

Chapter 5:

FINANCIAL ARRANGEMENTS WITH THE COMMONWEALTH

5.1 Introduction

5.2 Recent Developments

5.3 The Tasks Ahead

5.1 INTRODUCTION

In recent years Commonwealth-State financial arrangements have been increasingly influenced by issues relating to the nature of the Australian federation itself. This has been reflected in the debate regarding the distribution of tax powers and functions among the different levels of Government.

Some quarters have argued for centralisation on various grounds, including alleged efficiency savings and the need to maintain national standards of service delivery. However, arguments favouring the substantive devolution of taxing powers and spending decisions have also been based on the benefits of efficiency improvements, reduced duplication of administrative overheads and increased governmental accountability. In a broader context, arguments for devolution are driven by the need for checks and balances. On this basis a federal structure is expected to reflect a rational separation rather than a concentration of power.

The issues are well illustrated in Commonwealth-State¹ financial relations in Australia, which 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

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 prior to 1942 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

- an extensive system of **horizontal fiscal equalisation (HFE)** which governs the interstate distribution of Financial Assistance Grants (FAGs), and which is 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.

Annual decision-making has traditionally been made through established mechanisms which include all Heads of Government. These are the Financial Premiers' Conference/Loan Council, which determines the distribution of general revenue grants and Loan Council Allocations for the coming year; and the Council of Australian Governments (COAG), which deals with all other aspects of government policy.

Much of the current debate concerning Commonwealth-State financial relations and the latitude for reform is rooted in the issues of HFE and VFI. There remains much room for improvement, particularly to enhance governmental accountability and service delivery and to enable States to adopt more efficient tax policy regimes.

Interstate disagreements over HFE have been less apparent than in the early 1990s, as attention has shifted to VFI issues. In respect to horizontal relations the most significant development in recent years has been the increasing incidence of interstate tax competition. This has taken the form of either firm-specific tax concessions or the announcement by some jurisdictions of intentions to slash or abolish selected taxes in a bid to attract private business. To end such bidding wars and allow States to compete on the basis of business fundamentals will require VFI to be addressed or, as a minimum, voluntary agreement to be reached on defining the grounds for competition.

The issue of VFI remains intractable. At present, States account for only 19 per cent of total general government tax revenue, yet remain responsible for about 41 per cent of own-purpose outlays⁴.

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.

The vertical imbalance has worsened in the last two years. The ratio of the percentage share of own-source tax revenue to the percentage share of own-purpose outlays for the Commonwealth has increased from 1.39 in 1993-94 to 1.43 in 1995-96, while the same ratio for States has declined from 0.52 to 0.46⁵. These numbers indicate that there continues to be a very high degree of centralisation of revenue powers.

The Commonwealth continues to hold the broadest taxing powers including income and sales taxes and customs and excise duties. While originally States could levy all but customs and excise duties, a series of decisions by the High Court of Australia expanding the definition of “excise” have effectively barred States from imposing sales taxes except for a few franchise fees, which are continually under threat. In the absence of a High Court decision reinterpreting the definition “excise”, there remain a number of options for reform. These include a redistribution of the existing Commonwealth tax take - which would effectively result in an expansion of State tax powers without increasing the overall tax burden - and alternative forms of tax-sharing.

The VFI problem is also evident in payment arrangements relating to microeconomic reform. While the April 1995 national competition policy agreement between the Commonwealth and States indicates that there is much common ground, conditions imposed on States' access to competition-related payments in the nine years to 2005-2006 have effectively converted into tied grants a portion of general purpose payments to be made in those years. The present 3-year rolling guarantee on real per capita growth in FAGs which was agreed by COAG in April 1995 remains subject to the Commonwealth's determination that there is no “deterioration in macroeconomic circumstances” - a stipulation which leaves too wide a berth for the exercise of Commonwealth discretion.

⁵ Ideally the ratio should be at or close to 1.00 for each level of government in order for revenue powers to be broadly commensurate with expenditure responsibilities.

On the expenditure side, the ongoing COAG review of roles and responsibilities offers the prospect of a redistribution of functions such that they become more in line with the distribution of tax powers. A redistribution of expenditure responsibilities could potentially reduce tied grants. Work is progressing in the areas of public housing, health and community services. States are also pressing for changes in the areas of education, employment and training.

Following a continuous real decline in general purpose payments during the five years to 1992-93, New South Wales has had a real annual increase⁶ each year since 1993-94. Assuming that the recommendations of the 1996 Update Report of the Commonwealth Grants Commission will be accepted by Premiers' Conference in June 1996, New South Wales will post a real increase in general purpose payments of about 2.6 per cent in 1996-97. However, this still represents a rapid deceleration since 1993-94. The real growth of about 7.0 per cent in 1993-94 was merely a partial catch-up on a cumulative loss of \$1.1 billion in real terms over the preceding six years. Also, growth in real terms has not kept pace with expenditure demands and with growth in the economy more generally.

Specific purpose payments⁷ expressed as a share to total Commonwealth payments to all States remained high at around 41 per cent in 1995-96, up from 34 per cent a decade before. Corresponding percentages for New South Wales were 44 per cent and 38 per cent respectively. In 1996-97 these ratios are expected to change only marginally to 40/60 for all States and 43/57 for New South Wales, suggesting that the degree of budget flexibility of States remains restricted.

6 Net of the impact of the untying of Identified Road Grants beginning 1993-94. For FAGs alone the growth rates are shown in Table 5.1, which appears at the end of this chapter.

