

CHAPTER 4: INTERGOVERNMENTAL FINANCES

Overview

Recent developments in financial relations between the Commonwealth and the States and Territories (referred to as 'the States') and their implications for South Australia are summarised in this chapter, which includes sections on horizontal fiscal equalisation and local government finances.

Recent developments

Treasurers' Conference

The Ministerial Council for Commonwealth–State Financial Relations, also known as the Treasurers' Conference, was established by the Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations (IGA) as part of the substantial changes brought about by the Commonwealth's introduction of the Goods and Services Tax (GST).

The fifth meeting of the Ministerial Council was convened in Canberra on 26 March 2004, where it considered expected revenue payments to the States in 2003-04 and 2004-05, as well as a range of GST administration issues. The outcomes included:

- agreement that 2004-05 GST revenues will be distributed among the States in accordance with the final recommendations of the Commonwealth Grants Commission (CGC) Report on State Revenue Sharing Relativities 2004 Review;
- agreement by the majority of States to a work program on the CGC's methodology, focusing on simplification and data issues, but expressly excluding an examination of the underlying principles of horizontal fiscal equalisation;
- agreement that all States will abolish Bank Accounts Debits tax by 1 July 2005;
- agreement on the terms of reference for the review of a range of business stamp duties prior to the 2005 Treasurers' Conference. The review is limited to stamp duties on:
 - non-residential conveyances;
 - leases;
 - mortgages, debentures, bonds and other loan securities;
 - credit arrangements, instalment purchase arrangements and rental arrangements;
 - cheques, bills of exchange and promissory notes; and
 - unquoted marketable securities.

- endorsement of the Australian Tax Office's GST administration budget for 2004-05 and minor revisions to the GST Administration Performance Agreement;
- recognition that the Commonwealth is meeting its commitment under the IGA not to cut aggregate specific purpose payments (SPPs) as part of the national tax reform arrangements; and
- endorsement of Loan Council Allocations nominated by the Commonwealth and each State for 2004-05 (South Australia's Loan Council Allocation is detailed in Appendix A).

Commonwealth Grants Commission 2004 Review

In February, the CGC released its 2004 Review of per capita relativities for the distribution of Commonwealth GST revenue grants to the States in 2004-05. In the Review, the CGC examined all aspects of its methodology in the light of extensive submissions from all States.

The relativities are based on the principle of horizontal fiscal equalisation (HFE; see box opposite), which is a requirement of the IGA.

Overall, the 2004 Review relativities redistributed about \$494 million among the States (see Table 4.1), with grants redistributed to Queensland and Western Australia at the expense of the other four States and two Territories. This result was largely driven by the CGC's revisions to its capital assessments, which were widely recognised as being too generous in the past to New South Wales and the Northern Territory, mainly at the expense of Queensland and Western Australia.

South Australia's relativity fell to 1.20407 in the 2004 Review, which equates to a decrease in GST revenue grants of \$26.3 million compared to payments received using the previous relativities. Nevertheless, after the CGC's recommended distribution is implemented, South Australia will still receive approximately \$610 million more than if funding were distributed on a simple population share basis without regard to the fiscal needs and capacities of each State.

The fall in grants share for South Australia was primarily the result of the 2004 Review methodology revisions, with the CGC assessing lower relative costs of service provision for the State than under the previous methodology. Less favourable assessments of South Australia's relative wage and salary costs and of the cost of providing urban transit services were major contributors.

This fall was partly offset by the impact on the State's relative (compared to the national average) capacity to raise revenue of replacing 1997-98 data with 2002-03 data in the rolling five-year average assessment period used by the CGC. In particular, below average increases in wages and salaries and in the values of houses and commercial and industrial land reduced the State's relative capacity to raise payroll tax, stamp duty on conveyances and land revenue.

The CGC's next update of relativities is due in February 2005, for application to the 2005-06 grant pool. It will only take into account changes to the data used while the methodology will remain unchanged from the 2004 Review. Methodology reviews are only undertaken every five years.

Horizontal fiscal equalisation

The IGA includes a specific provision that GST revenue grants will be distributed entirely on a HFE basis.

The principle of HFE is based on Australia's commitment to ensuring that each State has the capacity to provide public services at a similar standard and level of efficiency as the other States for a comparable revenue-raising effort.

The CGC, an independent statutory body, annually recommends the shares of general purpose payments (GPPs) that each State should receive, with the CGC's methodology remaining fixed between major five-yearly assessment reviews. As outlined earlier in this chapter, the CGC released the findings of its most recent methodology review in February 2004. The CGC consulted widely with the States in the conduct of the 2004 Review.

Equalisation is an important element in ensuring equity for States, regardless of their demographic, economic or geographic circumstances.

History and international practice both support implementation of some form of fiscal equalisation. It is practised explicitly in most federations and implicitly takes place in nations with unitary systems of government. If Australia had a unitary system of government, the national government would seek to provide a broadly comparable level of services to all areas of Australia. HFE seeks to achieve a similar outcome in the current federal system.

New South Wales and Victoria have been arguing in recent times that the difference between the distribution of GPPs under HFE compared to an equal per capita distribution is becoming too large and the HFE process should be abandoned. To this end both States have over the years called for changes to the way GPPs are distributed ranging from partial equalisation to equal per capita and even incidence of tax collections.

