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Horizontal Fiscal Equalisation and Regional Development: A View From Western Australia

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Abstract
Australia has a well established system of financial assistance grants to State, Territory and Local Governments based on the principle of horizontal fiscal equalisation. From a regional development point of view, the current system for State/Territory level funding is not favourable for regions. Differences between the levels of State services to regions and to capital cities are entrenched in the Commonwealth system for GST revenue allocation to the States. The local government funding arrangements however provide considerable assistance to regional areas, but only in terms of local government functions. The paper examines the role of financial assistance grants in supporting regional development in Australia.

Keywords
Horizontal fiscal equalisation, regional development

Cover Page Footnote
The views expressed in this paper are solely the views of the author and do not represent the views of the Government of Western Australia.

Introduction

There is a view that workable cohesive federations require some form of transfer of resources between constituent units as part of the glue which holds the federation together (Walsh, 1992). In Australia, we have devised a system of financial assistance transfers to States and Local Governments based on the principle of horizontal fiscal equalisation (HFE). This paper focuses on the regional outcomes under these arrangements, with particular reference to a Western Australian (WA) perspective.

All Australian governments accept the place of financial assistance transfers to address vertical and horizontal fiscal imbalance. The continuing role of the Commonwealth Grants Commission (CGC) in this system was confirmed in the new framework for financial arrangements which commenced on 1 January 2009, *the Intergovernmental Agreement on Federal Financial Relations*.

Specifically, this paper explores the parameters of the systems which at the State level redistribute Goods and Services Tax (GST) revenues away from WA, largely because of the State revenue generated by the Pilbara region, and within the State redistributes financial assistance grants to the local governments of the Pilbara region. The methods for determining funding allocations are matters of importance and should be debated in our Federation, with a particular focus on improving funding outcomes for regional Australia.

Vertical Fiscal Imbalance and Horizontal Fiscal Equalisation

Fiscal equalisation is a transfer of fiscal resources across jurisdictions with the aim of offsetting differences in revenue raising capacity or public service cost (OECD, 2007, p. 5). A high level of vertical fiscal imbalance, whereby the financial resources available to governments do not match their constitutional (expenditure) responsibilities, is a feature of Australia's federal system (Webb, 2002). There is also a significant degree of horizontal fiscal imbalance. Australia has a relatively low disparity between regions/states compared to other jurisdictions (OECD, 2007, p. 5). Nevertheless there are differences between States/Territories, and between Local Governments, in their capacity to provide services. This imbalance is overcome by transfer payments from the Commonwealth to the States and Territories (derived from the GST revenue collection) and to local governments. The methods for allocating these transfer payments are based on the principle of horizontal fiscal equalisation. Unlike some countries equalisation is not mandated in the Australian Constitution, nor is it set in legislation, but it has evolved to be a key part of Commonwealth-State/Territory financial arrangements (CGC, 2009, p. 3).

There is much literature on fiscal federalism and equalisation, with notable contributors in the Australian context including Mathews (1980), Thomson (1990), Walsh (1993), and McGovern, Kay, Bristow and Pickernell (2002). The literature has tended to focus on economic aspects of fiscal decentralisation, such as tax and policy competition, including studies of how grants distort State/Territory fiscal behaviours (Dahlby and Warren, 2003) and analyses of economic efficiency in Federal/State and Territory funding, such as the so-called flypaper effects and congestion externalities (Dixon, Picton, and Rimmer, 2005). For example, Petchey examined the economic and spatial location efficiency implications of equalisation, and found that fiscal equalisation for revenue and expenditure results in strategic behaviours and a pattern of inter regional transfers of income that are inconsistent with the efficient spatial location of mobile factors of production (2008).

In contrast, the focus of this paper is an exploration of the relationship between grant allocations and regional development, but the issue of region needs to clarified up front. In much of the fiscal federalism literature, states are used almost interchangeably for regions. For example, Petchey (2008) uses the example of a regional economy as a federation of States. The CGC (2009) uses region virtually interchangeably for State. In the real world of public policy and popular political culture, however, most citizens operate on an assumption that Australia has many more than eight regions (Brown, 2006). Whereas the notion of States/Territories as regions is implied in this paper, greater emphasis is given to the regions and regional development within States/Territories, as well as local government.

