Warren, Neil

Article
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CESifo DICE Report

Provided in Cooperation with:
Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

Suggested Citation: Warren, Neil (2008) : Fiscal Equalisation in Australia: High Level VFI and Equity Focused HFE, CESifo DICE Report, ISSN 1613-6373, ifo Institut für Wirtschaftsforschung an der Universität München, München, Vol. 06, Iss. 1, pp. 10-15

This Version is available at:
http://hdl.handle.net/10419/166927

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FISCAL EQUALISATION IN AUSTRALIA: HIGH LEVEL VFI AND EQUITY FOCUSED HFE

NEIL WARREN*

Federation and the constitution

When the Australasian Federal Convention met in the late 1890s to discuss a draft constitution for the new Commonwealth of Australia, tax and expenditure responsibilities of the States (the former colonies) were the focus of much debate. Particular attention was given to whether the reference to customs duties should be extended to also include excise duties since customs duties were imposed on similar goods. The subsequent amendment to s. 90 of the Australian Constitution gave the Commonwealth Parliament exclusive power to impose duties of customs and excise, an action which was to have profound and unforeseen implications for the future taxing powers of States.

The Constitution also restricted States from levying duties/taxes on flows to/from other States (s. 92) and from imposing taxes on the Commonwealth (and the Commonwealth from imposing taxes on the States) without agreement to do so (s. 114). The Commonwealth was also prevented from levying taxes which discriminated between States (s. 51(ii)). In relation to inter-governmental financial arrangements, tax sharing was provided for (s. 87) along with provision for the Commonwealth to provide grants to States on any terms (s. 96). Following a Constitutional referendum in 1928, the Commonwealth also acquired the power to coordinate borrowing by State governments (s. 105A) which resulted in the setting up of the Loan Council.

In the case of expenditure responsibilities, the Constitution endows the Commonwealth Government (s. 51) with powers relating to defence, foreign affairs, maritime, trade (inter- and intra- national), and pensions and benefits. States, by default, retained responsibility for the major expenditure areas of health, education, transport, and law and order.

Since the Proclamation of Federation on 1 January 1901, the independence of States enshrined in the Constitution has been progressively eroded. S. 90 of the Constitution, which was designed to ensure States did not impose import duties on cross-border trade, has subsequently been interpreted by the High Court of Australia as excluding States from levying any form of sales tax or excise duty.

In the case of income based taxes, the colonies had imposed such taxes as early as the 1880s and retained these after federation. It was not until 1915 that the Commonwealth introduced an income tax. In 1942, the Commonwealth introduced the Uniform Income Tax Act and forced States to repeal their own income taxes. This was not because such State taxes were unconstitutional but because the Commonwealth indicated that any revenue raised by States from their own income taxes would result in an equivalent reduction in their grants from the Commonwealth. The States challenged the right of the Commonwealth to impose such conditions on its grants to States, but the High Court found in favour of the Commonwealth on the basis that s. 96 of the Constitution states that the Commonwealth “Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit”.

The impact on Australian States of the loss of access to income and consumption taxes is apparent from Table 1. States now rely on payroll taxes for 30 percent of revenue (assigned to them by the Commonwealth in 1971), taxes on motor vehicles for 25 percent and property based taxes for 19 percent. In con-

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* Neil Warren, Professor of Taxation and Head of School, Australian School of Taxation (Atax) University of New South Wales Sydney 2052 Australia email: n.warren@unsw.edu.au
1 The Australian Commonwealth comprises six states (New South Wales, Victoria, Queensland, South Australia, Western Australia and Tasmania) and two territories (Northern Territory and Australian Capital Territory). Hereafter, we shall refer to these states and territories as “States”.
2 See the Australian Constitution at www.aph.gov.au/senate/general/constitution>
Contrast, the Commonwealth receives 48 percent of its tax revenue from taxes on personal income, 23 percent from company income, 16 percent from the GST and 16 percent from excise duties. This is all at a time when States have retained the same expenditure responsibilities as they had at federation. Not surprisingly, the Commonwealth raises considerably more revenue than it requires for its own-purpose outlays, collecting 82 percent of all taxation revenue while being responsible for only 54 percent of total general government outlays. In contrast, the States collect 15 percent of taxation revenue and account for 40 percent of total general government outlays (Table 2). A high level of vertical fiscal imbalance (VFI) therefore characterises the Australian federation.