In each instance, the alternatives put forward by these States would be a major departure from the equity objective that underpins the present system and, as noted above, would be totally inconsistent with observed government policy in unitary systems. Further, those State governments do not follow these methods in allocating resources between regions within their borders.

At the recent Treasurers' Conference, all the other States again rejected calls by New South Wales and Victoria to ignore the recommendations of the CGC and use an alternate distribution method for the distribution of 2004-05 GPPs. However, it was agreed by a majority of States that a work program would be undertaken focusing on simplification of the CGC's methodology. The work program will consider:

- whether the present approach, which is based on a comprehensive assessment of virtually all receipts and expenses in the operating statements of States, is appropriate and necessary;
- the size and trend of the redistributions;
- simplification; and
- data issues.

Importantly, it was agreed that the work program will not examine the underlying principles of HFE.

Table 4.1: Commonwealth Grants Commission 2004 Review results

	2003 Update GST relativity ^(a)	2004 Review GST relativity ^(a)	Implied effect on grant share ^(b) (\$m)
New South Wales	0.89117	0.86750	-317.0
Victoria	0.87010	0.86534	-51.2
Queensland	1.01902	1.05504	262.7
Western Australia	0.96946	1.03054	230.9
South Australia	1.21215	1.20407	-26.3
Tasmania	1.59948	1.55939	-37.9
Australian Capital Territory	1.14979	1.12930	-13.4
Northern Territory	4.38638	4.26538	-47.7
Total redistributed among States			493.7

(a) The relativities show the per capita funding relative to an Australian average of 1.

(b) Estimated impact of change in relativities on the 2003-04 GST pool included in the CGC's 2004 Review report.

Commonwealth grants to the States

The Commonwealth provides funding to the States in the following forms:

- *GST revenue grants* are 'untied' payments that can be used freely by the States to finance their expenditure priorities. They are distributed to the States using CGC per capita relativities.
- *National Competition Policy (NCP) payments* are paid by the Commonwealth to the States to ensure they share in additional revenue accruing to the Commonwealth from the economic gains of implementing competition policy. NCP payments are distributed on an equal per capita basis, but payment is conditional on compliance with the NCP agreement as assessed by the National Competition Council (NCC).
- *Specific purpose payments (SPPs)* are grants that are 'tied' to particular Commonwealth Government expenditure objectives. SPPs are classified as those paid 'to' the State for programs administered by the State Government or 'on-passed' to entities such as non-government schools and local government. The administration of SPPs by the States is subject to guidelines agreed with the Commonwealth and their distribution and magnitude is determined through the Commonwealth Budget.
- *Contributions* are payments to the States to reimburse them for services considered to be Commonwealth own-purpose outlays provided on the Commonwealth's behalf. For example, Commonwealth Veterans' Affairs funding is paid to the South Australian Department of Human Services which provides the services to veterans. Apart from the Veterans' Affairs arrangements, the majority of these payments are relatively minor in nature.

Estimated levels of Commonwealth financial assistance for South Australia are set out in Table 4.2.

Table 4.2: Commonwealth payments to South Australia 2003-04 and 2004-05^(a)

	2003-04	2004-05	
	Estimated result \$ million	Budget \$ million	Change %
General purpose payments			
GST revenue grants	3 154.3	3 242.9	2.8
NCP payments ^(b)	40.1	46.9	16.9
Total general purpose payments	3 194.4	3 289.8	3.0
Specific purpose payments 'to' the State			
Australian Health Care Agreement (AHCA)	636.9	666.9	4.7
Government schools	167.5	177.6	6.0
Commonwealth–State/Territory Disability Agreement (CSTDA)	61.3	62.9	2.6
Commonwealth–State Housing Agreement (CSHA)	71.4	72.3	1.3
Roads ^(c)	63.2	77.8	23.1
Australian National Training Authority (ANTA)	87.0	88.0	1.1
Other 'to' payments	252.5	235.1	-6.8
Total specific purpose payments 'to' the State	1 339.8	1 380.6	3.0
Total payments 'to' the State	4 534.2	4 670.4	3.0
Major contributions^(d)			
Veterans' Affairs	64.8	65.6	1.2
'On-passed' specific purpose payments^(e)	448.3	459.1	2.4

(a) Data is compiled from agency estimates and Commonwealth Budget Paper No. 3 Federal Financial Relations 2004-05.

(b) The estimate for 2003-04 reflects the imposition of funding penalties due to the Commonwealth Government's view that the State failed to fully satisfy NCP requirements.

(c) Roads grants for 2004-05 do not include payments to be made under the Commonwealth's AusLink program, details of which are scheduled to be announced by the Commonwealth in June 2004.

(d) Major Commonwealth contributions to the State are not classified as SPPs. The States also provide services on behalf of the Commonwealth for which the Commonwealth makes contributions (that is fee for service); such minor payments are excluded.

(e) Includes Commonwealth grants for local government, non-government schools and additional First Home Owner Grant (FHOG) payments (2003-04 only).

General purpose payments

GPPs have been provided by the Commonwealth since Federation. From 1985-86 to 1999-2000 the main form of this funding was Financial Assistance Grants (FAGs), 'untied' payments from the Commonwealth that were distributed using CGC relativities.

With the advent of national tax reform, and the introduction of the GST on 1 July 2000, substantial changes were brought about in Commonwealth–State relations. The obligations of the Commonwealth Government and State governments under the new financial arrangements are set out in the IGA, which was signed by the Prime Minister and all State leaders in June 1999.

