

Chapter 5:

FINANCIAL ARRANGEMENTS WITH THE COMMONWEALTH

5.1 Introduction

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5.1 INTRODUCTION

Commonwealth-State¹ financial relations in the last two years have been marked by growing paralysis, with reforms being delayed or abandoned due to an unwillingness of the Commonwealth to address fundamental structural issues such as the distribution of revenue powers and expenditure functions between various levels of Government.

Some have argued for centralisation on efficiency grounds and the maintenance of national standards of service delivery. On the other hand, arguments favouring the substantive devolution of taxing powers and spending decisions have also been based on the benefits flowing from efficiency improvements of reduced duplication of administrative overheads, and increased governmental accountability.

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

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.

- 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 States⁴.

Annual decision-making has traditionally been made through established mechanisms which include all Heads of Government. These mechanisms are the Financial Premiers' Conference/Loan Council, which determines the distribution of FAGs 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.

The issue of VFI remains intractable. At present, States account for only 19.5 per cent of total general government tax revenue, yet remain responsible for about 42 per cent of aggregate own-purpose outlays⁵. On the other hand, the Commonwealth earns 77.1 per cent of tax revenue but spends only 54.7 per cent of general government expenditures.

Vertical imbalance has worsened in the last three years. After declining over the preceding three 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 1.41 in 1996-97, while the same ratio for States has fallen from 0.52 to 0.48⁶. These numbers indicate that there continues to be a very high degree of centralisation of tax powers and hence expenditure decisions.

4 In the 1997 Update of the Commonwealth Grants Commission, the shift in Western Australia's general revenue grant relativity means that that State has joined the ranks of donor States for the first time.

5 Own purpose outlays include payments to public trading enterprises.

6 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.

The determination of the Commonwealth Government to reduce its budget deficit through cuts to SPPs to the States has placed additional pressure on State finances and has highlighted the deficiencies associated with the current level of VFI. The Commonwealth announced a 3 per cent cut to the level of SPP funding at the 1996 Premiers' Conference, increasing by 1 per cent every financial year. An additional 1 per cent cut to SPPs, above and beyond these earlier reductions, was imposed by the Commonwealth at the March 1997 Premiers' Conference.

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 decisions by the High Court of Australia has expanded the definition of "excise" such that States are effectively barred from imposing sales taxes except for a few franchise fees.

The outcome of the recent *Allders* case in the High Court implies that businesses operating on Commonwealth property may not be liable for some State taxes. Moreover, matters currently being considered by the High Court of Australia relating to the interpretation of Section 90 of the Constitution hold the potential to bar States from imposing even the few business franchise fees which they currently levy. Such developments raise the prospect of a significant worsening in the degree of VFI.

In the absence of a High Court decision on Section 90 reinterpreting the definition of an 'excise' in a way that allows the States access to a broader range of taxes, 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 current Commonwealth Government has ruled out these options in its first term of office.

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 2005-2006 have effectively converted into tied grants a portion of GPPs to be made in those years.

On the expenditure side, the ongoing COAG review of roles and responsibilities has largely stalled. A clearer delineation of expenditure 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 such issues. In the last two years, the Commonwealth has focused on expenditure cuts rather than a fundamental redistribution of expenditure responsibilities.

New South Wales is expecting a real increase in GPPs of about 2.3 per cent in 1997-98. This follows a 2.9 per cent decline in GPPs in 1996-97. Growth in real terms has not kept pace with expenditure demands and with growth in the economy more generally.

Specific purpose payments are expected to be cut by a maximum of about 2 percent in nominal terms (of which 1 percent was already foreshadowed in the Commonwealth 1996-97 Budget) from the level in 1996-97, on the basis of information provided at the March 1997 Premiers' Conference.

On the whole there has been little qualitative change in Commonwealth-State financial relations in the past year. 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 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 -

