



## Specific purpose payments and the Australian federal system

Scott Bennett and Richard Webb  
Politics and Public Administration, and Economics Sections

### Executive summary

- Specific purpose payments (SPPs) are grants the Commonwealth makes to the states, usually subject to conditions as to how the money is spent, in areas such as health and education, which the states administer.
- A feature of Australia's federal system is that power over spending and policy-making is becoming increasingly concentrated in the Commonwealth.
- SPPs are a major mechanism for centralisation because they allow Commonwealth involvement in areas beyond those stipulated in the Constitution. Consequently, the Commonwealth now shares with the states many functions which were formerly the preserve of the states.
- Whilst there are valid reasons for the Commonwealth to provide SPPs, some see the Commonwealth's use of SPPs, especially the trends towards using SPPs for short-term political purposes and as a means of imposing the Commonwealth's priorities on the states, as undermining the federal system of government.
- Problems associated with SPPs include a lack of accountability, duplication of administration, and blame-sharing. One estimate has the fiscal cost of these problems at \$9 billion annually.
- Numerous proposals have been advanced to improve the operation of SPPs but few have been implemented. The proposals include focusing on outcomes, the pooling of Commonwealth and state funds, and expanding the states' tax base. The Commonwealth's extensive use of its SPP powers will continue while the states lack own-source revenue. But no moves are afoot to give the states greater taxation powers because this would entail fundamental change.

- The Commonwealth’s involvement in ever more functions through SPPs has led to the perception that the Commonwealth is primarily responsible for a function even when responsibility rests primarily with the other tiers of government. This involvement is leading to ever greater expectations of the Commonwealth government.
- The Rudd Government has promised to provide incentive payments to encourage the states to implement reforms that would include SPPs.

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## Introduction

The Australian federal system is notable in the degree to which the national government can influence the spending and policy priorities of state and local governments. An important instrument in this is the much-used power, under section 96 of the Constitution, whereby the Commonwealth can make conditional grants of money to the state and territory governments. These have become known as ‘specific purpose payments’ (SPPs) for programs in a wide range of areas. The states administer these payments which, in most cases, are subject to conditions (so-called conditionality) that the Commonwealth specifies.<sup>1</sup> In 2006–07, the Commonwealth spent almost \$29 billion or about 11 per cent of Commonwealth government expenses on SPPs.<sup>2</sup> Some see the Commonwealth’s use of SPPs, in areas traditionally the preserve of the states, as a key problem in Australian federalism:

Most complaints about the operation of the federal system concerning duplication, buck-passing, excessive administrative burdens, lack of accountability and lack of coordination can be traced back to the use of specific purpose payments (SPPs) by the Commonwealth Government.<sup>3</sup>

One estimate has the fiscal cost of these problems—that is, the higher than necessary costs of government—at \$9 billion annually.<sup>4</sup>

Election campaign activity during 2007 by the three major parties threw into sharp relief just how much the Australian federal system seems to be undergoing a major change in its nature due to the rapidly increasing use of SPPs by national parties for short-term political ends.

This Research Paper describes what functions specific purpose payments perform, how important they have become, their consequences for the delivery of services, how they might

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1. Only a few SPPs are not subject to conditions. An example is the compensation the Commonwealth pays to the states for the revenue that they have forgone following the commencement of the national scheme for the regulation of companies and securities.
  2. Australian Government, *Final Budget Outcome 2006–07*, <http://www.budget.gov.au/2006-07/fbo/html/index.htm>, accessed on 6 December 2007.
  3. A. Twomey and G. Withers, *Australia’s Federal Future*. Report prepared for the Council of the Australian Federation, April 2007, p. 47, [http://www.crawford.anu.edu.au/pdf/staff/glenn\\_withers/federalist\\_paper.pdf](http://www.crawford.anu.edu.au/pdf/staff/glenn_withers/federalist_paper.pdf), accessed on 6 December 2007.
  4. Access Economics, ‘The Costs of Federalism’ in Business Council of Australia, *Reshaping Australia’s Federation. A New Contract for Federal-State Relations*, 2006, <http://www.bca.com.au/Content.aspx?ContentID=100801>, accessed on 6 December 2007.

be improved, and whether their use might be gradually altering Australia's federal system in fundamental ways.

## What are Specific Purpose Payments?

The disappearance of internal tariff barriers at the time of Federation meant that the states lost a major source of revenue. Section 94 of the Constitution was designed to guarantee the states' financial well-being by empowering the Commonwealth parliament to provide to the states all surplus Commonwealth revenue. Despite the apparent security that section 94 provided the states, some Constitution-writers called for the Commonwealth to have extra powers in this area. Section 96 was thus included in the new Constitution, the key words of which stated:

... the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit.

