equal Per Capita (%) (6)
NSW	980.65	-11.17	981.25	-11.11	981.44	-11.09
Vic.	969.82	-12.15	970.34	-12.10	970.75	-12.06
Qld	1 137.08	+3.00	1 134.52	+2.77	1 134.58	+2.78
WA	1 267.40	+14.81	1 267.20	+14.79	1 267.06	+14.78
SA	1 299.40	+17.71	1 301.35	+17.89	1 301.01	+17.85
Tas.	1 436.20	+30.10	1 432.04	+29.72	1 431.24	+29.65
NT	4 300.00	+289.52	4 304.75	+289.95	4 292.72	+288.87
Ave[b]	1 103.91		1 103.91		1 103.91	

Notes:
(a) Per capita distribution of the combined implied general revenue grants and estimated specific purpose payments.
(b) Equal per capita distribution.
Source: CGC (1988a, Table 3.5, p.61).

TABLE 6

Effects on Implied Shares of General Revenue Assistance and Hospital Funding Grants of Treating Particular Specific Purpose Payments by Deduction, 1989-90 ($m)[a]

	Implied shares	Changes in implied shares with particular specific purpose payments treated by deduction		
		Hospital funding grants	Education grants	Welfare grants
	(1)	(2)	(3)	(4)
NSW	4 596.5	58.1	58.1	-1.5
Vic.	3 540.5	56.7	8.8	18.5
Qld	3 015.7	-32.9	-38.9	-17.9
WA	1 738.7	-38.2	-24.6	1.1
SA	1 824.8	-10.2	3.2	-0.1
Tas.	657.8	-4.9	-1.5	0.3
NT	722.5	-28.6	-5.0	-0.4
States and NT:				
Total grants	16 096.5			
Amount redistributed		114.8	70.1	19.9

Note:
(a) The data in this Table relate to the CGC 1990 Update using 1988-89 data.
Source: CGC (1990c, Vol.II, Table K-5).

in 1988-89[23] whereas 11.2 per cent of the total Medicare compensation grants were redistributed because of inclusion. The overriding effect is therefore smaller in the case of the hospital funding grants. The explanation for this is that such grants are distributed on an age-sex basis rather than the fee-revenue-forgone basis of the Medicare compensation grants. The actual interstate distribution of the hospital funding grants is then closer to that required by the principle of fiscal equalization.[24]

V *Fiscal Equalization and other Policy Objectives*

The differential effect of treating a specific purpose payment by deduction or inclusion has an important implication for policy. As already shown, the inclusion approach results in general revenue grants which contain a 'compensating variation' for any unequalizing differences in the distribution of the specific purpose payment between the States. To the extent that such a distribution is aimed at achieving a particular Commonwealth policy, that policy will then be subordinated to the achievement of fiscal equalization.

It might be mentioned at this stage that this overriding effect is not necessarily regarded as being undesirable by the States. Not surprisingly, some States have tended to support the use of the inclusion approach when the overriding effect will benefit them, and to argue against inclusion when the opposite is true. Queensland, for example, has consistently supported treating the Medicare compensation payments by inclusion (see CGC, 1985, Vol.I, para. 2.69; CGC, 1987, pp.16-18) and is generally in favour of the CGC's wide-ranging use of the inclusion approach (CGC, 1990c, Vol. I, para.9.24). As can be seen from Tables 3 and 6, Queensland stands to gain considerably from the treatment of health, education and welfare grants by the inclusion approach.[25]

The inclusion approach to specific purpose payments *may* put fiscal equalization and other

[23] The hospital funding grants in 1988-89 totalled $3079.9m (Australian Treasury, 1990, Table 56).

[24] It is for this reason also that Queensland's gain from the inclusion approach to hospital funding grants is $32.9m compared with its more substantial gain of $93.7m from the treatment of the Medicare compensation grants by inclusion.

[25] A review of the development of each State's position, and that of the Commonwealth Treasury, on this matter can be found in CGC (1990c, Vol.II, Appendix J).