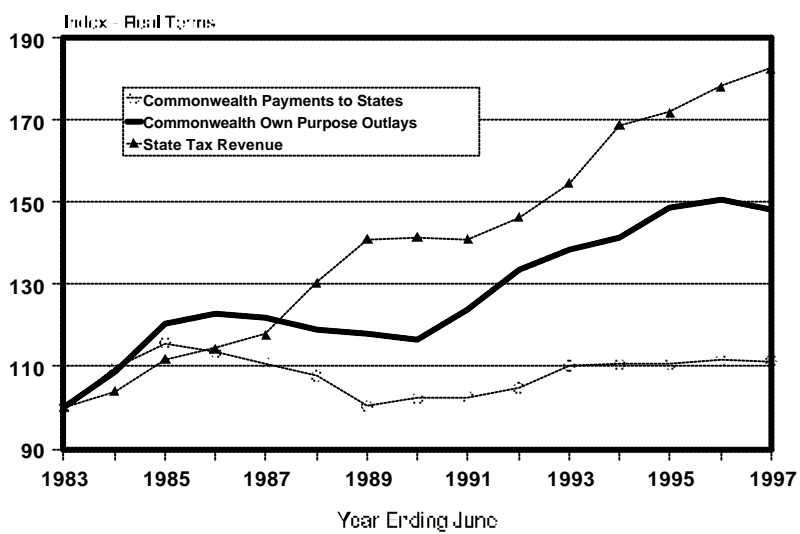
- Overall, Commonwealth payments to all States have shrunk in real terms since 1982-83 by a cumulative \$2.8 billion, while Commonwealth own purpose outlays have increased by \$31 billion and Commonwealth taxes have grown by \$44 billion over the same period.
- The Commonwealth improved its own budgetary 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 (4.8 per cent per annum in real terms).
- On average, between 1983 and 1997 Commonwealth own purpose expenditure and Commonwealth taxes have increased in real terms by 2.9 per cent and 3.2 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 1986 to 1990. (See Figure 5.1.)
- In contrast, States undertook fiscal consolidation and expenditure restraint, resulting in substantial improvements in States' aggregate fiscal position after 1991-92. This was reflected in average annual growth in real State tax revenue (3.8 per cent) substantially exceeding growth in State own purpose expenditure (1.8 per cent) during 1990-91 to 1996-97.
- 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 36 per cent in 1982-83 to 44 per cent in 1996-97. (See Figure 5.2).

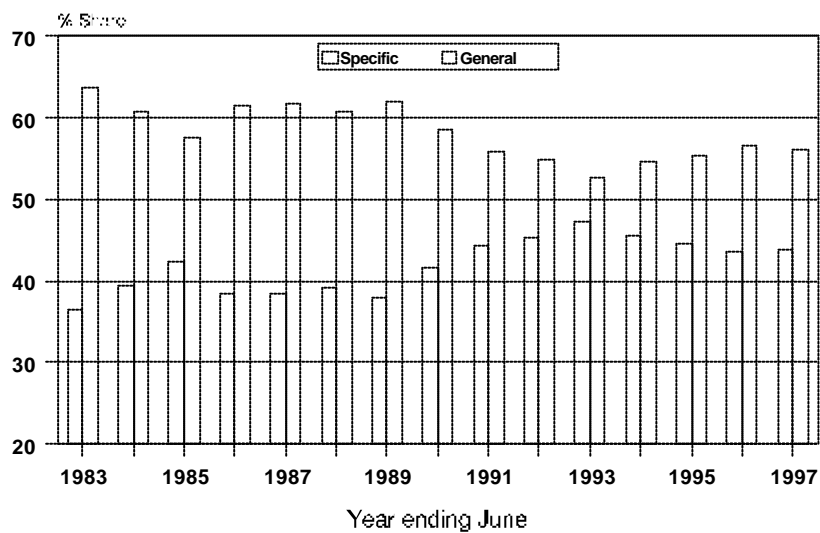
The Commonwealth has continued to shift its deficit problem to States via Fiscal Contribution Payments in 1997-98. In addition, the Commonwealth has imposed cuts in SPPs such that these payments no longer provide for growth in demand.

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

Figure 5.1
Commonwealth Own Purpose Outlays, Payments to States and State Tax Revenue, 1982-83 to 1996-97



**Figure 5.2
Commonwealth General and Specific Purpose Payments
to States, 1982-83 to 1996-97**



GENERAL PURPOSE PAYMENTS

The following developments will affect the level of general purpose payments to New South Wales in 1997-98 -

- maintenance of the real per capita terms guarantee on FAGs to States, including a roll-over of the guarantee to 1999-2000;
- release of the first tranche of Competition Payments pending the final recommendations of the National Competition Council (NCC) in June 1997;
- full absorption of Identified Road Grants into general purpose payments following a three-year transition period which ended in 1996-97; and
- Fiscal Contribution Payments (FCPs) to the Commonwealth to continue in 1997-98.

The combined result of these developments is that Commonwealth general purpose payments to New South Wales will increase by 2.3 per cent in real terms in 1997-98. Excluding Competition Payments, general purpose payments will increase by only 0.7 per cent in real terms (or by \$33 million in 1997-98 dollars).

National Competition Payments

The Agreement to Implement National Competition Policy and Related Reforms signed by the COAG in April 1995 sets out a schedule of Commonwealth payments which constitute the States' share of the revenue benefits of NCP reforms, with the payments commencing in 1997-98. The NSW potential share of the first tranche will be \$73 million.

The 1995 *Agreement* also specifies that compliance with the schedule of national competition policy (NCP) reforms will be a precondition for maintenance of the per capita component of the three-year rolling real terms guarantee on the growth of the FAG pool. Specifically, the Competition Payments and the per capita FAG growth for 1997-98 will depend on States meeting deadlines on the regulatory review, competitive neutrality, local government, and effective implementation of COAG agreements on reforms in electricity, gas and road transport.