Australia’s current approach to addressing VFI involves two basic strategies: a system of specific purpose payments (SPPs) by the Commonwealth as shown in Table 3. SPPs “through” States have grown in importance in recent years with the Commonwealth assuming direct funding responsibilities for initiatives by States, with or without their agreement. Examples include funding for non-government schools, a first home owner’s purchase support scheme, and financial assistance grants for local government.

SPPs “to” States have also been designed to fund the expenditure obligations of States in a way which the Commonwealth seeks to encourage. This has resulted in both tied and untied SPPs. This is possible because s. 96 of the Constitution gives the Commonwealth the power to provide grants to States on any terms. In the case of tied SPPs, this has had a disproportionate impact on States’ fiscal autonomy through the matching and maintenance conditions attached to the Commonwealth grants. For example, these tied grants provide around 15 percent of NSW total Budget revenues, but the conditions attached to these grants control around 30 percent of NSW budget outlays.

In the early 1980s, SPPs were some 34 percent of all grants to States, rising to around 48 percent in the early 1990s. As shown in Table 3, by 2005–06 SPPs comprised some 42 percent of all State grants received with some 21 percent of SPPs passed straight through to the States.

### Specific purpose payments

Reassigning expenditure responsibilities from the States to the Commonwealth has effectively occurred through the use of specific purpose payments (SPPs) by the Commonwealth as shown in Table 3. SPPs “through” States have grown in importance in recent years with the Commonwealth assuming direct funding responsibilities for initiatives by States, with or without their agreement. Examples include funding for non-government schools, a first home owner’s purchase support scheme, and financial assistance grants for local government.

### GST revenue sharing

In 1998, the Commonwealth released a proposal (Costello 1998) to introduce a 10 percent GST on 1 July 2000 and to assign the revenue to States in return for the abolition of some nine State taxes, Commonwealth Financial Assistance Grants (FAG) and Revenue Replacement Grants (RRP). At the Commonwealth level, the abolition of FAG would help fund the repeal of a multi-rate narrow based

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4 Ibid., p 22.
5 RRP were compensation to States for their loss of taxes on petrol, tobacco and alcohol following a successful Constitutional challenge to their legitimacy given s 90 of the Constitution.
Wholesale Sales Tax (WST). While the Commonwealth made much of the assignment of the GST revenue to States, in effect, only 58.5 percent of the GST funded their loss of FAG. As a consequence, the arrangement was less genuine revenue sharing and more an alternative to the then current system of FAG and RRP.

While the Commonwealth proposal further reduced the discretionary taxing revenue raising powers of States, the States responded positively. However, in May 1999, the Commonwealth amended its offer to the States as a result of needing to compromise to ensure the GST reforms passed through the Parliament. This involved excluding basic foods from the base of the proposed GST, funded in part through delays to the funding of State tax reforms.

To remove any concern on the part of the States that they might be worse off during the transition period, the Commonwealth agreed that each State would receive a Guaranteed Minimum Amount (GMA) such that if any State was worse off, they would receive Budget Balancing Assistance (BBA) to make up the shortfall. On 30 June 1999, the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations (IGA) was signed by the Commonwealth and the States and on 1 July 2000, the 10 percent GST was introduced.

While some State taxes were abolished within a year of introducing the GST, the States agreed to review the remainder by 2005 with a view to their possible abolition, conditional on the GST revenue sharing arrangement providing the necessary funding. By 2005, all States had either repealed these taxes or set dates for their repeal or further review. The Commonwealth has continued to argue that since all States are consistently better off (GST>GMA) they should embark on State tax reforms additional to those identified in IGA.

For States, the repeal of the various State taxes noted under the IGA has directly impacted on their discretionary sources of tax revenue (and VFI). In 2005–06, States collected 14.8 percent of all tax revenue, down from 19.5 percent in 1998–99 and over the same period, tax revenue as a proportion of total State general government operating revenue fell from 39 percent to 31 percent. Over the same period, the contribution to total State general government operating revenue by general revenue grants increased from 35 percent in 1998–99 (FAG) to 45 percent in 2005–06 (GST revenue).