There is considerably less literature on the local government equalisation arrangements, though the Commonwealth introduced National Reports in the 1995 legislation to more readily enable comparisons. The Productivity Commission's (2008) analysis of local government revenue raising capacity considered the distribution of Financial Assistance Grants (FAGs). Worthington and Dollery's (2000) paper on the productive efficiency dimension in local government grant allocations has been one contribution.

The quantum of funds being transferred is significant. Commonwealth payments to the States and Territories[1] comprised approximately $74 billion in 2007-08, comprising $42 billion in Goods and Services Tax (GST) revenue and $32 billion in specific purpose payments (Government of WA, 2009, p. 26).[2] GST grants account for 33 per cent of State budget revenues, with the percentages for individual States[3] varying from 25 per cent for WA to 69 per cent for the Northern Territory. In 2009-10, WA received around $3.3 billion or 8.1 per cent of GST revenue grants, and this

1 For the remainder of this article, the term 'States' is used to represent both the six Australian States and two mainland Territories of Australia.
2 This includes the local government financial assistance grants, $1.9b 2009/10, considered a special purpose payment to the States.
3 A reference to States in the remainder of this document also includes Territories unless otherwise specified.

was expected to fall to 5.7 per cent by 2012-13, significantly less than its 10.3 per cent national population share (Government of WA, 2009). The Commonwealth has also been providing financial assistance to the States for local government purposes since 1974-75. In that time the (per annum) quantum of funding has grown from $56 million to over $1.92 billion in 2009-10, totalling $15 billion over thirty-five years (DITRDLG, 2009).

The Commonwealth Grants Commission

The instrument for achieving HFE among the States and Territories in Australia is the independent Commonwealth Grants Commission (CGC), operating under the *Commonwealth Grants Commission Act 1973*. It was first established in 1933 to advise the Commonwealth on the distribution of special grants to claimant States (CGC, 1995). Western Australia's move to secede from the Federation in the early 1930s was one factor in its creation (Wilkinson, 2003). The application of HFE has had a long history in Australia, with the Commission's methods increasing progressively in breadth, complexity and comprehensiveness as it moved from the initial concept of minimum financial need to that of fiscal equalisation (CGC, 1995; 2009)

The CGC's role has evolved over time such that the main task now is to advise the Commonwealth Government on the distribution of the revenue from the goods and services tax (CGC, 2010, p. 30):[4]

> State governments should receive funding from the Goods and Services Tax revenue such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.

This is the essence of HFE, ensuring that all State governments have the same fiscal capacity to deliver services to their populations, after the distribution of GST revenues and taking into account own-source revenue capacity. The emphasis in the HFE definition is on equalising fiscal capacities, rather than performance or outcomes, and ensuring that there is no 'have' and 'have not' States (LeGoff, 2005).

The CGC operates such that:

- full reviews of State relativities (shares), and the methods used to calculate them, are done every five years (the last one completed in 2010); and

4 This has been the CGC definition since the 2004 review. This is a change from the previous statement that the fiscal capacity to provide services of the same standard, if they make the same effort to raise revenue from their own sources, and operate at the same level of efficiency (CGC, 2002). Significantly, a different definition of HFE is applied to the local government financial assistance grants (footnote ix), and the CGC (2001) have suggested that it be seen as a concept of relative need.

- in between reviews the relativities are updated annually, using the latest available figures and the methods of the last review.

The Commission's task of determining a distribution of GST revenues to equalise the fiscal capacities of the States is inevitably complex given the breadth of operations of State governments. The 2010 review of methods focused on simplification of CGC methods whilst maintaining consistency with the principle of HFE. The results of the review were reported in February 2010 (CGC, 2010), accepted at the March 2010 Treasurers' Conference, and applied from 2010-11. The focus on simplification is appropriate, given Pincus' (2008) comment that the current system delivers too much equalisation in too complex a fashion.

The HFE Debate

HFE is a highly contentious element of Australia's federal fiscal arrangements. There is considerable debate about how the CGC applies the principle of HFE, as well as reinterpretation of the HFE concept by the CGC. There is a need for judgements in CGC processes, about the ways of quantifying factors, and the extent to which factors are important (Review of Commonwealth-State Funding (RCSF), 2002; LeGoff, 2005). More fundamentally, the debate has been about the principle, with States frequently disagreeing with the CGC and each other about exactly what HFE should entail (RCSF, 2002). This was evident in the latest review (CGC, 2010).