7 For States' own purposes only. Excludes the following payments for which the State acts as an agent for payments to third parties: Higher Education; Non Government Schools (including cost escalation); Research at Universities; Financial Assistance to Local Government; and Local Government Identified Roads. Moreover, for comparability across years, funding shares are adjusted to account for the following: classification of Building Better Cities funding as a specific purpose capital payment; and the exclusion of TAFE payments in years prior to 1994-95 to account for their reclassification to a Commonwealth own-purpose payment from that year. However, TAFE payments continue to be recorded as a NSW budget receipt.

The high share of SPPs reduces the incentive for States to manage their budgets and deliver services efficiently. Any benefits from the broadbanding of SPPs, which was originally intended to increase State budget flexibility, could easily be eroded by an accompanying increase in SPP conditionality. States previously sought a reduction in the share of tied funding subject to the absorption of SPP funds into the general revenue pool. However, this has not occurred.

On the whole there has been little change in Commonwealth-State financial relations in the past year. Commonwealth payments to New South Wales and measures of vertical fiscal imbalance and the impact of fiscal equalisation over the past five years are given in Table 5.1, which appears 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 should be viewed 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 -

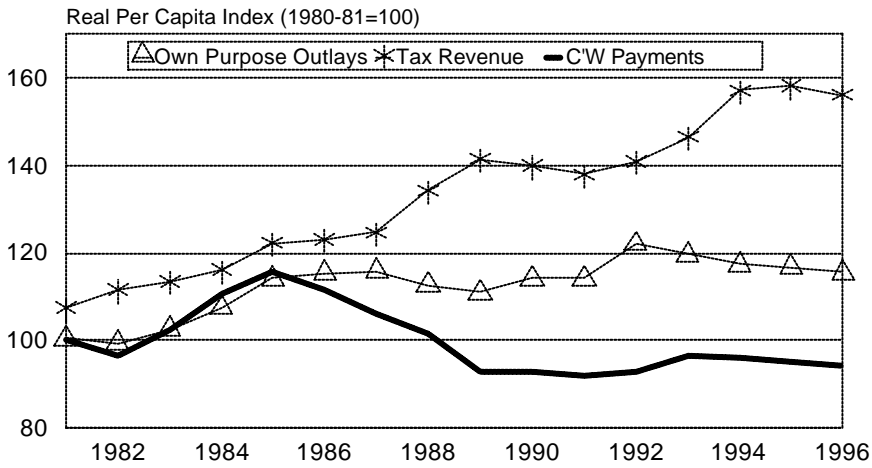
- Over the past 15 years Commonwealth own-purpose outlays grew in real per capita terms at a higher average annual rate (2.0 per cent) than either Commonwealth tax revenues (1.6 per cent) or Commonwealth payments to States (-0.3 per cent). Figure 5.1 shows that payments to States declined drastically in real per capita terms particularly during the late 1980s (-4.2 per cent annually) and has so far failed to regain pre-1987 levels;
- In contrast, States undertook fiscal consolidation and expenditure restraint, resulting in substantial improvement in States' fiscal position after 1991-92. This was reflected in average annual growth in real per capita State tax revenue (1.7 per cent during 1989-90 to 1995-96) substantially exceeding that of State own purpose expenditure (0.6 per cent during the same period) at the same time that Commonwealth payments to States increased at a rate of only 0.3 percent annually (Figure 5.2); and
- The decline in Commonwealth payments during the late 1980s was borne by general revenue grants. Increasing Commonwealth inroads into the delivery of State services was reflected in the progressively increasing share of SPPs to total Commonwealth payments to States during this period, from 34 per cent in 1985-86 to 40 per cent in 1996-97 (Figure 5.3). Although the share of SPPs has declined slightly from 42 per cent in 1992-93, the percentage remains relatively high.

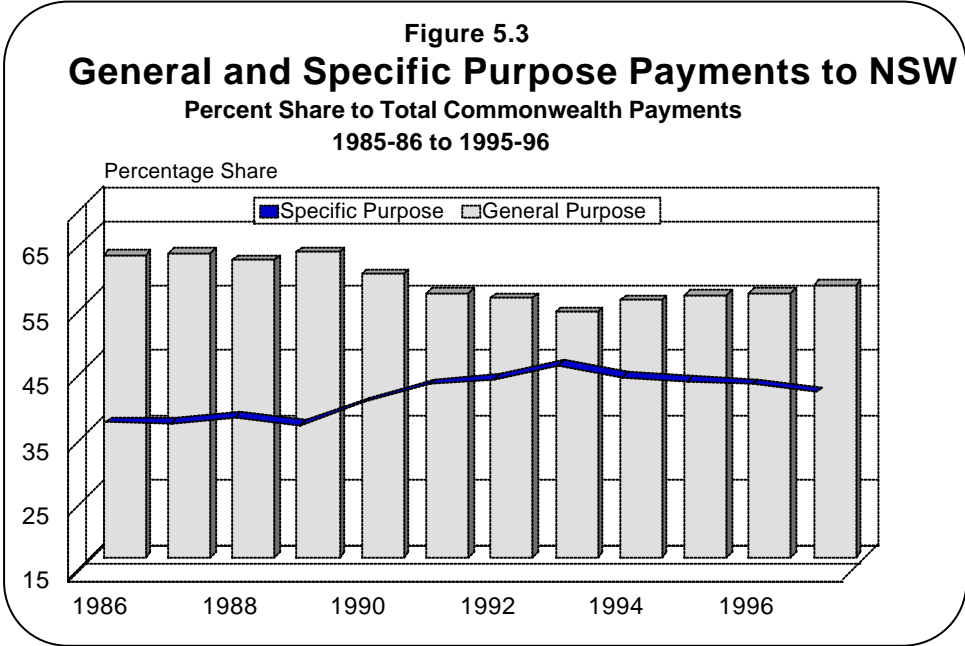
Given the marked difference in fiscal discipline exercised by the Commonwealth and States in recent years, it would not be appropriate for the Commonwealth to shift its deficit problem to States as part of the current round of fiscal tightening.

