

Chapter Four

Federal-State Relations and the Changing Economy

The Honourable Christian Porter

This analysis will attempt to make an essentially descriptive academic point, but one which may also prove to be a useful theoretical basis for some immediate practical reform of Federal/State financial relations in Australia. The point being made concerns the inter-relationship between what are the two most significant issues in the present landscape of Federal/State financial relations – Vertical Fiscal Imbalance (VFI) and Horizontal Fiscal Equalisation (HFE).

Simply put, this paper will propose that VFI in Australia is not being properly addressed by the existing system of HFE.

HFE operates predominantly through the mechanism of the Commonwealth Grants Commission (CGC) distributing goods and services tax revenues in accordance with a complex formula. The intention of this mechanism was to achieve a pure form of HFE. It has been proposed that HFE is alleviating the problems associated with a very high degree of VFI in Australia.

This paper will argue that this is an irretrievably flawed proposition. In addition, this paper will argue that the alternative, that HFE actually exacerbates rather than alleviates acute VFI in Australia, is an assertion that is entirely accurate but one that has been overlooked.

An appreciation that Australian HFE cannot be properly described as reducing the degree of VFI in Australia is a useful starting point from which to consider the options for achievable and immediate reform of Australia's fiscal federalism.

Ultimately this paper will conclude that, in circumstances where the States of Australia have too little of their own revenue (relative to the Commonwealth given the expenditures they must undertake), it is absurd that the central mechanism operates to redistribute State rather than Commonwealth revenue. Another conclusion is that perceiving the present system of HFE to be a remedy to the problem of VFI is the economic equivalent of the abandoned medical practice of treating patients with anaemia by bleeding them with leeches.

In developing this point, the paper will proceed in three parts, commencing with a brief analysis of the nature and extent of VFI and HFE in Australia; then considering how HFE is seen as a remedy to the problem of VFI; and how, in the present Australian context, this cannot be true.

Vertical Fiscal Imbalance (VFI)

VFI is a term used to describe some substantial degree of revenue-expenditure asymmetry in a federation. In financial terms VFI can be most simply defined as the difference between the share of revenue raised and expenditure made between the different tiers of government in a federation.¹ In this sense VFI describes the situation where the spending by sub-national governments in a decentralized/federal system is larger than the revenue raised by those sub-national governments.² Perhaps the

simplest academic measure of the phenomenon is the difference between own source revenue and own spending.³

In a federation, both political and fiscal power is divided between the central or Federal government and State or 'sub-national' governments. Given that the Commonwealth fiscal policies associated with re-distribution of taxation revenues presently do not delineate between States and territories, this paper will use the term "States" to refer to both sub-national States and territories. The absence of this delineation and its potential impact upon VFI will be discussed later. Proceeding with the division of fiscal power in broad terms, however, the nature of the fiscal separation that should exist in a federation was described in the *Federalist Papers* thus: "the individual States should possess an independent and uncontrollable authority to raise their own revenues for the supply of their own wants."⁴

Despite the use of the term "should", the paragraph above is a descriptive as well as normative statement. It proposes a description of what a federation should ideally encompass, notably, a very high degree of fiscal autonomy for both the State and Federal layers of the decentralized federal system. The economic definitions and measures of VFI referred to earlier indicate that the term, VFI, is also a descriptive term and, importantly, one that exists in opposition to a perceived ideal. VFI is a term used to describe variance from the model of fiscal autonomy in a federation. In that respect, VFI is said to exist when the situation that actually prevails inside a federation exhibits a divergence from the principle of federal fiscal organisation proposed in the *Federalist Papers*.

There are several arguments as to why a high degree of fiscal autonomy is a good structure in practice and why it is undesirable to stray too far from the model of States possessing independent authority to raise their own revenue. Essentially, these arguments revolve around the contention that, in practice, the best results in the efficient expenditure of tax revenue are achieved when the body responsible for the spending of revenue is also responsible for raising it.

Conversely, the argument is that government accountability is weakened, and transparency reduced, when the link is broken between one layer of government deciding how to spend revenue and another layer of government deciding how to raise and collect revenue.

Both because this is a short paper and because the ground is fairly well-trodden in academic writings, this paper will not focus on the theoretical arguments about why VFI can affect a federal nation's economic performance negatively and/or why the present extent of VFI in Australia is particularly problematic. What should be plain by now is that this paper proceeds from the author's philosophical acceptance (informed also by a little time observing State/Federal financial relations in practice) of the common sense proposition that accountability and transparency are enhanced and practical results improved when the government that spends revenue is also responsible for raising it.

While a division of spending and revenue-raising responsibilities and capacities necessarily exist in any federation, there is sound econometric evidence to suggest that several problems arise when there is an excessive degree of VFI. Chief among these problems are fiscal profligacy, the inefficient or underuse by sub-national governments of their existing taxing powers, and a tendency toward sub-national budget deficits and excessive borrowing.⁵ Examples of both State and national fiscal profligacy are not

difficult to identify. On the point of excessive borrowing, it has been said that the two basic ways that VFI can be addressed are through complex systems of inter-governmental grants or the imposition of spending guidelines by national governments upon sub-national governments.⁶

What does require brief examination in this paper is the practical manifestation and measure of VFI in the Australian Federation and an assessment of its comparative extent.

In practical terms, VFI exists in Australia where, from a national revenue pool, the States raise substantially less revenue than they require to meet their standard expenditures; and the Commonwealth Government raises substantially more revenue than it requires to discharge its standard expenditures. That this scenario exists in Australia is beyond doubt, although some debate exists regarding its extent compared to other federations.