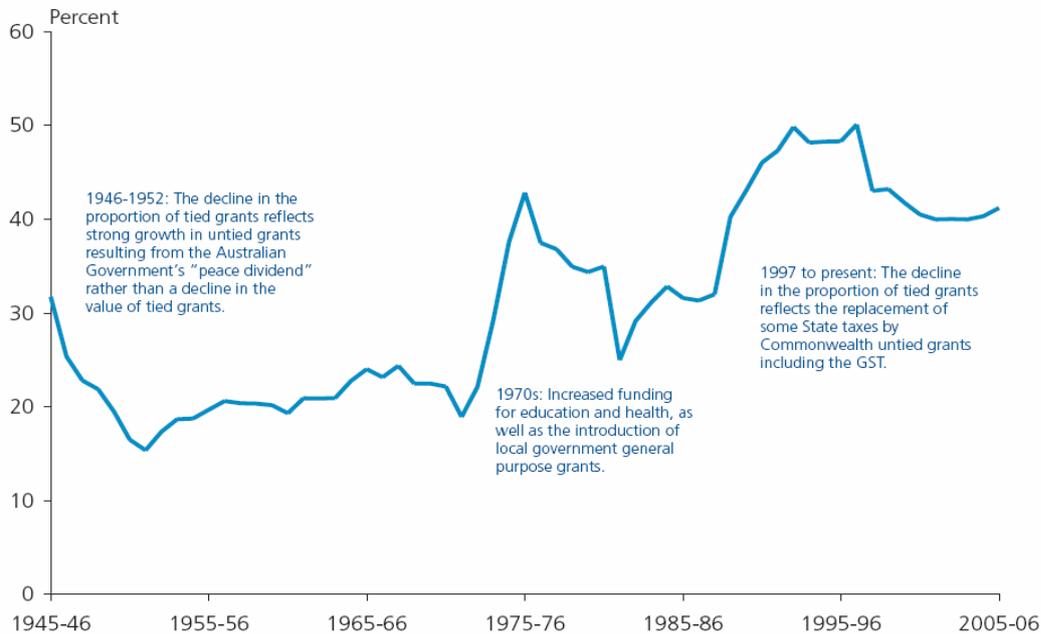
The basic reason for the insertion of these words was the desire to provide financial security for the states in the early years of the Commonwealth, as well as a means of helping the poorer states if they should require financial assistance. With section 94 becoming redundant in the first years after Federation as the Commonwealth found ways of ensuring that no surplus existed, the Commonwealth began to use section 96 to make annual payments to the states to assist in the delivery of services to their communities. Such payments came to be referred to as 'general-purpose' grants, by which it was understood that the states were free to spend the money as they saw fit.

A key move by the Commonwealth, however, occurred in 1923 when the Commonwealth Parliament passed the Main Roads Development Bill which granted the states money that they could use only on the development of main roads. This was the Commonwealth's first foray into the provision of SPPs that were subject to conditionality. With the failure of a Victorian High Court challenge against the legislation<sup>5</sup>, SPPs became part of the Commonwealth-state financial relationship although, for many years, they were a relatively small proportion of section 96 grants. However, since the Whitlam Government's (1972–75) deliberate decision to use such grants to impose major policy change on the states, successive Commonwealth governments have increasingly done the same, as shown in Figure 1.

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5. *Victoria v. Commonwealth* (1926) 38 CLR 399.

**Figure 1: Specific purpose payments as a proportion of total grants to the states**



Source: Western Australia Department of Treasury and Finance, *Discussion Paper on Commonwealth-State Relations*, April 2006, p. 25.

By the start of the 21st century, four of every ten dollars given by the Commonwealth to the states had conditions attached, and a large proportion of these grants was being made in policy areas that were not included in the original constitutional powers granted to the Commonwealth, such as health and education. Such a high level of conditionality is a major feature of the Australian federal model.

Under existing arrangements, SPPs—which can be for current or capital purposes—take the forms of:

- payments ‘to’ the states that supplement state funding of areas such as public hospitals, government schools and roads. In 2006–07, such payments accounted for about three-quarters of SPPs by value
- payments ‘through’ the states that the states pass on to targeted recipients such as non-government schools and local governments.<sup>6</sup> In 2006–07, payments through the states accounted for 20 per cent of SPPs by value, and

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6. For further information, see Richard Webb, ‘Commonwealth general purpose financial assistance to local government’, *Research Paper*, no. 9, Parliamentary Library, Canberra, 2007–08 <http://www.aph.gov.au/library/pubs/rp/2007-08/08rp09.pdf>, accessed on 6 December 2007.

- payments paid directly to local government for services such as disability, children's and other welfare services, or payments made under the Roads to Recovery program. These payments account for about five per cent of SPPs by value.

## The rationale for Specific Purpose Payments

Most SPPs are subject to conditions—which are not legally binding—that the states must meet, and so are called 'tied' grants.<sup>7</sup> According to an OECD working paper, such 'conditionality' takes a variety of forms:

- general policy conditions that may be attached to the grant of money (e.g. that the states provide free public hospital access for Medicare patients in return for funding under the Health Care Agreements)
- expenditure conditions (e.g. SPPs for schools to be spent on teacher salaries and curriculum development)
- input control requirements, in the forms of 'maintenance of effort' and 'matching funding' arrangements, where the states are required to maintain funding levels and/or match Commonwealth funding in a program area
- performance and financial information reporting by the states, and
- due recognition conditions, whereby the states are required to acknowledge publicly the Commonwealth's funding.<sup>8</sup>

By contrast, general purpose ('untied') section 96 grants are not subject to conditions. The main component of untied grants is the revenue from the goods and services tax. The value of other untied grants is relatively small and includes, for example, the compensation paid to the states for the revenue they have forgone since the introduction of the national scheme for the regulation of companies and securities.

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7. House of Representatives Standing Committee on Health and Ageing, *The Blame Game. Report on the inquiry into health funding*, Canberra, 2006, p. 144, <http://www.aph.gov.au/house/committee/haa/healthfunding/report/fullreport.pdf>, accessed on 9 January 2008.

8. V. Koutsogeorgopoulou, *Fiscal Relations Across Levels of Government in Australia*, OECD Economics Department Working Papers, No. 541, 23 January 2007, p. 15, [http://www.oalis.oecd.org/oalis/2007doc.nsf/LinkTo/NT000009EA/\\$FILE/JT03220724.PDF](http://www.oalis.oecd.org/oalis/2007doc.nsf/LinkTo/NT000009EA/$FILE/JT03220724.PDF), accessed on 6 December 2007.

Former ANU economics Professor, Russell Mathews, identified several reasons the Commonwealth might provide SPP assistance to the states.<sup>9</sup> First, there is the presence of what Mathews called ‘spillover’ effects. A state may have a very narrow view of a particular program that it is seeking to undertake, seeing it as relevant to its own residents, but ‘ignoring the fact that the activity might generate significant benefits for residents of other States’. This can lead to the allocation of insufficient resources. The Commonwealth may seek to encourage adequate expenditure by means of a SPP. Some argue that this is the only legitimate reason for the provision of tied grants.<sup>10</sup> An example of such grants is funding for interstate highways.