There would appear to be room for further budget tightening on the Commonwealth's own purpose expenditures. Since Commonwealth payments to States were already drastically pared down in previous budget cycles, further curtailment in the quantity and quality of State services cannot be sustained unless it is accompanied by a redistribution of expenditure functions.

Figure 5.1
Commonwealth Aggregates: Real Per Capita Growth
Tax Revenue, Own Purpose Outlays and Payments to States
1980-81 to 1995-96

Figure 5.2
All States: Real Per Capita Growth
Tax Revenue, Own Purpose Outlays and Commonwealth Payments
1980-81 to 1995-96





Developments in Specific Purpose Payments

Possible future changes to SPPs were foreshadowed by two reviews held in 1995-96.

The first was an inquiry by the Commonwealth Joint Committee of Public Accounts, whose final report⁸ was released in November 1995. Among other things, the report recommended that -

- future SPP agreements should contain an explicit statement defining roles and responsibilities of each party, measurable outcomes and program output indicators, data collection requirements and graduated sanctions for non-compliance;
- input controls (eg maintenance of effort clauses, matched funding and fund capping requirements) be phased out and replaced with performance agreements, and that performance evaluation be undertaken at least every three to five years; and
- the Commonwealth investigate the possibility of broadbanding existing SPPs and applying best practice to SPP administrative arrangements.

The Commonwealth also commissioned a Task Force on Payments to Statutory Authorities and SPPs to States in late 1995. This review was intended to examine cash management arrangements of Commonwealth statutory authorities and SPPs to States. While the report of the Task Force has not been made public, it is understood to have recommended changes in cash management arrangements which would yield savings to the Commonwealth ranging from \$100m to \$400m.

⁸ Report No. 342, *The Administration of Specific Purpose Payments: A Focus on Outcomes*, Joint Committee of Public Accounts, November 1995.

Should the changed arrangements apply to SPPs to States, this would result in the Commonwealth clawing back interest earnings on SPP cash balances. Given that SPP cash flows are already largely synchronised with States' needs, the proposed arrangements carry the risk of disrupting service delivery at the State level. The recommended changes to SPP payment arrangements follow major changes to SPP indexation arrangements announced in the Commonwealth 1995-96 Budget, which are expected to yield smaller funding increases for most SPPs than under previous arrangements.

1996 Update Report by the Commonwealth Grants Commission

The Commonwealth Grants Commission (CGC) is required to report on relativities for the distribution of general revenue funds among the States based on the principle of fiscal equalisation - i.e., the distribution of funds "should enable each State to provide, without having to impose taxes and charges at levels appreciably different from the levels imposed by the other States, government services at a standard not appreciably different from the standards provided by the other States".

The Commission updates general revenue grant relativities on the basis of new data each year and conducts a full review of its methodology every five or six years. The last methodology review was completed in March 1993. In February 1996 the CGC completed its 1996 Update Report, which recommended a \$7 million increase in New South Wales' share of general revenue funds in 1996-97. The relatively small net impact for New South Wales reflects offsetting positive and negative adjustments in the CGC's assessments.

Gains came primarily from the use of updated data; revised treatment of funding for repatriation general hospitals; and reduced revenue capacity on land revenue and vehicle registration fees and taxes during the review period. On the other hand, losses arose mainly from an expanded mining revenue base and increased revenue capacity for payroll, gambling and insurance taxation.

A major finding of the report pertains to significant changes in the composition of the standard budget of States due to increased reliance on States' own-source revenues and an increase in superannuation funded on a concurrent basis. These trends could exert increasing influence on general revenue grant relativities in future years. Should the CGC recommendations be adopted for 1996-97, New South Wales is expected to post a real increase in general purpose payments of about 2.6 per cent in 1996-97.

Loan Council Developments

Under Loan Council guidelines approved in 1993, each jurisdiction nominates its Loan Council Allocation (LCA) each year. The LCA consists of the projected surplus/deficit for the total State plus certain memorandum items⁹.

The 1996-97 LCA bid of New South Wales amounts to minus \$785m, as against the 1995-96 estimate of minus \$440m. Since a State's LCA is intended to provide an indication of that State's call on financial markets in the coming year, the negative LCA bid indicates that New South Wales expects to contribute to (rather than make demands on) national savings in 1996-97. Further details of the NSW bid are given in Budget Paper No. 6.

As agreed last year, LCAs will be subject to a tolerance limit of 2 per cent of non-financial public sector revenue, down from 3 per cent in 1995-96. This margin is designed to accommodate, among other things, changes to the LCAs arising from policy and parameter changes. Progress against budget time LCAs will be monitored in quarterly reports through the year.

In March 1994 Loan Council endorsed guidelines for the treatment of infrastructure projects with private sector involvement. The guidelines required an analysis of risk-sharing between the public and private sector in order to avoid project arrangements designed specifically to avoid Loan Council coverage.

A Loan Council Working Group has conducted a review of the guidelines and has recommended the options of either maintaining the present treatment, with further consideration to be given to discounting of asset values (a net liabilities approach); or including the full government contingent liability in the LCA (a gross liabilities approach). The options are still under discussion.

