

Chapter 5:

FINANCIAL ARRANGEMENTS WITH THE COMMONWEALTH

5.1 Introduction

5.2 Recent Developments

5.3 The Tasks Ahead

5.1 INTRODUCTION

A major development in Commonwealth-State¹ financial relations in the last year is the growing impetus towards national tax reform. If properly structured, fundamental reforms would deliver greater equity and efficiency in the taxation system and increase the accountability of governments at all levels.

Commonwealth-State financial relations in Australia have changed little over the past decade and are characterised by the following -

- a high degree of *vertical fiscal imbalance* (VFI), referring to the mismatch between tax powers and expenditure responsibilities of the Commonwealth and State Governments. The Commonwealth collects significantly more tax revenue than it requires for its own purposes. Consequently, it transfers funds to the States in the form of general purpose payments (GPPs)² and specific purpose payments (SPPs)³; and
- an extensive system of *horizontal fiscal equalisation* (HFE) which governs the interstate distribution of Financial Assistance Grants (FAGs) and overseen by the Commonwealth Grants Commission (CGC). This results in the transfer of roughly \$2 billion annually from donor States (New South Wales, Victoria, and the ACT) to other States.

The increase in VFI in recent years makes even more urgent the need to address the imbalance through national tax reform, which should restore some financial independence to the States. This can only be achieved by States having access to sufficient revenue bases to meet their expenditure responsibilities. The scope for improvement is great, and the benefits include enhanced government accountability, improved service delivery, and the opportunity for States to adopt more efficient tax policy regimes.

Without the August 1997 High Court decision on s90 of the Constitution, States accounted for 19.7 per cent of total general government tax revenue and were responsible for about 41.5 per cent of aggregate own-purpose outlays⁴. On the other hand, the Commonwealth accounted for 76.7 per cent of tax revenue but spent only 54.7 per cent of general government expenditures. Ideally, the ratio of own-source tax revenue to own-purpose expenditure should be much closer to 1.00 for each level of government in order for revenue powers to be broadly commensurate with expenditure responsibilities.

1 All references to 'States' in this chapter should be interpreted as referring to States and Territories.

2 GPPs are unconditional grants originally intended to compensate the States for losses on tariff revenue at Federation and the Commonwealth's takeover of income taxing powers after 1942. GPPs consist of financial assistance grants (FAGs) and special revenue assistance. For a number of years FAGs were determined annually. At present they are governed by a rolling 3-year real terms per capita guarantee subject to certain conditions relating to the implementation of National Competition Policy, as agreed by the Council of Australian Governments in April 1995.

3 SPPs are grants contingent on the States' compliance with certain conditions - for example, the purposes for which the funds may be used; specific monitoring and review arrangements; annual increases in funding; and/or maintenance of expenditure requirements. SPPs generally have a duration of one to five years depending on the terms of the individual SPP agreements, which are separately negotiated between the Commonwealth and States.

4 Own purpose outlays include payments to public trading enterprises and the private sector.

The Commonwealth continues to hold all of the broadest tax instruments including income and sales taxes and customs and excise duties. Section 90 of the Australian Constitution provides that States can levy all but customs and excise duties. A series of previous decisions by the High Court of Australia expanded the definition of “excise” such that States were effectively barred from imposing sales taxes and franchise fees.

The level of VFI worsened following the High Court decision in August 1997 proclaiming NSW tobacco franchise fees (and by implication, States’ liquor and petrol franchise fees) as invalid under s90 of the Constitution. This decision increased the Commonwealth share of general government tax revenue to 79.8 per cent, and reduced States’ share to 16.7 per cent. While the Commonwealth has implemented a number of ‘safety net’ taxes and a ‘windfall gains’ tax to protect States from retrospective claims, this is only a transitional arrangement.

The Commonwealth’s reduction of its budget deficit partly through cuts to SPPs to States in recent years has placed additional pressure on State finances and has highlighted further the deficiencies associated with the current level of VFI.

The outcome of the recent *Allders* case in the High Court implies that businesses operating on Commonwealth property are not liable for a number of State taxes. Such developments raise the prospect of a further worsening in the degree of VFI.

Payment arrangements relating to microeconomic reform also have VFI implications. Conditions imposed by the April 1995 *Agreement to Implement the National Competition Policy and Related Reforms* on States’ access to competition-related payments in the nine years to 2005-06 have effectively converted into tied grants a portion of GPPs to be made in those years.

On the expenditure side, a clearer delineation of responsibilities would have offered the potential to reduce tied grants or otherwise improve the conditions under which they are provided to States. Little substantive progress has been made on this issue, with the prospects for reform linked closely with the resolution of VFI. In the last two years, the Commonwealth has focused on expenditure cuts rather than a fundamental redistribution of expenditure responsibilities.

New South Wales expects a real increase in GPPs of about 1.5 per cent in 1998-99 (after Fiscal Contribution Payments). This follows a 0.9 per cent increase in GPPs in 1997-98. Growth in real terms has not kept pace with population growth, expenditure demands or with growth in the economy more generally. Specific purpose payments are expected to grow by 4.4 per cent in nominal terms or 2.9 per cent in real terms.

Overall, fundamental changes to Commonwealth-State financial relations remain a distinct possibility over the next year with the recent developments in national tax reform. However, a package of reforms which addresses VFI and at the same time meets the Commonwealth’s requirements will require substantial cooperation between the Commonwealth and States.

Data on Commonwealth payments to New South Wales, measures of VFI over the past five years, and measures of the impact of fiscal equalisation are given in the tables at the end of this Chapter. The remainder of this Chapter describes developments during the past year and canvasses issues in intergovernmental financial relations, which are likely to remain of concern in the immediate future.

5.2 RECENT DEVELOPMENTS

LONG TERM TRENDS IN COMMONWEALTH PAYMENTS TO STATES

Recent developments in Commonwealth payments to New South Wales, and the urgent need for reform in Commonwealth-State financial relations, are better understood within the larger context of long term trends in payments to all States.