Previously there has been agitation by New South Wales and Victoria for HFE to be abandoned and replaced by a per capita approach for GST revenue distribution. These States, together with Western Australia, contributed further to the debate by commissioning the Independent Review of Commonwealth-State Funding in 2002. This review, conducted by leading economists Ross Garnaut and Vince FitzGerald, coincided with the CGC's consultations and workings for its 2004 relativities review. The WA Government supported the independent review as an opportunity to query whether the large transfer of financial resources out of one of Australia's most prospective regions was inhibiting national development (WA Department of Treasury and Finance (DoTaF), 2002). On the one hand, there is the view that equalisation promotes mediocrity rather than efficiency, whereas other States support it as an integral part of the fabric of federation (LeGoff, 2005).

Consider the example of the resource rich Pilbara region in WA. Private sector investment, supported by State government investment, has provided the foundation for $29 billion in minerals and petroleum production (2009) generating around $1.5 billion in royalties for the State. The Pilbara is a remote region, remote from the main centres of population and sources of labour and services. While the benefits of investment are significant, the costs of development and on-going costs are high. The WA Government (and more so the Commonwealth) have benefited considerably from the revenues generated by these developments, but its above average mining production (Table 1) reduces the State's assessed GST shares (CGC, 2010, p. 99). Significant growth in royalties over the last decade has led to a steep decline in WA's share of Commonwealth funding. The WA Government has asked if this outcome reasonable and if it is sustainable in terms of its effect on the national economy? (DoTaF, 2002).

Table 1: Mining Income by State and Territories

2008-09	$m	Proportion of State/Territory revenue %
New South Wales	1,278.5	5.2
Victoria	46.4	0.2
Queensland	3,364.6	16.7
Western Australia	3,184.4	29.3
South Australia	152.4	2.4
Tasmania	32.0	.9
Northern Territory	227.6	21.6
Australian Capital Territory	0	0

Source: CGC, 2010, p. 129

The concern that equalisation reduces the incentives for States to seek resource development because extra revenues would be offset by lower equalisation grants is not unique to Australia, having also been expressed in Canada and Germany (CGC, 2009). Equalisation may reduce incentives for a State to promote economic growth because much of the extra State tax revenue generated by successful development is offset by reductions in its share of the GST. The balance is, in effect, transferred to the other States through increases in their shares of the GST. Moreover, another major source of revenue from such development, increased company tax, goes to the Australian Government (CGC, 2009).

Mining income makes a significant contribution to Commonwealth and State revenue, but importantly it has a major effect on WA's fiscal position relative to other states. Each year the WA Department of Treasury and Finance assesses the net redistribution of resources between the States arising from all Commonwealth general government fiscal transactions. A State is deemed to provide a fiscal subsidy to the Federation if total Commonwealth revenues derived from that State exceed total Commonwealth outlays on that State. Outlays include grants to State governments, but also include Commonwealth outlays, such as social security spending. New South Wales (NSW), Victoria (VIC), and WA provide a fiscal subsidy to the other States. In 2007-08 WA's subsidy to the other States was calculated at $8.2 billion (Government of WA, 2009, p. 290). The State provides the highest subsidy in both dollar and in per capita terms (Table 2), and these have increased dramatically since 2000-01. The subsidy of $3,832 per person reflects, among other things, the relatively high per capita taxes contributed by WA (particularly personal income and company tax), and the State's relatively low share of Commonwealth social security and health benefit payments and lower Commonwealth spending on services in the State.

Table 2: State/Territory Net Fiscal Subsidies to the Federation

2007-08	$m	$ per capita
New South Wales	4,637	668
Victoria	607	115
Queensland	-2,137	-504
Western Australia	8,204	3,832
South Australia	-5,221	-3,275
Tasmania	-5,221	-6,056
Northern Territory	-3,089	-14,214

Source: Government of WA, 2009, p. 290[5]

The above analysis has influenced the WA Government's case to the CGC relativity reviews. Its view has been that the CGC's assessments inappropriately redistribute the returns from economic development to other jurisdictions without properly recognising the cost of the investment made by a State in generating that development. These assessments lead to large imbalances in the bearing of fiscal costs and the sharing of revenue benefits across governments. This potentially discourages economic development such that fundamental reforms to the equalisation process need to be considered to remove the disincentives in the system (DoTaF, 2002).