Compliance with NCP conditions is being assessed by the NCC. States submitted their respective reports to the NCC on 31 March 1997. Based on these reports and consultations with States, the NCC is scheduled to make recommendations to the Commonwealth Treasurer in June 1997 regarding the

eligibility of States to receive their respective Competition Payments. It is expected that New South Wales will receive the full payment.

Fiscal Contribution Payment

At the June 1996 Premiers' Conference it was agreed that the need for State FCPs to the Commonwealth would be assessed each year. The Commonwealth made clear that given the deterioration in its fiscal position (documented in the *Mid-year Fiscal and Economic Outlook 1996-97* released in February 1997), the need for FCPs remains. Accordingly, New South Wales will make an FCP of \$216.3 million to the Commonwealth in 1997-98 following last year's contribution of \$209.5 million.

Identified Roads

At the July 1991 Premiers' Conference it was agreed to untie \$350 million worth of grants for arterial roads. This was followed by a three-year transition period where one-third of these road grants were successively absorbed each year into the FAG pool from 1994-95, with the remainder distributed to States based on historical shares.

In 1997-98, Identified Road Grants are to be fully absorbed into general purpose payments and distributed to States according to the grant relativities recommended by the Commonwealth Grants Commission (CGC). These grants will continue to be separately identified as road grants.

COMMONWEALTH GRANTS COMMISSION 1997 UPDATE REPORT

In the 1997 Update Report the CGC recommended a \$24.7 million increase in New South Wales' share of general revenue funds in 1997-98. The most significant reasons for the net gain to New South Wales are -

- data updates which resulted in the identification of increased expenditure needs for hospital services, corrective services, agriculture and fisheries and debt charges;
- a substantial increase in some Commonwealth SPPs to the smaller States, which reduced their relative financial need;

- reduced revenue raising capacity mainly in land, financial transactions and gambling taxes relative to other States, reflecting below-average growth in Gross State Product, wages and salaries, and employment in New South Wales; and
- relatively lower declines in government student numbers and higher growth in pensioner numbers relative to other States, which increased New South Wales' need for government education and housing, respectively.

A significant development in recent years has been an increasing share of own-source revenues for all States. This increase appears to have been more pronounced for the medium-sized and faster growing States, which accounts, in part, for the increased share of FAGs to the larger States such as New South Wales and Victoria.

Worthy of note for 1997-98 are changes in the assessed per capita global relativities used by the CGC to calculate State shares of FAGs. Western Australia's assessed global relativity for 1997-98 is now less than 1.00, shifting that State's status from recipient to donor for the first time. On the other hand, New South Wales' assessed per capita relativity is slightly larger in 1997-98 than in 1996-97.

DEVELOPMENTS IN SPECIFIC PURPOSE PAYMENTS

At the time of compilation, no details are available from the Commonwealth as to the amounts to be paid for individual SPPs. 'No policy change' estimates of selected SPPs were provided in the Commonwealth Offer at the 1997 Premiers' Conference, although the language of the Offer clearly foreshadowed that cuts in SPPs are planned. The estimates in the Offer were carefully qualified by statements that funding will be subject to decisions in the 1997-98 Commonwealth Budget.

The Commonwealth's 1996-97 Budget previously announced a 3 per cent 'efficiency dividend' to be applied in 1996-97 to all but a number of SPPs, with the dividend to increase by 1 per cent each year. On this basis, a 1 per cent cut in aggregate SPPs in 1997-98 was foreshadowed in the 1996-97 Commonwealth Budget.

At the March 1997 Premiers' Conference, the Commonwealth indicated that aggregate SPPs to all States would be cut in the 1997-98 Budget by no more than 1.3 per cent from the forward estimates for 1997-98 provided in the previous year's Commonwealth Budget.

Given the cutbacks already included in the 1996-97 Commonwealth Budget, this implies a total cut in the aggregate level of SPPs to States in 1997-98 of the order of 2.1 per cent (a further cut of around \$140 million) from the levels in 1996-97. This means that Commonwealth SPPs to the States in 1997-98 (excluding Debt Redemption Assistance) are expected to fall in real terms by \$409 million or 3.8 per cent (up to \$146 million or 4.2 per cent for New South Wales) in 1997-98.

Specific purpose payments which are expected to suffer the largest cuts are Commonwealth-State Housing Agreement (CSHA) block grants and funding for National Highways, and to a lesser extent disability services.

Negotiations on long-term reform in funding arrangements in public housing have stalled primarily over the funding implications. At present, CSHA funding is based on a three year interim agreement whereby the level of funding is determined unilaterally by the Commonwealth from year to year.

To date, the Commonwealth has not provided a formal commitment to funding the remaining two years of the interim agreement (1997-98 and 1998-99). Should there be a significant drop in funding levels, the State would need to urgently reassess the extent of its role in the area of public housing.

With respect to National Highways, SPP cuts are expected to lead to lower maintenance expenditure on national highways.