A second reason for the use of SPPs is a desire to promote co-operative arrangements between the Commonwealth and individual states to achieve national standards in particular services, ‘where no individual State could be expected to effectively deliver services or to deliver services in accordance with national objectives’.<sup>11</sup> A well-known, and long-delayed, example was the standardisation of Australian railway gauges.

Third, SPPs may provide a means of giving additional budget support to enable the states to meet their expenditure responsibilities. Such grants may take the form of cost-sharing arrangements between the Commonwealth and the states. Grants which assist the states to meet their hospital running costs illustrate this form of assistance.<sup>12</sup> Typically this is related very much to the states having an inadequate range of taxes with which to fund their responsibilities.

Fourth, at times, Commonwealth action may effectively amount to a Commonwealth ‘takeover’ of a particular policy area as it seeks to achieve economies of scale:

A single national government may more efficiently provide a service than several state governments; for example, social security administration.<sup>13</sup>

Such ‘takeovers’ can, of course, also be motivated by the Commonwealth’s desire to impose its own policies in preference to those of a state or states. Commonwealth activity during 2007 in regard to the handling of indigenous affairs in the Northern Territory is a recent example.

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9. For a fuller discussion, see Denis James, *Intergovernmental Financial Relations in Australia*, Australian Tax Research Foundation, 1992, p. 57.

10. *ibid.*

11. *ibid.*

12. *ibid.*

13. National Commission of Audit (Australia), *Report to the Commonwealth Government*, Canberra, 1996, p. 45, <http://www.finance.gov.au/pubs/ncoa/coaintro.htm>, accessed on 6 December 2007.

## Problems with SPPs

One problem associated with SPPs can be the intrusion of politics; this can affect the delivery of services in unexpected ways. The Howard Government was one of the two post-war Commonwealth Governments that have pushed hardest to change basic features of the federal system. In John Howard and Gough Whitlam we have seen two Prime Ministers who have not been enamoured with the Australian federal system and sought to change it.<sup>14</sup> These governments have been important in pushing the Australian federal model to outcomes that seem to have more to do with the Commonwealth's determination to intrude in state matters, than with any state desire for the introduction of particular policies. A case in point has been the Commonwealth's funding of school chaplains with the aim of lessening the role of school counsellors (see Box 1).<sup>15</sup>

### **Box 1: School counsellors**

The desire for central control can have unexpected consequences. Twomey has shown that in the school chaplain issue, the 'price' of such an appointment is not simply the sum of the grant handed over by the Commonwealth, for there are also the 'high levels of administration' that must be dealt with by both the school and the Commonwealth government that has given the money. The administrative load includes:

- satisfaction of the terms and conditions of the funding arrangement
- insurance requirements
- child protection requirements
- progress reports and financial acquittals of income and expenditure by Commonwealth bureaucrats
- on-site monitoring by Commonwealth bureaucrats
- 'feed-back' interviews, and
- examination of the documents kept by the school.

All this is a matter of 'normal' bureaucratic procedure. There is also a political aspect to the red tape that comes as a consequence of the conditions involving the 'recognition and acknowledgement' of the involvement by the Commonwealth. In accordance with the 'National School Chaplaincy Program Guidelines', all published materials relating to the program were required to include a national coat of arms and an acknowledgment of the fact that funding has been Commonwealth-sourced. Any school involved in the program "... must demonstrate in its progress and final reports that it has given effective recognition to Australian Government initiation, ownership and support through the National School Chaplaincy Program".<sup>16</sup>

Clearly, the Commonwealth's determination to have an impact on traditional state and territory areas of responsibility plays a major part in modern intergovernmental relations. However, this desire is closely linked with the possession of a huge purse, combined with a

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14. Scott Bennett, 'The politics of the Australian federal system', *Research Brief*, no. 4, Parliamentary Library, Canberra, 2006-07, pp. 13-15, <http://www.aph.gov.au/library/pubs/rb/2006-07/07rb04.pdf>, accessed on 6 December 2007.

15. A. Twomey, 'Aspirational Nationalism or Opportunistic Federalism?', *Quadrant*, October 2007, pp. 41-2.

16. *ibid.*

determined use of section 96, that enables the Commonwealth to buy into ‘any state area it wants to, and in the way it wants to’.<sup>17</sup>

## The impact upon the federal system

What do SPPs do to the federal system? Some argue that contemporary tensions in the federal system are due to the increased importance of SPPs since the Whitlam Government years, and that this has radically altered the federal system. Garnaut and Fitzgerald note, for example, that:

In reality, the enlarged role of SPPs since the 1970s has effectively converted some areas of state responsibility into areas of shared responsibility between the Commonwealth and the States.<sup>18</sup>

The use of SPPs means that today, a great many functions are shared between the Commonwealth and the states to a much greater extent than would have been envisaged by most of Australia’s prime ministers or premiers since Federation. Indeed, when compared with other federations, Australia has a ‘relatively high and increasing degree’ of shared governmental functions’.<sup>19</sup> Associate Professor Neil Warren of the University of New South Wales notes that SPPs can provide national benefits such as:

- achieving the implementation of national priorities in policy areas that are not covered in the Constitution and, therefore, are a state responsibility—gun control, for example
- achieving national priorities in the problematic policy questions that cross state borders—national land transport, salinity and water quality are cases in point
- enabling the Australian nation to comply with its international obligations in such matters as the protection of world heritage properties, and

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17. T. Colebatch, ‘It’s a federal election, on state issues’, *Age*, 20 November 2007.

18. R. Garnaut and V. Fitzgerald, *Review of Commonwealth–State Fundin., Final Report*, August 2002, p. 75, [http://www.dtf.wa.gov.au/cms/uploadedFiles/FinalReport\\_30August%20with%20letter%20of%20transmital.pdf](http://www.dtf.wa.gov.au/cms/uploadedFiles/FinalReport_30August%20with%20letter%20of%20transmital.pdf), accessed on 6 December 2007.