The IGA reforms provided State governments with all of the revenue generated by the GST, in place of the FAGs and revenue replacement payments previously provided by the Commonwealth to the States. In return the States agreed to the abolition or reduction of a number of State taxes, and to take on the additional expenditure responsibilities of the First Home Owners Grant scheme and GST administration costs.

The new financial arrangements were not expected to provide immediate budgetary benefits to the States. As a result, the IGA provided for a guaranteed minimum amount of funds to be paid to ensure that the States would not be worse off under the new arrangements.

All States required transitional assistance from the Commonwealth in the first two years following the introduction of the GST. However, stronger than expected growth in GST revenues, fuelled to a large extent by growth in the dwellings sector, has brought forward the date by which most States can expect to receive a net benefit from the arrangements.

On present estimates only New South Wales will require transitional assistance in 2003-04, with all States' GST revenues exceeding the guarantee from 2004-05 onwards.

At the time of last year's Budget, South Australia was estimated to gain from tax reform from 2006-07. Since then, upward revisions to GST revenue by the Commonwealth mean that South Australia's GST revenue grants are expected to exceed its GMA from 2003-04 onwards.

Table 4.3 shows the estimated net impact of the national tax reform package in South Australia until 2007-08.

Table 4.3: Estimated impact of national tax reform — South Australia (\$ million)

	GST revenue less GMA^(a)
2003-04	105.5
2004-05	120.5
2005-06	105.0
2006-07	171.9
2007-08	254.3

(a) A guaranteed minimum amount (GMA) is provided under the IGA to ensure that no State is made worse off by the national tax reform arrangements. Calculated on the basis of an agreed formula that takes account of the changes to funding arrangements contained in the IGA, it is based on the pool of funds that would be available had the reforms not been implemented.

South Australia will receive an estimated \$3290 million in GPPs in 2004-05, an increase of \$95 million, or 3.0 per cent, from the \$3194 million estimated to be received in 2003-04. The relatively modest growth in GPPs to South Australia, compared to the national growth in payments of 4.5 per cent, is due to the impact of the CGC's 2004 Review, which reduced South Australia's share of GST revenue.

Table 4.4 shows the effect of revisions to South Australia's GST revenue grants since the Mid-Year Budget Review.

Table 4.4: Estimated impact of revisions to GST revenue grants since Mid-Year Budget Review (\$ million)

	2004-05	2005-06	2006-07	2007-08
GST revenue as at MYBR	3 215.5	3 370.6	3 563.0	3 749.0
Plus				
CGC 2004 Review relativity revision ^(a)	-33.8	-43.9	-54.0	-62.6
Estimated future relativity movements	—	-6.0	1.0	5.8
Commonwealth Budget GST revenue revisions	61.4	49.2	51.9	54.5
Population updates	-0.2	-1.6	-2.2	-1.7
GST revenue as at Budget	3 242.9	3 368.2	3 559.7	3 745.0
Net change since MYBR	27.4	-2.4	-3.3	-4.0

(a) These figures differ from the estimate of \$26.3 million included in Table 4.1, which was calculated by the CGC using the 2003-04 GST pool. In this table, the change in relativities has been applied to the GST pool for the relevant year.

National Competition Policy payments

In April 1995 the Council of Australian Governments (COAG), made up of the Commonwealth and State governments, endorsed the Competition Principles Agreement (CPA).

The CPA puts in place policy elements that are considered essential for a comprehensive national competition policy (NCP). Under the CPA, the South Australian Government is required to review legislation that restricts competition. The basis for such reviews is that legislation should not restrict competition unless it can be demonstrated that:

- the benefits of the restriction to the community as a whole outweigh the costs; and
- the objectives of the restriction cannot be achieved through other means (including non-legislative approaches).

As the revenue benefits of NCP would accrue primarily to the Commonwealth while the States faced the costs of reform, the Commonwealth agreed in 1995 to make additional general revenue payments to the States provided they made satisfactory progress in implementing NCP reforms.

NCP payments began in July 1997, with a real increase in payments in 1999-2000 (second tranche) and again in 2001-02 (third tranche).

COAG confirmed in its November 2000 communiqué that the States' performance in meeting reform obligations will be assessed annually from 2002. Jurisdictions are required to submit an annual progress report to the National Competition Council (NCC), which then makes a recommendation to the Commonwealth Treasurer on NCP payments based on its assessment of progress in implementing reforms. The NCC can recommend a suspension or revocation of NCP payments.

Up until 2002-03, the NCC had recommended that South Australia receive its full distribution of NCP payments, but for 2003-04 it recommended permanent deductions¹ or suspensions totalling \$17.4 million relating to reviews of legislation which restrict competition. This comprised permanent deductions of \$5.8 million for chicken meat and liquor licensing legislative restrictions, a temporary suspension of \$2.9 million for the single barley export marketing desk and a similar temporary suspension of \$8.7 million related to 49 other legislative reviews where reform implementation had not been completed. Temporary suspensions which have not been dealt with by 1 July 2004 may become permanent deductions.

Two main issues are expected to feature in the NCC's assessment for 2003-04 — the COAG water reforms and the remaining legislation reviews not included in the 2002-03 assessment.