In regard to disability services, the Commonwealth Offer estimated a cut of 0.6 per cent from the previous year, which closely approximates the incremental 1.0 per cent efficiency dividend announced in 1996-97. A new Commonwealth-State Disability Agreement (CSDA) is being negotiated, as the current agreement expires in June 1997.

While the new draft agreement represents a considerable improvement over the current CSDA (in terms of framework, principles, and roles and responsibilities), negotiations have been hampered by the announcement of the Commonwealth's

intention to impose a 6 per cent cut in CSDA net transfers over the next four years. Support for the new agreement is unlikely without satisfactory resolution of funding issues.

The Commonwealth Offer indicated an increase of about 3.0 per cent in Medicare funding, although this is subject to decisions to be taken in the 1997-98 Commonwealth Budget. In 1996-97, the Commonwealth implemented a cost shifting penalty which involves a reduction in hospital funding grants if a State is deemed by the Commonwealth to be shifting on to Medicare those costs which the Commonwealth Government claims the State should have shouldered.

The public hospital system already faces severe funding pressures, and the policies proposed by the Commonwealth to lift private health insurance are costly and unlikely to be successful. Under the Medicare Agreement, reductions in the level of private health insurance by 2 per cent or more was supposed to trigger a renegotiation of funding levels. This has not occurred, at a cost to the NSW health system of \$17 million for every one per cent reduction in the level of insurance.

Any further withdrawal of Commonwealth funding for hospitals is likely to further aggravate the problem.

TAX TREATMENT OF STATE TRADING ENTERPRISES

At the March 1994 Premiers' Conference the Commonwealth and States agreed on a Statement of Policy Intent (SOPI) covering the taxation of all State Trading Enterprises (STEs). Under the SOPI it was agreed that all STEs would be exempted from both Commonwealth sales and income taxes. The States, in return, would apply tax equivalent regimes to their STEs so that they would gain no competitive advantage from the exemption.

The SOPI was intended to clarify the tax status of STEs, as it was unclear which were subject to Commonwealth taxation and which were exempt. It was therefore agreed that the States would compensate the Commonwealth for any revenue it was estimated they may lose as a consequence of clarifying the situation. The legislation providing the exemption was finally enacted by the Commonwealth Parliament in December 1995.

At the time the SOPI was agreed to, it was generally accepted by all parties that few, if any, STEs were Commonwealth taxpayers (being entitled to specific exemptions in taxation legislation) and therefore the scope for compensation from the States to the Commonwealth was very limited.

The Commonwealth has since sought to substantially broaden the scope for compensation under the 1994 agreement by applying two recent decisions of the full Federal Court which have cast doubt on the scope of the exemptions previously relied on by STEs.

The first case (*State Bank of New South Wales Ltd v Commissioner of Taxation for the Commonwealth of Australia and the Commonwealth of Australia 1994*) was a decision of the Federal Court in 1995 regarding the ability of the State Bank of New South Wales to claim a sales tax exemption. The sales tax legislation provides an exemption for 'authorities'. The Court decided that the State Bank was not entitled to an exemption because it was not an 'authority', as it did not have coercive or regulatory powers.

The Commonwealth used this decision to argue that all STEs were previously subject to Commonwealth income tax and wholesale sales tax (WST) on the basis they could not qualify for the relevant exemptions (as a 'public authority' under s23 (d) of the Income Tax Assessment Act or as an 'authority' under Item 126 of the First Schedule to the *Sales Tax (Exemptions and Classifications) Act 1992*). The Commonwealth argued that the States must therefore compensate the Commonwealth by transferring to it all tax equivalent revenue collected from STEs.

However, the States' liability to provide compensation should rightly be limited to those instances where the Commonwealth actually collected taxation from an STE which has since become exempt. To widen the scope for compensation would introduce the very uncertainty which the agreement with the Commonwealth was designed to eliminate. The Commonwealth acknowledged this point, but indicated that further discussion was required.

The second decision of the Federal Court having a bearing on the issue (*Totalizator Agency Board v Commissioner of Taxation 1995*) determined in 1996 that the TAB was liable to pay sales tax, again because it did not qualify for an exemption. This decision reinforces the Commonwealth's position in relation to sales tax but not income tax.

Alternative arrangements for taxation of STEs are being investigated, including a proposal for States to abandon Tax Equivalent Regimes (TERs) for STEs which would be liable to be taxed by the Commonwealth. In return the Commonwealth would provide compensation to the States to ensure both revenue and budget neutrality.

The issue remains unresolved. Of particular concern is the way in which the revenue neutrality principle is applied, as the concept has not been defined with any satisfactory precision.

The SOPI is a reflection of a broader principle, namely that one level of Government should not tax another. The Commonwealth sought to depart from this principle at the 1996 Premiers' Conference by seeking to apply WST to all State Government activities. This approach was rebuffed by the States, although a compromise resulted in States agreeing to make FCPs to the Commonwealth over the next three years and pay WST on motor vehicle purchases used for private purposes.

