

APPENDIX A

Vertical fiscal imbalance

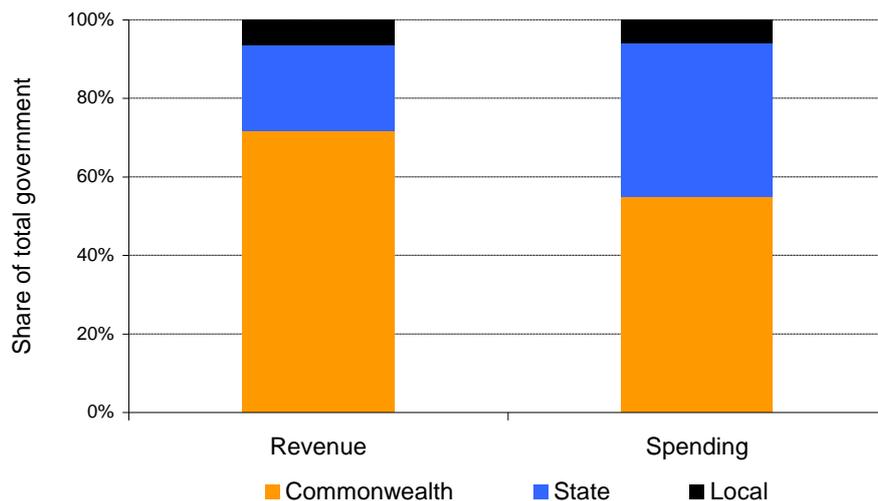
Australia's federal financial relations are marked by a high degree of vertical fiscal imbalance (VFI). VFI refers to the significant mismatch between:

- the States' large spending responsibilities but limited revenue capacity and
- the Commonwealth Government's capacity to raise much more revenue than it requires for its own expenditure needs.

VFI in Australia

In 2008-09, the Commonwealth Government accounted for around 72 per cent of own-source revenue raised by all levels of government, but was responsible for only 55 per cent of government own-purpose spending. State Governments accounted for around 22 per cent of own-source revenue and around 39 per cent of own-purpose spending (see Chart 1). Own-source revenue is revenue excluding grants from other levels of government. Own-purpose spending is spending excluding grants to other levels of government.

Chart 1: Own-source revenue and spending, by level of government: Australia, 2008-09



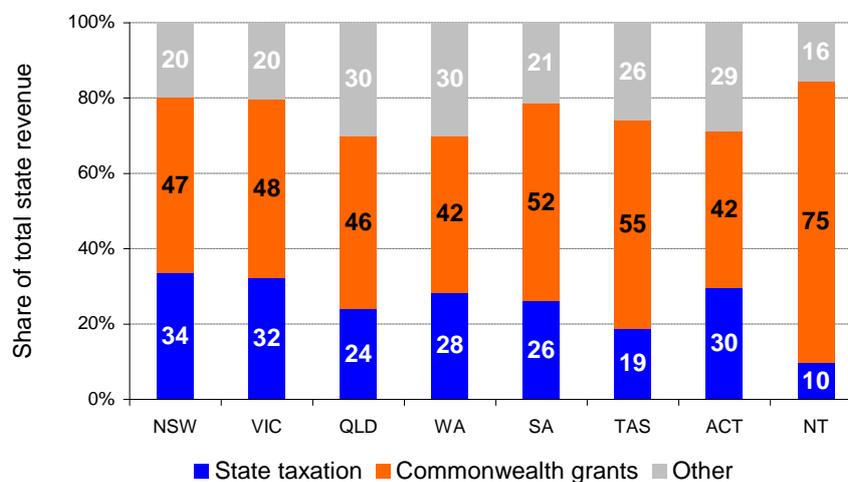
Source: NSW Treasury estimates based on ABS, *Government Financial Statistics, 2008-09* (Cat. No. 5512.0) and Australian Government, *Final Budget Outcome, 2008-09*.