A comparison of Commonwealth payments with other Commonwealth and State fiscal aggregates reveals the following trends -

- Overall, Commonwealth payments to all States have grown in real terms since 1982-83 by only \$2.4 billion, while Commonwealth own purpose outlays have increased by \$22.7 billion and Commonwealth taxes have grown by \$40.6 billion over the same period.
- The Commonwealth improved its own budgetary position in the late 1980s and early 1990s largely by shifting the burden to States via substantial cuts in grants. States have not benefited from buoyant Commonwealth tax growth particularly since 1992-93 (4.6 per cent per annum in real terms).
- On average, between 1983 and 1997 Commonwealth own purpose outlays and Commonwealth taxes have increased in real terms by 2.4 per cent and 3.3 per cent per annum respectively, while payments to States have increased by only 0.8 per cent per annum. Payments to States declined drastically during the late 1980s, averaging (-) 2.4 per cent per annum during 1985-86 to 1989-90 (see Figure 5.1).
- In contrast, States undertook fiscal consolidation and expenditure restraint, resulting in substantial improvements in the States' aggregate fiscal position after 1991-92. This was reflected in average annual growth in real State tax revenue (4.0 per cent) substantially exceeding growth in State own purpose outlays (1.4 per cent) during 1990-91 to 1997-98.
- The decline in Commonwealth payments during the late 1980s was effected through cuts in FAGs. Increasing Commonwealth inroads into the delivery of State services is reflected in the progressively increasing share of SPPs to total Commonwealth payments to States during this period, from 31 per cent in 1982-83 to 40 per cent by 1997-98 (see Figure 5.2).

Since Commonwealth payments to States were already drastically pared down in previous years, and since States continue to be front line service providers, the quantity and quality of State services will be threatened by further curtailment without a redistribution of revenue-raising powers.

Figure 5.1
Commonwealth Own Purpose Outlays and
Payments to States, 1982-83 to 1997-98

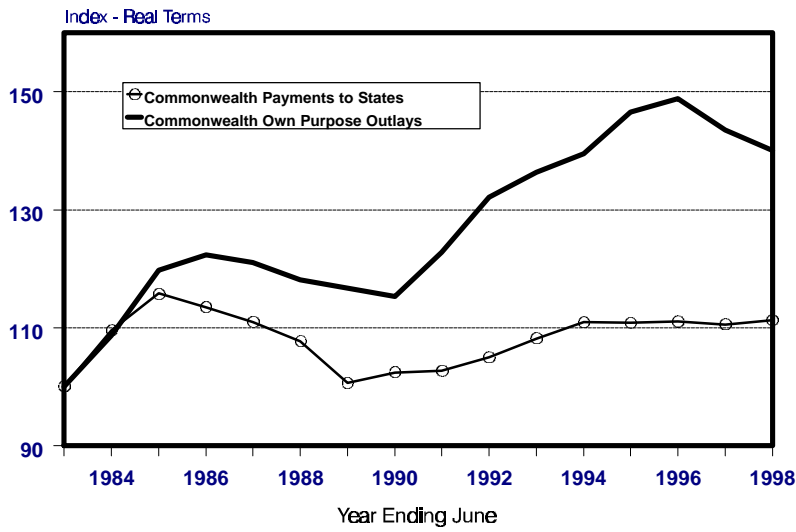
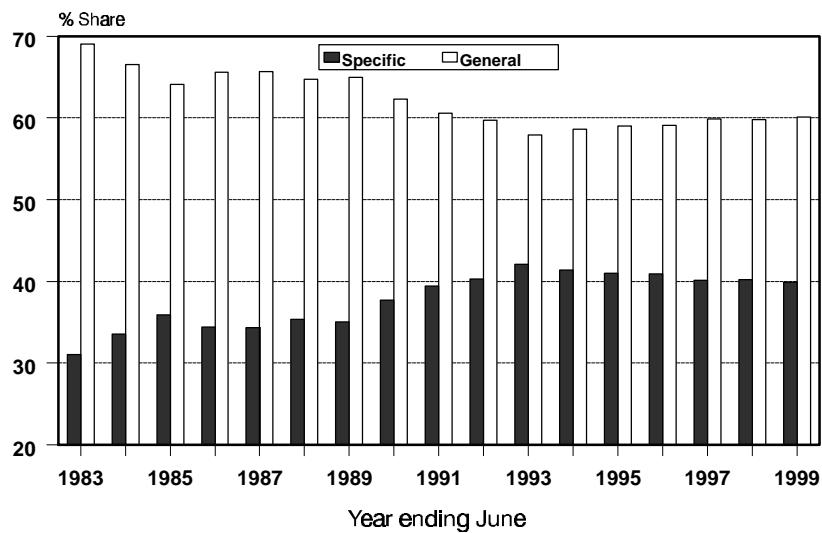


Figure 5.2
Commonwealth General and Specific Purpose Payments
to States, 1982-83 to 1998-99



GENERAL PURPOSE PAYMENTS

The following developments will affect the level of general-purpose payments to New South Wales in 1998-99 -

- maintenance of the real per capita terms guarantee on FAGs to States, including a roll-over of the guarantee to 2000-01;
- release of Competition Payments for 1998-99 pending the final recommendations of the National Competition Council (NCC) in June 1998; and
- payment of the final instalment of Fiscal Contribution Payments (FCPs) by States to the Commonwealth.

Financial Assistance Grants

The Commonwealth financial offer to States for 1998-99 and the subsequent Commonwealth Budget 1998-99 provided for the following -

- General revenue assistance to all States of \$17,096 million (a 2.5 per cent nominal increase over 1997-98). After taking into account State FCPs funded out of FAGs, general revenue assistance will rise in nominal terms by 4.1 per cent in 1998-99 over 1997-98.
- Maintenance of FAGs in real per capita terms in 1998-99 and extension of the real per capita guarantee on a rolling three year basis to 2000-01. The per capita component of FAGs and the Competition Payments (the latter amounting to \$217.2 million) would remain contingent on States' compliance with competition policy reform targets as assessed by the NCC.
- State FCPs to the Commonwealth to continue through the final year (1998-99) of a three-year period as agreed at the 1996-97 Premiers' Conference, notwithstanding the substantial improvement in the Commonwealth's fiscal position.
- Medicare guarantee payments to New South Wales and Victoria funded from outside the FAG pool (\$62 million) to cease, and the remainder of guarantee payments funded from within the pool (\$371 million) to be absorbed into the FAG pool.
- The pool of FAGs and Health Care Grants (HCGs) in 1998-99 to be distributed on a preliminary basis using the 'equalisation' per capita relativities calculated by the CGC and estimates of HCGs based on the Commonwealth's latest funding offer to the States for the Australian Health Care Agreements (AHCAs). Once the AHCAs are finalised, States' shares will be adjusted in 1998-99 based on the final size and distribution of HCGs.