There is a strong argument to suggest that, compared to other federations, the level of VFI in Australia is extreme.⁷ The recent Senate Select Committee report, *Australian Federation: an agenda for reform*, noted that the extent of VFI in Australia depends upon whether the GST revenues are characterised as State or Federal revenue:

In considering Australia's VFI, it should also be noted that the extent of the VFI varies depending on the assessment of the Commonwealth's revenue raising capacity. The OECD data notes that Australia's VFI increased with the introduction of the Goods and Services Tax (the GST). This was also noted in evidence to the committee [see NSW Government, *Submission 39*, Appendix A, p. 2]. Australia only has a large VFI if one treats the GST as Commonwealth revenue. Although legally accurate, as all of the revenue is distributed to the states and territories, including the GST when calculating the VFI is a distortion of the fiscal reality. Nevertheless, Australia's VFI is significant and entrenched.

Whether the GST should be properly considered as State or Federal revenue and, therefore, whether Australia's VFI is extreme or merely substantial, is a point to which this paper will return later.

For present purposes, it can be accepted that in measuring VFI, GST revenue is generally treated as Commonwealth revenue. As a consequence, the extent of VFI in Australia is generally characterised as very substantial and problematic and it is accepted that it leads to a range of economic inefficiencies. For instance, it has been noted in a historical summary of VFI in Australia that in

comparison with the fiscal federalism in advanced economies, the Australian federation is characterised by a substantial vertical fiscal imbalance between revenue and expenditure at the national and sub-national levels of governance. Whereas the Commonwealth government raises about 70 per cent of total public sector revenue, it only accounts for around half of all public expenditure.⁸

More recent figures from the WA State Treasury serve to illustrate the severity of VFI in Australia. Since 2000-01 the Commonwealth's share of revenue has never fallen below 80 percent and its share of overall government expenditure peaked in 2008-09 at 55 percent. Conversely, the States' share of revenue has never exceeded 16 percent and its share of overall government expenditure peaked in 2009-10 at 41 percent.⁹

In a paper presented to the Sir Samuel Griffith Society in 2010, Jonathan Pincus, using gross ABS data (rather than percentages), noted that to displace all Commonwealth grants, the States and territories would need to increase their own tax

revenues by about 140 percent, or their own taxes and charges by about 90 percent. This is because in 2007-08 State and territory tax revenues were \$53.1bn and expenditures were \$161.3bn, with the Commonwealth in that year making \$75.0bn in grants.¹⁰ In the same paper, concurring with the comparative assessment of Twomey and Withers, and Dollery, Pincus described Australia as having “an extraordinarily high degree of vertical fiscal imbalance and tax collection.”¹¹

Horizontal Fiscal Equalization (HFE)

The other great controversy accompanying fiscal federalism in Australia is horizontal fiscal equalization (HFE). The principle of HFE used by the Commonwealth Grants Commission (CGC) has been defined as follows:

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

The aim is for all States to have the same fiscal capacity to deliver services to their populations, after the distribution of the GST, and taking into account their capacities to raise revenue from their own sources.¹²

As noted in the recent Western Australian submission to the GST Review Panel, the equalisation principle used by the CGC is essentially an equity (or fairness) concept applied at the State government level. Pursuant to this concept, the “wealthier” States subsidise the “poorer” States (or sub-national governments) so that each has the capacity to provide the same standard of services to its people in fields such as health, education and law and order, without imposing higher taxes. According to Pincus, “roughly the goal of the CGC is to fund each jurisdiction so that it can afford to provide the average level of publicly-provided goods and services if it levied the average level of taxes and charges (and achieved the average net public financial assets).¹³

Two changes in the equalisation process (in 1978 and 2001) are worthy of note.

The present manifestation of the HFE principle can perhaps be traced back to 1978. In that year, the Commonwealth asked the CGC to review the distribution of financial assistance grants, using what was essentially the modern definition of the HFE principle.

Prior to 1978 the system had remained relatively unchanged from about 1959 and has been described in the following terms:

From the 1950s the problem of vertical fiscal imbalance was addressed by three types of grants (Groenewegen, 1979); namely, financial assistance grants (previously called tax reimbursement grants), special grants and specific purpose grants. Moreover, increasing weight was attached to specific purpose grants, which escalated from 23.7 per cent of total payments to the states in 1960/61 to 31.4 per cent in 1971/72.¹⁴

From about 1959 to the advent of the GST, changes to the system essentially entailed the changing proportion of monies allocated under the guise of different types of grants as well as changes to the overall pool of grants.¹⁵

The year 1978 marked a significant change. The “special grants” process came to an

end and the present HFE framework commenced. Since 1978, an increase in any one State's grant share has been necessarily at the expense of other States.

There was further significant development in 2001-02. Financial assistance grants were replaced with GST revenue grants under the 1999 Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations (known informally as the “GST Agreement”).

The national GST grant pool was larger than the financial assistance grant pool it replaced (and has grown significantly larger still as a consequence of growth in GST revenues). The immediate effect was to increase the base per capita grant for each State rather than altering the proportion of funds received by each State. However, the controversy presently surrounding the CGC distribution of GST derives from the combination of the 1978 adoption of the modern purist HFE principle combined with the 2001-02 replacement of financial assistance grants with GST revenue grants. Essentially, in 1978, a purist form of redistribution was adopted and, from 2001, the amount of funds that were to be distributed according to this purist version of HFE (with the addition of GST revenue) increased significantly.¹⁶

The formula by which HFE is deployed is notoriously complicated, certainly too complicated to be summarised here. It is the present outcome of the system that produces the modern controversy.¹⁷ From the practical starting point of an equal per capita share of the national GST pool, each State's share is adjusted in accordance with two fundamental principles. First, that States with a higher per capita capacity to raise revenue from their own sources (assuming each applied national average tax/royalty rates) have their GST share reduced; States with low capacity have their GST share increased. Second, States with higher per capita costs of service provision due to factors outside their control have their GST share increased and States with low costs have their GST share reduced.

