

## Chapter 2

### Commonwealth-state and territory fiscal relations<sup>1</sup>

#### An historical overview

2.1 The Australian Constitution confers on the Commonwealth limited exclusive powers, such as managing Australia's defence forces, and setting the rates of customs and excise.<sup>2</sup> The Constitution also provides for areas where the Commonwealth can exercise powers concurrently with the state governments, although the Commonwealth does hold legislative supremacy in the case of inconsistency. These powers include taxation, social welfare, postal services and telecommunications, banking and insurance and industrial disputes that extend over state borders.

2.2 The state governments have exclusive responsibility over all other service areas, including housing and urban development, law and order, energy, rail and road transport, and health care and education. Taxes on property (immovable property and financial and capital transactions) and payroll taxes account for a major share of total state tax revenue. The Commonwealth can be involved in areas of state responsibility through the granting of financial assistance on terms and conditions it deems appropriate, as, for instance, in the health care and education areas.<sup>3</sup>

2.3 The Commonwealth controls some of the broadest tax bases, including personal and corporate income taxes, and as previously noted, customs and excises. It collects the revenue of the Goods and Services Tax (GST), implemented in July 2000, but transfers it entirely to the states.

2.4 The dissolution of internal tariff barriers at the time of Federation meant that the states lost a major source of revenue. Section 94 of the Constitution was designed to guarantee the states' financial wellbeing by empowering the Commonwealth Parliament to provide to the states all surplus Commonwealth revenue. With the propensity of the Commonwealth Government in recent years to proclaim large 'surpluses,' one wonders why the states are not making a greater political call for

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1 This chapter draws heavily on *Specific purpose payments and the Australian federal system*, Mr Scott Bennett and Mr Richard Webb, Parliamentary Library Research Paper, January 2008, and on *Developments in Commonwealth-state financial relations since 2000–01*, Mr Richard Webb, Parliamentary Library Research Brief, March 2006.

2 *Commonwealth of Australian Constitution Act*, ss. 51, 52, 114 and 115.

3 Dr Vassiliki Koutsogeorgopoulou, *Fiscal relations across levels of government in Australia*, Organisation for Economic Co-operation and Development, Economics Department Working Papers no. 541, 2007, p. 8, [www.oecd.org/olis/2007doc.nsf/LinkTo/NT000009EA/\\$FILE/JT03220724.PDF](http://www.oecd.org/olis/2007doc.nsf/LinkTo/NT000009EA/$FILE/JT03220724.PDF) (accessed 4 July 2008).

'surplus revenue of the Commonwealth' to be returned to them, although over the years the Commonwealth has found ways of ensuring that no true surpluses exist.

2.5 States can also be assisted through section 96, the key part of which states:

...the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit.

The reason behind the insertion of these words was the desire to provide financial security for the states in the early years of the Commonwealth whilst also providing a means of helping the poorer states if they should require financial assistance. Section 94 becoming effectively redundant in the first years after Federation as the Commonwealth found ways of ensuring that no surplus existed. As an alternative, the Commonwealth began to use section 96 to make annual payments to the states to assist in the delivery of services to their communities. Such payments came to be referred to as 'general-purpose' grants, by which it was understood that the states were free to spend the money as they saw fit.

2.6 The Commonwealth Parliament's Main Roads Development Bill 1923 granted the states funding that could be used only on the development of main roads. This was the Commonwealth's first foray into the provision of funding subject to conditions. Five decades later, the Whitlam Government's decision to use tied grants to impose major policy change on the states signalled the beginning of a trend that has seen successive governments follow suit.

2.7 By the start of the 21<sup>st</sup> Century, about four of every ten dollars given by the Commonwealth to the states had conditions attached. A large proportion of these grants pertained to policy areas that were not included in the original constitutional powers granted to the Commonwealth, such as health and education. Such a high level of conditionality became a major feature of the Australian federal model.