Although the issue of FAGs was not discussed at Premiers' Conference in March 1998 due to disagreement over health funding, the Commonwealth announced that it would implement the contents of the offer on general revenue assistance.

Australian Health Care Agreement

The Commonwealth has proposed a new Australian Health Care Agreement (AHCA) to replace the current Medicare Agreement, which expires in June 1998. The new AHCA is intended to commence on 1 July 1998 and remain in effect for five years to 2002-03.

The Commonwealth AHCA offer includes the following -

- \$5.257 billion in funding for all States in 1998-99 and \$29.3 billion for the five years to 2002-03. This excludes all funding for veterans' health services, which are not covered by the AHCA.
- Components of funding provided are: admitted patients; non-admitted patients; quality assurance and access funding; mental health and palliative care; and system restructuring through a National Development Fund. The first two components account for 95 per cent of total funding.
- Annual indexation for admitted patients funding to reflect age-weighted population change; changes in private health insurance levels (on current estimates this amounts to additional funding of \$83 million per annum for each percentage point fall in the private health insurance participation rate); and changes in clinical practice, technology and drug treatments which are not associated with demographic changes.
- To directly reduce waiting lists, an additional \$120 million of one-off funding to be made available for 30 weeks commencing 16 March 1998.

The offer falls significantly short of States' needs. Since 1992-93, under the current Medicare Agreement, States as a group increased their own spending on all health services by a cumulative 21.9 per cent in real terms whilst Commonwealth expenditure increased by 16.0 per cent. The latter growth rate largely represents a one-off substantial increase in the first year of the current agreement. Reckoning growth from 1993-94, State expenditure increased by 28.8 per cent in real terms while Commonwealth expenditure rose by only 4.3 per cent (Figure 5.3).

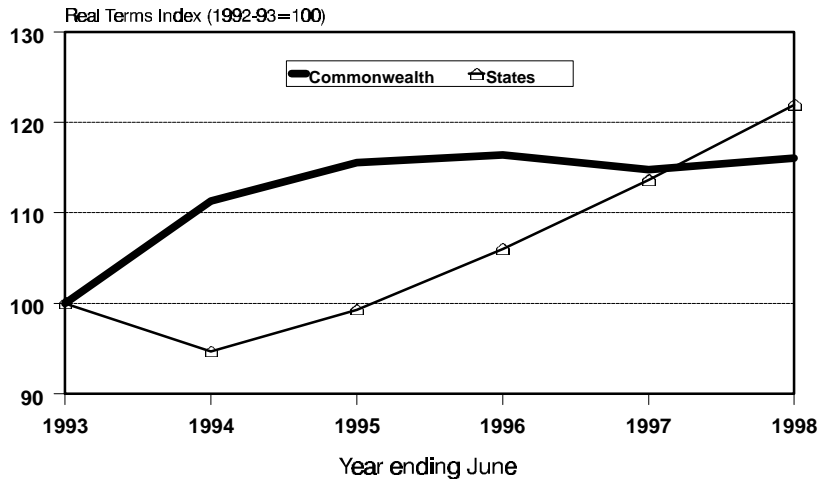
At the March 1998 Premiers' Conference, Premiers and Chief Ministers called on the Commonwealth to add \$1.1 billion to AHCA funding for 1998-99 to cover -

- Compensation for additional costs to States due to the decline in private health insurance in previous years (\$622.5 million);
- Additional costs to States due to escalation in acute hospital admissions, changes in clinical practice, technology, new drugs and cost escalation above the Commonwealth's indexation (\$396.5 million); and
- Restoration of cost-shifting penalties imposed unilaterally by the Commonwealth in previous years (\$81 million).

To date, two jurisdictions have committed themselves to signing the AHCA.

Figure 5.3

**Commonwealth and State Contribution to State Expenditure on All Health Services
Real Terms, 1992-93 to 1997-98**



National Competition Payments

In accordance with the *Agreement to Implement National Competition Policy (NCP) and Related Reforms* signed by the COAG in April 1995, Competition Payments to the States commenced in 1997-98.

For 1998-99, Competition Payments to jurisdictions will depend on NCC assessment of the extent to which States have complied with NCP obligations. Upon the Council's release of its Report in June 1998, the Commonwealth will consider whether each State should receive its share of Competition Payments, estimated to total \$217.2 million. The New South Wales share is \$73.5 million.

Compliance with the schedule of NCP reforms is a precondition for maintenance of the per capita component of the three-year real per capita terms rolling guarantee on the FAG pool. NCP reforms to be assessed for June 1998 will include States' compliance with commitments on legislative reviews, competitive neutrality, local government, and effective implementation of COAG agreements on reforms in electricity, gas and road transport.

Fiscal Contribution Payment

At the 1996 Premiers' Conference, States were required to make Fiscal Contribution Payments to assist the Commonwealth in addressing its budget deficit problem. FCPs commenced in 1996-97 and will terminate after 1998-99. Notwithstanding the fact that the Commonwealth's budget is performing significantly better than anticipated at the 1996 Premiers' Conference, FCPs are expected to be paid by States in the final year of the three year period. These payments amount to \$313.4 million in 1998-99 (\$101.5 million from New South Wales).

The Commonwealth has announced that it will continue to provide each State with flexibility as to the method of paying its FCP. In previous years, most States (including New South Wales) paid their FCPs via a reduction in FAGs, while three States opted for a cut in nominated SPPs.