Various examples can be cited to highlight this flaw in the CGC approach. The WA Government invested $160 million in multi-use infrastructure to facilitate further development on the Burrup Peninsula. None of this expenditure would be recognised in the CGC methodology. The gas processing developments were forecast to improve national GDP by $3.6 billion and generate nearly $600 million in net fiscal benefits for the Commonwealth Government. However, after taking into account State expenditures and the CGC's redistribution of net revenue benefits, WA is actually expected to incur a net loss of $61 million. Other States benefit by sharing in a redistribution of $447 million without making any investment or taking any risk (Marney, 2005). Similarly, the Gorgon Gas project was forecast to improve the

5 No ACT figure is provided in this table. "It is assumed that the ACT exists only to serve the federation and that if the federation was dissolved the ACT would cease to exist. Commonwealth expenditures and revenues attributed to the ACT have been allocated among the States according to population shares" (WA DoTaF, 2009).

Commonwealth's budget balance by between $11 billion and $14 billion. After taking account of State expenditures to service the increased population and the redistribution of net revenue benefits by the CGC, WA's forecast net fiscal benefit is only $300 million (Marney, 2005). Other States will receive a net fiscal benefit of around $3 billion. The fiscal benefits of the projects are shared around the nation, while economic development costs are either not recognised, or recognised at a standard level (DoTaF, 2003).

The State's view is consistent with federalism commentators such as Kasper (2008) who noted that where the economic failures of mendicant states are rewarded through federal-state financial transfers, the motivation to improve poor administrative practices is undermined. These findings were supported by the independent review, which found that the current system affects national economic performance, because the CGC distributes revenue benefits from economic development without sharing many of the costs born by States (RCSF, 2002) dulling the incentive for growth promoting policies. This finding was consistent with the WA Government view that there is a gap in the CGC assessment of economic development costs which needs to be addressed (DoTaF, 2002). The CGC's 2010 review provided greater recognition of the capital infrastructure needs of growth States, but has done little to address the WA Government's views on economic development costs, such that the State Treasurer commented at the time of its release that he would like to see "more incentive for States to develop their economies by limiting the penalty for success" (Barnett and Buswell, 2010.) The reduced incentives for States to initiate policies which support growth were raised by the Government of WA (2009a) in the State's submission to the Henry Tax Review.[6]

Since the introduction of the GST, some parties have supported a system of returning revenue to the States where it was generated. This is a common issue in federations where constituent States seek to receive revenue in line with the revenue raised by the federal government in their States. It is also sometimes raised by regions within States to demonstrate the inequity of State revenue and expenditure policies. Those who advocate a complete return of revenue to its State of origin are really advocating no equalisation, a position which runs counter to the political compromise underpinning the Federation over the last century (CGC, 2009).

The Regional Dimension

The current equalisation system does address regional (State) capacity constraints and needs. But from a regional development point of view, the current equalisation system does little for the regions within States. In fact, differences between the levels of services in regions within States are accepted and entrenched in the CGC system

6 The outcomes of the Henry Tax review (completed May 2010) were not known at the time of preparing this paper.

(RCSF, 2002). While HFE is fundamentally about equity, it is not about States providing all their residents with an equal level of services, or 'equal residents' in different States being provided with equal levels of services (CGC, 2002). The CGC does not estimate what level of service might be appropriate, even where it can be demonstrated that a level of service is below public expectations, professional guidelines or UN standards (CGC, 2002). The CGC can only reflect what the States actually do, and hence equalisation won't result in the same services being available in urban and rural areas (CGC, 2008).