## **Current arrangements**

2.8 The current framework for Commonwealth-state financial relations is heavily influenced by the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, which was negotiated between the Commonwealth and states and territories in 1998 and 1999 primarily to govern arrangements for the distribution of GST revenue.<sup>4</sup> Amongst other things the agreement provides that:

- the states can spend GST-related payments as they wish;
- revenue from the GST will be distributed among the states on 'horizontal fiscal equalisation principles', according to a formula implemented by the Commonwealth Grants Commission;

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4 A copy of the agreement can be obtained at:  
[www.coag.gov.au/ig\\_agreements/reform\\_of\\_comm-state\\_financial\\_relations.htm](http://www.coag.gov.au/ig_agreements/reform_of_comm-state_financial_relations.htm)  
(accessed 4 July 2008).

- the Commonwealth would, for a transitional period, ensure that no state is worse off under the new arrangements than under the old arrangements through the provision of 'budget balancing assistance';<sup>5</sup> and
- the states would abolish certain taxes<sup>6</sup> by specified dates, and that retention of some duties by states come under review in the future.<sup>7</sup>

2.9 The Committee notes that in April 2005, all states with the exception of New South Wales and Western Australia submitted a proposal that commits them to abolish, by no later than 1 July 2010, most of these duties.

2.10 Under the Intergovernmental Agreement, the States agreed to abolish a range of inefficient indirect taxes that were impeding economic activity. The States themselves nominated the taxes to be abolished.

2.11 By 1 July 2005, the States had abolished several taxes that were listed in the Intergovernmental Agreement. This first tranche of abolished state taxes included accommodation tax, financial institutions duty, quoted marketable securities duty and debits tax.

2.12 The agreement also provided for further state taxes to be abolished once GST revenues proved to be sufficient. In 2006, the Australian Government reached agreement with all States on a schedule for the abolition of a second tranche of taxes, including all but one of the remaining state taxes listed in the Intergovernmental Agreement. This second tranche of inefficient state taxes being abolished includes stamp duties on mortgages, leases, and credit and rental arrangements. Notwithstanding that all States are already receiving substantial revenue gains from the Australian Government's reforms, some of these state taxes will not be abolished until as late as 2012–13.<sup>8</sup> A timetable for the abolition of state taxes is included in Appendix 4.

2.13 The committee notes the States are still required to abolish the one remaining tax, the stamp duty on conveyances of real non-residential property, before all of their commitments under the Intergovernmental Agreement will have been met. So far, no State has specified when it will abolish this tax.

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5 This undertaking was originally scheduled to cease on 30 June 2006. The submission from Commonwealth Treasury (*submission 25*, p. 9) now lists cessation at 30 June 2009.

6 These included bed taxes, financial institutions duty, stamp duty on marketable securities, and debits tax.

7 These included duties on business conveyances, non-quotable market securities, leases, mortgages, bonds, debentures, credit arrangements, rental agreements, cheques, bills of exchange and promissory notes.

8 Australian Government, *Budget Paper no. 3, Federal financial relations, 2007–08*, May 2008, p. 4.

2.14 The committee makes a recommendation (Recommendation 6) for the Commonwealth Government to pursue this matter in chapter 8.

2.15 Since 1 July 2000 when the GST was introduced, the other main forms of Commonwealth financial assistance to the states have been budget balancing assistance, payments made under National Competition Policy, and Specific Purpose Payments (SPPs).

### **Specific Purpose Payments**

2.16 Under existing arrangements, SPPs—which can be for current or capital purposes—take the forms of:

- payments 'to' the states that supplement state funding of areas such as public hospitals, government schools and roads. In 2006–07, such payments accounted for about three-quarters of SPPs by value;
- payments 'through' the states that the states pass on to targeted recipients such as non-government schools and local governments. In 2006–07, payments through the states accounted for 20 per cent of SPPs by value; and
- payments paid directly to local government for services such as disability, children's and other welfare services, or payments made under the *Roads to Recovery* program. These payments account for about five per cent of SPPs by value.