In respect of the COAG water reforms, the Treasurer of South Australia has prepared a transparency statement demonstrating the extent to which water pricing arrangements comply with the COAG water reform obligations. This statement has been referred to the Essential Services Commission of SA (ESCOSA) to assess whether or not the processes followed comply with the COAG obligations.

Some of the legislative review issues which it is expected the NCC will examine in its assessment are:

- Liquor licensing

Following the 1997 review of the Liquor Licensing Act, a further review of the two remaining restrictions — the 'proof of need' test which constrains the number of outlets and the requirement that liquor can only be sold from stores devoted entirely to liquor sales — has been completed. The NCC has indicated that the requirement for sales from premises devoted entirely to liquor sales is a trivial restriction and no reform is required. The 'proof of need' test enables competitors to object to the issue of licences on the ground that there is no demonstrated need and permits objections by others if there is likely to be a significant social impact. The Government is considering the report's recommendations in relation to the 'proof of need' test.

- Taxi licence cap

Limitations on the number of taxi licences that may be issued annually may result in supply of taxi services being insufficient to meet the demand. There is no restriction on hire cars which provide similar telephone pre-booked services. The combined supply of passenger transport services by taxis and hire cars is considered to be adequate.

¹ Permanent deductions are irrecoverable reductions in competition payments for the current assessment year. The NCC may recommend that the permanent deduction not be imposed in subsequent years where the Government is assessed as having introduced appropriate reform. In the absence of such reform the NCC is likely to recommend in future assessments that the deductions be ongoing.

- Compulsory third party insurance (CTP)

Although this legislation review was completed some time ago and legislation has been passed confirming sole statutory provider arrangements in South Australia and continuation of community rating, the NCC has so far declined to assess this item. Legislation reviews in all States with sole statutory provider CTP arrangements and one with private providers (Queensland) have found in favour of sole statutory provision.

- Gambling

Gambling is considered a matter of social policy and the general legislative arrangements are not designed to be pro-competitive. In South Australia, these arrangements do not seek to achieve the emergence of a free market in gambling services where the level of, types of, and participants in gambling activity are determined by normal commercial forces.

Exclusive licences are provided to major gambling licensees. These arrangements are subject to compensation arrangements with licence holders involving significant break costs during these exclusivity periods — until July 2015 for the casino and January 2017 for the TAB. There are advantages in respect of probity regulation and harm minimisation to have only one major gambling provider. The case for the continuation of exclusive licences beyond the current exclusivity period will be evaluated toward the end of that time, including having regard to the financial benefit available to the community from granting exclusivity and the regulatory and policy options available to ensure a responsible gambling environment.

It is also considered appropriate that gaming machine licences be available only to hotels and clubs on a harm minimisation basis, restricting the prevalence and clearly delineating the location of gaming venues.

- Barley marketing

Under the existing legislation, export sales of barley must be conducted through the Australian Barley Board (ABB). The 2003 Round Committee's NCP review of the export barley marketing arrangements recommended examination of a licensing model similar to that adopted by Western Australia. A comprehensive appeal was lodged in September 2003 with the Federal Treasurer against the NCC's recommendation of an annual suspension of competition payments of \$2.9 million. The NCC Secretariat has since advised that it has no objection to SA's request for an extension of time in order to allow the completion of a number of legislation reforms, including in respect of barley.

A PIRSA Task Force is examining ways of reviewing current accountability and transparency issues for ABB Grain Ltd and examining the feasibility of a licensing model. Some legislative amendments are expected to be introduced in the 2004 spring session of Parliament to clarify long standing issues.

- Chicken meat

New legislation introduced in 2003 provided for compulsory mediation and compulsory arbitration of disputes between growers and processors. A permanent deduction of \$2.9 million of NCP payments relates to these provisions. Discussions are being held with the NCC to resolve its concerns.

- **Ownership restrictions**

Legislation governing a number of health and other professions, including dentists, currently restricts ownership of practices to qualified practitioners and their spouses. These restrictions are in the process of being removed and replaced by provisions prohibiting the exercise of undue influence by the owner of the professional practice. The Minister has discretion to approve exemptions for ownership of dental practices. Ownership restrictions applying to pharmacies will not be reconsidered until mid-2005.

Review of NCP

The Commonwealth Treasurer has recently provided terms of reference to the Productivity Commission for an inquiry into NCP arrangements, with a view to informing the Council of Australian Governments' review of the NCP due by September 2005.

Specific purpose payments

SPPs are provided under Section 96 of the Constitution for both recurrent and capital expenditure purposes. In 2004-05, South Australia will receive an estimated \$1840 million of funding in this form — an increase of 2.9 per cent from the \$1788 million estimated for 2003-04.

Of the total SPPs to be received by South Australia in 2004-05, \$459 million (or 25 per cent) will be 'on-passed', predominantly to non-government schools and local government. This represents an increase of 2.4 per cent from the amount received in 2003-04, primarily reflecting increases in payments to non-government schools.

SPPs 'to' the State (for a range of purposes including health, housing and government schools) are forecast to increase to \$1381 million in 2004-05, with the largest increases in health care grants, government schools grants and roads funding.

The allocation of SPPs among the States is based on many approaches, including Commonwealth discretion, historical allocation and formula-based allocation. The CGC takes the distribution of most SPPs into account in its recommendations for allocating general revenue assistance. For these 'included' SPPs, South Australia in recent years has received slightly in excess of its population share, resulting in a small reduction in its general revenue grants share.