The mismatch of spending responsibilities and revenue-raising capacities between the Commonwealth and State Governments produces a need for large financial transfers between levels of government.

- In 2008-09, the Commonwealth Government's grants to other levels of government totalled \$84 billion, of which around \$80 billion went to State Governments (with the remainder going to local government, either directly or 'through' the States). In other words, over a quarter (around 27 per cent) of total Commonwealth Government revenue of \$298 billion in 2008-09 was transferred as grants to State Governments.

- On the other side of the coin, in 2008-09 State Governments as a whole in Australia received nearly half (around 47 per cent) of total revenue from the Commonwealth Government. For individual States, the share of total revenue received from the Commonwealth Government ranged from 42 per cent for Western Australia and the Australian Capital Territory to 75 per cent for the Northern Territory (see Chart 2).

Chart 2: Composition of State revenue: 2008-09



Source: NSW Treasury estimates based on ABS, *Government Financial Statistics, 2008-09* (Cat. No. 5512.0) and state final budget outcomes for 2008-09. Other includes sales of goods and services, interest income, dividends and tax equivalents, regulatory fees and fines, royalties and other revenues.

The extent of VFI has increased since the introduction of the GST in July 2000, as GST payments from the Commonwealth Government have been substituted for revenue formerly raised by the states, such as financial institutions duty and debits tax and revenue replacement payments.¹

- In 1999-2000, the Commonwealth Government's payments to the States totalled \$31 billion (excluding payments 'through' the states and revenue replacement payments). This was equivalent to around 19 per cent of total Commonwealth Government revenue of \$167 billion.
- In 1999-2000 State Governments as a whole in Australia received a third (around 34 per cent) of total revenue from the Commonwealth Government. For individual States, the share of total revenue received from the Commonwealth Government ranged from 31 per cent for New South Wales and Victoria to 69 per cent for the Northern Territory.

¹ Revenue replacement payments, which replaced state franchise fees on petrol, tobacco and liquor in 1997, continued to be recorded as state taxation revenue in the ABS's *Government Financial Statistics*.

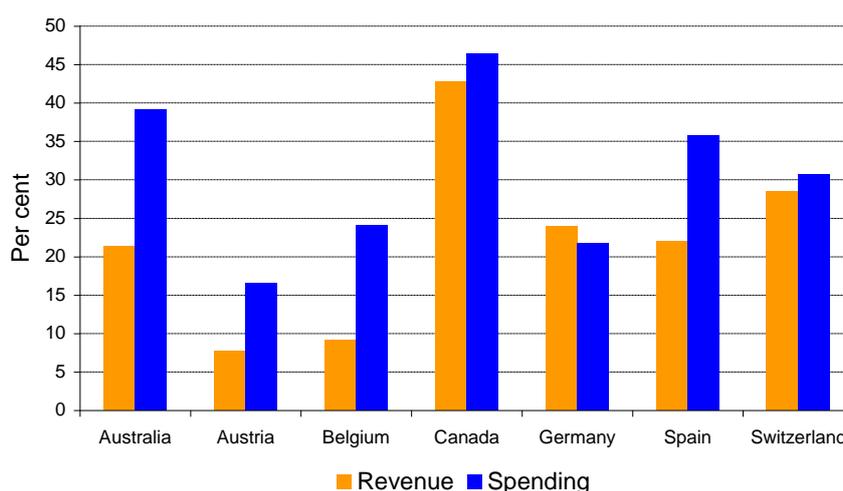
VFI and financial transfers in other federations²

The extent of VFI, and resultant fiscal transfers, is generally higher in Australia than in other federations. The level of VFI in Australia is less than that in Austria and Belgium, but considerably higher than that in Canada, Germany, Spain and Switzerland.

Chart 3 compares State shares of total government revenue and spending across a number of federations for the financial year 31 December 2007 for Austria, Germany, Canada and Spain and 31 December 2006 for Belgium and Switzerland. Data for Australia for the year ending 30 June 2007, from the same source, is included for comparative purposes.