COMMONWEALTH GRANTS COMMISSION 1998 UPDATE REPORT

The CGC recommends for each financial year the appropriate distribution of general revenue grants between the States. For 1998-99 the CGC's terms of reference required it to calculate two sets of relativities -

- Horizontal fiscal 'equalisation' (HFE) relativities which reflect the full range of factors which the Commission considers relevant to assessing States' financial needs; and
- 'Medicare-Adjusted' (MA) relativities, which are calculated by the CGC on the basis of certain directions to it concerning the treatment of health funding.

As a result of an agreement at Premiers' Conference in 1993, MA relativities have been used to distribute general revenue grants among States since 1993-94. However, given that the current Medicare Agreement expires at end-June 1998, the CGC was asked to calculate both MA relativities (on the assumption that the directions to the Commission about the treatment of health funding continue) and HFE relativities (on the assumption that the directions do not continue).

Based on the continued use of MA relativities, New South Wales would receive a \$10 million increase in its share of funding in 1998-99. This reflects offsetting impacts due to changes in CGC assessments.

New South Wales benefited from a reduction in assessed revenue capacity for Payroll Tax; changes in the value and distribution of SPPs; and a four-fold increase in Western Australia's grants in lieu of royalties, which redistributed grants to other States including New South Wales. These gains were largely offset by reduced need for Technical and Further Education and debt charges expenditure; and substantially increased revenue standards in categories where New South Wales has above-average revenue raising capacity, including Stamp Duty on Conveyances and Financial Transaction Taxes.

If HFE relativities were used for 1998-99, this would yield an additional gain of \$51.4 million for New South Wales over and above the \$10 million discussed above. This increment is due largely to changes in the CGC treatment of health funding, which (among other things) results in relativities being applied to a larger funding pool.

Traditionally, net donors through the CGC equalisation process have been New South Wales, Victoria and the ACT. Western Australia shifted to donor status in 1997-98. This pattern remains the same in the latest set of relativities.

As foreshadowed in the Commonwealth offer on general revenue grants, HFE relativities will apply in 1998-99.

DEVELOPMENTS IN SPECIFIC PURPOSE PAYMENTS

Specific Purpose Payments (SPPs) are expected to increase by 4.4 per cent in nominal terms (2.9 per cent in real terms) in 1998-99. This reflects real growth of 4.7 per cent in recurrent SPPs (mainly health, home and community care, supported accommodation assistance and disability services) and a real contraction of 3.7 per cent in capital SPPs (mainly for government schools, housing and roads).

The Commonwealth continues to apply so-called 'efficiency dividends' or reductions in funding to many SPPs. Efficiency dividends were introduced for the first time in the 1996-97 Commonwealth Budget (3 per cent in that year, ramping up by 1 per cent per year thereafter with no terminal year specified).

In respect to public housing, in the absence of a new Commonwealth-State Housing Agreement (CSHA), long-term funding arrangements remain highly uncertain for States. Reform initiatives stalled in 1997. Since 1996 States have remained under an interim arrangement which provides funding in six-monthly intervals, and which ends June 1999. The interim agreement merely maintains funding in nominal terms.

CSHA Block funding to New South Wales is estimated to decline by \$4 million in 1998-99. The uncertainty of funding beyond June 1999 hampers States' ability to manage the provision of public housing services. In April 1998 State Housing Ministers put to the Commonwealth draft multilateral and bilateral agreements. To date the Commonwealth has not responded to State initiatives to kick-start long-term reform or negotiations on a new CSHA.

Negotiations on a new Commonwealth-State Disability Agreement (CSDA) have also proved difficult due to most States' rejection of the Commonwealth funding offer. The offer was considered insufficient to provide for unmet demand, estimated at \$293.8 million for all States. The Commonwealth withdrew from the CSDA multilateral negotiations and is now negotiating bilaterally with all States. In the meantime, the existing CSDA has been extended on a month by month basis. Should the bilateral proposals proceed, this would pave the way for New South Wales to sign a multilateral CSDA for a further five years.

At a more general level, Commonwealth initiatives to date regarding SPPs have been couched mainly in terms of funding cuts rather than fundamental reform of functional responsibilities. This remains a major concern of States. Merely reducing SPPs without regard to the optimal distribution of functional responsibilities between levels of government does not provide a firm basis for reform of Commonwealth payments.

SPP data for 1998-99 reflect the fact that the Australian Bureau of Statistics now treats universities as a separate multi-jurisdictional category. Previously, Commonwealth funding for universities was treated as a grant through States. Consequently, trends cited in this budget paper treat funding to universities as a Commonwealth own-purpose payment, with corresponding adjustments in prior years.

LOAN COUNCIL ALLOCATIONS

As part of the Loan Council arrangements each jurisdiction is required to bid for a Loan Council Allocation (LCA) for the coming financial year. These bids are reviewed annually at Premiers' Conference for consistency with macroeconomic policy and prudent financial management.

LCAs of all jurisdictions were proposed at the March 1998 Premiers' Conference on the basis of a report by Heads of Treasuries (HOTs). The HOTs report determined that the LCA nominations were consistent with macroeconomic policy objectives, but noted the risks to growth due to recent developments in the Asian region.

Following the stalled discussions at Premiers' Conference over health funding, Loan Council endorsed the LCA nominations for 1998-99 through correspondence.

The 1998-99 Budget time LCA of New South Wales amounts to minus \$1,295 million. Since an LCA is intended to provide an indication of the call on financial markets in the coming year, the negative LCA bid by New South Wales indicates that the State expects to contribute to (rather than make demands on) national savings in 1998-99.

From 1997-98, government contingent exposures under infrastructure projects with private sector involvement were disclosed as a footnote to rather than a component of LCAs. These exposures, which are measured as the government's contractual liabilities in the event of termination of the project, may not actually be realised and are thus materially different from borrowings undertaken to finance the public sector deficit.

Governments agreed last year to adopt a revised uniform presentation framework (UPF) in order to rationalise reporting requirements under the Uniform Presentation Agreement, Loan Council Reporting and the National Fiscal Outlook (NFO). Following this agreement, the revised UPF provides for twice yearly reporting of full year estimates of outlays, revenue and financing transactions, as well as reporting of full year outcomes, for the general government and public trading enterprise sectors. From 1998-99, all jurisdictions' budgets and mid-year reports will also include three-year forward estimates for the General Government Sector.