Health

The previous Australian Health Care Agreement (AHCA) expired on 30 June 2003.

The States initially rejected the Commonwealth's new funding offer as it was less than expected (over \$900 million less than would have been received under the previous arrangement), included expenditure matching and reporting conditions that had not been present in previous AHCA's and introduced funding penalties for States that refused to sign the new agreement.

Despite the shortcomings of the Commonwealth offer, all States signed the new AHCA in late 2003 in order to avoid the funding penalties. It will operate for five years, expiring on 30 June 2008.

South Australia is estimated to receive \$667 million in AHCA funds in 2004-05, an increase of 4.7 per cent over the previous year.

Disability services

As part of the new Commonwealth–State/Territory Disability Agreement (CSTDA) offer, the Commonwealth asked States for a commitment to match its growth and indexation funding for the CSTDA of an average of 6.27 per cent per annum over the life of the Agreement. This was a major sticking point with all States.

The Commonwealth only provides 30 per cent of CSTDA funding, including substantial funding of Commonwealth–administered employment services. The States considered that the prescription of what they must spend on their own resources removed flexibility to shift funds between programs to achieve the best overall service provision. In the absence of a new agreement, the Commonwealth rolled over the old agreement to 2003-04.

Following negotiations with the Commonwealth, all States have now signed the new CSTDA. South Australia negotiated an acceptable level of State growth and indexation, approximately 5.0 per cent per annum, prior to signing the agreement.

South Australia is expected to receive \$63 million from the CSTDA in 2004-05, an increase of 2.6 per cent over the previous year.

Housing

Commonwealth housing assistance to the State is provided through the Commonwealth–State Housing Agreement (CSHA). These funds are used for public, community and Aboriginal housing, and the South Australian Housing Trust's smaller programs of private rental support and supported tenancies. The agreement provides for Commonwealth grant funds, distributed among the States on a per capita basis, to be matched by a State contribution.

The previous CSHA expired on 30 June 2003. An offer for a new agreement covering the five years to 2007-08 was received from the Commonwealth in November 2002 and was agreed to at the multi-lateral level by all States in mid-2003.

The main issues for the States in the offer included continuation of the 1.0 per cent per annum 'efficiency dividend', the discontinuation of the previous GST compensation component and the new provisions that make 5.0 per cent of funds contingent on States meeting reporting requirements and achieving a set of 'planned outcomes'. The one positive in the offer was the introduction of indexation, which will halt the steady decline in CSHA funds brought about by the application of the 'efficiency dividend' in the previous agreement.

The withdrawal of GST compensation funding means a significant real decrease in housing funding under the proposed new agreement. In 2004-05 it is estimated that CSHA funding assistance to South Australia will be \$72 million, a marginal increase (1.3 per cent) from the previous year, but still a reduction of almost \$10 million compared to that received in 2002-03 — the final year of the previous agreement.

Roads

The majority of SPPs for roads are made under the Australian Land Transport Development program, which incorporates specific funding for national highways, roads of national importance and black spots. Minor funding is also provided under the *Interstate Road Transport Act 1985*, and the Roads to Recovery program.

South Australia is estimated to receive approximately \$78 million in roads funding in 2004-05. This represents an increase of 23.1 per cent over the funds provided in 2003-04 and is due primarily to the provision of funding towards the Port River Expressway under the Roads of National Importance program. Despite this considerable increase, South Australia still receives a funding share significantly less than its share of the length of national highways.

In November 2002, the Commonwealth released a proposal for changed transport infrastructure funding which it called AusLink. It is designed to deliver an integrated inter-modal land transport network. At this stage, it is still unclear what implications will follow for State funding, as the Commonwealth is not expected to release details of State-by-State funding under the AusLink program until June 2004.

Schools

Recurrent and capital grants are provided to the States for both government and non-government schools. Recurrent school grants are provided mainly as block grants and are supplemented annually in line with movements in the Average Government School Recurrent Cost (AGSRC) Index based on data maintained by the Ministerial Council on Education, Employment, Training and Youth Affairs. The Building Price Index published by the Australian Bureau of Statistics (ABS) is used to index capital grants.

With the current schools SPP agreements due to expire on 31 December 2004, the Commonwealth announced in March an outline of its offer for the quadrennium 2005-2008. The offer retains the AGSRC index, which the Commonwealth estimates will continue to deliver growth in funding levels to government schools of around 6.0 per cent per annum. The offer also contains some new matching and reporting requirements, the full details of which are yet to be provided.

On the basis of the new offer, the Commonwealth estimates that SPPs in 2004-05 for government schools will be \$178 million, an increase of 6.0 per cent from 2003-04. SPPs for non-government schools are estimated to be \$376 million, an increase of 10 per cent. The trend of an increasing share of SPPs for non-government schools is expected to continue, reflecting the Commonwealth Government's policy initiatives in this area.

Vocational education and training

The development and maintenance of the national vocational education and training (VET) system is funded by both the Commonwealth and the States, with Commonwealth-State funding arrangements set out in the ANTA agreement.

The previous ANTA agreement expired on 31 December 2003. All States rejected the Commonwealth's offer for the period 2004-2006 and the previous agreement has been rolled over for 2004. It is expected that negotiations for an agreement for the 2005-2007 triennium will commence later this year.

