

Chapter 4

Vertical fiscal imbalance

4.1 One of the challenges faced by governments in all federations is that over time the financial costs of providing services tend to shift between the different levels of government. Unless financial adjustments are made, the constitutional responsibilities of one level of government can become misaligned with the capacity of that government to raise revenues needed to meet financial demands made upon it. If the misalignment becomes too substantial it can have serious consequences for the way the federation operates, with constitutional balances of power shifting often without formal constitutional reform. This chapter examines this issue in the context of the Australian federation.

4.2 The difference between the shares of revenue collection and of expenditure among various tiers of governments is called the 'vertical fiscal gap' or, in Australia, 'vertical fiscal imbalance' (VFI). VFI can exist between any two levels of government. In some countries, the VFI is most marked between national and regional governments (for example in Australia, Canada and India) while in others it can also be between national and local governments (for example in Brazil, Germany and the United States). In theory, there could be a VFI in which a lower tier of government collects more revenue than it expends, and transfer funds to a national government. In practice this never occurs. It is always the national government that gathers most revenue, and then transfers it to the state and local levels.

4.3 It is a commonly held belief among political practitioners within federations and academic theorists of government that excessive levels of VFI are undesirable. Among other things it creates inefficiencies, undermines accountability between different tiers of government, reduces fiscal transparency and can result in the misallocation of resources. As a result most federations have developed sometimes highly complex intergovernmental arrangements, involving transfers of large amounts of revenue to one or other tier of government in an effort to remedy the problem. The size and conditionality of the transfers are almost always controversial and lead to significant criticism of the system.

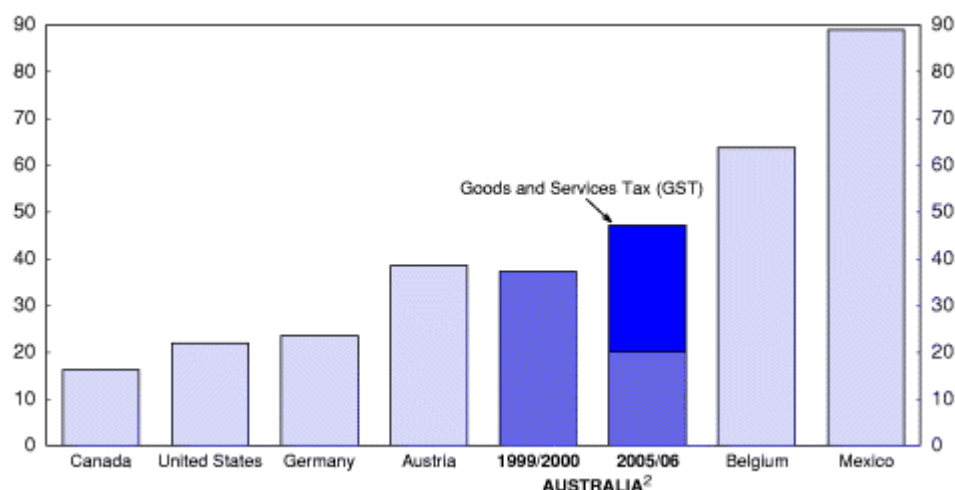
VFI within the Australian federal system

4.4 The Australian federal system is characterised by a significant level of VFI. Twomey and Withers have argued that 'some VFI is not unusual in a federation' but go on to note that 'its extent in Australia is the most extreme of any federation in the industrial world.'¹ Data collated by the Organisation for Economic Co-operation and

1 Dr Anne Twomey & Dr Glenn Withers, *Federalist Paper 1: Australia's federal future. Delivering growth and prosperity*. A Report for the Council of the Australian Federation, April, 2007, pp 37–38.

Development (OECD) indicates the degree of VFI within the Australian federal system compared with other federations.