### ***The rationale for Specific Purpose Payments***

2.17 Most SPPs are subject to conditions which, while not legally binding, must be met by the states, and so are called 'tied' grants. According to an Organisation for Economic Co-operation and Development (OECD) working paper,<sup>9</sup> such 'conditionality' takes a variety of forms:

- general policy conditions that may be attached to the grant of money (e.g. that the states provide free public hospital access for Medicare patients in return for funding under the Health Care Agreements);
- expenditure conditions (e.g. SPPs for schools to be spent on teacher salaries and curriculum development);
- input control requirements, in the forms of 'maintenance of effort' and 'matching funding' arrangements, where the states are required to maintain funding levels and/or match Commonwealth funding in a program area;
- performance and financial information reporting by the states; and

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9 Dr Vassiliki Koutsogeorgopoulou, *Fiscal relations across levels of government in Australia*, Organisation for Economic Co-operation and Development, Economics Department Working Papers no. 541, 2007.

- due recognition conditions, whereby the states are required to acknowledge publicly the Commonwealth's funding.

2.18 By contrast, general purpose ('untied') section 96 grants are not subject to conditions. The main component of untied grants is the revenue from the GST. The value of other untied grants is relatively small and includes, for example, the compensation paid to the states for the revenue they have forgone since the introduction of the national scheme for the regulation of companies and securities.

2.19 Several reasons exist for the Commonwealth to provide SPP assistance to the states. First, while a state may have a very narrow view of a particular program that it is seeking to undertake, seeing it as relevant to its own residents, it may not account for the benefit the activity might have for residents of other states. This can lead to the allocation of insufficient resources. The Commonwealth may seek to encourage adequate expenditure by means of an SPP. Some argue that this is the only legitimate reason for the provision of tied grants. An example of such grants is funding for interstate highways.<sup>10</sup>

2.20 A second reason for the use of SPPs is a desire to promote co-operative arrangements between the Commonwealth and individual states to achieve national standards in particular services. This is highlighted in circumstances where no individual state could be expected to effectively deliver services or to deliver services in accordance with national objectives.<sup>11</sup> A well-known example was the standardisation of Australian railway gauges.

2.21 Third, SPPs may provide a means of giving additional budget support to enable the states to meet their expenditure responsibilities. Such grants may take the form of cost-sharing arrangements between the Commonwealth and the states. Grants which assist the states to meet their hospital running costs illustrate this form of assistance. Typically this is related to the states having an inadequate range of taxes with which to fund their responsibilities.

2.22 Fourth, at times, Commonwealth action may effectively amount to a Commonwealth 'takeover' of a particular policy area as it seeks to achieve economies of scale. The committee recalls that in 2006 the NSW and South Australian Premiers actually argued in favour of yielding their responsibilities for health to the Commonwealth Government.<sup>12</sup>

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10 Professor Russell Mathews, as quoted in *Specific purpose payments and the Australian federal system*, Scott Bennett and Richard Webb, Parliamentary Library Research Paper, January 2008, p. 5.

11 Professor Russell Mathews, as quoted in *Specific purpose payments and the Australian federal system*, Scott Bennett and Richard Webb, Parliamentary Library Research Paper, January 2008, p. 5.

12 Patricia Karvelas and Adam Cresswell, 'States ask Canberra to control hospitals', *The Australian*, 2 June 2006. [www.theaustralian.news.com.au/story/0,20867,19335557-23289,00.html](http://www.theaustralian.news.com.au/story/0,20867,19335557-23289,00.html) (accessed 8 September 2008).

2.23 The use of SPPs means that today, a great many functions are shared between the Commonwealth and the states to a much greater extent than would have been envisaged by most of Australia's Prime Ministers and Premiers since Federation.

2.24 It must be noted, however, that sharing responsibilities creates problems for Australian federalism, including inefficiencies derived from the blurring of government responsibilities, wasteful duplication of effort, under-provision of services, and a lack of effective policy co-ordination. Most notable, however, is cost and blame-shifting among different levels of government.

2.25 Evidence was given that with shared responsibility, Commonwealth funding enabled State Governments to avoid accountability for their actions, or lack of action.

### ***State and territory government dependence on SPPs***

2.26 The level of SPP funding is an ongoing issue between the Commonwealth and the states. Paragraph 5(v) of the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations states:

The Commonwealth will continue to provide Specific Purpose Payments (SPPs) to the States and Territories and has no intention of cutting aggregate SPPs as part of the reform process set out in this Agreement, consistent with the objective of the State and Territory Governments being financially better off under the new arrangements.<sup>13</sup>

2.27 The reason for this provision is that the states were concerned that the Commonwealth would reduce funding of SPPs following the introduction of the GST and the Commonwealth's undertaking to provide all revenue from that tax to the states. The states have interpreted the provision to mean that the level of SPPs should be measured in real per capita terms using the consumer price index to remove the effect of inflation.