The methodology accepts that the level of services provided to provincial, rural and remote regions is much lower than in the capital cities (RCSF, 2002). The independent review questioned the equity of the CGC compensating a recipient State for the higher costs of delivering services in its capital when the standard of non-metropolitan services is well below that level (RCSF, 2002). There is a State Government role in redistribution through provision of services in regional areas, but ultimately most States are not able to provide a metropolitan level of service across the whole jurisdiction. Typically, the standard of service provided in each region reflects the need for, and the economic costs of, the service and differs between urban and rural areas (CGC, 2009; CGC, 2010).

> Equalisation is not directed to interpersonal, community or regional equality because States do not follow such policies. States do not provide residents of rural and remote areas with the same access to services as people in metropolitan areas. Accordingly, the equalisation standards reflect the different amounts States spend per person in different areas and on different groups of people. Equalisation is not intended to provide States with the capacity to implement policies they do not, on average, already follow. The Australian Government has other policy measures such as the tax and social security systems to address interpersonal equity (CGC, 2010, p. 36).

Nevertheless it might be considered 'remarkable that the current system emphasises the importance of horizontal equity yet does nothing to address disparities in access to services between regions within States' (RCSF, 2002, 3). To some extent the system ends up with poor people in the rich states subsidising the rich people in the poor states (Gittins, 2004). The same could perhaps be said for the regions.

Clearly there is a tension between the view that the equity focus should be on the treatment of individuals and households (RCSF, 2002), and the CGC perspective on equity among States. While this is symptomatic of the debate about the meaning and application of HFE, there is a regional dimension to the debate as well.

While the opportunity for the WA Government to spend mining royalty revenues in the regions to boost service standards in the regions is limited by the redistribution of benefits to other States, it maintains a regional focus through its *Royalties for Regions* program. This was established at the end of 2008 with a commitment to return the equivalent of 25 per cent of the State's mining and onshore petroleum royalties revenue to regional WA, as an additional investment in projects, infrastructure and community services. The program, with a value of $619 million in 2009-10, provides funding for country local governments for community infrastructure, a *Regional Community Services Fund* and a *Regional Infrastructure and Headworks Fund* (Department of Regional Development and Lands, 2010). Clearly, there are benefits to the State, and to its regions, from having a significant mineral endowment.

Not surprisingly, the call to return a fixed share of royalties to the regions has been taken up by incumbent and aspiring politicians in other jurisdictions, including a call for the Commonwealth to return more to the regions (reported, for example in the *Kununurra News,* 16 October 2009). At the Commonwealth level, there may be scope for the CGC to develop it methods to better recognise regional needs.

Horizontal Equalisation at the Local Government Level

A consideration of the impacts of HFE at the regional level would not be complete without reference to its application at the level of local government. The local government funding arrangement, which sees around $2 billion allocated to the sector annually, provides considerable assistance to regional areas, but only in terms of local government functions. While this funding represents the largest single component of external revenues for local government, there has been a long term decline in funding levels, from 1.01 per cent of Commonwealth taxation revenue (excluding GST) in 1996 to 0.68 per cent in 2008-09 (ALGA, 2010).

As the vehicle for achieving HFE, the objective of the *Local Government Financial Assistance Act 1995* is to provide financial assistance for the purposes of improving the financial capacity of local governing bodies and their capacity to provide their residents with an equitable level of service (DITRDLG, 2009). Local government's control over zoning, planning and development enables considerable control to be exerted over matters of regional development (Worthington and Dollery, 2000), and this is underpinned by the significant financial support provided through the grants system to local government in regional areas.

The Act provides for *National Principles* to be prescribed. In addition to HFE,[7] principles have been prescribed pertaining to effort neutrality, minimum grants, other

7 The National Principle defining HFE requires equalisation within a state:
'*General Purpose grants will be allocated to local governing bodies, as far as practicable, on a full horizontal equalisation basis as defined by the Act. This is a basis that ensures that each local governing body in the State/Territory is able to function, by reasonable effort, at a standard not lower than the average standard of other local governing bodies in the State. It takes account of differences in the expenditure required by those local governing bodies in the performance of their functions and in the capacity of those local governing bodies to raise revenue.*' (DITRDLG, 2009, p. 81)

grant support, Aboriginal and Torres Strait Islander Peoples, and the identified road component (DITRDLG, 2009). The FAGs are allocated by the Commonwealth as a specific purpose payment to the States for allocation to local governments, subject to certain conditions. The allocation of FAGs to local governments in a State must be in accordance with the National Principles.