Figure 4.1: The vertical fiscal imbalance: a comparison with other federations in per cent of total sub-national revenue²

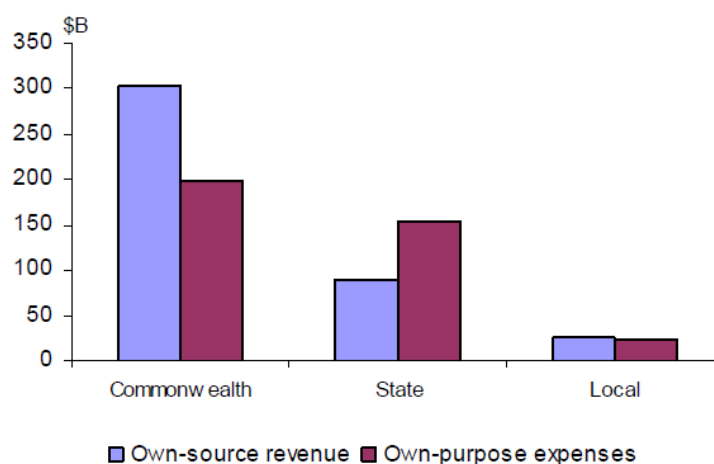


4.5 In considering Australia's VFI, it should also be noted that the extent of the VFI varies depending on the assessment of the Commonwealth's revenue raising capacity. The OECD data notes that Australia's VFI increased with the introduction of the Goods and Services Tax (the GST). This was also noted in evidence to the committee.³ 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.

4.6 The chart prepared by CAF demonstrates the disparity in the Australian federal system between revenue raising capacity and expenses across the levels of government.

2 OECD, Economic Survey of Australia 2006: Fiscal relations across levels of government, http://www.oecd.org/document/32/0,3746,en_2649_201185_37149600_1_1_1_1,00.html (accessed 22 June 2011). For all countries other than Australia, the chart is based on 2003 figures. This is the most recent OECD comparative survey of fiscal relations across federal governments.

3 NSW Government, *Submission 39*, Appendix A, p. 2.

Figure 4.2: Commonwealth, state and local government revenue and expenses⁴

1. Multijurisdictional sector (mainly public universities) not shown.

2. Own-source revenue defined as total revenue minus grant revenue; own-purpose expenses defined as total expenses minus grants to other levels of government.

Source: ABS 5512.0 2007-08

4.7 Australia's high level of VFI is not a recent phenomenon; it has been a characteristic of the federation for many decades and has led to the development of an extensive range of mechanisms to try to address the problem.

Managing VFI within the Australian federation

4.8 As the Commonwealth raises more revenue than the states and territories, these mechanisms all involve the Commonwealth transferring funds to the states to assist them to meet their expenditure responsibilities. As explored in chapter five, this is known as 'fiscal equalisation'. The different capacities of the states and territories to raise revenue has meant that their expenditure requirements are taken into account when allocating payments.⁵ As Twomey and Withers have noted, while Australia has significant VFI balancing, this is due to the fact that Australia 'also happens to have the highest level of fiscal equalisation.'⁶

4.9 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.

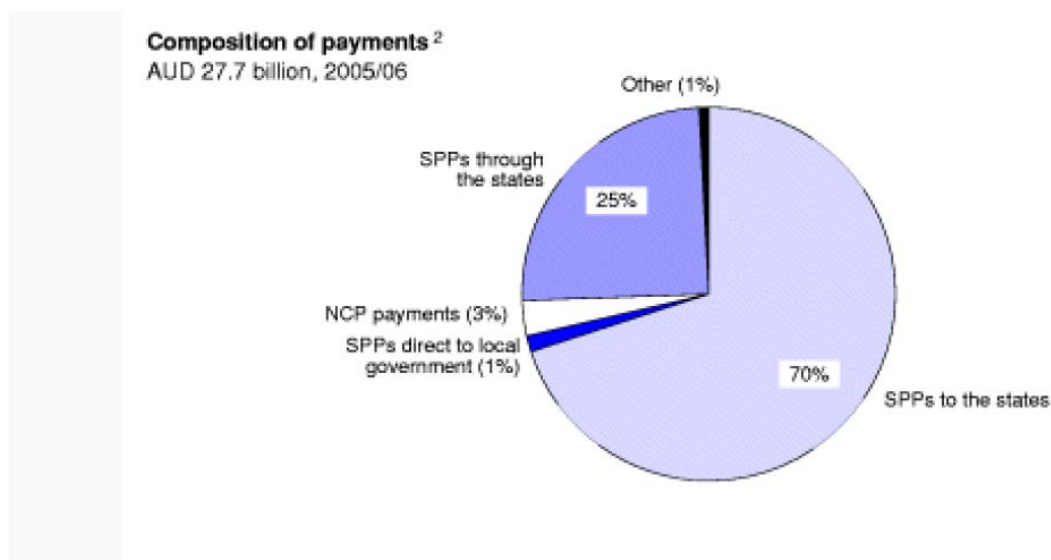
4 Council for the Australian Federation, *Submission to the Commonwealth's Henry Tax Review (Australia's Future Tax System)*, May 2009, p. 3.