19. N. Warren, *Benchmarking Australia’s Intergovernmental Fiscal Arrangements, Final Report to the NSW Treasury*, May 2006, p. xxi, [http://www.treasury.nsw.gov.au/\\_data/assets/pdf\\_file/0006/5793/fin-bench-rep.pdf](http://www.treasury.nsw.gov.au/_data/assets/pdf_file/0006/5793/fin-bench-rep.pdf), accessed on 6 December 2007.

- compensating the states for policies in areas of Commonwealth constitutional responsibility ‘that adversely impact on State finances’—Warren cites the example of the liberalising of access to Commonwealth pensioner concessions.<sup>20</sup>

It must be noted, however, that sharing responsibilities creates problems for Australian federalism, including:

... the inefficiencies which may emerge—as a result, usually, of a blurring of government responsibilities—from cost and blame-shifting among government levels, wasteful duplication of effort or under-provision of services, and a lack of effective policy co-ordination.<sup>21</sup>

The problems of blame-shifting and buck-passing that arise when responsibilities are shared are illustrated in the case of health. In this case, there have been accusations of cost-shifting and arguments over responsibilities.<sup>22</sup> Box 2 illustrates the complicated nature of health funding and service provision that give rise to such problems.

**Box 2: Division of government responsibilities in health care**

The main features of the current funding arrangements are as follows:

- under the Medicare system, the Commonwealth provides access to medical, pharmaceutical and hospital services for all Australians through: *i*) The *Medicare Benefits Scheme* rebates for listed medical services *ii*) the *Pharmaceutical Benefits Scheme* of subsidies for listed prescription drugs; and *iii*) the *Australian Health Care Agreements* (where funding is jointly shared with the states), ensuring access to free public hospital services based on clinical need. Moreover, the Commonwealth provides a premium rebate of between 30 to 40% for private health insurance holders
- the largest source of funds for residential and aged care comes from the Commonwealth, which also has responsibility for regulating residential aged care
- the states are responsible for most acute and psychiatric hospital services. They also provide and fund the majority of community health care services and public health care activities, including school dental services, child and maternal health care services, disability support, disease control and various inspection functions
- local governments may also provide residential and community old-age care services, home care and personal preventive services, such as pre-school immunisation clinics
- private providers deliver a significant proportion of primary, specialist and allied health care through general practitioners, specialists, pharmacists, physiotherapists and dentists. They are funded by a combination of user charges, Medicare and private health insurance.<sup>23</sup>

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20. *ibid.*, pp. 25–6.

21. Koutsogeorgopoulou, *op. cit.*, pp. 16-17.

22. Luke Buckmaster and Angela Pratt, ‘Not on my account! Cost shifting in the Australian health system’, *Research Note*, no. 6, Parliamentary Library, Canberra, 2005–06.

23. Koutsogeorgopoulou, *op. cit.*, p. 18.

Garnaut and Fitzgerald have noted that the confused state of contemporary Australian federalism has been compounded by the ‘considerable’ level of acceptance by the broad Australian community of the sharing of responsibilities. Garnaut and Fitzgerald believe that ‘it is not possible to solve the problems of SPPs simply by abolishing them’.<sup>24</sup> Arguably, public acceptance flows from a general satisfaction with how SPP money is spent. This was illustrated graphically by the apparently high level of local popular support in Devonport when the Commonwealth announced its takeover of the Mersey Hospital during the 2007 federal election campaign.

## State and territory government dependence on SPPs

Not surprisingly, the level of funding of SPPs is an on-going issue between the Commonwealth and the states. The *Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations* has governed Commonwealth–state financial relations since the introduction of the goods and services tax (GST). Paragraph 5(v) of the *Agreement* states:

The Commonwealth will continue to provide Specific Purpose payments (SPPs) to the States and Territories and has no intention of cutting aggregate SPPs as part of the reform process set out in this Agreement, consistent with the objective of the State and Territory Governments being financially better off under the new arrangements.

The reason for this provision is that the states were concerned that the Commonwealth would reduce funding of SPPs following the introduction of the GST and the Commonwealth’s undertaking to provide all revenue from that tax to the states. But from a state perspective, the provision is weak because it cannot ensure that the Commonwealth will not reduce the level of SPPs. Further, the wording of the provision is vague. ‘Cutting’, for example, is not defined. Ultimately the provision is meaningless because constitutionally, the Commonwealth cannot bind a future government. Hence any commitment in the GST legislation could be repealed by any later Act appropriating funds for SPPs, if the amount were cut. While politically it might have been important for the states to obtain some kind of commitment from the Commonwealth, because the provision is not binding on the Commonwealth, whether its terms are ‘weak’ or ‘strong’ is ultimately meaningless.

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24. R. Garnaut and V. Fitzgerald, *Review of Commonwealth–State Funding, Final Report*, August 2002, p. 75.

The states have interpreted the provision to mean that the level of SPPs should be measured in real per capita terms using the consumer price index to remove the effect of inflation. Thus defined, the Commonwealth has, to date, met this criterion.<sup>25</sup>

## Vertical fiscal imbalance

It is therefore clear that the Commonwealth's ability to involve itself in the states' provision of services ultimately rests on its financial power. The consolidation of financial power in the Commonwealth—particularly the power to levy taxes—is a key feature of Australian federalism.<sup>26</sup> The National Commission of Audit observed:

In the Australian context the reality is that the roles and responsibilities of the Commonwealth and States cannot be easily separated. This is largely because the Commonwealth has control of most of the revenue available to governments and because the political opportunities for expanding Commonwealth involvement flow directly from this.<sup>27</sup>

The difference between the relative revenue raising capabilities and spending responsibilities of the Commonwealth compared with the states is called 'vertical fiscal imbalance':

Vertical fiscal imbalance refers to situations where the revenue raising powers of one level of government are insufficient to meet their expenditure responsibilities and, for the other level, excessive, thus requiring a system of intergovernmental transfers or grants to correct the imbalance.<sup>28</sup>

The level of vertical fiscal imbalance in Australia is among the highest of any federation.<sup>29</sup> This is reflected in the fact that the Commonwealth collects around 80 per cent of taxation revenue but currently is responsible for around 54 percent of own-purpose spending.<sup>30</sup> In

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25. Richard Webb, 'Developments in Commonwealth-state financial relations since 2000–01', *Research Brief*, no. 11, Parliamentary Library, 2005–06, pp. 11–12.