Commonwealth policies in conflict, and if so, will result in fiscal equalization emerging as the dominant policy. It is stressed that a conflict *may*, not necessarily *will*, arise because its existence depends on whether the unequalizing distribution of the specific purpose payment is required in order to achieve another policy objective. In the case of the Medicare grants, for example, Victoria argued for the use of deduction on the grounds that the payments were intended as compensation to the States 'for the costs of implementing Commonwealth policy' (CGC, 1987, p.16). A contrary view is that the distribution of Medicare grants did not reflect a systematic Commonwealth policy but was rather a reflection of past developments in the relative levels of spending and charging by each of the States for hospital services.

The CGC itself does not accept that there is an overriding effect of inclusion 'in the sense of countering the objectives of individual [specific purpose payments]' (CGC, 1990c, Vol.I, para.9.26), although it agrees that inclusion does result in overriding 'in an overall financial sense'. This distinction, however, is difficult to sustain. As has already been demonstrated in Sections III and IV, the financial overriding which occurs under inclusion directly offsets any differences between the actual distribution of a specific purpose payment and the distribution required for fiscal equalization. If there are differences between these two distributions, any policy objectives pursued through the actual distribution are therefore subordinated to the objective of fiscal equalization, and a direct conflict arises between these other policy objectives and fiscal equalization.

The ability to choose between the deduction and inclusion approaches for treating specific purpose payments effectively gives the CGC discretion as to whether its assessed equalization grants will or will not override the actual distribution of a specific purpose payment. In exercising this discretion the CGC itself may, in some sense, be 'prioritizing' the achievement of Commonwealth policies where a conflict between these policies arises. Several interesting questions can be asked. Should the CGC be given such discretion? Is the Commonwealth government 'passing the buck' by not prioritizing its own policies? Should a trade-off between *full* fiscal equalization and other policy objectives be considered?

With regard to the discretion exercised by the CGC it must first of all be stressed that the CGC is doing no more than carrying out the task which it has been assigned, i.e. assessing general revenue grant relativities which achieve full fiscal equalization. On the normative question of whether such discretion *should* reside with the CGC, a strong case can be made for the CGC retaining such discretion *in so far as* the policy being pursued by the Commonwealth through a specific purpose payment is unaffected by the overriding effect of inclusion (if that approach is adopted by the CGC) *or* the Commonwealth is prepared to subjugate the achievement of this other policy objective to the achievement of fiscal equalization. If neither of these is the case then it can be argued that the discretion possessed by the CGC with respect to the treatment of the particular specific purpose payment should be removed by an explicit statement in its Terms of Reference. Such circumscription of the CGC's discretion in its Terms of Reference has occurred before. For example, for the 1988 review, the CGC was specifically instructed to 'exclude from its assessments payments of financial assistance that were received during the review period by Tasmania from the Commonwealth as a consequence of the Gordon-below-Franklin dam' (CGC, 1988a, Vol.I, p.xix).[26] In the absence of such constraints, the CGC has indicated that it proposes to use the inclusion method for most specific purpose payments in the future (CGC, 1990c, Vol.I, p.xx).

The above discussion is also pertinent to the question of whether the Commonwealth is 'passing the buck' on prioritization of policy. Given that it is the Commonwealth government which provides the Terms of Reference for the CGC, unless a specific instruction is included in such Terms of Reference constraining the approach to be adopted by the CGC with respect to one or more specific purpose payments, it can be assumed that one or other of the preconditions given above for the CGC's retention of discretion is fulfilled. As such, the Commonwealth could not be regarded as 'passing the buck', although it may be too generous to assume that absence of an explicit statement in the Terms of Reference represents a conscious decision on the part of the Commonwealth. It may well be that the matter is never explicitly debated in the policy formulation

[26] Specific purpose payments which are excluded from the CGC's assessments in this way are referred to as being 'quarantined'.

process, in which case the discretionary power may end up residing with the CGC by default.[27]

The third question raised earlier refers to the possibility of a trade-off between *full* fiscal equalization and other policy objectives, i.e. should the Commonwealth consider only *partial* fiscal equalization as an objective if a trade-off is possible between fiscal equalization and other policy objectives? At the outset it should be noted that in each of the four major reviews of general revenue grant relativities, the CGC's charter has been one of achieving full fiscal equalization. Under these conditions, it would seem that the CGC itself is not in a position to assess such grants in a way which would achieve only partial fiscal equalization.