Tax Treatment of State Trading Enterprises

⁹ These items are transactions having the characteristics of public borrowing but which do not strictly constitute formal borrowing. For instance, positive adjustments such as operating leases and a government's risk-weighted contingent exposure to private sector infrastructure projects; and negative adjustments such as the overfunding of employers' costs under public sector superannuation schemes.

At the 1994 Financial Premiers' Conference the Commonwealth and States agreed to a Statement of Policy Intent (SOPI) which committed the States to implement within three years uniform tax equivalent regimes applying to wholly-owned State trading enterprises (STEs), including those presently subject to Commonwealth taxation. In return the Commonwealth agreed to amend legislation to exempt those entities from income and wholesale sales taxes (WST).

Under the SOPI neither the States nor the Commonwealth would be financially advantaged or disadvantaged by the new arrangements. A Commonwealth State Tax Equivalent Regime (TER) Standing Committee was created to oversee implementation of the SOPI.

A Draft Compensation Policy for STEs was prepared by the Commonwealth last year. The policy broadly provides for the Commonwealth to compensate States for entities jointly owned by the Commonwealth and one or more States becoming subject to Commonwealth taxes; and for the States to compensate the Commonwealth for entities becoming exempt from Commonwealth taxes as a result of the implementation of the SOPI and which were taxable on 25 March 1995. Guidelines are also provided for the treatment of new entities created on or after 25 March 1994.

In line with SOPI commitments, legislative changes were introduced in the Commonwealth Parliament in March 1995 as part of the *Taxation Laws Amendment Bill No. 2 1995*. The legislation was passed in December 1995 and will apply retrospectively from 1 July 1994. Excluded State and Territory Bodies are to be prescribed in regulations to the legislation.

Entities which were taxed federally (and for which a public commitment was made to privatise the entity) at the time of the 1994 Premiers' Conference may be prescribed for continued federal income tax coverage until 30 June 1997, and may be prescribed for continued WST coverage. The TER Standing Committee is reviewing the States' lists of entities meeting the requirements of the new exemption provisions. To date, all States have prepared their prescribed lists. However, gazettal of the lists has been postponed due to elections in recent months in a number of jurisdictions.

Future work of the TER Committee will include establishing standards to assess the uniformity and effectiveness of TERs, and a review of each State's TER for consistency with Commonwealth legislation. A number of papers are being developed to deal with standards which, if approved, will eventually be recommended to be incorporated in States' TERs.

Tax Compensation for Privatisation

With respect to privatised agencies which were previously tax exempt, a Commonwealth-State working group was convened to develop guidelines for WST compensation associated with full or partial privatisation of STEs.

Work is also proceeding on the principles for income tax compensation for full privatisation. A formula under consideration is based on the present value of the projected net increase in tax cash flows of the Commonwealth. This approach creates problems associated with predicting future flows and determining appropriate discount rates. Significant differences between the Commonwealth and States remain, as the Commonwealth argues for a narrower basis for compensation than the States.

Discussions are also ongoing between the Commonwealth and States regarding the generic tax treatment of privatised STEs which were previously exempt from Commonwealth taxes. In this connection the Commonwealth announced last year its intention to introduce relevant changes to the *Income Tax Assessment Act 1936*. The changes are intended to introduce consistency in the treatment of such entities in lieu of the previous case-by-case treatment. A major issue is the setting of the opening value of fixed assets for depreciation purposes. While it has been agreed that the use of market value is appropriate, an acceptable formula is being determined in bilateral discussions between the Commonwealth and individual States.

Review of Commonwealth-State Roles and Responsibilities

Where the degree of VFI is excessive, the potential for overlap and duplication increases substantially because the borders of expenditure responsibility constantly change depending on the nature of financial transfers from the Commonwealth to the States. This is particularly true where the constraints on own-source tax revenue of States are fairly fixed, their expenditure responsibilities are broad and continually under upward pressure, and their general revenue grants are subject to a significant degree of uncertainty.

In the past, VFI has enabled the Commonwealth to enforce policy decisions or implement programs in areas more efficiently handled by States. This has resulted in significant overlap and duplication between the Commonwealth and States, an associated increase in SPPs, the imposition of more restrictive conditions on the use of Commonwealth funds, and fragmentation and inefficiency in service delivery.

Notwithstanding a number of attempts to address the issue, little progress has been made. However, in cognisance of the problem a 1993 Financial Premiers' Conference agreement led to a review of roles and responsibilities under the aegis of the COAG.¹⁰

This review has been guided by principles agreed by COAG in February 1994. It was agreed at that time that while SPP arrangements would vary across programs, in areas of shared responsibility the Commonwealth's interest would most often be in the area of broad, jointly agreed strategic goals. This would involve program planning and a concern for achievement of program performance and outcomes for clients. The States would retain interest in these matters but would have primary responsibility for program implementation and management.

The review of roles and responsibilities has resulted so far in some decisions being taken regarding health and community services and public housing.

¹⁰ The most significant effort to comprehensively address the issue was a major review of SPPs completed by a Commonwealth-State Working Group on Tied Grants and submitted to Special Premiers' Conference in November 1991. The review suggested several reform options and recommended principles and guidelines for agreements covering "shared responsibility" programs. States also canvassed reform options in 1994 as part of the COAG review of roles and responsibilities.