The FAGs to local government, made on the recommendation of State based Local Government Grants Commissions (LGGC) have two components - general purpose grants and identified local road grants. The Act specifies that the general purpose grant component be allocated between the States on a per capita basis, while the local road grants (not discussed further in this paper) are allocated on the basis of a historical formula more reflective of road needs (DITRDLG, 2009) (Table 3).

Table 3: Estimated 2009-2010 FAG Entitlements

2009/10 Estimated Entitlement	General Purpose ($M)	% Share	Identified Road Funding ($M)	% Share	Total ($M)	% Share
New South Wales	433.7	32.6	171.4	29.0	605.2	31.5
Victoria	330.2	24.8	121.8	20.6	452.1	23.5
Queensland	267.5	20.1	110.7	18.7	378.2	19.7
Western Australia	135.3	10.2	90.4	15.3	225.7	11.7
South Australia	99.2	7.5	32.5	5.5	131.7	6.9
Tasmania	30.7	2.3	31.3	5.3	62.1	3.2
Northern Territory	13.6	1.0	13.8	2.3	27.4	1.4
Australian Capital Territory	21.4	1.6	18.9	3.2	40.4	2.1
Total	1,331.7	100	590.9	100	1,922.7	100

Source: DITRDLG, 2009, p. 24.

A major impediment to equalisation at the local government level is the Act's minimum grant requirement, which guarantees all local governments receive a general purpose grant, regardless of equalisation need. For some local governments (e.g. City of Perth), the assessed revenue capacity exceeds the assessed expenditure need, but it still receives a general purpose grant entitlement. The legislation requires that local governments do not get less than 30 per cent of what would have been allotted had the funding been distributed solely on the basis of population. Despite the CGC review of the Act in 2001, and subsequently by the House of Representatives' Inquiry into Local Government and Cost Shifting, and the Productivity Commission's 2008 finding that that the current level of FAGs is insufficient to achieve HFE, the Commonwealth is yet to change the fundamentals of the local government funding arrangements.

Nevertheless, the grants system clearly goes a long way to addressing regional needs, for local governments in regional areas are intentionally big winners under this system. The allocations of minimum grants to councils are one indicator of this outcome. In the 2007/2008 WA assessment, there were 31 local governments (mainly metropolitan) with little or no equalisation need, which received grants based on the minimum grant or per capita provision. Together these local governments, with approximately 75 per cent of the State's population, accounted for just $30.7 million (22.7%) of the $135.3 million equalisation funding pool. Conversely, the lion's share of the funding ($105 milion; 77.3%) was distributed to the remaining local governments in regional WA, with 24.8 per cent of the population. At the same time, this outcome could be seen as supporting the conclusion that the "formula creates and encourages inefficiency by retaining small institutions" (cited in Worthington and Dollery, 2000, p. 4).

The skewed allocation of grants to regional areas is consistent with what is expected under HFE principles, and a similar effect could be observed in most non-metropolitan regions within Australia. The result is perhaps even more skewed in WA than in other States, given that a larger percentage of the State's population reside in minimum grant councils (DITRDLG, 2009). In 2007-08, 9.6 per cent of funds nationally went to minimum grant councils, compared to 22.7 per cent in WA.

The four Pilbara local governments consistently receive a larger than population share of financial assistance grants (Table 4).[8] This outcome is somewhat of a paradox, given that as described above the mineral wealth generated in the region plays a major role in the State's financial position and GST revenue allocations.

8 Pilbara councils assert to the WA Local Government Grants Commission that population is not a true indicator of expenditure need, referring to the needs generated by the transient workers who operate on a fly-on fly-out basis.