SPP reform

The States have for some time been concerned about the conditions imposed on SPPs, including maintenance of effort and matching conditions and targets that are often expressed in terms of inputs (that is dollars spent), rather than more meaningful measures such as outcomes/outputs achieved.

The extremely complex structure of many SPP arrangements also creates a lack of clarity about a State's obligations, distorts program objectives and activities, and creates unnecessarily high administrative overheads. The funding arrangements need to be simplified.

A Heads of Treasuries SPP working group, consisting of officials from Commonwealth and State Treasuries and the Commonwealth Department of Finance and Administration, was formed in 1999 to address these issues. To date, the following progress has been made:

- All State governments have adopted a set of 'best practice' SPP principles, which are aimed at producing simpler, more transparent agreements that are outcome, rather than input, focused.
- The Commonwealth has indicated that it supports the broad objective of the SPP principles to improve the efficiency and effectiveness of SPP arrangements. However, it is not prepared to endorse them as it considers input controls are necessary to guarantee the achievement of its specific policy objectives and are the most effective means of managing its financial risks.
- The working group is undertaking related case studies that will:
 - examine the use of performance indicators within an outputs/outcomes accountability framework for SPPs;
 - explore an SPP framework that will provide the best service delivery outcomes for the community, improved resource allocation and efficiency, and a basis for the assessment of Commonwealth objectives; and
 - provide empirical evidence of the impact that SPP maintenance of effort and matching conditions have on State budget flexibility.

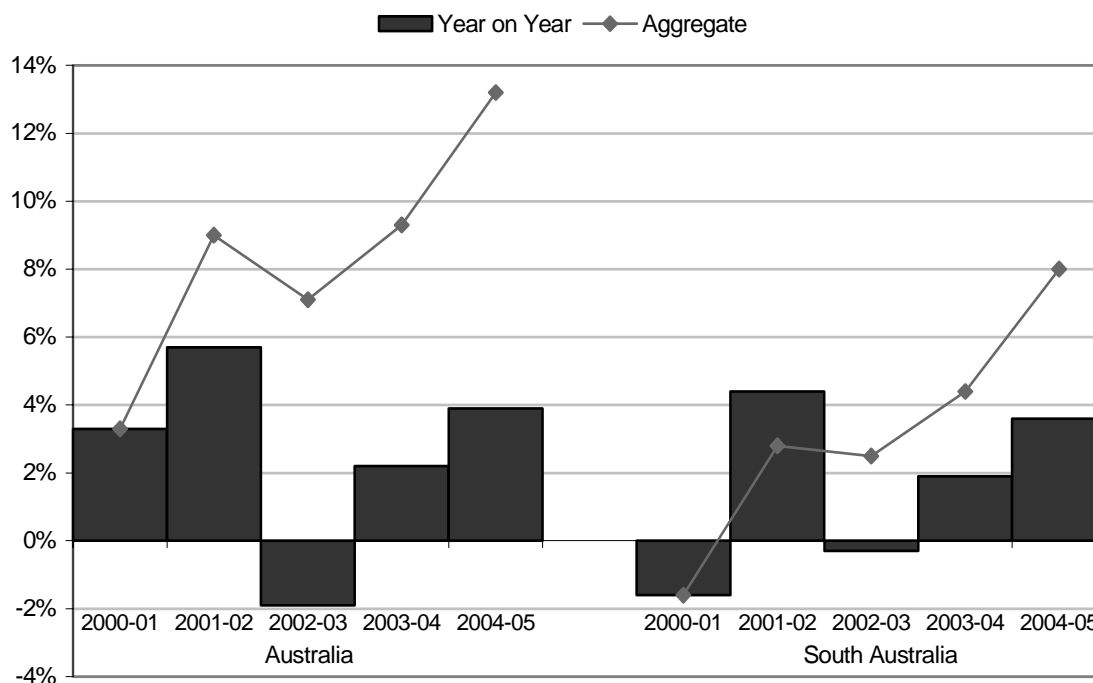
In addition, the State members of the SPP working group monitor renegotiations of major SPPs to check consistency with the SPP guidelines, and the level of SPPs to ensure that the Commonwealth is continuing to honour its commitment under the IGA not to cut aggregate SPPs as part of the national tax reform arrangements.

On the basis of current 2004-05 Commonwealth Budget estimates, the Commonwealth is meeting its commitment. Figure 4.1 shows the growth in SPPs in real per capita terms since 1999-2000. It indicates that, although meeting the 'aggregate SPP' benchmark, total SPPs fell in real per capita terms in 2002-03. This is of concern to States as it indicates that the year-to-year volatility inherent in pre-tax reform SPPs may continue.

For South Australia the 1999-2000 level of SPPs included unusually high levels of road grants and 'one-off' funding for a number of large capital projects, which explains the poor

performance against the benchmark in 2000-01. From 2001-02 onwards the Commonwealth has been meeting its commitment to South Australia in real per capita terms.

Figure 4.1: SPPs — growth in real^(a) per capita terms since 1999-2000^(b)



(a) In accordance with Ministerial Council agreement, nominal values are deflated using the national CPI.

(b) For consistency, data for Australia and South Australia has been sourced from Commonwealth Budget Paper No. 3 Federal Financial Relations 2004-05.