In health and community services, the COAG agreed in principle in April 1995 to reorganise the boundaries of existing programs into three streams (general care, acute care and coordinated care) and to reform planning and monitoring arrangements on the basis of care outcomes rather than program inputs. However, progress has been generally slow. Concerns remain with respect to corresponding changes in funding arrangements. More recently, press reports have foreshadowed a transfer to the States of much greater responsibility for major health, housing, nursing home and child care programs. These reforms are expected to be discussed at the next COAG meeting in 1996.

In public housing the Commonwealth and States have been negotiating a new interim Commonwealth-State Housing Agreement (CSHA). The interim CSHA has yet to be finalised, and is intended to serve as a transition to new long term arrangements which would entail a major shift in responsibilities. The proposed long-term arrangements for public housing would make the Commonwealth solely responsible for the provision of housing subsidies. The States and the private sector would have responsibility for the delivery of housing services and tenancy and property management, which would be operated on a purely commercial basis.

At a Leaders' Forum held 12 April 1996, State Premiers and Chief Ministers agreed to support the general direction of reforms in health and community services, subject to the restructuring of key programs and reforms in associated tied grants. Agreements at the Leaders' Forum (discussed in more detail in the next section) carry the potential for genuine long-term changes in the distribution of Commonwealth and State roles and responsibilities.

National Commission of Audit

In March 1996 the Commonwealth announced the terms of reference for a National Commission of Audit (NCA) to recommend ways to improve the Government's fiscal position over the medium to long term. The NCA is expected to report to the Federal Treasurer and the Minister for Finance by 19 June 1996.

Although the announcement relates to the Commonwealth's own fiscal position, some areas of the terms of reference could impact on Commonwealth-State financial arrangements. Among other things, the NCA is instructed to look into the effectiveness and efficiency of current service delivery arrangements between States and the Commonwealth, and identify areas of overlap, duplication and cost-shifting.

The NCA will examine the relationship between service funder and service provider roles, the scope for contestability in service provision, and the options for restraining the growth in total outlays and improving the quality of public expenditure. These could include efficiency savings through the use of performance benchmarks and cost implications of demographic changes.

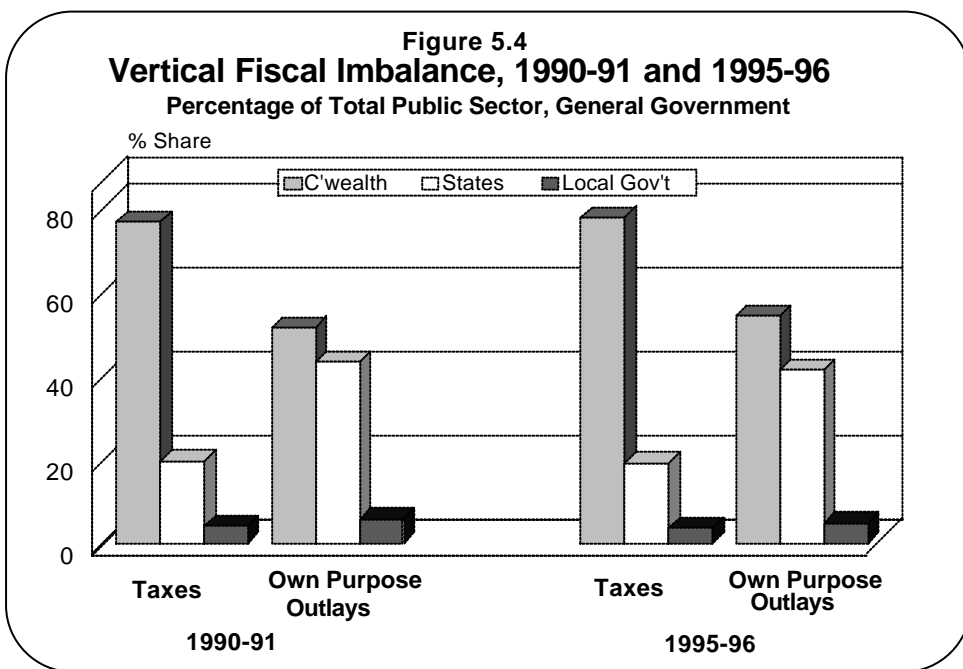
States will be making a joint submission to the NCA. The submission will address the following key areas -

- The opportunity for long-term reform of Commonwealth-State roles and responsibilities and financial relations;
- Proposal/s to reduce VFI and for the States to receive revenue more in line with their expenditure responsibilities; and
- As a matter of urgency, duplication in service delivery to be removed particularly in health and community services, employment and training, education and housing.

5.3 THE TASKS AHEAD

Vertical Fiscal Imbalance

The degree of imbalance between Commonwealth and State Governments remains excessive compared to other federations, and has changed little in the last five years (Figure 5.4).



VFI produces a number of negative consequences.

It undermines governmental accountability for taxing and spending decisions. Ideally, to the extent possible governments responsible for providing services should also be responsible for raising the revenue to finance those services. The inconsistency between revenue-raising and spending powers greatly hampers States' ability to respond to community needs in a timely and effective manner.

Because VFI allows the Commonwealth to impose fund matching requirements, it produces a bias towards over-expenditure and distorts States' spending priorities. Moreover, it serves as a disincentive for States to exercise discipline through the credit-rating process, as the high level of States' financial dependence on the Commonwealth gives rating agencies the impression that the Commonwealth bears the risk of States' financial obligations.

VFI results in costly duplication and overlap of services and/or associated administrative systems.