### Grant distribution consultative framework

The institutional framework for determining the grant distribution to States is outlined in Figure 1. Central to the process is the Council of Australian Governments (COAG) which is the peak intergov-

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8 See Collins and Warren(2007), Table 1.
ernmental forum in Australia and involves the Prime Minister, each State’s Premier and a representative from local government. Consultation and cooperation between the Commonwealth Government and States in specific policy areas is facilitated by over 30 Commonwealth-State Ministerial Councils under COAG. Both Ministerial Councils and COAG can initiate, develop and monitor the implementation of policy reforms of national significance requiring cooperative action. When formal agreement is needed, this is embodied in an intergovernmental agreement.

One such instance is the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations (IGA), which resulted in the establishment from 1 July 1999 of the Ministerial Council for Commonwealth-State Financial Relations (the “Treasurers’ Conference”). Its functions include oversight of IGA and its regular review; oversight of the operation of the GST; discussion on the Commonwealth Grants Commission (CGC) recommendations on relativities prior to the Commonwealth Treasurer making a determination; and making recommendations to the Commonwealth Treasurer on GMA.

Grant distribution methodology

Critical to the allocation of s. 96 grants amongst States is the advice provided by the Commonwealth Grants Commission (CGC) to the Commonwealth Treasurer on their allocation. The CGC’s terms of reference require it to redress any horizontal fiscal imbalance by developing per capita relativities which provide all States with the same fiscal capacity to provide services to their populations if they make the Australian average effort to raise revenue and operate at the average level of efficiency.

The objective of horizontal fiscal equalisation (HFE) in Australia is therefore focused on compensating disadvantaged States for their expenditure disabilities (due to their relatively high per capita costs for providing public services) and revenue disabilities (having relatively small per capita tax bases). No consideration is given to inefficiencies arising from their own discretionary policies. Rather than performance equalisation, the focus is on equalising per capita capacity equalisation in a way that does not force the adoption of uniform policies across States. In assessing that capacity, the CGC treats all Specific Purpose Payments (SPP) from the Commonwealth to States as simply another revenue source (unless the CGC is directed to quarantine these grants – which is more the exception than the rule10).

The precise methodology applied by the CGC in preparing State relativities (Wi) is outlined in Figure 2 along with how it is applied to derive each State’s share of the grant pool. In practice, this pool includes both the revenue from the GST and the total of all (unquarantined) Health Care Grants (HCG) allocated under the Health Care Agreement between the Commonwealth Government and each State. The resulting distribution of the GST/HCG pool detailed in Table 4 provides all States with the same fiscal capacity to provide services to their populations, if they make the Australian average effort to raise revenue and operate at the average level of efficiency.11

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9 For a description of COAG, see www.coag.gov.au/ministerial_councils.htm
10 “Quarantined” SPPs are a small proportion of total SPPs and have historically related to direct grants to non-government schools and local governments.
Applying HFE Principles in Australia

For each State expenditure category:
- Aggregate expenditure of all States
- Total Australian Population
  - average per capita ("standard" expenditure)
  - unique disability factors of State (eg, scale, dispersion, inputs costs, etc.)
  - standardised expenditure per capita (unique to each State)

All State Average Budget Result (Deficit) per capita where State Budget Result is GST grant plus HCG plus SPP plus non-revenue revenue less expenses.

Assessed Expenditure in State i
- Sum of all standardised per capita expenditure
- Unique disability factors of State

Assessed Revenue in State i
- Sum of all standardised per capita revenue
- Relative size of the revenue base per capita of State
- Standardised revenue per capita (unique to each State)

Definitions:
- Relative size of the revenue base per capita of State = Taxation effort of State divided by the national average per capita.
- Unquarantined SPPs in State i = (included as they are available to fund standard expenditure).


The future

With the introduction of the GST in 2000 and the repeal of various State taxes, the proportion of State revenue subject to the HFE process increased 100 percent (between 1998–99 and 2005–06). This is at a
time when State tax revenue rose by only 25 percent. Unsurprisingly, past concerns with the HFE methodology are now the focus of considerably greater attention with two issues in the forefront. Firstly, there has been a long standing concern that the emphasis on ensuring an equitable distribution of the grant pool between States has come at too high a price in terms of economic inefficiencies. While the CGC asserts that its approach is State policy neutral, in practice this is not the case. States’ policies directly influence the CGC estimates of national averages (as shown in Figure 2). In the case of taxes, this can mean that a State’s effort to grow its tax base (and economy) with rate or base changes can result in a transfer of these benefits to mendicant States. This can act as a disincentive to a State implementing efficiency improving reforms.