- Australia's States accounted for 21 per cent of total government revenue and 39 per cent of total government spending, with a gap of 18 percentage points between the two.
- The state share of total government revenue was lower than Australia's in only Austria and Belgium and virtually the same in Spain. All other federations considered here have a higher state share of total government revenue.
- At the same time, the State share of total government spending was higher than Australia's only in Canada, with most federations having a substantially lower state share of spending.
- Putting the two together, the absolute gap between State shares of total revenue and total spending was highest in Australia, while the relative gap was higher only in Austria and Belgium.

Chart 3: *State government own-source revenue/own-purpose spending as a share of total government revenue/spending, 2007*



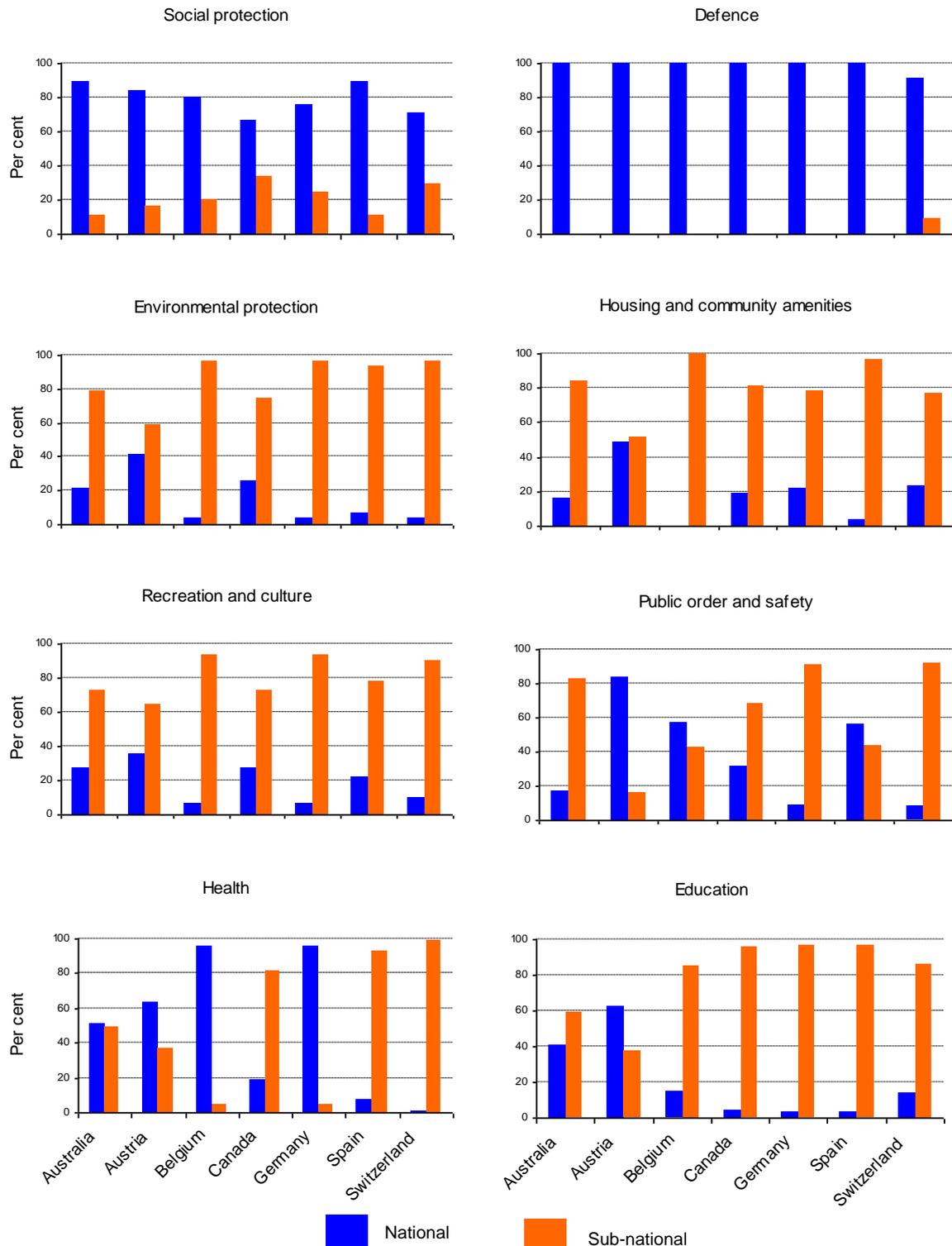
Source: International Monetary Fund (IMF), *Government Finance Statistics Yearbook, 2008*.