Inside the above principles, revenue capacity assessments are based on the (per capita) size of each State's revenue base (for example: mining value of production for royalties; wages and salaries for payroll tax; and value of properties transferred for stamp duty on conveyances). Expenditure assessments recognize higher costs in providing services to indigenous people, the aged (in health care), younger people (in education) and remote areas, and may reflect higher service usage rates by some population groups and/or higher costs per service.

The ultimate result for Western Australia has been that its higher revenue raising capacity relative to other States (driven by the strength of its resources sector) now far outweighs its historically higher cost of service provision, which exacerbates the difference between its GST grant share and its population share.¹⁸

Space does not allow re-argument of the economic questions associated with this distribution or how the inequity of the distribution is presently so great as to require reform. It is relevant to address one argument that often arises regarding the unfairness of the present distribution of GST monies. This is the argument that equity is preserved in the long term because States who may now be donors were previously recipients under the broader history of the HFE system.

The first problem with this argument is that it assumes that some simple measure exists that would allow for comparison of a particular State's gain as a recipient in, say, the period 1930-40, to its losses in a later period between 2010-20. Ultimately, it is not possible to make such comparisons for a number of reasons. While equalisation has

been a feature of the Australian federation from very shortly after 1901, its rationale and various manifestations have changed significantly between even short periods of time. What might have been the purpose of “equalization” in 1930 is not necessarily that of the 1990s, making long-term comparative analysis largely meaningless.

The present system of HFE is a redistributive principle meant to effect a broad outcome of funding each jurisdiction (national and sub-national governments) so that it can afford to provide the average level of publicly provided goods and services if it levied the average level of taxes and charges. Previously, fiscal equalisation was far more ad hoc, from time to time taking account of specific advantages or disadvantages suffered by jurisdictions due to prevailing federal policies. While concerns about the fiscal weakness of some States arose shortly after federation, the arrangements which governed equalisation have changed constantly. The CGC itself notes that the Commonwealth began providing Special Grants in 1910. These were aimed generally at giving the weaker States a fiscal capacity comparable to the stronger States.¹⁹ After being initially addressed through Special Grants to financially distressed States, the equalisation process has been administered by the CGC since 1933, with the CGC seeking to adjust revenue relativities in Federal Government transfers and determine specific purpose payments.²⁰ However, to characterise the transfers of monies from the Commonwealth to States prior to 1978 as a general attempt to equalise fiscal capacity is only part of the story of Australian equalisation in all its iterations.

For several periods of time, when financially weaker States were beneficiaries of equalisation, a component of the benefit was intended as a direct compensation for a loss in revenue to them occasioned by federal protectionist policies. This was a point noted in the Western Australian Submission to the Review of GST Distribution where it is described that, in the early years of federation, the less populous States of Western Australia, South Australia and Tasmania identified that they were disadvantaged in a number of ways. These stemmed from their primary production-based economies, which were exposed to global competition and thus were adversely affected by tariffs that increased their input costs, which also led to some countries imposing retaliatory tariffs on imports from Australia.²¹ Dollery characterises the period 1919-20 to 1932-33 in the following terms:

The system of equal per capita payments, supplemented by special grants to compensate Western Australia and Tasmania for their high contribution to customs revenue, continued during the twenties, despite growing opposition from the states, especially the less populous South Australia, Tasmania and Western Australia.²²

Because gains under the 1910 equalisation system often included the payments specifically made to compensate certain States at certain times for specific Commonwealth policies which caused them identifiable disadvantage, the long-term comparison of gains and losses is methodologically difficult and substantially uninformative. This problem is exacerbated by the ad hoc nature of payments meant to compensate certain States and the often political rather than statistical or economic basis on which compensatory payments were sought and granted. A prime example of the operation of the system involving compensatory payments appears in a history of the CGC which recounts that,

In 1929 Western Australia approached the Commonwealth seeking an increase in the level of the grant from \$600,000 to \$1,200,000. The Bruce-Page Government

offered \$900,000 on condition that the State ceded the north-west to the Commonwealth.²³

To argue, as some do, that present inequity, no matter how gross, is justified because equity is somehow maintained in the long-term on the basis that past gains can be compared with, and quantitatively militate against, present losses is a very superficial and ultimately uninformative analysis.

To be of any analytical merit, comparisons of gains and losses should be confined to periods when the system that distributed monies was relatively stable. From 1988-89 until 30 June 2000, when financial assistance grants were replaced by the GST revenue grants system, Western Australia was a beneficiary. Its net gain of \$5.2bn in that period is being completely eclipsed in the period 2001-02 to 2015-16 by a projected loss of \$17.3bn (this is so even accounting for relative changes in the value of the amount over the relevant time period).²⁴

The reason for this shift is that, presently, HFE is a comprehensive or purist form of equalization. The redistributive system of personal income tax is not a perfect analogy but is nevertheless able to provide a highly illustrative conceptual comparison. The GST HFE distribution and the Australian income tax systems both seek to transfer wealth from households with more of it to households with less.

Other than the fact that HFE seeks to effect this on an interstate scale, there are two important differences which emerge. The first critical difference is that the CGC HFE scheme pursues a theoretical outcome close to total equalisation. HFE seeks in theory to equalise State fiscal capacities thoroughly and completely by redistributing *all* of what is determined to be above average revenue.²⁵ This is not a stated objective of the income tax system. What is immediately notable about this objective is that, in other contexts, totally equalising the benefits of above average revenue generation would be considered inequitable and thereby unsustainable (such as, for instance, the application of a 100 percent marginal personal income tax applying to wage and salary income above a determined average).