5 Commonwealth Grants Commission, *Commonwealth-state financial relations*, http://www.cgc.gov.au/fiscal_equalisation/navigation/1 (accessed 20 May 2011).

6 Dr Anne Twomey & Dr Glenn Withers, *Federalist Paper 1: Australia's federal future. Delivering growth and prosperity*. A Report for the Council of the Australian Federation, April, 2007, pp 37–38.

4.10 Prior to the IGA on Federal Financial Relations, discussed below, the Commonwealth provided financial assistance to the states and territories primarily in two forms: general revenue assistance – mainly GST revenue⁷ and Specific Purpose Payments (SPPs).⁸ Data provided by the OECD indicates the measures that existed as of 31 July 2006.

Figure 4.3: Measures to address VFI in Australia as of 31 July 2006⁹



4.11 Commenting on these measures, the OECD concluded that:

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- 7 The method for the distribution of GST revenue was initially agreed to at a Premiers' Conference on 9 April 2000. At that Conference, the then Prime Minister together with the then Premiers and Chief Ministers of each state and territory agreed to the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*. That agreement was annexed as Schedule 2 to the [A New Tax System \(Commonwealth-State Financial Arrangements\) Act 1999](#). Section 13 of that Act provided for the calculation and distribution of GST revenue among the states and territories pursuant to the Intergovernmental Agreement. Section 13 was repealed by Item 19, Schedule 1 to the *Federal Financial Relations (Consequential Amendments and Transitional Provisions) Act 2009*, which also retitled the earlier Act to become the *A New Tax System (Managing the GST Rate and Base) Act 1999*. Arrangements and calculations for the distribution of GST revenue are now contained in the *Federal Financial Relations Act 2009* which commenced on 1 April 2009.
- 8 Payments made by the Commonwealth to the states under s 96 of the *Constitution*. Section 96, titled 'Financial assistance to States' provides: 'During a period of ten years after the establishment of the Commonwealth and thereafter until the Parliament otherwise provides, the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit'.
- 9 OECD, *Economic Survey of Australia 2006: Fiscal relations across levels of government*, http://www.oecd.org/document/32/0,3746,en_2649_201185_37149600_1_1_1_1,00.html (accessed 22 June 2011).

[a] simpler system of inter-governmental transfers involving so-called “specific-purpose payments” would contribute to a clearer specification of spending responsibilities. The specific-purpose payments should become less complex and inflexible. A first step would be to develop an outcome/output performance and reporting framework for each SPP. This is an ambitious task as outcome/output measures of service delivery are difficult to clearly define, measure and enforce in a robust way. Nevertheless, such frameworks could ultimately lead to a move towards the funding of such payments on an outcome/output basis in certain areas.¹⁰

Intergovernmental agreement on federal financial relations

4.12 On 26 March 2008, COAG agreed to a new microeconomic reform agenda for Australia, 'with a particular focus on health, water, regulatory reform and the broader productivity agenda'.¹¹ As part of its reform agenda, COAG agreed, on 29 November 2008, to a new framework for Commonwealth-State financial relations, the terms of which were set out in the Intergovernmental Agreement on Federal Financial Relations (the 'IGA on Federal Financial Relations').¹²

4.13 The IGA on Federal Financial Relations recognises that 'the primacy of state and territory responsibility in the delivery of services in these sectors is implicit in the Constitution of the Commonwealth of Australia' but also 'that coordinated action is necessary to address many of the economic and social challenges which confront the Australian community'.¹³

4.14 The aim was to:

- Improve the quality and effectiveness of government services by reducing Commonwealth prescriptions on service delivery by the States;
- Provide states with increased flexibility in the way they deliver services to the Australian people;
- Provide a clearer specification of roles and responsibilities of each level of government and an improved focus on accountability for better outcomes and better service delivery;

10 OECD, Economic Survey of Australia 2006: Fiscal relations across levels of government, http://www.oecd.org/document/32/0,3746,en_2649_201185_37149600_1_1_1_1,00.html (accessed 22 June 2011).

11 COAG, http://www.coag.gov.au/coag_meeting_outcomes/2008-03-26/index.cfm (accessed 26 May 2011).

12 COAG, *Intergovernmental Agreement (IGA) on Federal Financial Relations* http://www.coag.gov.au/intergov_agreements/federal_financial_relations/index.cfm (accessed 26 May 2011).