Gaps between revenue raising and expenditure responsibilities can lead to shared responsibilities between levels of government for funding and/or service delivery in particular functions.

² This section is based on, and updates data provided in, Neil Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements*, May 2006. Other parts of this submission also draw heavily on that report, which was commissioned by the NSW Treasurer on 5 March 2006.

Chart 4 presents data on national and sub-national government shares of spending in major functional areas in a number of federations.

Chart 4: National government and sub-national government expenditure shares by major policy functions



Source: Data for all countries from IMF, *Government Finance Statistics Yearbook, 2008*. Australian data is for 2006-07, Austria and Belgium 2005, Canada 2006-07 (fiscal year ends 31 March), Germany and Spain 2007 and Switzerland 2006. Sub-national refers to state and local governments. The categories general public services and economic affairs were excluded given their general nature.

In most federations considered here, either national or sub-national governments dominate spending in most major functions.

- Across all countries, national governments dominate in social protection and defence.
- In all countries except Austria, and to a lesser extent Australia and Canada, sub-national governments dominate in environmental protection, housing and community amenities and recreation and culture.
- In public order and safety, health and education, one level of government dominates, though in different countries it can be the national or sub-national governments.

Australia and Austria stand out as having spending split (in the 50/50 or 60/40 ranges) between national governments and sub-national governments in the categories of education and health. Belgium and Spain, and to a lesser extent Canada, split public order and safety spending between national and sub-national governments.

Reasons for VFI in Australia

The mismatch between revenue raising capacities and the spending responsibilities of the national and state governments in Australia results from the provisions of the Australian Constitution, the High Court's interpretation of those provisions and conventions established since federation. These factors have tended to constrict the revenue raising capacities of the states, while leaving them with responsibility for providing the main services – like hospitals, schools, roads and other transport facilities, police and justice services – used by Australians on a day-to-day basis.

Revenue raising

Australia's tax system is highly centralised. The broadest tax bases – personal and corporate incomes and goods and services – are dominated by the Commonwealth Government, with the States left to rely on comparatively narrowly-based and inefficient transactions taxes like stamp duties.

The Constitution gives the Commonwealth Government (under section 90) exclusive power to impose excise and customs duties. Initially this was interpreted by the High Court to mean taxes on the production of goods. In 1997 the High Court decided that the tax included distribution and sale as well as production, effectively eliminating state business franchise fees, which at the time accounted for about 15 per cent of the States' own-source revenue.

The impediments to State income taxation are not legal but practical, with the national government dominating this revenue raising source. The States began taxing income in 1895. The Commonwealth first taxed incomes during the First World War. Between the world wars, income tax was a more important source of revenue for the States than the Commonwealth Government.

States levied income taxes up until 1942 when as a war measure the Commonwealth overrode the state income tax powers. States have never resumed income taxation: they have been limited either by conditions placed by the national government on its payment of grants to the States or by the Commonwealth Government's unwillingness to reduce its income tax take to accommodate State income tax.

Section 109 of the Australian Constitution provides that, where there is a conflict between a law of a State and a law of the Commonwealth on any matter, the Commonwealth law takes

precedence and the State law is invalid. The Commonwealth has used the precedence given to its laws to force states to vacate a number of fields of taxation.