### ***Inputs and outcomes***

2.28 As noted above, conditionality sometimes takes the form of so-called input controls such as the states having to match Commonwealth funding. Generally speaking, in recent years, input controls have been relatively benign. Short of replacing SPPs with untied grants, another option that has been proposed is for conditionality to focus on outcomes and results.<sup>14</sup>

2.29 Input controls may have the effect of:

- A focus on input controls may not place clients first, particularly for SPPs providing services directly to individuals and groups within the community;

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13 [www.coag.gov.au/ig\\_agreements/reform\\_of\\_comm-state\\_financial\\_relations.htm](http://www.coag.gov.au/ig_agreements/reform_of_comm-state_financial_relations.htm) (accessed 4 July 2008).

14 Professor Ross Garnaut and Dr Vince FitzGerald, *Review of Commonwealth-State funding, Final Report*, August 2002, p. 71.

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- A focus on inputs distracts attention from meeting SPP objectives and may not provide any indication of what is being achieved via the service provision;
  - Input controls limit incentives for service providers to improve their efficiency, and prevent the redirection of efficiency savings into other areas of expenditure; and
  - Input controls do not allow service providers the flexibility to move funds between program elements within SPPs to ensure that overall objectives are achieved.

2.30 To address these concerns, it has been suggested that input controls should be replaced by output controls – where State Governments receive funding at least partly based on outcomes. However replacing input controls with output controls does not necessarily mean improvements:

- It is much easier for States to meet input controls. For example, it is much easier for a school to know in advance that they will meet a requirement to have a flagpole than to meet a requirement for test results of a particular standard. As a result, input controls provide more funding certainty.
- It is easier to administer input controls and they have lower compliance costs.

2.31 The committee makes a recommendation (Recommendation 8) relating to the further consideration of the costs and benefits of input and output controls in chapter 8.

### **Vertical fiscal imbalance**

2.32 Vertical fiscal imbalance refers to the relationship between the relative spending responsibilities of a tier of government and its capacity to raise revenue. It is common to most, if not all, federal systems. In Australia, the states have relatively large constitutionally-assigned spending responsibilities but, in recent decades, relatively few own-revenue sources. The reverse is true at the Commonwealth level.

2.33 Even before the GST was introduced, Australia had a comparatively high degree of vertical fiscal imbalance. It is surpassed by countries, for example, Belgium and Mexico but exceeds other countries such as Canada, United States and Germany.<sup>15</sup> The Commonwealth raises about 75 per cent of total general government revenue but is responsible for about only 60 per cent of total expenditure on government programs. In 2003–04, the Commonwealth raised about 78 per cent of total government revenue and was responsible for about 65 per cent of total government expenditure.

2.34 It can be argued that the advent of the GST and the abolition of some state taxes have contributed to the rise in the degree of vertical fiscal imbalance. Indeed, the

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15 Department of the Treasury, *Architecture of Australia's tax and transfer system*, August 2008, p. 301.

states frequently complain that the shift in revenue-raising power to the Commonwealth and their lack of own-source revenue have increasingly led to a situation where the Commonwealth is virtually able to dictate to the states the terms of SPPs.

2.35 On the other hand, it could be argued that the Commonwealth is, in effect, merely acting as an agent who collects the GST on the states' behalf; that this is tantamount to shifting some revenue-raising capacity back to the states; and that this rolls back somewhat the vertical fiscal imbalance in the states' favour.

2.36 The presence of vertical imbalance, with the states relying on transfers from the Commonwealth, leads to design issues concerning the inter-governmental transfer arrangements to bridge the vertical fiscal gap. Concerns include the potential for: undermining accountability to taxpayers for expenditure decisions; creating duplication and overlap in the provision of services; constraining beneficial tax competition across jurisdictions; and weakening incentives for tax and microeconomic reform. Increasing the states' revenue raising capacity would be a step towards reducing the vertical fiscal gap.<sup>16</sup>

2.37 Many witnesses raised the question of the states resuming an incomes tax ability with the Commonwealth vacating a certain percentage of the income tax collections and allowing the states to impose their own level of top-up income tax requirements. It was argued that this would increase the states' accountability.