13 COAG, *Intergovernmental Agreement (IGA) on Federal Financial Relations*, Items 6 and 7, http://www.coag.gov.au/intergov_agreements/federal_financial_relations/docs/IGA_federal_financial_relations.pdf (accessed 26 May 2011).

- Rationalise the number of payments to the states for Specific Purpose Payments (SPPs), reducing the number of such payments from over 90 to five.¹⁴

4.15 The IGA on Federal Financial Relations, which commenced on 1 January 2009, consolidated and simplified the forms in which the Commonwealth provides payments to the states and territories. By it the Commonwealth could deliver three types of financial support to states and territories:¹⁵

- Continued provision of 'general revenue assistance, including the on-going provision of GST payments, to be used by the states and territories for any purpose.'¹⁶ It was agreed that the distribution of payments would continue to be made 'in accordance with the principle of horizontal fiscal equalisation.'¹⁷
- National Specific Purpose Payments (SPPs). The previous arrangements for over 90 SPPs were replaced with five new national SPPs corresponding with the five areas COAG identified as 'key service delivery sectors.'¹⁸ The Commonwealth agreed to increase the total appropriation for SPPs by \$7.1 billion over five years. Each SPP is associated with a National Agreement that contains the objectives, outcomes, outputs and performance indicators as well as clarification of roles and responsibilities.¹⁹

14 COAG, *Intergovernmental Agreement (IGA) on Federal Financial Relations*, http://www.coag.gov.au/intergov_agreements/federal_financial_relations/docs/IGA_federal_financial_relations.pdf (accessed 26 May 2011).

15 COAG, *Intergovernmental Agreement on Federal Financial Relations* (2009), cl. 19, http://www.coag.gov.au/intergov_agreements/federal_financial_relations/docs/IGA_federal_financial_relations.pdf (accessed 26 May 2011).

16 COAG, *Intergovernmental Agreement on Federal Financial Relations* (2008), cl. 19(a), http://www.coag.gov.au/intergov_agreements/federal_financial_relations/docs/IGA_federal_financial_relations.pdf (accessed 26 May 2011).

17 COAG, *Intergovernmental Agreement on Federal Financial Relations* (2008), cl. 26, http://www.coag.gov.au/intergov_agreements/federal_financial_relations/docs/IGA_federal_financial_relations.pdf (accessed 26 May 2011).

18 The five SPPs are a National Healthcare SPP; a National Schools SPP; a National Skills and Workforce Development SPP; a National Disability Services SPP; and a National Affordable Housing SPP. Each SPP is associated with a specific National Agreement between the Commonwealth and the states and territories which sets out mutually-agreed outcomes and performance benchmarks to be monitored and assessed by the independent COAG Reform Council.

19 As at 1 July 2010, COAG had agreed to six National Agreements: National Healthcare Agreement; National Education Agreement; National Agreement for Skills and Workforce Development; National Disability Agreement; National Affordable Housing Agreement and the National Indigenous Reform Agreement. All are available at COAG, *Intergovernmental Agreement (IGA) on Federal Financial Relations*, http://www.coag.gov.au/intergov_agreements/federal_financial_relations/index.cfm (accessed 26 May 2011).

- A new category of financial support, 'National Partnership' payments. These are designed 'to support the delivery of specified outputs or projects, to facilitate reforms or to reward those jurisdictions that deliver on nationally significant reforms.'²⁰ These payments fall into three categories: project payments (to support national objectives and help fund the delivery of specific projects); facilitation payments (to help a state lift its standards of service delivery in areas identified as national priorities); and reward payments (incentives to encourage states to undertake reforms and attain performance benchmarks). There has now been agreement to the first wave of these payments.²¹

4.16 COAG agreed that '[a]ll intergovernmental financial transfers other than for Commonwealth own purpose expenses will be subject to the IGA on Federal Financial Relations.'²²

4.17 Ms Mary Ann O'Loughlin, Executive Councillor and Head of Secretariat, COAG Reform Council, advised that the IGA on Federal Financial Relations is intended to rationalise the previous measures to address Australia's VFI:

The intergovernmental agreement is a set of significant reforms of Australia's federal financial relations. It governs all the policy and financial relations between the Commonwealth and the states. It set up new financial arrangements, national agreements and national partnerships between the Commonwealth, state and territory governments. The national agreements replaced the more prescriptive tied grant arrangements. The focus of the new agreements is on agreed outcomes and performance indicators, milestones and benchmarks to measure progress.²³