For example, between 1895 and 1910, States levied land taxes. In 1910 the Commonwealth imposed its own land tax and used section 109 to make State land tax laws invalid. Land tax was returned to the States in 1956 after the Commonwealth abandoned land tax in 1952.

Subject to the prohibition on State excise taxes, the Commonwealth can also vacate tax fields and allow States to occupy them. Payroll tax was a Commonwealth tax until 1971. It was abandoned by the Commonwealth and implemented by the States as a trade off to prevent States from implementing a broad based receipts duty. In 1982 the Commonwealth abandoned its Bank Accounts Debits (BAD) tax allowing the States to take over this tax base.

Under the Intergovernmental Agreement that accompanied the introduction of the GST the States agreed to abolish certain taxes and not to reimpose them in exchange for the revenue from the GST. While the taxes abolished were relatively inefficient, the IGA does constrain States' tax flexibility.

Spending responsibilities

The Constitution provides the Commonwealth Government with a limited number of exclusive powers and non-exclusive powers in a wide range of areas, like trade and commerce with other countries and among the states; taxation; communications; defence; banking; insurance; foreign corporations, and trading or financial corporations formed within the limits of the Commonwealth; conciliation and arbitration for the prevention and settlement of industrial disputes extending beyond the limits of any one state, and so on. State Governments can also make laws in these areas, but in cases of inconsistency, Commonwealth laws prevail.

State Governments retain responsibility for areas not mentioned in the Australian Constitution, like education, health, the environment and roads.

However, the trend since federation generally has been for the Commonwealth Government to broaden its influence into these areas of traditional State responsibility through the use of specific purpose payments (SPPs). Control over funding for specific purposes has given the Commonwealth Government policy input into these areas. In the past, SPP funding often came with matching funding conditions that further constrained States' budget flexibility, though the greater flexibility and focus on outcomes rather than inputs in the National Agreements that accompanied COAG's reform of SPPs agreed in November 2008 was directed at addressing this issue.

Consequences

An excessive degree of vertical fiscal imbalance (VFI) and shared responsibilities for funding and/or service delivery can have a number of undesirable consequences.

In breaking the connection between government decisions on the level of service provision and the revenue that needs to be raised to fund VFI can weaken government accountability to the public. Confusion regarding which level of government is responsible for which government services can further blur accountability, produce an inadequate or inappropriate funding of services and slow the responsiveness of governments to the needs of their communities.

Bureaucratic overlap, duplication and excess and the cost of administering grants between governments can waste resources

Australia's high level of VFI leaves states with no policy control over a large proportion of their revenues. Moreover, dependence on the Commonwealth Government for funding gives the Commonwealth Government considerable leverage in extending its policy influence into functional areas over which it does not have primary responsibility.

There is a strong argument to be made that responsible government is enhanced when taxing powers and spending responsibilities are closely aligned.

The closest possible alignment of taxing powers and spending responsibilities enhances transparency and accountability, reducing the potential for popular confusion over the respective funding and service delivery roles of national and state governments. It enhances the environment for the cost-effective delivery of government services reflecting community preferences and local conditions.

Where a clear assignment of tax powers between levels of government cannot be aligned with spending responsibilities, intergovernmental fiscal transfers will be required. The transfer mechanism/allocation formula should be easily understandable and administered, should not reduce the incentive for States to provide services efficiently, and should reinforce the accountability of States for the provision of services for which they are responsible.

Horizontal fiscal equalisation

Payments from the Commonwealth Government to the States in Australia take the form of general revenue payments – which can be used by the States for any purpose – and specific purpose payments – which must be used by the States for purposes, either broadly or more narrowly, defined by the national government. In 2008-09, total payments from the Commonwealth to State Governments of \$84 billion were split half and half between specific purpose payments (\$41.7 billion) and general revenue payments (\$42.4 billion).³

Horizontal fiscal equalisation (HFE) is the principle that guides the distribution of GST revenue among the states. GST revenue payments account for the vast majority of federal general revenue payments to the states (\$41.2 billion in 2008-09).