That this complete and comprehensive level of redistribution, as the aim of HFE, is likely excessive appears to have been accepted in large degree by the recent GST Review. It indicated that one worthwhile option is a redefining of the principle, such that:

The Panel intends to investigate whether providing comparable capacities for States would be an approach more suitable to current challenges than the present one of providing materially the same capacities. This would improve efficiency by reducing the size of any capacity effects as well as the ability of States to influence average policy. Further, the Panel would be keen to explore the practicalities of equalising to an external standard, or a standard below the average of all States.²⁶

The second difference is that the CGC HFE process (unlike the simple income tax formula) distributes according to an immensely complicated formula that seeks to equalise the fiscal capacities of all States by redistributing all of what is determined to be above average fiscal capacity (through the mechanism of reduced share of GST monies) — but only after a contemporaneous assessment of each State's needs. Needs are measured by going beyond the comparative ability (or inability) to raise revenue and assessed in terms of actual needs in service delivery. Needs in this sense are conceptualised as being related to cost variations between the States in delivery of

services to some nominal average level. In this way, the CGC HFE process utilises a formula to determine what amount of redistributed funds should be taken away from a donor State, but the formula simultaneously assesses both capacity (in terms of revenue raising capacity), as well as need, measured in terms of service delivery difficulties (which manifest in higher costs of some determined average level of service delivery).²⁷

An obvious problem with this process is the defining of “needs”. The recent GST Review was quite correct in its acknowledgment of the incredibly important point in the modern Australian context, that:

While the current system includes an assessment of infrastructure costs, this primarily recognises the relative growth of each State’s total population. This assessment of infrastructure costs does not therefore directly account for the costs borne by States for mining related infrastructure, particularly when it is not recorded in the General Government sector. The Panel is inclined to the view that changes to the current arrangements are required to ensure that all mining related infrastructure is appropriately recognised.²⁸

In the end result, Australia’s purist and comprehensive form of equalisation is currently the equivalent of a 100 percent marginal tax rate on any above-average fiscal capacity for any State (later balanced against an assessment of those States possessing any greater than average spending needs – but excluding the necessity to spend on the infrastructure that contributes to the revenue generation in the first place). The result is an equalisation process that has become highly divisive.

As was noted in the Western Australian submission to the GST Distribution Review, the problem of divisiveness caused by extreme results is not just a concern of those States adversely affected. It was also recognised by the Commonwealth Treasury in its advice to the Gillard Government following the 2010 federal election when it stated that:

... recent focus on the Commonwealth Grants Commission methodology, including the impact of Western Australia’s growing prosperity, has placed pressure on the principle of horizontal fiscal equalisation, a key element of federal financial relations since the 1930s . . . growing pressures on horizontal fiscal equalisation may require consideration of whether adjustments are needed to ensure sustainability of the arrangements into the future.²⁹

As has already been noted, academic unanimity may not attach to a conclusion regarding whether VFI in Australia is extreme by international comparison or only very substantial. However, one area where a strong conventional wisdom does appear to exist is the view that, given the existence of a federal system, the level of VFI in Australia is of a degree significant enough that it must be addressed.

For many decades a variety of mechanisms have been employed to address VFI in Australia. Dollery notes the situation in the following terms: “Given the growing magnitude and chronic nature of fiscal imbalance in the Australian federation, it is not surprising that debate amongst economists during the twentieth century focussed on the best methods of dealing with this difficult question”.³⁰

The inadequacy of HFE as a remedy to VFI

The methods that can be employed to alleviate VFI are essentially two-fold: decrease State spending or increase State revenue. In a federation, a reduction in sub-national

spending can be achieved either by simply not providing (at all) a range of services or infrastructure traditionally and presently provided by the sub-national governments, or by transferring some spending responsibilities from the sub-national to the national government. Conversely, an increase in State revenue may be achieved either in the form of grants or, more substantively, in the form of the provision to the sub-national governments of powers to levy and collect revenue of some type previously not collected by sub-national governments.

If there is some dispute about the comparative extent of VFI and the magnitude of its negative effects on the Australian economy, then perhaps the strongest indicator of a consensus of opinion that the problem is real and significant is the enormous policy and political effort taken to remedy VFI. Twomey and Withers have noted that Australia has significant VFI balancing simply because Australia, in their view, has the highest level of fiscal equalisation. The Senate Committee, which cites the Twomey and Withers paper, notes that all the mechanisms for equalisation in Australia essentially involve the Commonwealth transferring large sums of money to the States to assist them to meet their expenditure responsibilities.³¹ In short, substantial sums of money would not be transferred by the Commonwealth to the States if VFI was not a real and substantial problem.

Given that the existence and negative effects of VFI *and* the operation and extent of HFE are the two central controversies of the modern Australian federal system, it is worth examining why HFE is itself held out to be a remedy for VFI. On this point it is important to note that HFE is not just the basis for the distribution of GST monies; it is also the effective basis of distribution applying to the majority of Commonwealth grant monies other than GST.

The present situation was well described by Pincus when he noted that the existence of VFI in Australia means that almost half of the spending of the Australian States and territories is funded by Commonwealth grants. In 2010-11 the Commonwealth Government budgeted to provide the States with \$94bn in payments, being an amount equivalent to 6.7 percent of GDP and just under 30 percent of Commonwealth tax revenues. Importantly, Pincus noted: “The grants are about 50/50 GST and other; and approaching half of the ‘other’ get pooled with the GST for purposes of fiscal equalisation”.³²

It makes perfect sense to describe the half of Commonwealth grants not pooled with the GST for the purposes of fiscal equalisation as grants directed at achieving an alleviation of VFI. And, further, it makes some sense also to characterise the “other” half of grants that get pooled with the GST for purposes of fiscal equalisation as grants directed at achieving an alleviation of VFI. This is because these grants, in practical terms, represent a true distribution of Commonwealth revenue from the Commonwealth to the States.

The central contention of this paper is, however, that it does not make any sense whatsoever to characterise the GST payments (which are subject to comprehensive HFE) as being properly directed toward, or in any way actually achieving, an alleviation of VFI.