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.

Loan Council endorsed the LCAs nominated by the Commonwealth and each State for 1997-98. The 1997-98 LCA bid of New South Wales amounted to minus \$1,413m, as against an estimated outcome (as at Premiers' Conference) of minus \$549 million in 1996-97. The latest estimate for the 1996-97 outcome is given in Budget Paper No. 6.

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 1997-98.

In regard to exposure to infrastructure projects with private sector involvement, Loan Council agreed last year to shift from a risk-weighted approach to the full contingent exposure, as measured by the government's termination liabilities (to be disclosed as a footnote to rather than a component of LCAs). This in-principle decision was confirmed at the 1997 Loan Council meeting.

Loan Council also agreed to exempt Telstra Corporation Ltd from its monitoring and reporting arrangements under criteria agreed in 1991 for the exemption of public trading enterprises which operate within a sufficiently competitive environment.

REVISED UNIFORM REPORTING FRAMEWORK

In 1991, Premiers' Conference agreed to a number of uniform financial reporting requirements based on Australian Bureau of Statistics (ABS) standards. Following a review of the issue by Heads of Treasury, Loan Council agreed to the implementation of a revised uniform presentation framework (UPF) for government financial information beginning in 1998-99.

The revised UPF represents an attempt to rationalise reporting requirements under the existing Uniform Presentation Agreement, Loan Council Reporting and the National Fiscal Outlook (NFO). It is proposed to merge the three reporting frameworks and at the same time adopt various enhancements. The main enhancements are -

- Introduction of three year forward estimates (Budget year plus three years) for the general government sector as part of Budget Papers;
- Introduction of a mid-year report encompassing revised estimates for the Budget year and three forward years for the general government sector (to be published by end February at the latest); and
- Inclusion in the uniform presentation requirements of outcomes for the Public Financial Enterprise Sector (once the ABS develops standards).

The proposed framework represents a significant improvement on existing arrangements for the following reasons -

- The revised framework addresses the issues of duplication and complexity of current reporting arrangements. The number of reports required to be produced will be reduced with no loss of information for users.
- Simplifying the reporting process will result in reduced resource demands within jurisdictions.
- The framework will improve interstate consistency in reporting in Budget Papers.
- Reports will become more useful for users, with the focus on annual outcomes and forward estimates in the general government sector.

The most significant change proposed is the requirement to publish a mid-year report by February updating the position of the general government and providing projections for the following three years on a no policy change basis.

CHALLENGES TO STATE FRANCHISE FEES

New South Wales currently faces a number of challenges to its Constitutional right to levy tobacco and petroleum franchise fees. In the case of tobacco, two of these challenges were heard by the High Court in March 1997.

In previous High Court challenges of a similar nature (most recently the 1993 case of *Capital Duplicators Pty Ltd and Another v Australian Capital Territory and Another*), the High Court upheld a series of precedents which defined the term 'excise' broadly and thereby effectively barred States from imposing sales taxes except for a few franchise fees (tobacco, liquor and petroleum). These franchise fees are continually under threat.

In the latest challenge, the NSW submission (supported by most States and Territories) argued that the High Court reopen its decision in *Parton v Milk Board* (1949) 80 CLR 229. The *Parton* case was the first in which a majority of the High Court held that a tax on or with respect to the manufacture or production of goods or on any step in their distribution and sale (but not consumption) was an excise, and therefore contrary to section 90. New South Wales has argued that if the High Court does not agree to reopen this precedent, the existing precedents which enable the franchise fees to be levied should not be overruled.

The case put by the States stresses a number of factors which suggest that a narrower definition of s90 is appropriate -

- Firstly, the States have argued that at the time the Constitution Conventions debated the draft Constitution, the term 'excise' in Australia was applied only to taxes on manufacture and production, but not to taxes on sale, as was the case in the United Kingdom. Therefore it is inappropriate to use the broader definition to strike down State taxes on retail sales.
- Secondly, it was argued that other references to the word 'excise' in the text of the Constitution supports the proposition that the term 'excise' should only apply to taxes levied on the fact of production or manufacture, and not to non-discriminatory taxes on sale.
- Thirdly, if the first two arguments were not accepted and the meaning of the term 'excise' could only be determined from the purpose of s90, the definition of 'excise' adopted in the *Parton* case would have involved providing the Commonwealth with exclusive power over commodity taxation. It was argued by the States that s90 was only intended to

provide the Commonwealth with exclusive control of tariff policy. If this argument is accepted, State franchise fees are not inconsistent with s90 as they do not interfere with Commonwealth tariff policy.

The High Court heard the cases in March 1997. It has reserved its judgment, which will be handed down by the end of August 1997.

The High Court decision will have very significant implications for States' sources of revenue in future.