4.18 The Committee was informed that the IGA on Federal Financial Relations provides for the new funding arrangements to be independently reviewed. The COAG Reform Council is required to 'monitor, assess and publicly report on the performance of governments in implementing nationally agreed reforms.'²⁴ Ms O'Loughlin advised that:

20 COAG, *Intergovernmental Agreement on Federal Financial Relations* (2008), cl. 19(c), http://www.coag.gov.au/intergov_agreements/federal_financial_relations/docs/IGA_federal_financial_relations.pdf (accessed 26 May 2011).

21 As at 26 May 2011, COAG had agreed to 16 National Partnership agreements, COAG, *Intergovernmental Agreement (IGA) on Federal Financial Relations*, http://www.coag.gov.au/intergov_agreements/federal_financial_relations/index.cfm (accessed 26 May 2011).

22 COAG, *Intergovernmental Agreement on Federal Financial Relations* (2008), cl. 23, http://www.coag.gov.au/intergov_agreements/federal_financial_relations/docs/IGA_federal_financial_relations.pdf (accessed 26 May 2011).

23 Ms Mary Anne O'Loughlin, Executive Councillor and Head of Secretariat, COAG Reform Council, *Committee Hansard*, 2 December 2010, p. 30.

24 Ms O'Loughlin, COAG Reform Council, *Committee Hansard*, 2 December 2010, p. 30.

for the six national agreements...council undertakes a comparative analysis of government's performance against the agreed outcomes, indicators and targets of the national agreements. For reward national partnerships...the council is the independent assessor of whether the predetermined milestones and benchmarks have been achieved before the Commonwealth decides on incentive payments to reward reforms...²⁵

4.19 The committee was also advised that the Heads of Treasury Committee is reviewing the National Agreements, National Partnerships and performance framework, with particular reference to the availability of data. The Committee is to report to COAG by the end of 2011.²⁶

Federal Financial Relations Act 2009

4.20 The *Federal Financial Relations Act 2009* was enacted to implement the arrangements of the IGA on Federal Financial Relations, including consolidating in one place the arrangements for Commonwealth payments to states and territories.²⁷ Previous arrangements for the distribution of GST revenue and appropriations for health, infrastructure and offshore petroleum and greenhouse gas storage to the states and territories were repealed.²⁸ Consistent with its object, the Federal Financial Relations Act made provision for the calculation and distribution of GST revenue, SPPs and National Partnership payments. It took effect on 1 April 2009.²⁹

Subsequent amendment to federal financial arrangements: health reform

4.21 In April 2010, COAG – with the exception of WA – reached agreement on the establishment of a National Health and Hospitals Network. It was agreed that:

- From 1 July 2011, the Commonwealth will fund 60% of the efficient price of all public hospital services delivered to public patients, 60% of recurrent expenditure on research and training functions undertaken in public hospitals, 60% of capital expenditure on a 'user cost of capital' basis where possible, and (over time) up to 100% of the efficient price of 'primary health care equivalent' outpatient services provided to the public.
- The Commonwealth will also fund 100% of primary health care (e.g. GP services) and aged care (other than in Victoria).

25 Ms O'Loughlin, COAG Reform Council, *Committee Hansard*, 2 December 2010, p. 30.

26 Ms O'Loughlin, COAG Reform Council, *Committee Hansard*, 2 December 2010, p. 34.

27 *Federal Financial Relations Act 2009*, s. 3., <http://www.comlaw.gov.au/Details/C2009C00218> (accessed 26 May 2011).

28 *Federal Financial Relations (Consequential Amendments and Transitional Provisions) Act 2009*.

29 *Federal Financial Relations Act 2009*, s. 2. <http://www.comlaw.gov.au/Details/C2009C00218> (accessed 26 May 2011).

- The Commonwealth will provide additional \$5.4 billion from 1 July 2010 for health reforms and investment
- From 2011-12 the Commonwealth will dedicate a portion of the states' (excluding WA) GST revenue to health.³⁰

4.22 It was also agreed to make all necessary amendments to the IGA on Federal Financial Relations and related Commonwealth legislation to reflect the agreement on the National Health and Hospitals Network.³¹

4.23 The effect of this agreement is that from 1 July 2011, significant changes will be made to the Commonwealth's distribution of GST revenue and SPPs amongst the states.