For instance, a recent consultancy study by ACIL Economics¹¹ found that while estimates of direct overlap in administrative costs may be low relative to total program expenditure, indirect overlap and duplication tends to be more pervasive but less visible and less easily quantifiable. Based on case studies in transport, housing, education and an assessment of overall government approval risk¹², the ACIL study concluded (among other things) that SPPs and the development approvals process constitute the main areas where indirect overlap and duplication occur.

A by-product of VFI is that it forces States to rely on narrow, inefficient and regressive taxes to finance their services.

11 ACIL Economics, *Costs of Overlap and Duplication Between Different Levels of Government*, September 1995.

12 This refers to the risk of "shifting of the goalposts" - ie, the possibility of government approval being withheld or withdrawn, or the terms of approval modified unilaterally, to the detriment of the project.

A substantial proportion of State taxes fall on business inputs. A recent study by Access Economics on Federal-State financial relations¹³ found that the most distortionary State taxes are stamp duties¹⁴, land tax, motor vehicle registration charges and business franchises, in that order. These four items account for roughly 40 per cent of State taxes, fees and fines. The same study estimated that Australian incomes would be 1.1 per cent higher if tax bases available to States were freed up, and that if such reform had been implemented in 1970 and the extra income saved, net foreign debt would have been about a third of current levels.

Finally, VFI serves as a gross disincentive to the pursuit of microeconomic reform, since States must bear the brunt of the costs of implementation but cannot directly access the increase in revenue resulting from these reforms.

The VFI problem may be addressed by a redistribution of either taxation powers or expenditure responsibilities.

Tax Powers

With respect to the distribution of tax powers, there is the possibility of a High Court decision which might re-interpret the definition of "excise" more narrowly. However, the degree of VFI could also worsen in future depending on the outcome of challenges to State franchise fees filed in the High Court.

A previous High Court decision (*Capital Duplicators Pty Ltd versus the ACT*) in December 1993 upheld the validity of liquor and tobacco licensing legislation but raised doubts about petroleum product license fees. Should these fees be ruled invalid, New South Wales would lose an estimated \$530 million (\$1.4 billion for all States).

A case filed by *Arafura Transport Pty Ltd* in January 1994 challenging the validity of NSW petroleum franchise fees has not progressed. However, more recently, another case (*Terril Pty Limited and James Forrest*) has been filed in the High Court seeking the invalidation of NSW tobacco franchise fees on constitutional grounds.

¹³ *An Access Economics Study on the Distribution of Federal/State Financial Powers* (Draft), September 1995.

¹⁴ Excluding stamp duties on motor vehicle third party and insurance contracts.

As the tobacco under question was alleged to have been exported from Australia and then subsequently imported back into the country, this case differs from previous cases in that it invokes the part of Section 90 relating to the Commonwealth's exclusive power to impose customs duty. It remains uncertain how far this case can progress given the 1993 Capital Duplicators decision.

Previous efforts have been made to canvass reform options entailing a redistribution of tax powers.¹⁵ In a working party report to Special Premiers' Conference in late 1991, Commonwealth-State officers examined the options of -

- adjustments to existing State taxes;
- the introduction of new State taxes; and
- a reallocation of part of Commonwealth taxes to States.

All three options included corresponding reductions to Commonwealth payments to States. Against a number of criteria (reliability and efficiency of the tax base, no impairment of macroeconomic management, revenue neutrality on a national basis, correspondence of the tax base with expenditure responsibility, accommodation of locational diversity, acceptance of the principle of fiscal equalisation) tax-sharing options performed most favourably. At the time these proposals were put forward, they were caught up in political developments at the time and were rejected by the Commonwealth.

Consistent with the direction of reforms canvassed in recent years, Premiers and Chief Ministers agreed at the Leaders' Forum in April 1996 that they remain committed to a federal structure in which there is a guaranteed revenue base for States which matches their expenditure responsibilities.

Expenditure Responsibilities

¹⁵ The most important of these was a report of the Working Party on Tax Powers to the 20-21 November 1991 Special Premiers' Conference, entitled *Taxation and the Fiscal Imbalance Between Levels of Australian Government: Responsibility, Accountability and Efficiency*. In like vein, the more recent Access Economics study on Federal-State financial powers (September 1995) attempted to quantify the impacts of the transfer of all or part of selected Commonwealth tax powers to States.

In the absence of a redistribution of taxing powers or revenue-sharing with the Commonwealth, work should continue on a clear delineation of Commonwealth and State roles, which would be the basis for any redistribution of expenditure responsibilities.

The increasing debate over the form and structure of the Australian federation in the lead-up to the centenary of federation offers the opportunity to undertake fundamental reforms. Ideally the distribution of functions should be based on a number of key principles. These are -

- *Australian Nation principle* - all Australian Governments should recognise the social, political and economic imperatives of nationhood while accepting the need to maintain diversity where national interests are not involved;
- *subsidiarity* - functions should be devolved to the maximum extent consistent with the national interest;
- *structural efficiency* - increased competitiveness and flexibility of the Australian economy requires structural reform in the public sector to complement private sector reforms; and
- *accountability* - the structure of intergovernmental relations should promote democratic accountability and transparency of the government to the electorate.

Based on these principles, decisions need to be taken on whether governmental functions are best served by shared Commonwealth-State responsibility or by one level of government taking sole responsibility. Once this is clearly defined, the appropriate financial arrangements (ie, whether Commonwealth payments should be an SPP or a contract/fee-for-service arrangement) and corresponding reforms in the system of tied grants can follow.

New South Wales has consistently argued for a reduction in the share of tied payments subject to their absorption into the general revenue pool, a wind-down of matching requirements on the remaining tied grants, and interstate distributional issues being addressed.