Table 4: Western Australian Regional Shares of FAGs 2009/2010

Region Shares	Population	% of State total	Total general purpose grants 2009/10	% of State total	Grants per capita 2009/10
Gascoyne	9,668	0.4	6,617,510	4.9	684.48
Goldfields-Esperance	58,074	2.7	9,445,911	7.0	162.65
Great Southern	57,439	2.6	6,630,644	4.9	115.44
Kimberley	34,185	1.6	13,778,159	10.2	403.05
Mid West	53,741	2.5	15,430,814	11.4	287.13
Peel	99,252	4.6	4,768,028	3.5	48.04
Perth	1,587,278	73.1	32,231,920	23.8	20.31
Pilbara	45,983	2.1	10,523,271	7.8	228.85
South West	152,087	7.0	9,632,011	7.1	63.33
Wheatbelt	73,490	3.4	26,285,595	19.4	357.68
TOTAL	2,171,197	100	135,343,863	100	62.34

Source: Derived from grant allocations to local governments (WA Local Government Grants Commission 2009). Non-metropolitan regions are as defined by the *Regional Development Commissions Act 1999.*

This outcome for Pilbara councils reflects their relatively weaker revenue capacity and higher service delivery costs relative to WA State averages. The rate base of these local governments is significantly constrained by State Agreement Acts which typically restrict local government rating of improvements on mining tenements to an unimproved land value (Pilbara Regional Council, 2004), and this constitutes a form of revenue leakage (WALGA, 2009).[9] Consequently, the mining and industrial sectors account for just 22 per cent of rates levied in the Pilbara, with the residential and commercial sectors shouldering more of the rating burden (Table 5). Given this constrained rate base, the WA LGGC allocates financial assistance grants totalling $14 million to the councils to equalise their capacity to provide services.

[9] State Agreements are contracts between the Government of WA and proponents of major resources projects which are ratified by an Act of the State Parliament. They specify the rights, obligations, terms and conditions for development of the project and establish a framework for ongoing relations between the State and the project proponent. For more than fifty years, State Agreements have been used by successive governments to foster major developments, including mineral, petroleum, and related downstream processing projects, together with associated infrastructure investments. Such projects require long term certainty, extensive or complex land tenure and are often located in relatively remote areas of the State requiring significant infrastructure development. Currently there are 71 such Acts in place (DSD 2010) http://www.dsd.wa.gov.au/6641.aspx.

Table 5: Pilbara Local Government Rate Revenues and FAGs 2007/2008

Local Government ($ '000)	Residential rates	Commercial rates	Industrial rates	Mining rates	Pastoral rates	Total rates	Total FAGs
Ashburton	2,390	581	191	943	166	4,425	3,794
East Pilbara	1,789	195	340	2,240	233	4,798	4,464
Port Hedland	6,187	1,751	771	528	48	9,370	2,388
Roebourne	6,816	2,063	915	429	60	10,282	3,300
Pilbara region total	17,182	4,591	2,217	4,140	507	28,875	13,947

Source: Information Returns to the WA Local Government Grants Commission
Total FAGS includes road grant component.

In exploring this local government dimension of HFE it is interesting to consider some interstate comparisons of FAG allocations, given that a different methodology is applied in each state by the respective LGGC. While it is difficult to make relevant comparisons with the Pilbara councils some comparisons of other regional councils in Australia are proposed here (Table 6). The local governments presented have some community similarities (such as Kalgoorlie-Boulder and Broken Hill); however the grant outcomes in a per capita sense are significantly different.

Table 6: Selected Interstate Comparisons

Local Government	Population 2008	General Purpose Grant ($)	General Purpose Grant per capita ($)	Road Grant*($)	Total Grant ($)
Broome (WA)	15,386	2,441,582	158.69	672,472	3,114,054
Charters Towers (Q)	12,506	4,612,293	368.81	2,103,762	6,716,055
Katherine (NT)	9,912	639,505	64.52	543,826	1,183,331
Broken Hill (NSW)	20,001	3,809,317	190.46	421,280	4,230,597
Kalgoorlie-Boulder (WA)	31,716	930,586	29.34	1,313,011	2,243,597
Mount Isa (Q)	21,570	2,068,079	95.88	1,144,072	3,212,151
Swan Hill (V)	21,765	3,521,233	161.78	1,623,016	5,144,249
Alice Springs (NT)	27,481	885,454	32.22	830,716	1,716,170
Whyalla (SA)	22,801	4,301,672	188.66	327,955	4,629,627

Source: DITRDLG, 2009

** Road grants are allocated on a different basis, reflecting roads needs. Their inclusion in this table provides a proxy indicator of the scale of the road management task in each area.*

The significant differences in outcomes for 'similar' local governments in different States, such as the differences between Broome and Katherine or Kalgoorlie and Broken Hill, can be explained by a range of factors operating at a variety of scales:

- Differences of place;
- Differences of context; and
- Differences of methodology.