26. For a discussion, see Denis James, 'Federal-State Financial Relations: The Deakin Prophecy', *Research Paper* no. 17, Parliamentary Library, Canberra, 1999–2000, <http://www.aph.gov.au/library/pubs/rp/1999-2000/2000rp17.pdf>, accessed on 6 December 2007.

27. National Commission of Audit (Australia), *Report to the Commonwealth Government*, Canberra 1996, p. 46.

28. See the reference in Productivity Commission, *Annual Report 2004–05*, Canberra, 2005, p. 4, at [http://www.pc.gov.au/data/assets/pdf\\_file/0011/8687/annualreport0405.pdf](http://www.pc.gov.au/data/assets/pdf_file/0011/8687/annualreport0405.pdf), accessed 6 December 2007.

29. Warren, *op. cit.*, p. xx.

30. Commonwealth own-purpose spending is revenue less transfers to the states and local governments.

contrast, the states collect about 16 per cent of taxation revenue but account for 40 per cent of own-purpose outlays.<sup>31</sup>

Critics argue that a high degree of vertical fiscal imbalance is antithetical to an effective federal system. Former senior Treasury official, Mr Robert Carling, for example, argues:

The point that requires emphasis here is that fiscal autonomy of sub-national governments is a *sine qua non* of an effective federal structure. A high degree of financial dependency on central government stifles federalism. The dependency culture is the antithesis of financial responsibility and accountability. Expenditure responsibility needs to be matched by revenue responsibility if sensible public choices are to be made. Vertical fiscal imbalance breaks the link between expenditure and revenue raising decisions. It raises a confusion of accountability in the minds of voters and a tendency for the central government's influence on sub-national expenditure choices to grow, resulting in overlapping responsibilities. It works against efficiency in public expenditure. And it curtails the flexibility of individual states to carry out their responsibilities differently from other states and to cater to their own residents' different preferences.<sup>32</sup>

Some argue that expenditure assignment should be matched by an ability to raise taxes to fund those expenditures:

... where the subsidiarity principle supports the allocation of a function to a lower level of government ... both the necessary expenditure and taxing powers should also be delegated to that level of government.<sup>33</sup>

## Conditionality

Much of the criticism of the Commonwealth's role in SPP provision pertains to conditionality, that is, the practice whereby the Commonwealth requires the states to meet certain undertakings as a condition of the states receiving grants. While accepting that there are valid reasons for conditionality, some argue the Commonwealth has taken conditionality too far:

There is also a very limited legitimate role for tied grants where the recipient (lower) levels of government left to their own devices would deliver a suboptimal national level of service provision or there is an agreed national policy objective that can only be achieved through

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31. Warren, op. cit., p. xxxi.

32. R. Carling, *State Taxation and Fiscal Federalism. A Blueprint for Further Reform*, Centre for Independent Studies, Policy Monograph 73, 2006, p. 17, [http://www.cis.org.au/policy\\_monographs/pm73.pdf](http://www.cis.org.au/policy_monographs/pm73.pdf), accessed on 6 December 2007.

33. Productivity Commission, *Annual Report 2004–05*, Canberra, 2005, p. 4.

coordinated sub-national service delivery. However, tied grants in Australia have gone well beyond this narrow scope.<sup>34</sup>

The states have argued that conditionality has negative consequences for them. For example, it has been argued that conditions are often poorly designed, and can adversely affect the states' ability to provide services by requiring the states to contribute additional resources without giving thought to what the states already do.<sup>35</sup>

A proposed solution to problems of conditionality is to replace SPPs with untied grants:

Consideration [should] be given to replacing major SPPs ... with unconditional grants (possibly as Identified Funding Grants) to provide greater flexibility, lower risk for States and reduce duplication and administrative costs.<sup>36</sup>

However, from the Commonwealth's perspective, replacing SPPs with untied grants would mean that the Commonwealth would have to abandon its reasons for conditionality and lose an important control mechanism over the states.

## Inputs and outcomes

As noted, conditionality sometimes takes the form of so-called input controls such as the states having to match Commonwealth funding. Short of replacing SPPs with untied grants, another option that has been proposed is for conditionality to focus on outcomes and results.<sup>37</sup>

Problems input controls generate include:

A focus on input controls does not place clients first, particularly for SPPs providing services directly to individuals and groups within the community.

A focus on inputs distracts attention from meeting SPP objectives and does not provide any indication of what is being achieved via the service provision.

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34. Carling, op. cit., p. 18.

35. Western Australia, Department of Treasury and Finance and Department of the Premier and Cabinet, *A Strategic Framework for Specific Purpose Payments*, Information Booklet, July 2002, p. 4, [http://www.dtf.wa.gov.au/cms/uploadedFiles/SPP\\_StrategicFramework.pdf](http://www.dtf.wa.gov.au/cms/uploadedFiles/SPP_StrategicFramework.pdf), accessed on 6 December 2007.

36. State and Territory Treasuries, *Specific Purpose Payments*, Discussion Paper, July 1999, p. 4, [http://www.dtf.wa.gov.au/cms/uploadedFiles/FinalReport\\_30August%20with%20letter%20of%20transmittal.pdf](http://www.dtf.wa.gov.au/cms/uploadedFiles/FinalReport_30August%20with%20letter%20of%20transmittal.pdf), accessed 6 December 2007.