Broadly, HFE seeks to equalise States' capacities to provide services to their residents. It seeks to do so by adjusting the payment of GST revenue to the states for the 'disabilities' that States face in raising their own revenue or providing services to their populations. States' disabilities are those non-policy factors of demography, geography or economic environment that may reduce a state's ability to raise its own revenue or increase a State's costs of service delivery relative to other States.

Australia's definition of equalisation

The definition of HFE has evolved significantly over time. Initially, when it was set up in the early 1930s, the Commonwealth Grants Commission (CGC) determined special grants to states in financial need. These grants were determined 'by the amount of help found necessary to make it possible for that State by reasonable effort to function at a standard not appreciably below that of other States.'⁴

³ Australian Government, *2008-09 Final Budget Outcome*, p. 59.

⁴ Garnaut, R and V FitzGerald, *Review of Commonwealth-State Funding – Final Report*, 2002, p. 33. The Garnaut-FitzGerald report was commissioned by the Governments of New South Wales, Victoria and Western Australia in November 2001.

Over time the CGC has moved to the current position of attempting to make assessments across all areas of states' revenues and expenditures and attempting to achieve full equalisation of capacity to provide services at the same standard.

In the 2010 Review of GST Revenue Sharing Relativities, the CGC revised the definition of HFE further to:

State governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.⁵

In practice, this means that equalisation now extends to revenue capacities, expenditure needs and the capacity of states to have equal per capita stocks of infrastructure assets and net financial assets.

The CGC has extended equalisation beyond operating statement concepts of revenues and expenditures and into balance sheet concepts of physical assets and financial worth.

International comparisons

Most federations have some form of fiscal redistribution designed to assist the fiscally weaker states in providing services. However, other comparable federations do not attempt to equalise as fully or undertake as comprehensive a system of fiscal equalisation as Australia.

Australia attempts to equalise the fiscal capacity of the States to provide services and the associated infrastructure 'at the same standard'. This is not the objective in other federations.

- In Canada the objective is 'reasonably comparable levels of public services at reasonably comparable levels of taxation across provinces.'
- In Germany, the objective is 'to equalise the differences in financial capacity of states.'
- In Switzerland, the objective is 'to provide minimum acceptable levels of certain public services without much heavier tax burdens in some cantons than others.'

Australia's system of fiscal equalisation is comprehensive. Australia equalises both revenues and expenditures and, as noted earlier, the CGC in the 2010 Review expanded the scope of equalisation to include the capacity of States to hold equal per capita stocks of infrastructure assets and net financial assets. In other federations, the scope of equalisation is less comprehensive. Canada and Germany equalise on the revenue capacity side only.

Consequences

The consequences of Australia's attempt at total and comprehensive fiscal equalisation are large cross-subsidies paid by the larger to the smaller States; a complex and data intensive method of equalisation yet one which still relies on large measures of judgement; and a method of equalisation which potentially has significant adverse impacts on resource allocation in Australia.

⁵ CGC, *Report on GST Revenue Sharing Relativities – 2020 Review*, Volume 1 – Main Report, p. 34.