This is because the GST money is already supposed to constitute State money and, accordingly, the GST/CGC system does not in any practical sense represent a shift of revenue from the Commonwealth to the States, but merely a redistribution of State money between States for the purported end of equalisation.

The proposition that the GST monies distributed according to HFE alleviates VFI is no more absurd than Robin Hood arguing that he had effected his end of transferring wealth from rich to poor by redistributing money between poor people: to the very poor from the not quite so poor (in circumstances where the wealth of the rich remained untouched).

So silly is the characterisation of the GST distribution as alleviating VFI that it is both surprising that the contention persists at all and surprising that it is not more often criticised. But the contention is made, nevertheless, and from the most authoritative sources. The recent Senate Committee report was unequivocal when it stated, under the heading, “Managing VFI within the Australian federation,” that “measures that have been introduced to attempt to improve the fiscal imbalance between the tiers of government *include GST distribution*, Specific Purpose Payments (SPPs), National Partnership Payments (NPPs) and general revenue assistance”.³³ [Emphasis added]

The Senate Select Committee itself noted that the extent of VFI in Australia depends upon whether the GST is considered Commonwealth revenue, noting that “. . . Australia’s VFI is significant and entrenched.”³⁴

Whatever its statutory basis for collection, there is broad agreement that the GST was meant to be State revenue and the Senate Committee, in the foregoing passage, appears to acknowledge this practical fact. Buttressing the contention that the GST should be considered in practice as State revenue is the fact that to achieve receipt of GST monies, the States agreed to give up a range of revenue sources to which they previously had access.³⁵ The significance of what was given up in terms of revenue to achieve the GST is indicated in an article by the Under-Treasurer of Western Australian, Tim Marney. He noted, “for the first three years of the GST funding arrangements GST grants were insufficient to cover the forgone revenues and additional expenditures in most states (including Western Australia), requiring top up ‘budget balancing assistance’ from the Commonwealth under the terms of the IGA.”³⁶

It can be seen that, originally, GST was meant to alleviate VFI by providing the States with a growth source of revenue untied by the Commonwealth. Certainly, had GST as a revenue source grown as anticipated for all States, its characterisation as a remedy to VFI may have found greater merit. For States such as Western Australia, however, the GST has not grown as was expected. Indeed, even in total terms, it was noted as early as 2006 that the revenue windfall said to have been achieved by the GST for the States was actually tiny in the general scheme of things, being \$1.2bn in 2005-06 or 0.1 percent of GDP.³⁷

In recent times the size of the overall benefit to the States from the GST has been further diminished by slower than expected growth in the GST pool owing to sluggish consumption and changing consumption patterns. But the original purpose of providing *all* the States with an untied growth source of significant revenue has been most substantially subverted because the extreme nature of HFE means that large amounts of revenue now being used to benefit financially weaker States are being sourced from what would otherwise constitute the revenue of other States.

The simple fact is that prior to the advent of the GST in 2001-02, the financial donation to financially weaker States that occurred under the banner of equalisation was achieved using revenue that was unequivocally Commonwealth revenue.

The serious and under-explored question that now arises is why, in the context of severe VFI in Australia, does the burden of improving the circumstances of those States

that may from time to time be financially weaker than their counterparts fall on the remaining States (rather than on the Commonwealth, which presently raises more money than it is required to spend).

The Senate Select Committee concluded that, “by comparison with all other federations, Australia has a high level of VFI. Over time, the VFI has severely undermined the capacity of the States and territories to raise the revenue necessary to undertake their assigned constitutional responsibilities.”³⁸ The Committee further noted that, over many decades, an extensive range of mechanisms have been developed to address the problem. The obvious question arises that, if VFI has severely undermined the capacity of the States and territories to raise the revenue necessary to undertake their assigned constitutional responsibilities, why does it fall on already underfunded States to provide so much of the funds now used for the equalisation of capacity in financially weaker States?

The unreality of now characterising GST payments distributed according to a comprehensive HFE as alleviating VFI is perhaps clearest when considering the case of the Northern Territory.

Where Pincus noted that VFI means that almost half of the spending of the States and territories is funded by Commonwealth grants, he also noted that this figure was more than 80 percent in the Northern Territory.³⁹ Moreover, despite the Commonwealth’s relative revenue wealth compared to the States, a very significant proportion of the money devoted to the Northern Territory derives from other States’ GST monies.⁴⁰

The situation is, now, that there is, first, a striking correlation between donors and recipients in 2012-13:

Western Australia will subsidise the Northern Territory;

Victoria will subsidise South Australia;

New South Wales will subsidise Tasmania; and

Queensland will subsidise the Australian Capital Territory.

Second, of a total donated amount of \$4.016bn in 2012-13 more than *half of this amount, totalling \$2.224bn, is received by the Northern Territory*. The other recipients are South Australia, \$1.007bn; Tasmania, \$629m; and the Australian Capital Territory, \$156m.

There is no doubting the need of the Northern Territory, Tasmania and South Australia.

As was noted above, the CGC/HFE process uses measures of both revenue and need in terms of service delivery costs. The Northern Territory has very high relative costs of service delivery which correlates to its very high share of Australia’s indigenous population, and that each of the present recipient States/territories of Northern Territory, Tasmania and South Australia show much higher than average low socio-economic communities.⁴¹

In practical political terms, the paucity of State revenue generally, and relative abundance of Commonwealth revenue, the needs for assistance manifest in the Northern Territory, Australian Capital Territory, Tasmania and South Australia are in large part being met by the remaining States.

Indeed, more than half of the divisiveness caused by the present system of GST distribution is caused by the fact that despite the severe nature of VFI in Australia, and despite the far stronger revenue base of the Commonwealth, the responsibility of

meeting the needs of the Northern Territory beyond its own capacity to raise revenue no longer falls on the Commonwealth (as it always did, prior to 2000). That responsibility now falls to the four largest States which, in the context of VFI, can least afford that responsibility.