37. Garnaut and Fitzgerald, op. cit., p. 71.

Input controls limit incentives for service providers to improve their efficiency, and prevent the redirection of efficiency savings into other areas of expenditure.

Input controls do not allow service providers the flexibility to move funds between program elements within SPPs to ensure that overall objectives are achieved.<sup>38</sup>

Not surprisingly, the states have advocated replacing input controls with outcomes measures.<sup>39</sup>

Benefits that might derive from funding SPPs on an outcomes basis rather than an input basis:

... include an improved use of state resources, through granting states greater flexibility on the allocation of federal funds, and incentives to service providers to raise efficiency. Moreover, a focus on outcomes could enhance transparency and accountability.<sup>40</sup>

This assumes, however, that performance in service delivery can be measured. A challenge is to develop outputs and outcomes and a reporting framework for each SPP:

This is an ambitious task as outcome/output measures of service delivery are difficult to define, measure and enforce in a robust way.<sup>41</sup>

The experience of developing outcomes and reporting frameworks for Commonwealth agencies underscores these difficulties.<sup>42</sup> A review prepared for the OECD of results-oriented budget reforms in Australia and the United Kingdom concluded:

When the effects of the results-oriented financial management reforms are examined, it can be stated that the reforms are not a panacea which will solve all financial management problems, but do generate positive as well as negative effects.<sup>43</sup>

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38. *ibid.*, p. 70.

39. State and Territory Treasuries, *op. cit.*, p. 4.

40. Koutsogeorgopoulou, *op. cit.*, p. 20.

41. *ibid.*, p. 31.

42. See Richard Webb, 'The Commonwealth Budget: process and presentation', *Research Brief*, no. 7, Parliamentary Library, Canberra, 2006–07, pp. 16–18, <http://www.aph.gov.au/library/pubs/rb/2006-07/07rb07.pdf>, accessed on 6 December 2007.

43. B. Scheers, M. Sterck and G. Bouckaert, 'Lessons from Australian and British Reforms in Results-oriented Financial Management', *OECD Journal on Budgeting*, vol. 5, no. 2, 2005, p.156, <http://www.oecd.org/dataoecd/61/24/37033986.pdf>, accessed on 6 December 2007.

The Commonwealth has moved towards placing a greater emphasis on results. As SPPs have been renegotiated, the Commonwealth has sought to clarify objectives, while requiring the states to provide agreed financial information and performance indicators. An example is the requirement that state governments meet a number of new performance conditions in order to obtain federal funding for education over the period 2005–08.<sup>44</sup>

However, a reason the Commonwealth imposes input controls is to prevent the states from shifting costs on to the Commonwealth.<sup>45</sup> According to some commentators, the Commonwealth's emphasis on inputs thus seems likely to continue:

While the new approach represents a step towards an outcome accountability framework, funding for SPPs will continue to be input-based as, in the Commonwealth's view, input controls remain the best way to protect the federal government against financial risks associated with service delivery, which is the responsibility of the states. Input controls are further seen by the Commonwealth as a means of ensuring that state sub-national governments do not shift responsibility for service provision over time to the central level.<sup>46</sup>

## Proposals to improve the SPP regime

The need to define clearly the respective roles and responsibilities of the Commonwealth and the states has assumed additional significance following the endorsement of the [National Reform Agenda](#) by the Council of Australian Governments in February 2006. The Agenda encompasses human capital, competition and regulatory reform issues and thus entails considerable joint responsibility. For example, with respect to provision of economic infrastructure—which is mainly a state responsibility—processes for its planning, funding and regulation vary and overlap considerably.<sup>47</sup>

## Clarification of roles and responsibilities

A theme of recent reports on problems in Australia's federal system is that the magnitude of such problems would be reduced if the roles and responsibilities of each tier of government were clarified. For example, an OECD report on fiscal relations across the levels of government in Australia concluded:

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44. Koutsogeorgopoulou, op. cit., p. 20.

45. Garnaut and Fitzgerald, op. cit., p. 71.

46. Koutsogeorgopoulou, op. cit., p. 20.

47. Allen Consulting Group, *Infrastructure Investment for a more Prosperous Australia*, report to the Government of Victoria, May 2005, p. 36, [http://www.dpc.vic.gov.au/CA256D800027B102/Lookup/COAGInfrastructureReport/\\$file/COAG%20Infrastructure.pdf](http://www.dpc.vic.gov.au/CA256D800027B102/Lookup/COAGInfrastructureReport/$file/COAG%20Infrastructure.pdf), accessed on 6 December 2007.

The current pattern of widespread shared government involvement increases the necessity to clearly define roles and responsibilities ...<sup>48</sup>

Some argue that this should entail a better allocation of financial resources between the Commonwealth and the states, with each managing and funding its own responsibilities.<sup>49</sup>

This raises the question of the basis on which functions could be allocated to the different tiers of government. An attempt to reallocate functions is beyond the scope of this paper. Suffice it to say that there is no 'best' model.<sup>50</sup> The 'subsidiarity' principle may, however, provide some guidance. This principle holds that the central government should limit its activities to those which lower levels of government cannot perform effectively, that is, responsibility should rest, where possible, with the lowest level of government.<sup>51</sup> With respect to the appropriate role for the Commonwealth, the ALP Advisory Group on Federal-State reform has argued that there are two fundamental principles which must be balanced: the national interest principle, and the subsidiarity principle:

The Commonwealth should be engaged when there are genuine national interests at stake, but only to that extent. Otherwise the subsidiarity principle should prevail ...

But as a general principle the Commonwealth should only become involved in those issues traditionally managed by the States where Commonwealth-State inter-action is necessary to enhance efficiency, equity and/or access, or the basic rights and heritage.<sup>52</sup>

The subsidiarity principle would suggest, for example, that the Commonwealth should be responsible for defence, state governments for the delivery of public transport and public hospital services, and local governments for household garbage collection.