The pursuit of full fiscal equalization implies full inclusion of a specific purpose payment if that approach is adopted by the CGC with the concomitant dollar-for-dollar substitution at the margin of specific purpose for general revenue grants. But *partial* fiscal equalization is also a possible objective and could be reflected in *partial inclusion* of a specific purpose payment. In terms of equation (4), partial inclusion would result in only a partial subtraction of other Commonwealth assistance from the TFAR as follows:

$$TFAR_i/P_i - t(O_i/P_i) = G_i/P_i \quad 0 < t < 1 \qquad (10)$$

where t is the proportion of other Commonwealth assistance to be deducted. Under these circumstances, a one dollar increase in a State's specific purpose payment would result in a *less than* one dollar reduction in its assessed equalization grant and conversely for a one dollar decrease in a State's specific purpose payment.[28] Of course, although the partial inclusion factor t is applied in equation (4) to all other Commonwealth assistance, it would be possible to apply partial inclusion to only a subset of specific purpose payments—in particular that subset for which full fiscal equalization is being traded off in favour of some other objective. A different degree of partial inclusion could also be applied to different payments within the subset.

[27] It may also be the case that some participants in the policy-making process do not fully understand the implications of the CGC's methodology. For an example of this, see the first of 'several interesting points' made in CGC (1983, p.130).

[28] Note that if $t=1$ there would be full inclusion.

Since partial inclusion would result in only partial equalization, it seems that such a treatment of specific purpose payments would lie outside the charter of the CGC as specified in the Terms of Reference for the various relativities reviews to date. In any event, the concept needs considerably more development than the cursory treatment given here, particularly in terms of the distribution model adopted by the CGC.[29]

VI Conclusion

Specific purpose payments play an important role in the methodology of the CGC. This paper has provided an overview of the distribution model used by the CGC and explained the three main approaches which it adopts to the treatment of specific purpose payments, viz. the exclusion approach, the deduction approach and the inclusion approach. The particular approach adopted is critical in determining the value of a State's assessed equalization grant as demonstrated by a discussion of the Medicare compensation payments, and hospital funding, education and welfare grants.

The specific aspect of interest in this paper has been the relative effects of treatment of a specific purpose payment by deduction and inclusion. The former results in general revenue grants which do not offset any unequalizing effects of the actual distribution of the specific purpose payment while the latter completely overrides such effects. To the extent that the unequalizing effects of the specific purpose payment are an intentional outcome of a Commonwealth policy, inclusion would result in that policy objective becoming secondary to fiscal equalization.

This possible conflict between fiscal equalization and other policy objectives leads to a consideration of whether the CGC should have discretion over the approach to be adopted to specific purpose payments. It is argued that a compelling case can be made for the CGC having such discretion if

[29] Mathews (1980), in discussing the development of a fiscal equalization model for the European Economic Community, derived a model which specifically incorporated an adjustment for the relative macroeconomic performance of the member countries so that relatively poor macroeconomic performance would penalize a country by reducing its equalization grant. This distribution model provides an example of one which incorporates a trade-off between full fiscal equalization and macroeconomic performance.

either the policy objective being pursued by the Commonwealth through the specific purpose payment is unaffected by inclusion *or* the Commonwealth wishes fiscal equalization to be the dominant objective in the event of such a conflict. If neither of these is the case, then the Commonwealth should dictate the approach to be adopted for the specific purpose payment in the Terms of Reference for the CGC. This argument also leads to a rejection of the position that the Commonwealth is abrogating its responsibility for prioritizing policies by giving discretion to the CGC. Given that the Commonwealth is responsible for setting the Terms of Reference for any CGC inquiry, it is completely within its power to constrain the approach adopted by the CGC if it considers the overriding effect of inclusion to be inappropriate.

The final aspect considered concerned the possibility of attempting to achieve only partial fiscal equalization and developing the concept of partial inclusion as an approach to specific purpose payments. Although this might well lie outside the various Terms of Reference for the CGC to date because of their specification of full fiscal equalization as the objective, this approach may well enable a trade-off between fiscal equalization and other policy objectives to be explicitly incorporated into the distribution model.

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