Leaving aside arguments regarding the natural constitutional responsibility which the Commonwealth may maintain with respect to the Australian Capital Territory and the Northern Territory, there is a powerful proposition that emerges. Notably, that it is less than reasonable to expect the four largest States to bear such a substantial share of the burden of assisting the Northern Territory (and other jurisdictions requiring “equalisation”) by the donation of what was meant to be a significant growth source of revenue for those States.

The strength of this proposition should be assessed in the context of both the severity of VFI in Australia and two other important contextual considerations.

These two other contextual factors are, first, that equalisation in the form of wealth subsidies from one State to another already occurs in Australia by a range of means other than through the formal mechanism of monies distributed by the CGC. And, second, it is a readily identifiable phenomenon that when the Commonwealth experiences periods of financial distress (often associated with the need to reduce Commonwealth Budget deficits), a key method employed to return to surplus is to decrease monies allocated to already underfunded States.

Western Australia provides a \$15bn plus net fiscal contribution to the federation (all other States except New South Wales are subsidised).⁴² This is driven by the high level of Commonwealth revenue derived from Western Australia (company tax, personal income tax and petroleum extraction revenue), together with the low draw on Commonwealth social security and health benefits by residents of Western Australia. Western Australia has been providing a net contribution to the federation since the mid-1980s, with the amount increasing substantially in subsequent years. Western Australia’s growing economic strength, the Commonwealth’s proposed mining tax and the State’s falling share of GST revenues are likely to see its net contribution to the federation continue to grow substantially.⁴³

On the second issue of declining grants to the States, the 2012-13 Commonwealth Budget is a case in point. To achieve the enormous fiscal consolidation promised by the Commonwealth Government, and to bring a budget in deep deficit back to a small projected surplus, major cuts in States’ funding were made. The official letter to State premiers and treasurers regarding the 2012-13 Commonwealth Budget included a document entitled, *Supplementary Information to the States and Territories on the 2012-13 Budget – Fact Sheet 1*.⁴⁴ It showed that, despite the acute level of VFI in Australia, the total financial assistance to the States decreased in one year from \$96.156bn in 2011-12 to \$90.370bn in 2012-13. This represents a very substantial reduction of \$5.786bn in one year. A huge \$1.124bn of this loss will be borne by Western Australia.

The mischaracterisation of GST payments as a mechanism alleviating VFI presents some obvious clues to practical, immediate and achievable reform of the GST distribution.

The several potential solutions to VFI have had frequent discussion in proceedings of The Samuel Griffith Society. They include the future sharing of income tax revenue, a potential broadening of the base, and increasing the rate, of the GST, or the

provision to the States of some other revenue source such as a share of the Petroleum Resource Rent Tax.⁴⁵

The proposal in this paper is more modest but has the advantage that it is immediately and quickly achievable if the Northern Territory and the Australian Capital Territory had been directly funded by the Commonwealth and the GST pool had then been distributed amongst the States only on a per capita basis.⁴⁶

If this method had prevailed in 2011-12, all four large States would have received more GST monies: New South Wales \$1.043bn more; Victoria \$1.432bn more; Queensland \$939m more; and Western Australia \$1.552bn more. The States that would have received less under this method would have been: South Australia, with \$851m less; and Tasmania with \$614m less. However, that combined loss (\$1.465bn) represents a significant mitigation because of the increased size of the pool that would have occurred had the Northern Territory and the Australian Capital Territory been nominally funded directly by the Commonwealth. Indeed, that loss of \$1.465bn could be potentially mitigated by the four large States through special agreement and all four large States would still be better off than under current arrangements. It may also be conceivable that the remaining \$1.465bn loss could be mitigated by the Commonwealth.

The central point is that in a scenario where the Commonwealth assumed responsibility for all payments to the Northern Territory and the Australian Capital Territory presently drawn from the GST pool, the recurrent cost to the Commonwealth Budget in 2012-13 would be \$3.652bn. Such a responsibility would be truly consistent with constitutional lines of responsibility. It would allow also for a swift end to the present divisiveness of the GST system. Further, it would allow for a starting point of a per capita sharing of GST monies with scope for some agreement between the remaining States that would see the four largest States significantly better off and Tasmania and South Australia potentially no worse off than under the present system.

Indeed, were the Commonwealth to subsume responsibility for all subsidies beyond the per capita shares to States, this would be achieved at a cost to the Commonwealth Budget of \$4.016bn in 2012-13. Whether this is a large or reasonable impost on a Commonwealth Budget should be considered in light of the fact that in 2012, grants to the States were cut by \$5.786bn. Either scenario would greatly reduce the problem of VFI, end the divisiveness of the present GST distribution system and allow the large Australian State economies the flexibility they need to fund services and infrastructure. All this could be achieved without the introduction of any new taxes.

Conclusion

The Senate Select Committee recently concluded that:

On the basis of the material presented to the committee, the committee sees merit in a comprehensive assessment of the IGA on Federal Financial Relations and taxation levels and structures, to determine if measures can be taken to provide the states certainty regarding their revenue raising and their capacity to meeting their responsibilities.⁴⁷

There is little to disagree with in the above proposition. It omits, however, a further substantive benefit of reducing VFI. A modern and essential benefit of actually and substantively reducing VFI in Australia is that it would allow the four large State economies the flexibility to invest in infrastructure designed to develop their

economies and wealth and revenue for the entire nation. This has never been more important than in the present economic conditions in Australia, which represent a fundamental restructuring of the economy and where, to expand their economies, State governments increasingly need to react quickly to fluid economic opportunities. At present, the large growth States do not have sufficient revenue to invest in these opportunities.