The differences in place refer to a local level effect on the outcomes. They include differences in the demographic structure and socio-economic status of the population within each local government. An area with many aged persons, or children and youth, may be getting increased grants per capita because these issues are recognised by Grants Commissions as 'disability factors' requiring increased expenditure. There are also differences in the local economic base. One local government may be predominantly residential and have a relative low revenue base while a second city may have a large commercial centre and have a significantly larger revenue base.

The differences in context refer to a State level effect on the outcomes. The number of local governments in a State will affect the outcomes when comparisons are made between like councils in different States. This is due to the number of local governments which will have 'flagfall' costs which need to be recognised. The number of minimum grant councils varies between States, and this will have an impact on outcomes, as will the percentage of the State population residing in minimum grant councils (see above for figures for WA). In States with a higher proportion of the population in minimum grant councils, more funds have effectively been freed up for distribution for non-minimum councils; grant allocations will tend to be relatively higher in per capita terms. The services provided by the local government sector vary from State to State; for example, Victorian local governments have traditionally played a larger role in the community services field.

The relative position of a local government within a State also has an impact. For example, while Mount Isa and Kalgoorlie-Boulder may be 'like' communities, the latter is considerably closer to its nearest capital city than the former. Broome and Katherine may be similar is size, but in the WA context Broome is a relatively remote and disadvantaged council, whereas in the Northern Territory, Katherine is a relatively advantaged council that is not as distant from the capital.

The differences in outcomes, highlighted by Broome and Katherine, or Kalgoorlie and Broken Hill, also reflect the legislative requirement for equalisation within a State. The Queensland Government submission to the 2000 review of the *Local Government (Financial Assistance) Act 1995* referred to the significant differences in the demographic patterns of each State, Queensland being demographically different in that it is more decentralised, with a greater population living outside the metropolitan area. The submission also pointed to the "differences in the size and structure of local government systems, differences in valuation bases used for rating; functional variations and variations in revenues and expenditures" (Queensland Government, 2000, p. 2).

Differences in State Grants Commission methodology also account for the different outcomes among like councils. There are differences in the what and how of the Commission's assessments. These include differences in equalisation model, differences in the approach to assessing revenue raising capacity and differences in the way expenditure needs are assessed (DITRDLG, 2009).

So long as grants are determined by State Grants Commissions, rather than by a national body, methodology differences are inevitable, and there will always be implications for grant distributions. It is contended that this approach leads to a generally better outcome for regions, that is, the local governments in regional areas, than would be the case if there was a centralised approach to determining grant allocations. To further strengthen regions, the Australian Local Government Association (ALGA) have called for supplementary funding and a Parliamentary Inquiry into the external funding of local government. This culminated in the Commonwealth's 2008 announcement of the establishment of a *Regional and Local Community Infrastructure Program* (ALGA, 2010).

Conclusion

All governments accept that there is a place for financial assistance grant arrangements to address the vertical and horizontal fiscal imbalances in Australia. While accepting the role of the Commonwealth Grants Commission in determining appropriate shares for jurisdictions, the WA Government has been a keen contributor to the debates on methodology. Fundamentally, these debates about the meaning and application of horizontal fiscal equalisation is healthy for the federation.

The gap in the CGC assessment of economic development costs still needs to be addressed to remove the disincentives for States to initiate policies that support growth. States which do not assist resource development benefit by sharing in the redistribution of the royalty revenues without making any investment or taking any risk. There is also scope for regional needs to be better recognised in the determining funding allocations to the States.

The local government grants system, in providing significant support to regional local governments, is contributing to regional development. At the same time the arrangements for State funding make it difficult for the regions within States by implicitly accepting the lower service levels provided in the regions, since the system cannot address the level of services that are needed. This constraint is one reason for an independent inquiry to redefine the objectives and design a simpler and more transparent system to achieve HFE, and importantly the need to take into account regional needs (Walsh, 2008).

Australia's State and local governments, as well as stakeholders in the regions, will keenly follow the further evolution of this important facet of Australia's Federal system.

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