After 1992-93 there was indeed a reduction in the share of tied grants to total payments to States. However, this was not part of a broader agenda to reform the system of Commonwealth payments, and was not accompanied by a corresponding increase in general purpose payments. New South Wales strongly supports a move to untied funding as an integral part of a review of roles and responsibilities between levels of Government.

With respect to those tied grants which are retained for areas of shared responsibility, New South Wales supports the reforms proposed in the Joint PAC report on the administration of specific purpose payments. However, care should be taken that any generic approach to SPPs does not entail an increase in SPP conditionality and allows for diversity in service provision.

It is also necessary that the Commonwealth agree not to impose unfunded mandates on State Governments. In the past the Commonwealth has issued legislation or committed itself to international agreements which imposed financial obligations on States. Indiscriminate recourse to the Commonwealth treaties power without adequate consultation with States would result in unanticipated costs to States, and could wreak havoc with States' fiscal management.

At the Leaders' Forum held on 12 April 1996, State Premiers and Chief Ministers agreed on a number of areas of reform in Commonwealth-State roles and responsibilities. During the coming year the States' priority will be to progress this reform agenda with the Commonwealth. State Leaders agreed to seek reforms in Commonwealth-State roles and responsibilities and associated SPP arrangements in a number of specific functional areas.

In *health and community services*, States seek the Commonwealth's agreement to fund all health SPPs as one payment or to absorb them into FAGs. The latter would generate some administrative savings for the Commonwealth and give the States sole responsibility for health and community services other than Commonwealth transfers/subsidies such as Medical Benefits Supplement (MBS) and Pharmaceutical Benefits payments (PBS). Regulatory duplication could be removed by making only one level of Government responsible for the registration of service providers of pathology services, neo-natal intensive care, private hospitals and (in some States) nursing homes.

Alternatively, State Leaders may consider the option of pooling Commonwealth program funds for health and community services provided that one level of Government becomes solely responsible for the coordination and delivery of services, and it is demonstrated that this will reduce cost-shifting and improve efficiency. However, before agreeing to adopt this model States seek a major restructuring of the MBS and PBS programs - including a shift in emphasis from quantity to quality general practices, targeting high-growth areas in the MBS Schedule and allowing the substitution of services.

In *employment and training*, States seek improvements in the linkage between employment and training programs, particularly technical and further education (TAFE). There remains a great deal of duplication and operational restrictions imposed on States, and it is States' view that the Australian National Training Authority (ANTA) does not currently meet its objectives.

In *education*, States will push for the immediate transfer from the Commonwealth to States of responsibility and funding for government school education programs which are currently funded through SPPs. There are many opportunities for tradeoffs in functional responsibilities in the education, training and employment area. For instance, while the States could take over sole responsibility for school education and TAFE, the Commonwealth could become solely responsible for the funding and oversight of universities.

With respect to the *environment* States seek improved consultation on World Heritage area listings; the removal of exemptions of Commonwealth places and activities from State environmental and land use laws; and accreditation of State environmental practices and procedures under the Intergovernmental Agreement on the Environment.

Interstate Competition for Private Business

Given the benefits to be derived from economic growth, it is not surprising that Governments feel compelled to actively compete for footloose industry. While many forms of interstate competition need not require additional outlays (for instance, conducive regulatory regimes; provision of information and facilitation services), most of the recent inducements offered to private businesses have entailed the loss of tax revenue or the provision of additional expenditure by State governments.

Recent examples of interstate competition include Queensland's halving of share duty last year and the announcement to phase down land tax over a ten-year period; and various incentives to encourage specific firms or special events to locate in certain jurisdictions.

While horizontal competition between States can encourage greater efficiency, there is also a high risk that it could yield a zero-sum or negative-sum result Australia-wide because public resources absorbed by incentives have opportunity costs, and it is by no means certain that purported benefits would be sustainable.

Based on experience in other countries, incentives have been successful and their benefits more sustainable when these incentives were addressed to pricing, regulatory or incentive regimes at a general level rather than in the form of specific incentives to particular firms. For example, criteria which appear to have successfully generated productive investment include a preference for local over imported capability, activities with substantial positive externalities, and the use of instruments or implementing mechanisms which are firm - or interest-group neutral.

New South Wales remains of the view that a fiscally responsible State cannot compete effectively and innovatively with other jurisdictions unless the VFI problem is addressed. As long as States' revenue bases remain narrow, inefficient and inelastic, State Governments will have little or no room to manoeuvre on tax policy. Merely reducing or removing exemptions on existing State taxes would hardly be sufficient to resolve the vertical imbalance.

For this reason New South Wales considers it necessary to end the practice of bidding wars, possibly through interstate agreement to phase out selective and discriminatory subsidy policies. The preferred approach is for States to compete for mobile investment within Australia on the basis of business fundamentals - i.e., in terms of costs and market conditions generally available to prospective firms in different jurisdictions.

States could also explore voluntary agreements defining the grounds for competition in certain areas - for instance, agreements to harmonise selected tax rates or bases; or the adoption of consistent pricing or regulatory regimes across State borders.

Horizontal Fiscal Equalisation

Despite the expected real increase in general revenue grants to New South Wales in 1996-97, the State's FAG per capita remains 32 per cent less than the average of the four smallest States. New South Wales and Victoria will receive an estimated average of \$713 per head compared with \$1,044 for the other jurisdictions.

Based on the 1996-97 distribution of general revenue grants recommended by the CGC, New South Wales, Victoria and the ACT will continue to be net donors. The level of transfers from these States to the other 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 \$855 million to the smaller States in 1996-97. The combined transfer from New South Wales, Victoria and the ACT is about \$1.5 billion.