Since the start of the Global Financial Crisis, Australia has added 92 000 jobs in mining and 62 500 in construction. But by November it had lost 127 000 jobs in manufacturing, almost as many as in the entire 1990-91 recession. Employment in manufacturing has fallen in Australia during the last decade but manufacturing itself has actually increased in the same period in Western Australia. Indeed, it is notable that in the December 2011 quarter alone, 7 000 jobs were created in manufacturing in Western Australia. In the year to December, Australian domestic demand (that is, spending) grew by 4.6 percent (faster than GDP growth): only because Western Australia and Queensland drove this figure up – demand grew by 13 percent in Western Australia and 8.2 percent in Queensland. In all other States, demand was basically flat, growing only between 0.1 and 1.7 percent. Western Australia is, at present, driving the national economy. With only 10 percent of the nation's population, WA will contribute:

- 20 percent company tax take;
- 60 percent (Mining Resource Rent Tax);
- 40 percent of Australia's total exports; and
- 45 percent of Australia's total merchandise trade.

In the year to April 2012, 70 percent of all new Australian jobs were created in Western Australia.

From time to time different States, in response to rapidly changing global economic conditions, will have the opportunity to increase revenue and employment for the entire nation. The great tragedy of modern VFI, however, is that they will be immediately constrained by a lack of real flexible revenue to take greatest advantage of those situations. That outcome is to the detriment of the national economy.

Endnotes

1. Senate Select Committee Report on Reform of the Australian Federation “Australian Federation: an agenda for reform” published 30 June 2011 see 4.2. Available online at: http://www.aph.gov.au/~media/wopapub/senate/committee/reffed_ctte/reffed/report/report_pdf.ashx (“Senate Select Committee Report on Reform of the Australian Federation”).
2. *Karpowicz I*, “Narrowing Vertical Fiscal Imbalances in Four European Countries”, IMF Working Paper see page 1, available online at <http://www.imf.org/external/pubs/ft/wp/2012/wp1291.pdf>
3. For the use of this definition, see R. Bird, and A. Tarasov, “Closing the Gap: Fiscal

- Imbalances and Intergovernmental Transfers in Developed Federations,” *Government and Policy*, 2004, vol. 22, 77–102. And for the operative use of a similar working definition, being the share of sub-national own spending not financed through own revenues see Eyraud L., and Lusinyan L., “Decentralizing Spending More than Revenue: Does It Hurt Fiscal Performance?” 2011 IMF Working Paper 11/226 (Washington: International Monetary Fund).
4. The Federalist No. 32, Concerning Taxation (continued), *The Federalist Papers*, Penguin Books, 1987, 220.
 5. See Eyraud, L., and L. Lusinyan, 2011, “Decentralizing Spending More than Revenue: Does It Hurt Fiscal Performance?” IMF Working Paper 11/226 (Washington: International Monetary Fund). And see Rodden J “The Dilemma of Fiscal Federalism: Grants and Fiscal Performance around the world need full reference. And see
 6. Craig, J. (1997), “Australia”, in T. Ter-Minassian, (ed.)(1997), *Fiscal Federalism in Theory and Practice*, Washington: International Monetary Fund, 175-200.
 7. Twomey, A. & Glenn Withers, *Australia’s Federal Future. Delivering growth and prosperity*, Federalist Paper No 1, Report for the Council of the Australian Federation, April, 2007, 37–38.
 8. Dollery B., “A Century of Vertical Fiscal Imbalance in Australian Federalism”, *History of Economics Review*, 2002, 38. On this point Dollery illustrates the point using a table which shows the relative degree of vertical fiscal imbalance in Australia on the measure of ‘vertical current balances’ being the own source revenues for each level of government to own source current expenditures. At the time Australia had a ratio of 1.45 above Canada 1.05, Germany 1.03 and the USA 0.93.
 9. Data sourced from Department of Treasury for Western Australia and it should be noted this data does include GST revenues as Commonwealth revenue. For further details, see Appendix 1: <http://samuelgriffith.org.au/docs/vol24/vol24chap4-appendices.pdf>
 10. Pincus, J. J., “Revisiting Proposals for a State Income Tax” Paper presented at 22nd Samuel Griffith Society Conference Perth 2010, Chapter 6. Available online at <http://samuelgriffith.org.au/docs/vol22/vol22chap6.pdf> citing data from (ABS 5506.0 – Taxation Revenue, Australia, 2008-09).
 11. *Op. cit.*, Pincus, 58.
 12. Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities — 2011 Update*. <https://cgc.gov.au/attachments/article/26/2011%20Update%20Report.pdf> (“GST Revenue Sharing Relativities — 2011 Update”).

13. *Op. cit.*, Pincus, 58.
14. *Op. cit.*, Dollery, 35.
15. *Op. cit.*, Dollery, 35 – 37.
16. Northern Territory and the ACT were brought into the arrangements in 1988 and 1993 respectively.
17. For a slightly fuller description see Porter C., “*The Grants Commission and the Future of the Australian Federation*” Public Policy 2001 Vol. 6 No. 1/2 at 55.
18. Source: Western Australia Department of Treasury. For further details, see Appendix 2: <http://samuelgriffith.org.au/docs/vol24/vol24chap4-appendices.pdf>
19. *Op. cit.*, GST Revenue Sharing Relativities – 2011 Update.
20. *Op. cit.*, Dollery, 27.
21. WA Submission to the Review of GST Distribution October 2011 at 6 where it is also noted that interstate free trade hampered the growth of secondary industry (in the less populous States) by facilitating ‘dumping’ by New South Wales and Victorian manufacturers; and the Commonwealth’s *Navigation Act and Conciliation and Arbitration Act* resulted in artificially high freight rates and wage costs respectively, placing export oriented States at a competitive disadvantage. Available online at: http://www.gstdistributionreview.gov.au/content/submissions/downloads/issues_paper/wa_gov.pdf (“WA Submission to the Review of GST”).
22. *Op. cit.*, Dollery, 33.
23. Commonwealth of Australia *Equality in Diversity – Fifty Years of the Commonwealth Grants Commission*, Australian Government Publishing Service, 1983, 9. Ultimately, this publication notes the very point that a central rationale for the establishment of the CGC was to put financial assistance for disadvantaged States on a more systematic basis; see 12 and 16.
24. For further details, see Appendix 3: <http://samuelgriffith.org.au/docs/vol24/vol24chap4-appendices.pdf>
25. *Op. cit.* Twomey & Withers noted that the pursuit of equalisation in Australia exceeds the pattern in all other comparable federations. As a consequence, it provides greater disincentives for sub-national governments to seek and provide efficient delivery of government services. At a minimum, more transparent and less complex equalisation processes with improved incentives for efficiency could be developed.