Following the 1997-98 Loan Council decision to rationalise separate reporting requirements, Loan Council also agreed in 1998 to a proposal to cease mandatory publication of monthly and year-to-date budget sector data ('Niemeyer statements'). However, New South Wales will continue to publish these statements due to legislative requirements in this State.

LOSS OF STATE FRANCHISE FEES

On 5 August 1997, the NSW tobacco franchise fee was declared to be an 'excise' by the High Court and therefore invalid under s90 of the Constitution. Consequently, States repealed their business franchise fees (BFFs) on tobacco, petroleum and alcohol. The Commonwealth agreed to a request from States to introduce 'safety net' tax arrangements to compensate States for the loss of revenue.

Under the safety net, the Commonwealth imposes an excise surcharge on tobacco and petroleum and a wholesale sales tax surcharge on alcohol, and returns the money to States. These safety net arrangements, embodied in a legislative package of Acts, applied from 6 August 1997.

As part of the safety net arrangements, the Commonwealth also implemented a 100 per cent 'windfall gains' tax to protect the States from claims for refunds of past franchise fee payments. The windfall tax applied from 5 August 1997.

The legislative package that gave effect to these changes comprised nine Acts -

- Franchise Fees Windfall Tax (Collection) Act 1997;
- Franchise Fees Windfall Tax (Imposition) Act 1997;
- Franchise Fees Windfall Tax (Consequential Amendments) Act 1997;
- Sales Tax (Customs) Alcoholic Beverages Act 1997;
- Sales Tax (Excise) Alcoholic Beverages Act 1997;
- Sales Tax (General) Alcoholic Beverages Act 1997;
- Sales Tax Assessment Amendment Act 1997;
- Excise Tariff Amendment Act (No. 3) 1997; and
- Customs Tariff Amendment Act (No. 3) 1997.

It was agreed that the operation of the 'safety net' would be reviewed after six months. Heads of Treasuries (HOTs) established a Working Party to undertake this review. A report was prepared for consideration and endorsement by Heads of Government at the March 1998 Premiers' Conference, although this failed to eventuate.

The Report addressed four key issues -

- Safety net revenues, including ongoing revenue raising capacity, revenue shortfalls occurring in the transitional period and options to deal with any shortfall;
- Distribution of 1997-98 revenue losses;
- Distribution of safety net revenues in 1998-99 and beyond; and
- Operation of Queensland and NSW petroleum safety net arrangements to prevent cross-border leakages.

Based on collections to date, the report concluded that safety net taxation rates appear to provide a sufficient ongoing revenue yield. However, the report noted that there have been significant transitional revenue losses principally impacting States' 1997-98 budgets. The Working Party attributes these losses to -

- Timing differences between the receipt by jurisdictions of previous business franchise fees (BFF) and safety net revenues;
- Additional 'surcharge-free' tobacco clearances from bond by cigarette companies immediately prior to and just after the High Court decision;
- The cost of refunds to the liquor industry associated with unexpired license fees; and
- A blowout in petrol subsidy costs primarily because of the shifting of product through Queensland.

Safety net arrangements are considered transitional only. More permanent replacement arrangements are needed, which preferably address the issue within the broader context of national tax reform.

HIGH COURT DECISION IN THE *ALLDERS* CASE

In *Allders International Pty Ltd v Commissioner of State Revenue (Victoria)*, which was decided in November 1996, the High Court found that the Victorian Government could not impose stamp duty on a lease of a duty free store at Tullamarine Airport. The High Court viewed the tax as having a direct effect on Commonwealth territory and therefore as a breach of section 52(i) of the Constitution which provides that the Commonwealth shall have exclusive power over 'all places acquired by the Commonwealth for public purposes.'

The immediate outcome of the *Allders* case was that stamp duty and a number of other State taxes cannot be levied on Commonwealth places. The decision does not affect the tax revenue of the Territories. The decision has the potential to create State tax 'havens' which could weaken State revenue bases and considerably aggravate VFI. Another consequence of the decision is that it would confer a competitive advantage on businesses which would be exempt from State taxes simply because they are located on Commonwealth property. This contravenes the principles underlying NCP reforms.

Following discussions with the States, Commonwealth legislation was passed by Parliament with effect from 6 October 1997, imposing taxes which 'mirrored' the State taxes in the State surrounding each Commonwealth place. The State taxes to be 'mirrored' by the Commonwealth are stamp duty, payroll tax, financial institutions duty and debits tax.

The Commonwealth also agreed to implement a 100 per cent 'windfall gains' tax requiring State governments to pay to the Commonwealth any refunds ordered by a Court of taxes collected at Commonwealth places in the past.

New South Wales supports proclamation of all 'mirror' taxes as soon as possible so that there can be no doubt as to the tax liability of operations at Commonwealth places.

RECIPROCAL TAXATION

At the May 1994 Premiers' Conference, the Commonwealth and States agreed to the introduction of a Tax Equivalent Regime (TER) for sales and income tax on State (and Commonwealth) business enterprises in return for certainty in regard to their Commonwealth tax status. This agreement was embodied in a Statement of Policy Intent (SOPI).

Under the TER, State enterprises pay (a) the equivalent of wholesale sales and income tax to their owner State Government; and (b) State taxes. This was to ensure the existence of a level playing field between government and private sector enterprises. However, the implementation of SOPI arrangements remained contentious on the manner of application of the revenue neutrality principle.

