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Public Finance and Vertical Fiscal Imbalance

Introduction

A feature of Australia's federal system is that the States have relatively large constitutionally-assigned spending responsibilities but few own-revenue sources whilst the reverse is true at the Commonwealth level. The difference between the relative revenue and spending responsibilities of the Commonwealth and States is known as vertical fiscal imbalance (VFI).

The merits of VFI have long been debated. The issue became more prominent with the introduction of the GST. This was associated with an increase in VFI since under the agreement that the States receive all GST revenue, the States agreed to abolish or reduce some taxes.[1] This Research Note canvasses some of the issues in the debate over VFI.

How big is VFI?

Australia has the greatest degree of VFI of any federal country.[2] The Commonwealth's own-source revenue—about 75 per cent of total Commonwealth and State revenue—exceeds its own-purpose outlays of around 57 per cent of Commonwealth and State spending combined.[3]

The gap between State own-revenue and spending is filled by Commonwealth grants in the forms of general purpose payments and specific purpose payments (SPPs).[4] In 2002–03, payments to the States are estimated to be equivalent to more than 30 per cent of Commonwealth spending.[5]

Why VFI?

VFI is attributable to a number of interrelated factors.[6] First, the Commonwealth's financial power has increased through time at the States' expense. A major factor was the Commonwealth's taking control of income tax in 1942. Another factor has been the High Court's increasingly broad interpretation of 'excise', a tax constitutionally reserved for the Commonwealth. For example, in 1997, the Court ruled that State tobacco franchise fees are an excise.

Second, the States are constitutionally responsible for major areas of spending such as health and education. The Commonwealth has used section 96 of the Constitution—which allows the Parliament to grant financial assistance to any State on such terms and conditions as it sees fit—to extend its influence in the post-war period into areas of State responsibility through SPPs.

Criticisms of VFI

Critics have argued that VFI reduces government accountability. The underlying argument is that governments should be accountable for both spending and how they raise revenue. This principle is undermined when one tier of government raises revenue but another tier spends it. An example is the GST: the States spend all GST revenue but the Commonwealth imposes the GST.

A second criticism is that VFI forces the States to rely on narrowly-based taxes for own-source revenue. A taxation principle is that the tax base—such as land or consumption—should be as broad as possible, that is, with minimal exemptions. The Commonwealth imposes the main broadly-based taxes—the GST and personal income tax—leaving the States with only a few such taxes, namely payroll and land taxes, and a number of narrowly-based taxes such as stamp duties.

Third, it is argued that the Commonwealth's financial power diminishes the political power of the States. This argument holds that the States are best placed to determine priorities in the areas for which they are responsible. But the Commonwealth uses its financial power to override State priorities, for example, by requiring the States to spend more on a function than they would prefer.

A related argument is that VFI is likely to distort the pattern of public spending away from State functions towards Commonwealth functions, and therefore from areas such as economic infrastructure and community services.

Fifth, it is argued that the negotiation of agreements between the Commonwealth and the States involves unnecessary policy duplication and waste of resources.

Arguments for VFI

Advocates of VFI (though not necessarily of current arrangements) make the following claims.

First, the Commonwealth is best placed to determine 'national' interests as distinct from narrower State interests. An example might be the restoration of the Murray

Darling basin where the reconciliation of divergent State interests is an issue.

Second, some argue that the Commonwealth should have resources to help reduce cycles in the level of economic activity. Further, the Commonwealth should be able to influence the allocation of resources throughout the economy by its spending and revenue decisions.

A related argument is that the Commonwealth should be responsible for meeting equity objectives through the taxation/welfare system.

Fourth, the Commonwealth's access to revenue allows it to pursue horizontal fiscal equalisation, that is, to ensure that each State has the capacity to provide services at national average levels at average levels of efficiency.[7]

Fifth, it has been argued that a centralised tax administration is more efficient than a decentralised one. Further, centralised administration reduces scope for 'tax competition' whereby States match tax cuts in other States.

A sixth claim is that the alleged adverse effects of VFI are overstated. One proponent of this view has put it in these terms:

> Although vertical fiscal imbalance has often been criticised, it has not been demonstrated from a national interest point of view that a pressing problem exists. The States do conduct substantial revenue raising in their own right. This means that although *on average* the States do not raise the full amount of every dollar they spend, *at the margin* they must raise their own revenues to fund their own discretionary spending programmes.[8]

VFI Issues

The debate over VFI raises the question of whether there are principles that can help determine the assignment of spending and taxing responsibilities to different tiers of government. It is widely accepted that some degree of fiscal devolution is desirable to allow local considerations to be taken into account in decisions. Further, there are theories about the optimal assignment of spending and taxing responsibilities to different tiers of government. For example, one line of thought holds that lower tiers can play a useful role in resource allocation decisions but that equity and stabilisation roles are best left to national governments. But in Australia, as elsewhere, there is little agreement on the degree of governmental centralisation and, in practice, federations exhibit varying degrees of VFI.

Conclusions

Major change that would alter the degree of VFI seems unlikely. High Court decisions have precluded the States from imposing broadly-based consumption taxes such as the GST.

Similarly, the States seem unlikely to gain access to the personal income tax base. The Fraser Government legislated to allow the States to impose income tax. But this failed partly because the Government did not make 'tax room' by cutting personal tax rates. The States would have had to impose a surcharge which none was willing to do. The Hawke Government repealed the legislation that would have allowed the States to impose a surcharge. The last major attempt the States made to gain access to a large tax base was in the early 1990s, when they sought access to income tax. With the failure of that attempt, the situation remains that the Commonwealth makes grants to the States conditional on them not levying income tax.[9]

Another option to reduce VFI would be for the Commonwealth to take over some functions from the States. But this would face legal and political hurdles.

Richard Webb
Economics, Commerce and Industrial Relations Group
Information and Research Services

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1. The Agreement is a schedule to *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999*.
2. See Review of Commonwealth-State Funding Background Paper, p. 30.
3. Budget Paper No. 3, 1999–2000, p. 15. State data include local government.
4. Specific purpose payments are also called tied grants.
5. Budget Paper No. 3, 2002–2003, p. 5. Includes general revenue assistance of $2.5 billion.
6. For a history, see Denis James, Federal-State Financial Relations: The Deakin Prophesy, *Research Paper*, no. 17, Department of the Parliamentary Library, 1999–2000.
7. For a discussion, see Richard Webb, Horizontal Fiscal Equalisation, *Research Note*, no. 1, Department of the Parliamentary Library, 2002–03.
8. J. Hancock and J. Smith, Financing the Federation, South Australian Centre for Economic Studies, September 2001, p. 76.
9. Denis James, Federal and State Taxation: A Comparison of the Australian, German and Canadian Systems, *Current Issues Brief*, no. 5, Department of the Parliamentary Library, 1997–98.