26. GST Distribution Review Interim Report March 2012 at 80 (“GST Distribution Review Interim Report”).
27. See *op. cit.*, Porter C
28. *Op. cit.*, GST Distribution Review Interim Report, 101.
29. *Op. cit.*, See WA Submission to the Review of GST, 12 quoting (Commonwealth Treasury 2010, 17).
30. *Op. cit.*, Dollery, 27.
31. *Op. cit.*, Twomey & Withers, 37–38. The Senate Committee to which this paper was presented noted that “As the Commonwealth raises more revenue than the states and territories, these mechanisms [for equalisation] all involve the Commonwealth transferring funds to the states to assist them to meet their expenditure responsibilities “ see Senate Select Committee Report on Reform of the Australian Federation, 5.
32. *Op. cit.*, Pincus, 58.
33. *Op. cit.*, Senate Select Committee Report on Reform of the Australian Federation, 57. See also Ahmad E., and Craig J., 1997, “Inter-governmental Transfers”, in Ter-Minassian T. (ed), 1997, *Fiscal Federalism in Theory and Practice*, Washington: International Monetary Fund, 73-107 at 76 the authors characterise the Australian approach to the issue of VFI as being the third of three possible responses; whereby the vertical and horizontal imbalances are dealt with simultaneously through a system of grants, including equalisation payments and special purpose grants.
34. Senate Select Committee Report on Reform of the Australian Federation, 56.
35. At a Premiers’ Conference on 9 April 2000 Premiers and Chief Ministers agreed to The *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*. This Agreement was annexed as Schedule 2 to the *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999*. Part 2 s.5(iv) of the Agreement stated that the taxes to be abolished were listed in Appendix A which also set the then required timeline for abolition.
36. Marney, T., “The GST agreement – setting the record straight”, *Tax Policy Journal*, vol 3, 2007, 6.
37. *Op. cit.*, Marney at 6 citing Macquarie Bank research paper, Federalism Watch – 4 July 2006: Four facts missing from the debate on Federal / State relations”.
38. Senate Select Committee Report on Reform of the Australian Federation, 69.

39. *Op. cit.*, Pincus, 58.
40. For further details, see Appendices 4 and 5: <http://samuelgriffith.org.au/docs/vol24/vol24chap4-appendices.pdf>
 What is depicted in Appendix 4 is the donors and recipients under the GST system from the present 2012-13 financial year to the end of the forward estimates.
 The graphs in Appendix 4 depict projected GST relativities from 2012-13 to 2015-16 using the data set contained in 2012-13 Western Australian State Budget but incorporating GST pool estimates from the 2012-13 Commonwealth Budget. The graphs in Appendix 5 have been included for completeness and depict projected GST relativities from 2012-13 to 2015-16, using the data set contained in 2012-13 Commonwealth Budget and GST pool estimates from the 2012-13 Commonwealth Budget. This analysis will focus on the data set produced by Western Australian Department of Treasury, which has a more sophisticated methodology for calculating forward estimates of royalty revenues than does the Commonwealth Treasury, and has consequently proved more accurate in predicting actual GST shares into the out-years.
41. Commonwealth Grants Commission, Presentation to the Panel reviewing the GST Distribution, 6 May 2011, Available at: https://cgc.gov.au/attachments/article/40/CGC_2011_presentation_to_GST_Review_panel.pdf
42. For further details, see Appendix 7: <http://samuelgriffith.org.au/docs/vol24/vol24chap4-appendices.pdf>
 Appendix 7 demonstrates Western Australia's net contribution to the Australian federation, distinguishing the contribution through the GST system from all other contributions.
43. *Op. cit.*, WA Submission to the Review of GST, 9.
44. Supplementary Information to the States and Territories on the 2012-13 Budget – Fact Sheet 1 delivered in letter dated 8 May 2012 from Prime Minister Gillard to Premier Barnett and Treasurer Porter. For further details, see Appendix 8: <http://samuelgriffith.org.au/docs/vol24/vol24chap4-appendices.pdf>
45. At the 2010 conference Professor Jonathan Pincus argued in favour of income tax sharing and *op. cit.*, Twomey and Withers, *op. cit.*, 49, argued at the Senate Select Committee Report on Reform of the Australian Federation that: *[s]erious tax reform would recognise that Australia overtaxes incomes and undertaxes spending compared to other OECD economies. Our overall tax take is at the lower end of industrial economies as a share of GDP but is strongly biased toward income tax sourcing. Both personal income taxes and corporate income taxes represent higher shares of public revenue in Australia than in most comparable countries.*"

46. For further details, see Appendix 9:
<http://samuelgriffith.org.au/docs/vol24/vol24chap4-appendices.pdf>
Appendix 9 shows distribution of the GST in 2011-12 for two scenarios:
1. What actually happened in terms of distribution of the GST in 2011-12.
 2. What would have happened in terms of distribution if the Northern Territory and the Australian Capital Territory had been directly funded by the Commonwealth and the GST pool had been distributed amongst the States only on a per capita basis.
47. *Op. cit.*, Senate Select Committee Report on Reform of the Australian Federation.