Local government finances

This section provides information on the overall financial performance and position of local government in South Australia and the financial relationships local government has with both the Commonwealth and the State Government.

Financial performance and position

The financial performance data shown in Table 4.5 is presented using a simplified ABS Government Finance Statistics framework. The data is drawn from the annual financial statements of councils which are prepared in compliance with Australian Accounting Standard (AAS) 27 and in a format prescribed by regulations under the Local Government Act. Consistent with an agreement between the Commonwealth and the States whereby each jurisdiction presents financial information on a Uniform Presentation Framework (UPF) basis, some councils in South Australia also have begun to provide a common core of financial information (similar to Table 4.5) in their budget papers and financial statements to enable more meaningful comparisons of each council's finances.

Table 4.5: Local government operating statement (\$ million)

		1998-99	1999-2000	2000-01	2001-02	2002-03
	Operating revenue	799	855	901	966	1 039
<i>less</i>	Operating expenses ^(a)	884	930	976	1 021	1 091
<i>equals</i>	Operating deficit	-85	-75	-75	-55	-52
<i>add</i>	Capital revenue ^(b)	44	56	50	79	97
<i>equals</i>	Net surplus (+)/deficit (-) resulting from operations ^(c)	-41	-19	-25	24	45
<i>less</i>	Acquisition of non-current assets ^(d)	181	217	206	274	322
<i>add</i>	Depreciation of non-current assets	210	218	227	247	258
<i>equals</i>	Accrual net lending (+)/ borrowing (-)	-12	-18	-4	-3	-19

(a) Operating expenses include depreciation and the value of non-current assets donated by councils, but exclude book losses on the sale or revaluation of non-current assets.

(b) Mainly Commonwealth grants for local roads and the value of non-current assets donated to councils.

(c) This measure essentially is equivalent to the 'net operating balance' measure used under the ABS Government Finance Statistics framework.

(d) Capital investment expenditure on non-current assets (new and replacement) and the value of non-current assets donated to councils, less proceeds from sale of non-current assets and the value of non-current assets donated by councils.

As shown in Table 4.5, local government as a whole is consistently returning a relatively small accrual net borrowing result. The level of annual operating deficits is reducing steadily as many councils seek to raise more revenue for an increasing level of asset replacement/rehabilitation works. Local government taxation revenue (from general rates on property) is expected to be approximately \$700 million in 2003-04. Together with other own-source funding (for example user charges, investment income), in excess of 85 per cent of local government operating revenue is from its own sources. In real terms, operating revenue for local government increased by 16.8 per cent over the four-year period from 1998-99 to 2002-03. Total operating expenses increased in real terms by 10.8 per cent over the same period.

Table 4.6 shows an abridged balance sheet for local government as a whole as at 30 June 2001, 2002 and 2003.

Table 4.6: Local government balance sheet (\$ million)

	30 June 2001	30 June 2002	30 June 2003
Assets			
Cash, investments and loans to community groups	146	171	184
Receivables	48	58	66
Inventories	27	29	26
Land, buildings, road infrastructure & other non-financial assets	8 002	8 453	8 805
Other	18	19	23
Total Assets	8 241	8 730	9 104

Table 4.6: Local government balance sheet (\$ million) continued

	30 June 2001	30 June 2002	30 June 2003
Liabilities			
Payables	80	88	108
Borrowings, deposits held, finance leases etc	365	391	418
Employee entitlements	70	73	79
Other	13	16	12
Total Liabilities	528	568	617
Net Worth	7 713	8 162	8 487
Net Debt ^(a)	219	220	234

(a) Net debt equals the sum of borrowings, deposits held, finance leases etc minus the sum of cash, investments and loans to community groups.

Local government net debt at 30 June 2003 was \$234 million which is equivalent to 22.5 per cent of local government's operating revenue in 2002-03. Net debt per capita was \$154 at 30 June 2003. Put in the context of local government physical assets, with a value of \$8.8 billion, local government in South Australia (in an aggregate sense) is in a sound financial position. Local government superannuation liabilities are fully funded.

With assistance in various ways from the State Government, the Local Government Association (LGA) in South Australia has created a number of financial institutions to manage, on behalf of councils, a range of commercial arrangements. These include the Local Government Finance Authority, the LGA Mutual Liability Scheme, the Local Government Superannuation Scheme, and the LGA Workers Compensation Scheme. At 30 June 2003 these institutions were managing assets valued at nearly \$1.2 billion and had a combined net worth of \$63 million. These amounts are not included in Table 4.6.

Financial relationships with Commonwealth and State governments

Commonwealth Government

The Commonwealth provides both general and specific purpose payments to local government in South Australia.

The general purpose payments are made to the State and 'on-passed' to councils on the recommendations of the South Australian Local Government Grants Commission. Arrangements for the payment of these untied financial assistance grants to councils are embodied in the Commonwealth's *Local Government (Financial Assistance) Act 1995*. The financial assistance is provided in two parts — general purpose grants and identified local roads grants. For South Australia, these grants are estimated to be \$107.2 million in 2004-05, consisting of \$81.3 million in general purpose funding and \$25.9 million in untied local road funding. The Act provides for the allocation of grants to councils within the State on the basis of HFE principles, subject to a minimum grant provision, which requires that each council receives, as a minimum, 30 per cent of its per capita share of the general-purpose pool.