2.38 The Committee does not necessarily support the 'reform' of Income Tax Collections by reducing the Commonwealth's collections with a corresponding reduction in the payment of SPPs to the States and transferring to the States the ability to raise their own income tax by adding a surcharge to the Commonwealth's base income tax collections to fund what previously came to them as an SPP payment, but believes there should be serious consideration of that proposition, to address the States' concerns of vertical fiscal imbalance and to impose more accountability on, and lessen blame shifting by, the States. The need for States to impose their own income tax revenue would provide opportunities for competitive taxation systems across the nation. Any such enquiry should carefully assess benefits and costs and determine if the ability of the States to impose their own income tax would be in the national interest.

2.39 Nevertheless the Committee does believe that this option needs to be considered in detail by a specialised taskforce. Such an inquiry should carefully assess benefits and costs and determine if the ability of the States to impose their own income tax would be in the national interest. A specialised taskforce should comprise leading economists and senior officials of the Commonwealth's and each

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16 Dr Vassiliki Koutsogeorgopoulou, *Fiscal relations across levels of government in Australia*, Organisation for Economic Co-operation and Development, Economics Department Working Papers no. 541, 2007, p. 5.



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State/Territory's Treasury. The committee makes a recommendation (Recommendation 7) in this regard in chapter 8.

### **Horizontal fiscal equalisation**

2.40 Whereas vertical fiscal imbalance refers to the Commonwealth-state relationship, horizontal equalisation refers to the relative distribution amongst the states. Beginning in 2002–03, the states, in aggregate, have benefited under the new arrangements in that the amount of GST payments they have received has exceeded the amount they would have received under the old system. However, these 'gains' have been distributed unequally, with Queensland gaining the most (in dollar terms) principally at the expense of NSW but also Victoria.<sup>17</sup> The main reason for the uneven distribution is the application of the horizontal fiscal equalisation principle, on which the Commonwealth Grants Commission bases its calculations of the relativities used to determine each state's GST entitlement.

2.41 Questions have been raised regarding the appropriateness of the current equalisation mechanism in terms of the equity it achieves against the potential efficiency losses and the cost of institutional complexity it entails. Concerns arise about the usefulness of extensive interstate fiscal equalisation given the relatively low pre-equalisation disparities.<sup>18</sup> There have, in recent years, been a number of calls to reform and to remove horizontal fiscal equalisation, for example by the Victorian Employer's Chamber of Commerce and Industry.<sup>19</sup>

### ***Transitional and other assistance***

2.42 The Commonwealth also provides compensation to the states for the deferral of GST revenue resulting from its decision that small businesses and non-profit organisations, which voluntarily registered for the GST, could pay and report GST on an annual, rather than monthly or quarterly, basis. Due to an overpayment of this compensation to the states, the Commonwealth agreed with the states to suspend the payments for 2006–07.<sup>20</sup>

2.43 In March 2008, the Council of Australian Governments announced a change to the architecture of Commonwealth-state financial arrangements. This new financial framework will result in a significant rationalisation of SPPs; consolidating the nearly

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17 Mr Richard Webb, *Developments in Commonwealth-state financial relations since 2000–01*, Research Brief no. 11, 2006, Parliamentary Library, p. 2.

18 Dr Vassiliki Koutsogeorgopoulou, *Fiscal relations across levels of government in Australia*, Organisation for Economic Co-operation and Development, Economics Department Working Papers no. 541, 2007, p. 6.

19 See for example: Victorian Employer's Chamber of Commerce and Industry, *Horizontal Fiscal Equalisation: The business plan to make GST distributions transparent, efficient and equitable*, 2006.