Since FAGs were originally intended as compensation by the Commonwealth to States for their loss of income taxing powers, a second method of measuring the equalisation transfer is by reference to 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 three donor States is of the order of \$2.2 billion in 1996-97, over half of which is expected to come from New South Wales.

During the five years to 1996-97, on the basis of the second measure about \$11.0 billion has been redistributed away from donor States (of which \$8.2 billion was redistributed through CGC fiscal equalisation). Of this amount, based on the second measure New South Wales contributed \$6.2 billion (\$4.5 billion through CGC fiscal equalisation).

Although the CGC equalisation component has declined from \$1.1 billion in 1992-93 to \$855 million in 1996-97, in per capita terms the transfer from New South Wales clearly remains substantial. In fact there has been an increase in the cross-subsidy by New South Wales from \$186 per head in 1994-95 to over \$200 per head in 1996-97. Over the long run such sizeable cross-subsidies are not sustainable.

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.

New South Wales continues to seek fundamental changes to HFE, and remains committed to reforms which would put the larger States (New South Wales, Victoria, the ACT, Queensland and Western Australia) on equal ground while preserving full equalisation for the three smallest jurisdictions.

**Table 5.1: Intergovernmental Financial Relations, Selected Indicators
1991-92 to 1996-97**

Item	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97 Est
COMMONWEALTH PAYMENTS TO NEW SOUTH WALES						
Million \$, Nominal						
General Purpose (Total)	3,690.0	3,744.3	4,099.4	4,389.4	4,580.7	4,756.0
General Purpose (net of untied Identified Road grants) /1	3,690.0	3,744.3	4,047.6	4,285.8	4,471.0	4,604.9
Specific Purpose /2	3,181.3	3,877.8	3,407.5	3,351.1	3,539.7	3,566.0
Gross Payments /2	6,871.3	7,622.0	7,507.0	7,740.5	8,120.4	8,322.1
Net Payments	5,960.8	6,451.5	7,116.4	7,066.0	7,733.1	7,966.1
Percent Annual Change, Real (1995-96) Terms /2						
General Purpose (Total)	(-) 2.2	(-) 0.9	8.2	4.5	2.8	2.6
General Purpose (net of untied Identified Road grants) /1	(-) 2.3	(-) 0.9	7.0	3.2	2.8	2.7
Of which: FAGs	(-) 2.3	(-) 0.9	3.5	4.8	2.6	2.6
Specific Purpose	1.8	7.7	0.5	1.2	1.1	(-) 2.3
Gross Payments	(-) 0.5	3.0	4.6	3.0	2.0	0.4
Net Payments	(-) 0.4	9.3	(-) 0.9	(-) 5.0	6.4	1.0
Real Per Capita (1995-96 dollars) /2						
General Purpose (Total)	661	651	699	723	735	747
General Purpose (net of untied Identified Road grants) /1	661	650	690	706	717	728
Of which: FAGs	646	636	653	678	688	698
Specific Purpose	546	584	583	584	584	565
Gross Payments	1,208	1,235	1,282	1,308	1,320	1,311
Net Payments	1,189	1,290	1,269	1,194	1,257	1,255
VERTICAL RELATIONS						
Ratio of % share of own-source tax revenue to % share of own-purpose expenditure /3						
Commonwealth	1.49	1.44	1.39	1.38	1.43	n.a.
States	0.45	0.48	0.52	0.50	0.46	n.a.
Local Government	0.73	0.75	0.81	0.80	0.75	n.a.
HORIZONTAL RELATIONS						
Total Redistributed among States						
Amount (\$million) /4	2,252	2,316	2,075	2,164	2,246	2,233
Of which:						

CGC Equalisation	1,839	1,987	1,656	1,542	1,566	1,499
------------------	-------	-------	-------	-------	-------	-------

**Table 5.1: Intergovernmental Financial Relations, Selected Indicators
1991-92 to 1996-97 (cont)**

Item	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97 Est
Redistribution away from NSW						
Total (\$million) /4	1,379	1,390	1,198	1,135	1,208	1,259
Of which:						
CGC Equalisation	1,024	1,110	887	781	827	855
Per capita transfers from NSW to other States						
Total (\$)	232	232	199	186	196	202
Of which:						
CGC Equalisation	172	185	147	128	134	137

n.a. - not available.

SOURCES OF DATA:

1. Commonwealth Budget Paper No. 3, *Commonwealth Financial Relations with Other Levels of Government*, for 1991-92 to 1994-95.
2. 1996 National Fiscal Outlook projections for Commonwealth payments in 1995-96 and 1996-97.
3. NSW Treasury for inflation forecasts and estimates of HFE redistribution.
4. ABS Catalogue 5501.1, *Government Financial Estimates 1995-96* for VFI ratios.

NOTES TO TABLE 5.1:

1. The table shows both General Purpose Payments with and without the impact of the untying of Identified Road grants. General purpose payments net of Identified Road grants would place the numbers on a more comparable basis over the six-year period.
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 Commonwealth Budget Papers -
 - ◆ 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; and
 - ◆ For comparability across years, dollar amounts and growth rates are adjusted to account for the following changes during the period.
 - (a) the one-off payment in 1992-93 for GIO tax compensation; and
 - (b) reclassification of TAFE payments as a Commonwealth own-purpose payment beginning in 1994-95.
3. Own purpose expenditures include payments to public trading enterprises.
4. 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).