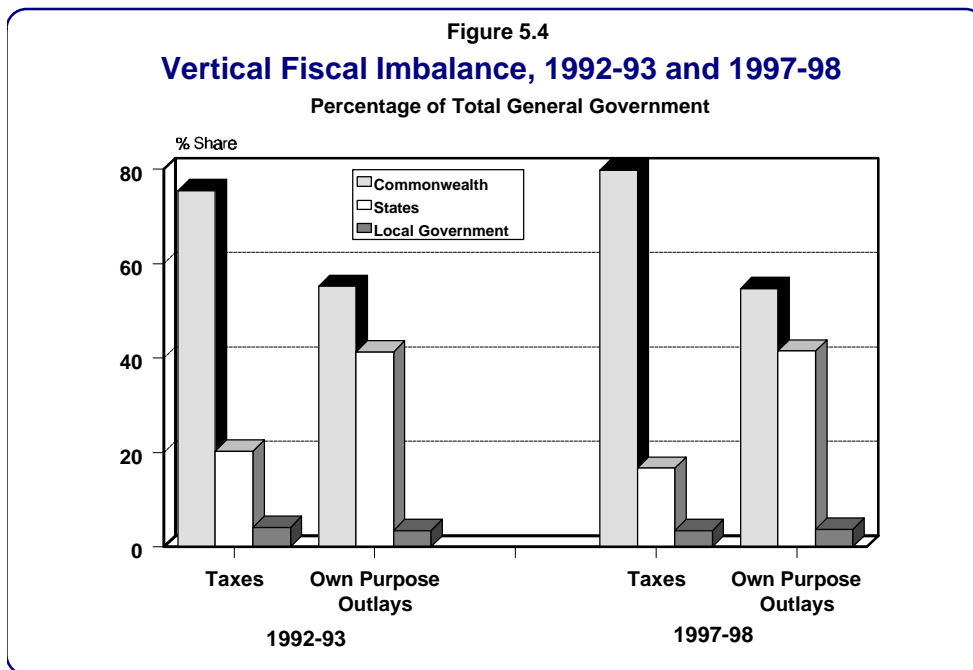
In July 1997 the Commonwealth and the States negotiated an Interjurisdictional Tax Agreement (IJTA). Under the Agreement the Commonwealth would introduce safety net arrangements to protect State revenues in the wake of adverse High Court rulings on *Allders* and s90. In return, States agreed to participate in a review of the merits of reciprocal taxation. Reciprocal taxation is the principle by which each government and its trading enterprises are subject to the taxes of the other levels of government.

The review was conducted by Heads of Treasuries and completed in February 1998 for consideration at the March 1998 Premiers' Conference. In the event the report was not considered and the matter is yet to be resolved.

5.3 THE TASKS AHEAD

VERTICAL FISCAL IMBALANCE

The degree of imbalance between the Commonwealth and State Governments remains excessive compared to other federations. The imbalance worsened following the High Court decision on State franchise fees (Figure 5.4).



VFI produces a number of negative consequences -

- It undermines governmental accountability for taxing and spending decisions because governments responsible for providing services are not necessarily responsible for raising the revenue to finance those services. This hampers States' ability to respond to community needs in a timely and effective manner.
- To the extent that the Commonwealth imposes fund matching requirements on its payments to States, VFI produces a bias towards over-expenditure, distorts States' spending priorities, and serves as a disincentive for States to exercise fiscal discipline. The imbalance results in costly duplication and overlap of services and/or associated administrative systems.

- The Commonwealth's effective domination of broad-based taxes forces States to rely on narrow, inefficient and regressive taxes. Periods of fiscal consolidation tend to increase even further the dependence of States on these taxes to finance their services, creating a vicious circle.
- Finally, VFI serves as a disincentive to the pursuit of microeconomic reform, since States must bear the brunt of the costs of implementation but cannot directly access the major increase in Commonwealth revenue resulting from these reforms.

The VFI problem may be remedied through a redistribution of either taxation powers or expenditure responsibilities, but in practice requires action on both.

NATIONAL TAX REFORM

The impetus for national tax reform offers a greater opportunity to address the VFI problem than has been possible in recent years. On August 13 1997 the Prime Minister stated that the Australian tax system was in need of reform, and that a Taxation Task Force would examine reform options based on the following principles -

- There should be no increase in the overall tax burden.
- Any new taxation system should involve major reductions in personal income tax with special regard for the taxation treatment of families.
- Consideration should be given to a broad-based, indirect tax to replace some or all of the existing indirect taxes.
- There should be appropriate compensation for those deserving of special consideration.
- Reform of Commonwealth-State financial relations must be addressed.

There is general consensus among diverse groups (ranging from the social welfare lobby to the business sector) that tax reform is urgently needed. In considering national tax reform at their October 1997 meeting, State Leaders emphasised that in addition to the principles enunciated by the Prime Minister, the following should guide deliberations on reform options -

- Reducing the tax burden on exports and business inputs in order to boost investment, jobs and international competitiveness;
- Reducing VFI by providing States with access to broad based growth taxes to replace the worst of their current taxes;
- Abolition of the majority of Commonwealth grants while maintaining fiscal equalisation to protect the smaller States and Territories; and
- Long term certainty and consistency in the tax system.

New South Wales is fully committed to the pursuit of national tax reform that delivers greater equity and efficiency in the tax system and enhances the accountability of governments. The States' inefficient and inequitable taxes and the long recognised problem of VFI should be addressed as integral parts of any national tax reform program. Therefore include the abolition of the most inefficient State taxes. These are the financial taxes such as financial institutions duty, debits tax, share transfer duty, loan security duty and stamp duty on business transactions. These should be replaced with access to appropriate tax bases.

It has been suggested that payroll tax also be abolished. However, payroll tax is one of the very few State taxes which are broadly based and relatively

1. Also, it has a relatively immobile tax base, and gives States the flexibility to determine the rates.

Abolish the grants by the High Court, and a substantial percentage of Commonwealth grants remaining in the form of tied payments have reduced States' financial independence. This can only be restored through a substantial reduction in Commonwealth grants offset by enhanced State access to appropriate tax bases. That is, VFI must be reduced.

2. Abolition of the worst State taxes

It is not possible to consider national tax reform without undertaking a review of State taxation. The overall tax system includes taxes imposed by States, many of which are narrowly based, relatively inefficient and inequitable.

National tax reform should therefore include the abolition of the most inefficient State taxes. These are the financial taxes such as financial institutions duty, debits tax, share transfer duty, loan security duty and stamp duty on business transactions. These should be replaced with access to appropriate tax bases.