### Table 4

**Distribution of the GST/HCG "pool" and the effect of horizontal fiscal equalisation in 2006–07**

<table>
<thead>
<tr>
<th>Population 31 December</th>
<th>GST relativities (Wi)</th>
<th>Weighted population (1) x (2)</th>
<th>Share of GST/HCG &quot;pool&quot;</th>
<th>Unquarantined HCGs</th>
<th>Share of GST revenue (5) – (6)</th>
<th>GST/HCG &quot;pool&quot; share less equal per capita distribution of &quot;pool&quot;</th>
<th>distribution of &quot;pool&quot; by State Household Final Consumption Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>mm</td>
<td>mm</td>
<td>AUS$m</td>
<td>AUS$ per head</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
<td>(6)</td>
<td>(7)</td>
<td>(8)</td>
</tr>
<tr>
<td>NSW</td>
<td>6.864</td>
<td>0.873</td>
<td>5.994</td>
<td>13,821</td>
<td>2.787</td>
<td>11,034</td>
<td>-293</td>
</tr>
<tr>
<td>VIC</td>
<td>5.128</td>
<td>0.896</td>
<td>4.593</td>
<td>10,591</td>
<td>2.018</td>
<td>8,573</td>
<td>-242</td>
</tr>
<tr>
<td>QLD</td>
<td>4.090</td>
<td>1.024</td>
<td>4.188</td>
<td>9,656</td>
<td>1.607</td>
<td>8,049</td>
<td>54</td>
</tr>
<tr>
<td>WA</td>
<td>2.073</td>
<td>1.005</td>
<td>2.083</td>
<td>4,804</td>
<td>826</td>
<td>3,978</td>
<td>10</td>
</tr>
<tr>
<td>SA</td>
<td>1.562</td>
<td>1.189</td>
<td>1.856</td>
<td>4,280</td>
<td>689</td>
<td>3,591</td>
<td>434</td>
</tr>
<tr>
<td>TAS</td>
<td>0.490</td>
<td>1.549</td>
<td>0.760</td>
<td>1,752</td>
<td>179</td>
<td>1,573</td>
<td>1,266</td>
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<tr>
<td>ACT</td>
<td>0.331</td>
<td>1.146</td>
<td>0.379</td>
<td>874</td>
<td>106</td>
<td>768</td>
<td>335</td>
</tr>
<tr>
<td>NT</td>
<td>0.208</td>
<td>4.328</td>
<td>0.902</td>
<td>2,079</td>
<td>94</td>
<td>1,985</td>
<td>7,672</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>20.746</strong></td>
<td><strong>20.754</strong></td>
<td><strong>47,856</strong></td>
<td><strong>8,304</strong></td>
<td><strong>39,552</strong></td>
<td><strong>0</strong></td>
<td><strong>0</strong></td>
</tr>
</tbody>
</table>

factors applied to each results in some 359 expense factor assessments) and 37 State tax bases. However, there is doubt about whether all this sophistication achieves a superior equalisation outcome (Warren 2006, 82). A related concern is the CGC’s inclusion of HCGs and SPPs in its analysis. This is despite the level and initial distribution of HCGs and SPPs being determined in direct discussions between individual States and the Commonwealth. In effect, the action of the CGC in subtracting SPPs from a State’s total requirement for financial assistance when allocating a grant pool that includes both GST and HCGs usurps the intent of the direct Commonwealth-State discussions on the level and distribution of these payments.

While there have been numerous calls for change to the current HFE methodology, at no stage have these proposals recommended the abandonment of HFE principles in the allocation of grants between States in Australia. What is at issue is the precise methodology applied and its comprehensiveness. Reforms proposed include:

1. Quarantining some or all SPPs and HCGs from the HFE methodology.
2. Reducing the reliance on a complex array of both tax and expenditure variables when applying HFE principles.
3. Removing some taxes from HFE consideration to provide an incentive for States to rely more heavily on such taxes.
4. Benchmarking “standard” revenue (in Figure 2) to less than 100 percent of the actual average per capita revenue.
5. Distributing less than 100 percent of the general revenue grants through the equalisation pool.

While change will no doubt come slowly to the institutional framework designed to address VFI in Australia, there is growing acceptance that some change is inevitable in order to address the adverse efficiency impact of the past emphasis on equity in the distribution of grants amongst the Australian States.

References