Should the High Court decide in the States' favour and redefine the term 'excise' narrowly, the legality of existing franchise fees would be beyond question, and the option of reforming these taxes to improve their efficiency would be available. Should the High Court confirm that the term 'excise' is to be interpreted broadly and rule that franchise fees are unconstitutional, New South Wales stands to lose revenue of up to \$1.8 billion per annum.

Any adverse decision would require the Commonwealth and States to agree on arrangements to provide a replacement source of revenue. In this event, the preferred option in the short term is for the Commonwealth and States to reach agreement on safety net arrangements whereby the Commonwealth collects the equivalent of State franchise fees and returns these funds to the States. However, this will increase VFI further, diminishing the political and fiscal independence of the States.

HIGH COURT DECISION IN THE *ALLDERS* CASE

In *Allders International Pty Ltd v Commissioner of State Revenue (Allders)*, which was decided in September 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 is that stamp duty cannot be levied on leases relating to Commonwealth places. Clearly, the loss of stamp duty on

such transactions would be a considerable loss of NSW tax revenue. The implication of this decision on the ability of the States to impose other taxes on businesses operating on Commonwealth property is still being assessed. Overall, the outcome of the *Allders* case carries the potential to considerably worsen VFI.

Another consequence of the decision is that it would confer a competitive advantage on businesses which would be exempt from stamp duty simply because they happen to be located on Commonwealth property. This contravenes the principles underlying NCP reforms.

In a related development at the March 1997 Premiers' Conference the Commonwealth requested States' cooperation in implementing a proposed surcharge of up to 15 per cent on superannuation contributions made on behalf of high income earners (persons receiving taxable income in excess of \$70,000 per annum). The Commonwealth sought States' support to ensure that public service employees were treated in the same manner as other employees subject to the charge.

Both the *Allders* and superannuation issues are currently the subject of discussions between the Commonwealth and States.

FINANCIAL TAXES REFORM

Two taxes are currently levied by most States on financial transactions - Financial Institutions Duty (FID) (imposed on all deposits) and Debits Tax (imposed only on debits to accounts with a cheque facility). These taxes are the subject of a great deal of criticism from both the finance industry and the community generally, and are considered to be inequitable, distortionary and involve very high compliance costs.

At the Leaders' Forum⁷ meeting on 7 March 1997, a majority of States agreed to a proposal by Heads of Treasury for reform of financial taxes. Discussions on the matter are continuing. The proposal consists of the following elements -

⁷ The Leaders' Forum is a consultative forum consisting of all State Premiers and Territory Chief Ministers.

- the replacement of the existing Debits Tax on cheque linked bank accounts with a broad based Debits Tax on all withdrawals from all accounts of financial institutions;
- abolition of FID so there is only one financial tax instead of two;
- replacement of the revenue lost from FID, by increasing the revenue raised by the reformed Debits Tax;
- a nationally uniform rate of tax to prevent accounts moving to the jurisdiction with the lowest tax rate; and
- a revenue sharing agreement between States which allows considerable simplification of the tax and ensures that all parties will receive a fair share of the available revenues.

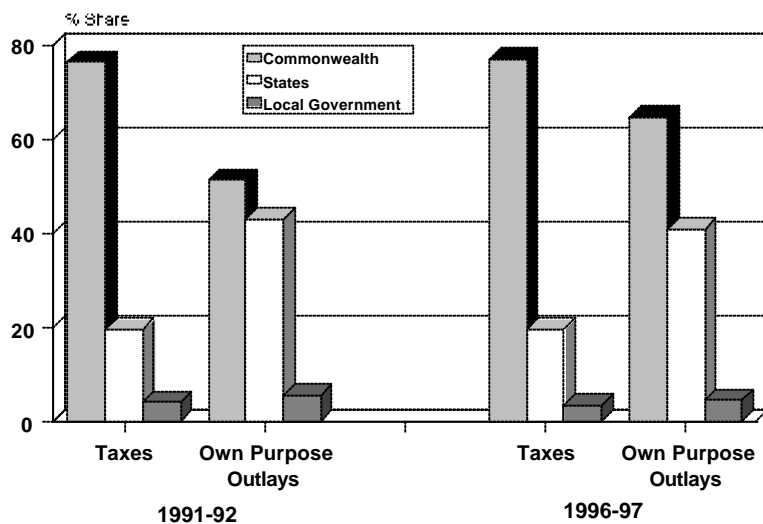
In the event the reform proposal is endorsed by all States (which is required for it to work effectively), low income households and small businesses will, on average, benefit through a reduction in their tax liability. In addition, the reform proposals have been well received by the financial community since they simplify State taxes and significantly reduce compliance costs.

5.3 THE TASKS AHEAD

VERTICAL FISCAL IMBALANCE

The degree of imbalance between the Commonwealth and State Governments remains excessive compared to other federations, and has changed little in the last five years (Figure 5.3).

Figure 5.3
Vertical Fiscal Imbalance, 1991-92 and 1996-97
 Percentage of Total Public Sector, General Government



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.