During 1997-98, the South Australian Local Government Grants Commission conducted a comprehensive review of the methods used to distribute the grants within the State.

Changes are being phased in over a seven-year period, concluding with the determination of grants for 2004-05.

Commonwealth specific purpose payments to local government are estimated to be \$25.9 million in 2004-05, which includes \$20.8 million under the Roads to Recovery program and an extra \$4.25 million for local road funding. The extra \$4.25 million is part of an additional \$26.25 million to be provided over three years, as an interim measure, to address the State's current unfair share of identified local road grants being received under the Commonwealth's *Local Government (Financial Assistance) Act*. The decision by the Commonwealth to provide these additional funds follows a substantial campaign by the State Government, the Local Government Association and councils and will ensure that, by 2006-07, the State's overall share of local road funding will align with the State's share of local road grants (8.3 per cent) under the Roads to Recovery program.

State Government

In mid-2002, the State Government established the Minister's Local Government Forum. The Forum's role is to provide advice on key issues at the interface between State and local government and to facilitate solutions to identified problems of significance to both spheres of government. Specific priority issues are being addressed in areas such as stormwater management and flood mitigation, septic tank effluent drainage schemes and strategic assessment and supply of public land.

During 2003-04, a State-Local Government Relations Agreement was established to improve consultation arrangements and communication practices and to build more productive and collaborative working relationships between the State and local government.

In relation to financial arrangements between the State and local government, there have been suggestions that, by comparison with interstate jurisdictions, South Australian councils receive a lower level of State government financial support. It is a complex matter to compare the arrangements applying in each State.

First, accounting differences in recording and reporting payments to councils can limit the extent of comparison possible. For example, some jurisdictions provide 'grants' to councils for expenditure on maintaining State-owned roads. In South Australia, payments to councils of this nature take the form of a 'fee for service' and are recorded as State expenditure on roads.

Second, the allocation of responsibilities and functions undertaken by the State and local government varies considerably between jurisdictions. By comparison with interstate local government jurisdictions, the set of functions undertaken by South Australian councils is relatively limited.

Third, analysis in this area needs to take account of any activity which was previously the joint responsibility of the State and local government and which now has been taken over by the State. This can lead to significant expenditure reductions for councils.

Table 4.7 sets out arrangements under which the State provides grants and subsidies to councils (including for State programs) or payments to councils for local government or joint State-local government programs. Amounts included in the table do not include funding that is provided by the Commonwealth to the State and 'on-passed' to local government.

Table 4.7: Specific purpose payments from the State to local government (\$'000)

Program/purpose	2003-04 Estimated result	2004-05 Budget
Premier and Cabinet		
Cultural Facilities and Equipment Program	33 ^(a)	35 ^(a)
Festivals, Events and Commissions Program	—	10 ^(a)
Natural Disaster Mitigation Program	—	700 ^(a)
Public Art and Design Program	21 ^(a)	25 ^(a)
Public Art and Design Program – Western Gateway Project	143	300
Public Library Services	14 901	15 264
Trade and Economic Development		
European Wasp Program	70	70
Septic Tank Effluent Drainage Scheme	3 050	3 050
Supporting Rural Councils Program	75	—
Treasury and Finance		
Ad hoc assistance for disasters and other adverse events	640	1 110
Justice		
Regional Crime Prevention Program	600	600
Primary Industries and Resources		
Contribution to administration of Municipality of Roxby Downs	525	525
Subsidy of electricity provision at Coober Pedy	3 010	3 010
Administrative and Information Services		
Community Recreation and Sport Facilities Program	873 ^(a)	— ^(b)
Human Services		
Community Capacity Building – Salisbury North Project	23	23
Council rate concessions for pensioners, self-funded retirees and other eligible groups	37 267	38 646
Family and Community Development Program	624	640
Home and Community Care Program	2 823	3 148
Integrated Youth Strategy – Youth Advisory Committees	160	250
National Youth Week	101	100
Parks Community Centre – Grant to City of Pt Adelaide Enfield	1 790	1 790
Transport and Urban Planning		
Metropolitan Open Space System Program	1 500	1 400
North Terrace Upgrade Stage 1	3 000	1 900
Places for People Program	1 500	1 500
Provincial City Bus Services	964	988
Regional Open Space Enhancement Scheme	1 000	1 000
Regional Roads Program	700	700
State Bicycle Fund	200	410
State Black Spot Program – Safer Local Roads	1 750	1 630
TravelSmart SA Program	300	300
Further Education, Employment, Science and Technology		
Broadband SA Program	—	— ^(b)
Digital Bridge Program	—	200
Youth Traineeship Program – Local Government Trainees	168	375
Environment and Conservation and the River Murray		
Accelerating Local Sustainability Program	10	10
Catchment Management Subsidy Scheme	3 025	4 900
Coast Protection Board grants (mainly regional councils)	306	— ^(c)
Heritage Cemeteries Fund	26	25
Local Heritage Reviews	5	30
Local Sustainability Exchange Scheme	40	—
Metropolitan Council Coast Protection Works	620	— ^(c)
State Heritage Fund grants	20 ^(a)	50 ^(a)
Total	81 863	84 714

(a) The portion of funding for the program which was allocated to local government, or which is estimated will be allocated.

(b) Funding in 2004-05 dependent on the success of any applications received under a competitive grants process.

(c) Budget for 2004-05 program not yet determined.