It has been suggested that payroll tax also be abolished. However, payroll tax is one of the very few State taxes which are broadly based and relatively efficient. Also, it has a relatively immobile tax base, and gives States the flexibility to determine the rates.

3. Abolition of safety net arrangements for Business Franchise Fees

The current arrangements, which involve complex subsidy arrangements to industry, are not sustainable in the medium term. The safety net should be replaced by more permanent arrangements which provide fiscal flexibility to individual States.

Each of these three reform elements requires the State to gain access to a broader tax base. This would be best achieved through access to the Commonwealth personal income tax base, with the Commonwealth reducing its claim on that base by an equivalent amount so as to avoid any increase in the overall tax burden. This approach would not involve the imposition of an additional income tax, which the New South Wales Government would oppose.

Based on the above elements, one possible reform package could include the following -

- Abolition of financial institutions duty, debits tax, share transfer duty, loan security duty, non-residential conveyance duty, and a range of stamp duties (about \$5.4 billion in total).
- Abolition of safety net arrangements for business franchise fees on petrol, tobacco and liquor and incorporation of the safety net taxes in Commonwealth indirect tax reform (\$5.2 billion).
- A reduction in the level of Commonwealth grants to the States by about \$12 billion.
- The total cost to the States of these three changes (about \$23 billion) would be offset by the States gaining access to the personal income tax base without increasing overall personal income tax. This would involve transferring to the States a slice of the Commonwealth income tax base, leaving the progressivity of the rate scale unaffected and always under Commonwealth control. The Commonwealth would continue to define the base and administer all personal income tax collections.

The above proposal would essentially involve a tax swap, leaving the balance between direct and indirect taxation unchanged. This would obviate the need for complex compensation arrangements to selected groups within the community.

HORIZONTAL FISCAL EQUALISATION

Despite an expected slight real increase in general purpose payments to New South Wales in 1998-99, the State's FAG per capita remains 32.0 per cent less than the average of the six smaller States. New South Wales and Victoria will receive an estimated average of \$752 per head (before FCPs to the Commonwealth) compared with \$1,097 for the other jurisdictions. The estimated FAG per capita by State for 1998-99 is given below.

Financial Assistance Grants per capita, by State, 1998-99*

State/Territory	Financial Assistance Grant (\$ per capita)
New South Wales	746.65
Victoria	758.97
Queensland	918.80
Western Australia	878.37
South Australia	1,126.67
Tasmania	1,563.93
Northern Territory	5,343.15
Australian Capital Territory	908.74
AUSTRALIAN AVERAGE	894.84

* Before taking into account Fiscal Contribution Payments to the Commonwealth. Most States are expected to take the FCP as a reduction in FAGs, while the remaining States are considering the option of taking the FCP as a cut in nominated SPPs.

Based on the 1998-99 equalisation relativities calculated by the CGC, New South Wales, Victoria and Western Australia are net donors.

The level of transfers from donor States to recipient States can be measured on two different bases. The first is measured by reference to the difference between actual FAG payments and an equal per capita distribution of funding (CGC equalisation). On this basis New South Wales will be transferring \$944 million to the smaller States in 1998-99.

The combined transfer from New South Wales, Victoria and Western Australia⁵ is about \$1.6 billion before taking into account FCPs to the Commonwealth. FCPs increase the cross-subsidy from New South Wales because these payments are borne by States on an equal per capita basis, while FAGs are distributed on the basis of equalisation relativities.

The cross-subsidy from New South Wales to other States due to CGC equalisation has increased from \$781 million in 1994-95 to \$944 million in 1998-99. On a per capita basis, this amounted to an increase from \$128 per head in 1994-95 to \$148 per head in 1998-99.

Since FAGs were originally intended as compensation by the Commonwealth to States for their loss of income taxing powers, a second method measures the equalisation transfer as the difference between FAGs paid to each State and the level of Commonwealth personal income tax raised in that State. On this measure the transfer from the donor States is of the order of \$2.3 billion in 1998-99, over half of which is expected to come from New South Wales.

In overall terms, the transfer from New South Wales clearly remains substantial. In fact there has been an increase in the total cross-subsidy by New South Wales from \$187 per head in 1994-95 to \$217 per head in 1998-99. Over the long run, such sizeable cross-subsidies are not sustainable.

Table 5.2 at the end of this Chapter indicates the amounts transferred from donor States to recipient States in 1998-99.

In relation to interstate competition, some jurisdictions which have historically been recipients of HFE transfers are in a position to offer incentives to private business which they may not otherwise have been able to do in the absence of HFE. In this respect, the current HFE process remains an obstruction to the design of efficient State tax regimes.

More fundamentally, New South Wales continues to seek basic changes to HFE and remains committed to reformed arrangements which would put the fiscally stronger States (New South Wales, Victoria, the Australian Capital Territory, Queensland and Western Australia) on equal ground while preserving full equalisation for the three fiscally weakest jurisdictions.

⁵ Western Australia is a donor in terms of CGC equalisation, but remains a net recipient in terms of total redistribution because it continues to be a net recipient on the basis of tax equalisation. On the other hand, the Australian Capital Territory is a donor in terms of tax equalisation but a recipient in terms of CGC equalisation.

National tax reform offers the opportunity for reforming fiscal equalisation arrangements.

In the event that States and the Commonwealth agree to tax base sharing and a reduction in Commonwealth grants to the States, there is the possibility of reducing the equalisation pool and revising the CGC's assessments of State revenue capacity.

Since HFE transfers tend to distort tax policy choices of States, national tax reform in tandem with fundamental changes to fiscal equalisation would allow States to engage in beneficial interstate tax competition without necessarily 'bidding away' their own tax bases.