Carling argues that applying the subsidiarity principle would not result in a narrowing of state responsibilities and would lead to a reduction in central government interference in state service delivery through the conditionality of tied grants.<sup>53</sup>

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48. Koutsogeorgopoulou, op. cit., p. 30. The Business Council of Australia has advanced similar arguments, see Business Council of Australia, *Reshaping Australia's Federation. A New Contract for Federal-State Relations*, November 2006.

49. Twomey and Withers, op. cit., p. 5.

50. Productivity Commission, *Annual Report 2004–05*, Canberra, 2005, p. 4.

51. For a discussion of the principle, see *ibid.*, p. 3.

52. ALP Advisory Group on Federal-State reform, *A Framework to Guide the Future Development of Specific Purpose Payments (SPPs)*, 31 July 2007, p. 3, [http://www.alp.org.au/download/now/070731\\_alp\\_advisory\\_group\\_on\\_federal\\_state\\_reform.pdf](http://www.alp.org.au/download/now/070731_alp_advisory_group_on_federal_state_reform.pdf), accessed on 6 December 2007.

53. Carling, op. cit., p. 17.

It has been argued that assigning complete responsibility for a function to only one tier of government would eliminate some of the problems associated with SPPs.<sup>54</sup> Warren has noted that there is an international trend in this direction. For example, in the case of health, responsibility is largely confined to a single level of government, whether national or subnational.<sup>55</sup>

However, national interest considerations mean that responsibility for some functions should be shared:

... it will never be possible to completely delineate the respective responsibilities of the Commonwealth and the States. Most importantly, the extent of inter-relationships between different policies (eg education and economic performance) means that whole-of-government solutions that necessarily involve both the Commonwealth and the States are increasingly called for.<sup>56</sup>

Twomey and Withers have argued that where responsibilities are shared, an approach needs to be taken to reallocation not in relation to responsibilities but in relation to allocating roles in managing shared responsibilities.<sup>57</sup>

It is important to distinguish between responsibility for funding and responsibility for service provision. Under SPPs, the states are responsible for service provision. Funding, on the other hand, is sometimes shared between the Commonwealth and the states and sometimes not. Reform proposals envisage different combinations of responsibility for service delivery and funding. For example, in the case of health care where funding is shared, it has been suggested that:

Either Canberra or the states can take full responsibility for funding health care, or the state and federal governments can pool their health funds, as proposed by the Victorian government.

The options are not as different as they may sound ... If the Australian government became the sole public funder of health care, the states could still play a major role in the provision of health services. That is, the federal government in effect would buy acute health-care services from the states and the private sector.<sup>58</sup>

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54. National Commission of Audit (Australia), *Report to the Commonwealth Government*, Canberra 1996, op. cit., p. 45.

55. Warren, op. cit., p. xliii.

56. ALP Advisory Group on Federal-State reform, op. cit., pp. 4-5.

57. Twomey and Withers, op. cit., p. 47.

58. Alan Mitchell, 'High-stakes health care', *Australian Financial Review*, 29 August 2007.

## Expansion of the states' tax base

Proposals that the states assume additional responsibility for funding services are meaningless unless they are also accompanied by an increase in the states' ability to raise revenue. Assuming that is desirable to reduce vertical fiscal imbalance, a question that arises is: what additional revenue-raising powers should the states have?<sup>59</sup> Given that the states are constitutionally precluded from imposing a broadly-based consumption tax, an option is for the states to impose a surcharge on Commonwealth income tax.<sup>60</sup> This would, however, probably require the Commonwealth to 'make room' for the states by lowering personal income tax rates. In 1978, the Fraser Government legislated to allow the states to impose an income tax surcharge to allow the states to broaden their tax base. The initiative failed partly because the Commonwealth did not cut tax rates to make room for surcharges.<sup>61</sup>

State income tax surcharges would have advantages and disadvantages. An advantage is that the cost of administration would not increase greatly if the base were unchanged and identical across the states, and the Commonwealth administered and collected the tax.<sup>62</sup> Another possible advantage is that competition among the states would be likely to limit any increase in surcharge rates. A state surcharge could, however, face considerable barriers because it would entail a fundamental change to Commonwealth–state financial arrangements. That would require the agreement of all jurisdictions which may not be forthcoming.<sup>63</sup>

## Pooling of funds and broadbanding

Proposals to reduce problems associated with shared responsibilities include pooling and broadbanding. Pooling is where funding from both the Commonwealth and the state for related programs—for example, health—is placed in a pool and not earmarked for specific programs. Broadbanding is the grouping together of SPPs that are directed toward broad outcomes for particular groups. The National Commission of Audit, for example, proposed:

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59. For a discussion, see Richard Webb, 'Public finance and Vertical Fiscal Imbalance', *Research Note*, no. 13, Parliamentary Library, Canberra, 2002–03, <http://www.aph.gov.au/library/pubs/rn/2002-03/03rn13.pdf>, accessed on 6 December 2007.

60. The states ceded their rights to impose income tax during the Second World War. In 1946, the Commonwealth announced that it intended to continue uniform taxation indefinitely, see James, 'Federal-State Financial Relations: The Deakin Prophecy', *op. cit.*, pp. 8-11.

61. Denis James, 'Federal and State Taxation: A Comparison of the Australian, German and Canadian Systems', *Current Issues Brief*, no. 5, Parliamentary Library, Canberra, 1997–98, <http://www.aph.gov.au/library/pubs/CIB/1997-98/98cib05.htm>, accessed on 6 December 2007.

62. Koutsogeorgopoulou, *op. cit.*, p. 22.

63. *ibid.*, p. 22.