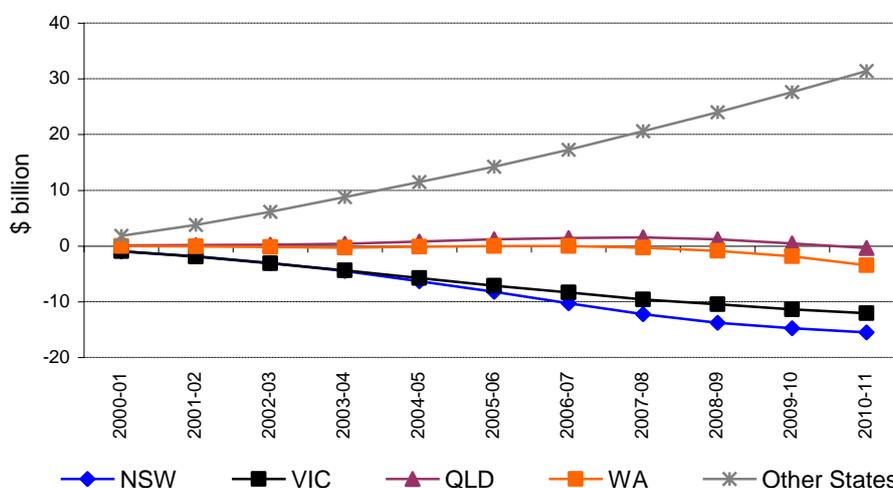
Large cross-subsidies

Horizontal fiscal equalisation (HFE) means the States with larger populations cross subsidise the other states. Since the GST was introduced, New South Wales and Victoria have largely carried the burden of cross subsidising the smaller states under HFE. Queensland and Western Australia have been more recent contributors, largely reflecting the trends in revenue raising capacities from the middle of the decade, particularly the rapid growth in revenue from mining royalties. These trends are evident whether the cross-subsidies are measured against a GST distribution based on state population shares or shares of GST revenue generated.

Chart 5 shows cumulative GST cross subsidies calculated on a population basis for the period 2000-01 to 2010-11.

Over the period, New South Wales has contributed \$15.5 billion (or 46.7 per cent) of the total cross subsidies of \$33.2 billion paid to recipient States. Victoria has contributed \$12.1 billion (36.4 per cent). Queensland and Western Australia have been both donors and recipients of cross subsidies at various times over the period. Queensland has been a net contributor of \$0.4 billion and Western Australia a net contributor of \$3.4 billion.

Chart 5: Cumulative GST cross-subsidies – Population-based



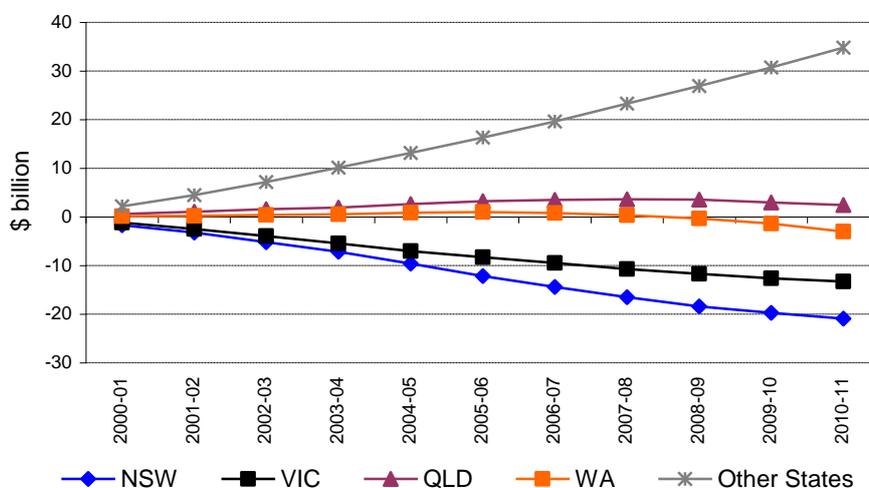
Source: NSW Treasury estimates based on GST payments from Australian Government, *Final Budget Outcome*, various, and 2010-11 Budget Paper No. 3, Table 3.7, pp. 119-120. Populations used are December estimated resident populations from ABS, *Australian Demographic Statistics*, Sep 2009, (3101.0).

Chart 6 shows cumulative GST-generated cross subsidies for the period 2000-01 to 2010-11.⁶ Over the period, New South Wales has contributed \$20.9 billion (or 53.0 per cent) of the total cross subsidies of \$39.4 billion, calculated on a GST-generated basis, paid to recipient States. Victoria has contributed \$13.3 billion (33.8 per cent).