**Table 5.1: Intergovernmental Financial Relations, Selected Indicators
1993-94 to 1998-99**

Item	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99
COMMONWEALTH PAYMENTS TO NEW SOUTH WALES						
Million \$, Nominal						
General Purpose (Total) - after Fiscal Contribution Payments	4,099.4	4,386.2	4,566.6	4,688.1	4,811.0	4,830.5
General Purpose (net of Competition Payments) (1)	4,099.4	4,386.2	4,566.6	4,688.1	4,738.8	4,757.0
Specific Purpose (2)	3,407.5	3,331.6	3,430.2	3,524.9	3,601.2	3,718.4
Gross Payments (2)	7,507.0	7,717.8	7,996.8	8,213.0	8,412.2	8,548.9
Net Payments	7,114.1	7,044.3	7,609.5	7,754.5	7,967.9	8494.1
Percent Annual Change, Real (1998-99) Terms (2)						
General Purpose (Total)	8.2	5.0	2.8	(-) 3.6	0.9	1.5
General Purpose (net of Competition Payments) (1)	8.2	5.0	2.8	(-) 3.6	(-) 0.6	1.5
Of which: FAGs (after FCPs)	3.5	5.3	2.6	(-) 3.9	2.1	6.0
Specific Purpose	0.5	1.2	(-) 1.5	(-) 2.5	0.2	2.9
Gross Payments	4.6	3.3	0.9	(-) 3.1	0.6	2.1
Net Payments	(-) 0.9	3.3	1.0	(-) 3.1	0.5	2.4
Real Per Capita (1998-99 dollars) (2)						
General Purpose (Total)	736	765	778	740	739	742
General Purpose (net of Competition Payments) (1)	736	765	778	740	727	731
Of which: FAGs	688	717	727	690	697	731
Specific Purpose	614	615	599	576	571	582
Gross Payments	1,350	1,381	1,377	1,316	1,310	1,324
Net Payments	1,336	1,367	1,365	1,305	1,298	1,316
VERTICAL RELATIONS						
Ratio of per cent share of own- source tax revenue to per cent share of own-purpose expenditure (3)						
Commonwealth	1.32	1.32	1.27	1.33	1.46	n.a.
States	0.53	0.52	0.55	0.51	0.40	n.a.
Local Government	1.13	1.09	1.03	0.91	0.91	n.a.

n.a. - not available.

For footnotes, see next page.

NOTES TO TABLE 5.1

1. Identified Roads Grants have been subsumed into Financial Assistance Grants as from 1997-98.
2. Specific and general purpose payments are adjusted for letterbox, extraordinary or reclassified items (listed below, this footnote). In the calculation of real growth rates, nominal amounts are deflated using the Gross Non Farm Product deflator. Real per capita dollars and real annual growth rates reflect the following adjustments to nominal amounts published in the Commonwealth Budget Papers and Offer Document -
 - Only payments for State's own purposes are included. The following recurrent/capital payments are excluded - Higher Education; Non Government Schools including cost escalation; Research at Universities; Financial Assistance to Local Government; and Local Government Identified Roads.
 - Reclassification of Building Better Cities funding as a specific purpose payment rather than a general-purpose capital payment.
 - For comparability across years, dollar amounts and growth rates are adjusted to account for the following changes during the period -
 - (a) Reclassification of TAFE payments as a Commonwealth own-purpose payment beginning in 1994-95.
 - (b) Conversion of Higher Education and Research at Universities into a Commonwealth own-purpose payment from 1998-99.
3. Own purpose expenditures include payments to public trading enterprises.

Table 5.2: Estimates of Redistribution Through Fiscal Equalisation, 1998-99*

	RECIPIENT STATES					
	Qld	WA	SA	Tas	NT	Total
DONOR STATES						
(\$ million)						
CGC Redistribution						
NSW	86.3	36.5	180.7	166.6	474.0	944.1
VIC	58.0	24.5	121.5	112.0	318.6	634.6
ACT	(0.4)	(0.2)	(0.8)	(0.8)	(2.2)	(4.3)
WA	2.8	1.2	5.8	5.4	15.2	30.3
TOTAL	146.7	62.0	307.2	283.2	805.6	1,604.7
Tax Equalisation						
NSW	40.1	17.0	84.0	77.5	220.4	439.0
VIC	11.6	4.9	24.3	22.4	63.7	126.8
ACT	15.0	6.3	31.5	29.0	82.5	164.4
WA	(3.4)	(1.4)	(7.1)	(6.5)	(18.5)	(36.8)
TOTAL	63.4	26.8	132.7	122.4	348.1	693.4
Total Redistribution						
NSW	126.5	53.4	264.8	244.1	694.4	1,383.2
VIC	69.6	29.4	145.8	134.4	382.2	761.4
ACT	14.6	6.2	30.7	28.3	80.4	160.1
WA	(0.6)	(0.3)	(1.3)	(1.2)	(3.3)	(6.5)
TOTAL	210.1	88.7	439.9	405.6	1,153.7	2,298.1
NSW PER CAPITA CONTRIBUTION						
(\$ per Capita)						
CGC Redistribution	14	6	28	26	74	148
Tax Equalisation	6	3	13	12	35	69
Total Redistribution	20	8	42	38	109	217

***NOTES TO TABLE 5.2:**

1. The following examples illustrate how to interpret the numbers in the table. New South Wales contributes a total of \$944 million to other States through CGC fiscal equalisation, of which Queensland receives \$86m, Western Australia receives \$37m and so on. On the part of recipient States, the table shows that the Northern Territory receives a total of \$806m from all States, of which New South Wales contributes \$474m.
2. Transfers from donor States are allocated based on recipient States' average shares of the cross-subsidy in the past five years. Hence the numbers should be viewed as approximations only. (WA, for instance, appears in some instances to be 'subsidising' itself – this is due to this State being a donor on a CGC equalisation basis for only the last two years, whereas the estimates are based on five-year averages.)
3. Amounts shown above are before Fiscal Contribution Payments to the Commonwealth. Total redistribution is the sum of amounts redistributed due to (i) Commonwealth Grants Commission equalisation and (ii) tax equalisation. Tax equalisation is the difference between an equal per capita distribution and the level of payments if they were distributed in proportion to personal income tax collections in each State. Grants Commission equalisation consists of revenue equalisation (ie., taking into account the underlying revenue raising capacity of each State) and expenditure equalisation (ie. taking into account differential demand and supply factors which affect expenditure levels).

SOURCE: NSW Treasury estimates.