Constitutional limitations force 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 gross 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 addressed by a redistribution of either taxation powers or expenditure responsibilities.

Prospects for the immediate future in regard to tax powers will depend on the outcome of the High Court challenge on State franchise fees and remedies to the anomaly created by the *Allders* decision (discussed above).

In respect to expenditure responsibilities, work should continue on a clear delineation of Commonwealth and State roles in service delivery.

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 the principles of subsidiarity, accountability, structural efficiency and a recognition of the social, political and economic imperatives of nationhood.

Based on these principles, New South Wales remains of the view that appropriate financial arrangements (eg, whether Commonwealth payments should be an SPP or a contract/fee-for-service arrangement) and corresponding reforms in the system of tied grants can only be determined once a clear delineation is

made of roles and responsibilities between levels of government for specific governmental functions.

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.

At the June 1996 COAG meeting, Heads of Government agreed on a number of reforms in Commonwealth-State roles and responsibilities in respect to health and community services and public housing. However, in the past year little progress has been made.

To date, the Commonwealth's reform agenda has mainly been dominated by the need to rein in its budget deficit. In addition, the importance of COAG's role as a vehicle for reform appears to have been down played by the Commonwealth over the past year. The cancellation of the scheduled COAG meeting in November 1996 delayed the progress of reforms.

In respect to health, funding pressures are becoming more severe. At the Leaders' Forum held on 7 March 1997, State Premiers and Chief Ministers agreed that health reform was now becoming an urgent priority and that health should be a major area of discussion at the next COAG meeting. The current Medicare Agreement expires in June 1998, and is due for renegotiation soon. It is essential that the new agreement address these issues.

Funds allocated by the Commonwealth for private health incentives should be redirected to the public hospital system. New South Wales strongly supports the conduct of a wide-ranging assessment of the funding of health care in Australia, which goes beyond the investigation of private health insurance commissioned by the Commonwealth last year. The aim will be to develop a longer term framework for the health care system which provides improved incentives for efficiency, accountability and access to health care.

At the last Leaders' Forum, State and Territory leaders also expressed concern at the Commonwealth's wavering commitment to funding for public housing through the CSHA. In the meantime that there is no agreement on long-term reforms, the uncertainty of funding beyond the end of 1997 hampers States' ability to manage the provision of public housing services. For the remainder of

the interim agreement, it is unacceptable to New South Wales and other States for CSHA funding to continue to be provided for six-month intervals.

At a broader level, Commonwealth initiatives to date regarding SPPs (in public housing and health as well as other functional areas) 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.

INTERSTATE COMPETITION FOR PRIVATE BUSINESS

Inducements offered to private businesses to locate in a jurisdiction entail the loss of tax revenue or the provision of additional expenditure by State governments. Examples include the reduction or waiving of payroll tax or stamp duties.

While horizontal competition between States can encourage greater efficiency, there is 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. 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 they 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.

In July 1996 the Industry Commission (IC) completed a draft report on *State, Territory and Local Government Assistance to Industry* which canvassed some of these issues.

Analysis by the Commission and in the United States indicates that industry assistance by an individual State has significant cross-border spillover effects. In

the case of major events, in particular, a lack of incentives to take into account the impact of a State's actions on other States can result in over-bidding⁸.

Among other things, the IC report concluded that -

- most State budgetary assistance tends to be selective and discretionary, and tends to increase secrecy. In turn this creates conflicts of interest for officials who are publicly accountable;
- most industry assistance has little or no positive welfare effect on Australia as a whole. Gains from providing assistance at the State level are illusory. Rivalry between jurisdictions for development and jobs at best shuffles jobs between regions and at worst reduces overall activity; and
- on balance, while States find it difficult to abstain from competitive bidding because of the perceived economic and political cost of losing out to other States, there is a strong case for States to agree to cease or limit assistance to industry, possibly through COAG.

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.

The conclusions of the IC report are consistent with New South Wales' views that interstate competition should be on the basis of business fundamentals rather than in the form of discretionary or firm-specific incentives.

One way of achieving this is for States to enter into voluntary agreements - for instance, on harmonised tax or pricing structures. Generally, greater competition can be encouraged on immobile tax bases and voluntary agreements on mobile

⁸ Industry Commission *State, Territory and Local Government Assistance to Industry* Draft Report, July 1996, p.58.

tax bases. The proposed national approach to reform in financial taxes, for instance, is a step in this direction.

HORIZONTAL FISCAL EQUALISATION

Despite an expected slight real increase in general purpose payments to New South Wales in 1997-98, 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 \$733 per head (before FCPs to the Commonwealth) compared with \$1,064 for the other jurisdictions. The estimated FAG per capita by State for 1997-98 is given in Table 5.2 at the end of this chapter.

Based on the 1997-98 distribution of FAGs recommended by the CGC, New South Wales, Victoria and the ACT will continue to be net donors.