⁶ GST generated in each State is estimated by NSW Treasury using household consumption expenditure – excluding spending on rent, food, health and education services – plus private dwelling construction spending and private ownership transfer costs to approximate the GST revenue base. Data is obtained from ABS, *Australian National Accounts: State Accounts, 2008-09* (Reissue), 5220.0. State shares for 2009-10 and 2010-11 are extrapolations.

Queensland has been a donor of cross subsidies calculated on a GST-generated basis from 2008-09 and Western Australia from 2006-07. However, Queensland has been a net recipient of \$2.4 billion in GST-generated cross subsidies over the period 2000-01 to 2010-11, while Western Australia has been a net donor of \$3.0 billion.

Chart 6: Cumulative GST Cross Subsidies – GST-generated



Source: NSW Treasury estimates based on GST payments from Australian Government, *Final Budget Outcome*, various, and 2010-11 *Budget Paper No. 3*, Table 3.7, p. 120. See footnote 6 for derivation of GST generated.

Complexity

Attempts to equalise revenues, expenses and the capacity of states to hold equal per capita stocks of capital assets and net financial assets produce a very complex equalisation process, requiring large amounts of data, notwithstanding the CGC's effort to simply its methodology in the 2010 Review.

Inefficiency

The HFE system strives to achieve full equalisation between the states without regard to the efficiency costs. Australia's other great equaliser – the income tax and welfare system which moderates income distribution – does not attempt to achieve full equalisation. The progressive nature of the income tax system means that those with higher incomes contribute more, but they retain at least some of their extra income to maintain incentives to earn extra income.

The HFE system is designed to flatten as much as possible the differences between the states. Above average revenues are equalised away and there is no incentive to improve efficiency. There is a disincentive against expanding the revenue base, either through increasing activity in the state or through undertaking additional expenditure to fund economic development, as the increased revenue capacity will result in lower GST revenue.

The efficiency costs of HFE take the following form:⁷

- fiscal transfers reduce incentives for resources (including people) to move from low productivity locations to high productivity locations

⁷ Garnaut and FitzGerald, Chapter 10.

- States with higher grants may overspend on publicly provided goods and services relative to underlying community demands
- the current system provides modest incentives for States to increase their grants by increasing taxation or expenditure effort in areas where there disabilities are large
- there is little incentive in the current system for increasing the efficiency of public services due to the focus on cost disabilities in the expenditure assessments

The CGC acknowledges that redistributive processes such as equalisation may affect aggregate national welfare, though past attempts to measure the size and direction of the effects produced a range of results depending on the assumptions made in the study.⁸

These efficiency costs are difficult to measure. An economic study commissioned by the 2002 Garnaut-FitzGerald review of Commonwealth-state funding arrangements put the quantifiable economic costs of the current system of interstate transfers at between \$150 million and \$280 million each year. However, Garnaut and FitzGerald's view was that the dynamic costs of the discouragement of policies favouring economic development and growth may be much larger.⁹

New South Wales has long argued for reform of the current system for distributing GST revenue payments between the states. We acknowledge the need to support States, such as South Australia, Tasmania and Northern Territory, with relatively low populations and/or economic bases. However, we believe this can be done with a much simpler and more transparent method than currently, and one which potentially could have less adverse impact on efficient resource allocation in Australia.

New South Wales believes an alternative system of fiscal equalisation could be based on:

- recognition of the need for fiscal support for South Australia, Tasmania and the Northern Territory to give those states the capacity to provide state services at a standard not appreciably below the average of the other States and Territories
- the measurement of their grant share should be based on the core economic and social functions that are shared by all States, eliminating the need to assess needs for functions that are largely the result of state policy choice
- once the shares for South Australia, Tasmania and the Northern Territory are determined, the remaining GST revenue could be shared between the other States and the ACT on an equal per capita basis.

The first step is a thorough investigation of the impact on national welfare of Australia's system of HFE.

This is a national economic issue on which national leadership is required.

⁸ CGC, *2010 Review*, p.31.

⁹ Garnaut and FitzGerald, p. 2.