20 Department of the Treasury, *Submission 25*, p. 10.

ninety existing SPPs into five or six new national agreements for delivery of core government services. These are health, affordable housing, early childhood and schools, vocational education and training, and disability services. The reform is said to be finalised by the end of 2008, and the new framework will commence from 1 January 2009 with the reform of payments for healthcare to be implemented by 1 July 2009.<sup>21</sup>

2.44 The Australian National Audit Office (ANAO) has identified the development and implementation of the new federal financial framework as a potential audit topic in 2008–09.<sup>22</sup> The committee would support the ANAO undertaking such an audit and accordingly makes a recommendation (Recommendation 9) in chapter 8.

### **Reforming funding arrangements**

2.45 Clarifying government roles and responsibilities has the potential to improve public sector efficiency. Fragmentation of decision making and funding arrangements, particularly in the areas of hospital services and old-age care, creates incentives for cost and blame-shifting between different levels of government. A collaborative approach between different levels of government to overcome some of these problems, would help to develop better governance arrangements and improve spending assignments. A less complex system of inter-governmental transfers would also contribute to a more effective specification of spending responsibilities. Stronger revenue-raising capacity on the part of the states, through a further improvement in the efficiency of the state tax system, would raise the ability of state and local governments to meet expenditure responsibilities and allow them to be better prepared for coping with demographic change.<sup>23</sup>

2.46 However such reforms could come at significant cost. Collaboration between governments could well mean a reduction in competitive pressures which should be there to increase efficiency. Reduced complexity of payments to states could mean fewer conditions, and therefore lesser accountability, on the states and stronger revenue-raising capacity for the states could result overall in higher taxation for Australians.

2.47 There is no straightforward solution to the question of dividing responsibilities between jurisdictions. The 'subsidiarity' principle may, however, provide some guidance. This principle holds that the central government should limit its activities to those which lower levels of government cannot perform effectively.

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21 Council of Australian Governments' Meeting, *Communiqué*, 26 March 2008, p. 3, [www.coag.gov.au/meetings/260308/docs/communique20080326.pdf](http://www.coag.gov.au/meetings/260308/docs/communique20080326.pdf) (accessed 21 July 2008). See also 2008–09 Budget Paper No. 3, p. 6.

22 Australian National Audit Office, *Planned Audit Report Programme*, July 2008, pp 69–70.

23 Dr Vassiliki Koutsogeorgopoulou, *Fiscal relations across levels of government in Australia*, Organisation for Economic Co-operation and Development, Economics Department Working Papers no. 541, 2007, p.1.

That is, responsibility should rest, where possible, with the lowest level of government.

2.48 It is important to distinguish between responsibility for funding and responsibility for service provision. Under SPPs, the states are responsible for service provision. Funding, on the other hand, is sometimes shared between the Commonwealth and the states and sometimes not. Reform proposals envisage different combinations of responsibility for service delivery and funding.

2.49 It is interesting to note that the Business Council of Australia estimated in 2006 that Australian taxpayers were \$836 million a year worse off because of higher spending by the Federal Government on areas of responsibility like pharmaceuticals, general practitioners and aged care facilities than for services that would have been more efficiently provided by public hospitals which are the responsibilities of the states.<sup>24</sup> The Business Council of Australia also calculated the cost of the inefficiencies in the Federal system were \$8.9 billion,<sup>25</sup> including:

- a \$2.8 billion cost of inefficient state taxes such as taxes on insurance, land tax, stamp duty and commercial conveyances and other stamp duties;<sup>26</sup>
- a \$2.3 billion cost in inefficient state spending;<sup>27</sup>
- a \$1.8 billion cost from duplicated spending or administration of inefficient grants.<sup>28</sup>

2.50 An operator of an interstate train in Australia may have to deal with six access regulators, seven rail safety regulators, with nine different pieces of legislation, three transport accident investigators, 15 pieces of legislation covering occupational health and safety of rail operations and 75 pieces of legislation with powers over environmental management.

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24 Business Council of Australia, *Submission 16, Attachment C*, pp 20 and 127.

25 Business Council of Australia, *Submission 16, Attachment C*, p. 127.

26 Business Council of Australia, *Submission 16, Attachment C*, p. 169.

27 Business Council of Australia, *Submission 16, Attachment C*, p. 166.

28 The figure \$1.8 billion is an aggregate of \$861 million and \$931 million from the Business Council of Australia, *Submission 16, Attachment C*, p. 127.