For programs where there is joint Commonwealth/State responsibility, funding should go to pools that extend to all related programs, rather than being earmarked to specific programs. Again, this allows the States some allocative discretion within funding pools.<sup>64</sup>

With respect to broadbanding, the National Commission of Audit advocated:

Where specific purpose payments (SPPs) are considered necessary, the Commonwealth should focus on specifying policy objectives and establishing improved accountability frameworks and give the States greater freedom in designing program delivery. This would facilitate a reduction in the number of SPPs by grouping together or 'broadbanding' SPPs which are directed at broad outcomes for particular groups. This would reduce administrative duplication, overlap and inefficiency.<sup>65</sup>

The states have also advocated broadbanding to reduce duplication and administration costs.<sup>66</sup>

An example of broadbanding is that proposed by Garnaut and Fitzgerald:

The centrepiece of the proposed reform is a new cooperative model for SPPs in the key merit areas of health and aged care, and education and training. SPPs in these areas would be broad-banded into two national programs in which the States have clear authority over service delivery, without micromanagement and input controls. A third national program would be established in indigenous community development. The Commonwealth would have primary control over services provided under this program but would work in cooperation with the States. Opportunities would be sought for rationalising responsibility for functions within or closely related to these three areas.<sup>67</sup>

Advantages of broadbanding include clearer responsibility for administration, reduced administrative costs, and increased flexibility as to how funds are spent.<sup>68</sup> However, from the Commonwealth's perspective, broadbanding would entail a loss of control over how the states spend grants.<sup>69</sup>

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64. National Commission of Audit (Australia), *Report to the Commonwealth Government*, op. cit., p. 48.

65. *ibid.*, p. 48.

66. State and Territory Treasuries, op. cit., p. 4.

67. Garnaut and Fitzgerald, op. cit., p. 3.

68. Koutsogeorgopoulou, op. cit., p. 20.

69. Koutsogeorgopoulou, op. cit., p. 21.

## Conclusions

Australia's federal system has changed fundamentally since 1923 when SPPs were first made available to help fund the provision of roads. Power over spending and policy-making has become increasingly centralised in the Commonwealth government, a consequence of the consolidation of financial power in the Commonwealth's hands. SPPs have been a major mechanism for centralisation by allowing the Commonwealth to become involved in areas well beyond those stipulated in the Constitution to the point where the Commonwealth shares many major functions with the states.

As noted, a large number of complaints about the federal system revolve around the Commonwealth's use of SPPs, and this paper has examined ways in which their operation could be improved. But major change to arrangements for SPPs does not seem in prospect. Consequently, the problems associated with SPPs—blurring of responsibility, cost and blame-shifting among government levels, wasteful duplication of effort and so on—are likely to remain. Several factors are relevant.

First, Commonwealth involvement in the provision of services will continue while the states lack the own-source revenue to fund those services, and no moves are afoot to give the states greater taxation powers because this would entail fundamental and difficult change. Second, there is an element of political convenience in existing arrangements in that the Commonwealth and the states can blame each other when problems arise. One level of government assuming full responsibility for funding a particular function would mean that it would be unable to blame the other when things went wrong. For their part, the states would be likely to be reluctant to assume increased taxing powers because they would have to bear the opprobrium of having to impose taxes.

The Commonwealth's involvement through SPPs in ever more areas has led to the perception that the Commonwealth is primarily responsible for an activity even though responsibility rests primarily with the other tiers of government. An example is road funding where calls for additional funding are often directed to the Commonwealth even though it accounts for only about 20 per cent road-related expenditure (the states and local government account for about 40 per cent each).<sup>70</sup> Policies such as the Howard Government's take over of the operation of the Mersey Hospital and the Labor Party's proposals to take over the operation of public hospitals in certain circumstances can only reinforce such perceptions.

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70. Bureau of Transport and Regional Economics, [Australian transport statistics 2007](http://www.btre.gov.au/publications/46/Files/ATS2007.pdf), p. 14, accessed on 6 December 2007.

The Rudd Government has promised a new era in Commonwealth–state relations. At the December 2007 [meeting](#) of the Council of Australian Governments (COAG), it was agreed that the focus would be more on outputs and outcomes. The Commonwealth also undertook to provide payments to the states in return for their adopting reforms including reform of SPPs.

## Glossary

**Broadbanding:** the grouping together of SPPs that are directed toward broad outcomes for particular groups.

**Capital purpose grants:** payments made by the Commonwealth to the states for investment purposes such as constructing roads.

**Conditionality:** the practice whereby the Commonwealth imposes conditions with which the states must comply in order to receive funding.

**Cost-shifting:** the practice whereby a tier of government attempts to move the cost of funding a service to another tier of government. Cost-shifting is most marked when functions are shared.

**Current purpose grants:** payments made by the Commonwealth to the state for non-capital purposes, for example, legal aid.

**Economic infrastructure:** refers to physical infrastructure such as roads, airports and power stations. Social infrastructure includes schools, hospitals and libraries.

**General purpose grants:** grants the Commonwealth makes to the states (and local government) which the recipients can spend as they wish. The main form of such grants is the goods and services tax revenue the Commonwealth provides to the states.

**Input controls:** requirements that the Commonwealth places on grants often in the form of requiring the states to match Commonwealth funding dollar for dollar or to undertake certain activities.

**Outputs:** the production of goods and services that contribute to outcomes.

**Pooling:** where funding from both the Commonwealth and the state for related programs—for example, health—is placed in a pool and is not earmarked for specific programs.

**Specific purpose payments:** grants the Commonwealth makes to the states under section 96 of the Constitution on whatever conditions the Commonwealth government thinks fit.

**Subsidiarity:** the principle which holds that responsibility for a particular function should, where practicable, reside with the lowest level of government.

**Tied grants:** another name for specific purpose payments. Grants are called ‘tied’ because they are subject to conditions the Commonwealth imposes.

**Vertical fiscal imbalance:** the imbalance between the expenditure responsibilities of each tier of government and its own-source revenue. Australia is characterised by a high degree of fiscal imbalance with the Commonwealth raising about 80 per cent of taxation revenue but currently being responsible for around 54 per cent of own-purpose spending. In contrast, the states collect about 16 per cent of taxation revenue but account for about 40 per cent of own-purpose spending.

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