The level of transfers from New South Wales, Victoria and the ACT 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 \$866 million to the smaller States in 1997-98. The combined transfer from New South Wales, Victoria and the ACT is about \$1.5 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 HFE relativities.

The cross-subsidy from New South Wales to other States due to CGC equalisation has increased from \$781 million in 1994-95 to \$866 million in 1997-98. On a per capita basis, this amounted to an increase from \$128 per head in 1994-95 to \$138 per head in 1997-98.

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 donor States is of the order of \$2.2 billion in 1997-98, 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 \$205 per head in 1997-98. Over the long run, such sizeable cross-subsidies are not sustainable. Table 5.3 at the end of this chapter indicates the amounts transferred from donor States to recipient States in 1997-98.

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.

The CGC is due to review its grant distribution methodology in February 1999 and has sought State comments on this process. The NSW main submission (April 1997) has recommended a number of changes to the CGC's methodology. Among other things, the recommended changes seek to streamline the CGC's methodology and to take efficiency into account in the Commission's assessments.

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 ACT, Queensland and Western Australia) on equal ground while preserving full equalisation for the three fiscally weakest jurisdictions.

**Table 5.1: Intergovernmental Financial Relations, Selected Indicators
1992-93 to 1997-98**

Item	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98
COMMONWEALTH PAYMENTS TO NEW SOUTH WALES						
Million \$, Nominal						
General Purpose (Total)	3,744.3	4,099.4	4,386.2	4566.8	4,684.9	4,876.6
General Purpose (net of Competition Payments) (1)	3,744.3	4,099.4	4,386.2	4,566.8	4,684.9	4,803.6
Specific Purpose (2)	3,877.8	3,407.5	3,331.6	3,430.2	3,529.6	3,620.8
Gross Payments (2)	7,622.0	7,507.0	7,717.8	7997.0	8,213.9	8,497.4
Net Payments	6,451.5	7,116.4	7,044.3	7,609.5	7,756.3	8,071.9
Percent Annual Change, Real (1997-98) Terms (2)						
General Purpose (Total)	(-) 0.9	8.2	4.4	2.7	(-) 2.9	2.3
General Purpose (net of Competition Payments) (1)	(-) 0.9	8.2	4.4	2.7	(-) 2.9	0.7
Of which: FAGs	(-) 0.9	3.5	4.7	2.5	(-) 3.2	3.5
Specific Purpose	7.7	0.5	0.7	(-) 1.6	0.2	(-) 1.5
Gross Payments	3.0	4.6	2.7	0.8	(-) 1.6	0.6
Net Payments	9.3	(-) 0.9	(-) 5.3	5.1	(-) 2.5	1.2
Real Per Capita (1997-98 dollars) (2)						
General Purpose (Total)	675	726	750	762	731	748
General Purpose (net of Competition Payments) (1)	675	726	750	762	731	736
Of which: FAGs	660	678	703	713	681	705
Specific Purpose	606	605	603	587	581	572
Gross Payments	1,282	1,331	1,354	1,349	1,311	1,319
Net Payments	1,068	1,260	1,235	1,283	1,236	1,251
VERTICAL RELATIONS						
Ratio of % share of own-source tax revenue to % share of own-purpose expenditure (3)						
Commonwealth	1.44	1.39	1.38	1.32	1.41	n.a.
States	0.49	0.52	0.51	0.61	0.48	n.a.
Local Government	0.74	0.77	0.76	0.38	0.75	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 payments 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) 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.

Table 5.2: Financial Assistance Grant Per Capita, By State, 1997-98*

State/Territory	Financial Assistance Grant (\$ Per Capita)
New South Wales	733
Victoria	734
Queensland	915
Western Australia	877
South Australia	1,062
Tasmania	1,461
Northern Territory	5,177
Australian Capital Territory	778
AUSTRALIAN AVERAGE	870

* 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.

Table 5.3: Estimates of Redistribution Through Fiscal Equalisation, 1997-98

	RECIPIENT STATES					
	Qld	WA	SA	Tas	NT	Total
DONOR STATES (\$ million)						
CGC Redistribution						
NSW	87	7	162	159	451	866
VIC	63	5	118	115	327	629
ACT	3	0	5	5	15	29
TOTAL	154	12	285	280	793	1,523
Tax Equalisation						
NSW	311	17	61	29	9	426
VIC	99	5	20	9	3	136
ACT	112	6	22	10	3	154
TOTAL	522	28	103	48	15	716
Total Redistribution						
NSW	398	23	223	188	460	1,292
VIC	162	10	137	124	330	764
ACT	115	6	28	16	18	183
TOTAL	676	40	388	328	808	2,239
NSW PER CAPITA CONTRIBUTION (\$ per Capita)						
CGC Redistribution	14	1	26	25	72	138
Tax Equalisation	49	3	10	5	1	68
Total Redistribution	62	4	36	30	74	205

NOTE TO TABLE 5.3:

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.