Concerns with the effect of VFI on Australia's federal system

4.24 Evidence to the committee highlights concerns with Australia's VFI. CAF was critical of the extent of Australia's VFI, arguing that an excessive degree of VFI is undesirable as it can:

- weaken government accountability to the public by breaking the nexus between a government's decisions on the level of service provision and the revenue raised to fund it. For every dollar spent by state governments, less than 60 cents is raised directly for those purposes.
- reduce transparency regarding who is responsible for which government services, allowing governments to avoid responsibility by shifting blame for funding and operational shortfalls to other spheres of government. Health policy has been a prime example where different spheres of government responsibility, for funding, operating and regulating across different areas of the health care system, has resulted in public confusion and opportunity for blame-shifting.
- create inefficiencies, including through bureaucratic overlap, duplication and excess and the cost of administering grants between governments.
- misallocate resources, including the inadequate or inappropriate funding of services.
- slow the responsiveness of governments to the needs of their communities.³²

30 Australian Government, *2010-11 Budget: Australia's Federal Relations, Budget Paper No. 3*, Commonwealth of Australia, Canberra, 2010, pp 13–14.

31 Australian Government, *2010-11 Budget: Australia's Federal Relations, Budget Paper No. 3*, Commonwealth of Australia, Canberra, 2010, p. 8.

32 CAF, *Submission 38*, p. 5.

4.25 The Australian Chamber of Commerce and Industry was similarly critical of the imbalance between the taxing and spending powers of the Commonwealth and the states, arguing that several problems arise including:

- Weakening of accountability: a separation between the two authorities that raise and spend the revenue (the Commonwealth Government and the State Government) leads to a weakening of accountability and inefficiencies in the delivery of state services as State Governments do not bear the political ill will of raising the taxes to pay for the services.
- Reliance on inefficient taxes: the States are forced to rely on inefficient taxes such as stamp duty and payroll tax in order to raise revenue as their ability to impose more efficient taxes is restricted.
- Limits incentive for states to cut taxes: the taxes that states can impose are inefficient and regressive but their reduced revenue raising capacity gives them very little incentive to reduce taxes.³³

4.26 This position was echoed by the NSW Business Chamber, which argued that:

Restrictions on the taxing powers of State and Territory Governments mean that States are unable to take unilateral action to address this issue. These restrictions on State powers mean that State Governments are forced to rely on the few taxing powers they have for significant amounts of revenue, even where it is commonly acknowledged that such taxes are inefficient and volatile. This can hamper the process of State tax reform.³⁴

4.27 For the Government of Western Australia, 'the need for a new federal fiscal framework is the most important and pressing element of "the reform of relations" between the Commonwealth and States.'³⁵ A similar claim was advanced by the Pearce Division of the Liberal Party of Australia:

The fact that States lack the capacity to raise the funds required to fulfil their spending responsibilities is problematic as it reduces direct government accountability, with State governments not having to make the difficult choices attached to balancing taxation and expenditure.³⁶

4.28 Further to this, it was the Pearce Division's belief that:

Reform of the financial relationship between the Commonwealth and the States is necessary to strengthen the federation by ensuring that the States have financial independence and the capacity to independently raise sufficient revenue to fulfil their constitutional responsibilities.³⁷

33 ACCI, *Submission 10*, p. 5.

34 NSW Business Chamber, *Submission 30*, p. 7.

35 Christian Porter, Attorney-General, Western Australia Government, *Submission 44*, p. 3.

36 Pearce Division Liberal Party of Australia, *Submission 14*, p. 3.

37 Pearce Division Liberal Party of Australia, *Submission 14*, p. 4.

4.29 It was put to the committee that the current mechanisms to address the fiscal imbalance do not provide certainty to the states. Professor Galligan argued that the Commonwealth continues to attempt to control the measures to address VFI through use of 'accustomed carrots and sticks of intergovernmental bargaining.'³⁸ Referring to the negotiations around national health reforms, the Professor stated that the Commonwealth had proposed allocating one-third of the GST to fund the hospitals network; thereby moving away from the current model of untied grants of GST revenues.³⁹ On this point Professor John Uhr commented that the VFI arrangements 'seemed to be really cutting right into the whole small c Constitution of the GST.'⁴⁰

4.30 Professor Galligan articulated a view that seemed to summarise the general spread of opinions on VFI given in the evidence to the committee:

Few perhaps prefer the status quo in Australian fiscal federalism—for federalists it is too centralized, but for centralists it is too complex and variegated from state to state. Prospects for change are not promising, however. The Commonwealth was dealt the superior hand by the constitution, and that superiority was embellished and legitimated by the High Court.⁴¹

4.31 Evidence before the committee indicates that the objectives of the IGA on Federal Financial Relations may not be being fulfilled as well as was hoped. Several submitters commented that, while the IGA was designed to rationalise the proliferation of Special Purpose Payments, much of the complexity and prescriptiveness of the old system appears to be returning via the 'back door' of increased detail in the new National Agreements and National Partnerships. The Tasmanian government observed:

It can be argued that only a few of the new NPs and IPs [*Implementation Plans sitting under National Partnership agreements*] fully comply with the new IGA principles. Rather than focusing on outcomes, many agreements remain focussed on inputs – where and how the money is spent but without much regard for what is actually achieved. In some cases, the agreements remain highly prescriptive and continue the practice of Commonwealth micromanagement over state service delivery.

The new framework has not yet fully realised its ambition of reducing the administrative burden on Commonwealth and state departments. The level of oversight and monitoring by the Commonwealth and the reporting requirements placed on states is increasing costs and diverting resources away from service delivery.⁴²

38 Professor Brian Galligan, *Submission 46*, p. 10.

39 Professor Brian Galligan, *Committee Hansard*, 5 May 2011, p. 29.

40 Professor John Uhr, *Committee Hansard*, 5 May 2011, p. 33.

41 Professor Brian Galligan, *Submission 47*, p. 12.

42 Tasmanian Government, *Submission 40*, p. 7.

4.32 Dr Anne Twomey's assessment was more blunt:

[T]he new system of national partnership payments appears to be a backdoor way for the Commonwealth to interfere again in areas of State policy through the placement of conditions on payments. As time goes by, it is likely that specific purpose payments will shrink, national partnership payments will increase and we will be back to where we started with precisely the same problems in terms of excessive administration costs, duplication, waste and blame-shifting.⁴³

4.33 The Tasmanian government was also critical of the level of VFI in Australia, but it did note that it was potentially 'more efficient for a national government to raise certain revenues...compliance with a national tax regime can be more efficient for businesses that operate in more than one jurisdiction.'⁴⁴

Options for reform

4.34 The reform of fiscal federalism is a particularly complex area of governance, admitting of few easy solutions. The position put by the Business Council of Australia summarises the situation well:

Ideally, each Government should raise the funds necessary to fulfil its responsibilities. It is questionable, however, whether Australia's revenue raising system could be so radically adjusted given how far the pendulum has swung in favour of the Commonwealth. Without adjustments, however, it is likely that the States will become increasingly the service deliverers of the Commonwealth's policy agenda.⁴⁵

4.35 At their heart, all negotiations around fiscal reform appear to suffer from the structural disadvantage by which states and local government are always placed in an inferior bargaining position. Most options for reform presented in submissions attempted to address the structural disadvantage through a clearer reallocation of roles and responsibilities across the different layers of government as well as providing states and territories with a greater share of revenue over time to support their functions. Such an approach assumes that it is actually possible to achieve a list of separate and distinct roles.

4.36 Whilst there is a growing number of people and organisations calling for a reallocation of roles between the federal and state and territory governments, it is less clear that any consensus could be achieved on reallocating those roles. This is

43 Dr Anne Twomey, *Submission 32*, p. 3.

44 Tasmanian Government, *Submission 40*, p. 5.

45 Business Council of Australia, *Modernising the Australian federation, A discussion paper*, 2006, p. 12, <http://www.bca.com.au/Content/101346.aspx> (accessed 1 June 2011).

especially so in Australia which has 'a relatively high and increasing degree of shared functions between different levels of government.'⁴⁶

4.37 Twomey and Withers propose a two-tier method for dealing with reallocation.

There are two ways of dealing with a reallocation of functions. The first is the higher level 'clean lines' approach, in which defined subjects of jurisdiction are allocated to each level of government. For example, the Commonwealth Government's National Commission of Audit suggested that States be responsible for preschool, primary and secondary education, with Commonwealth funding of secondary education being through untied grants. The Commission suggested that the Commonwealth take full responsibility for vocational education and training and higher education.

Not all areas of government are susceptible to 'clean lines' divisions. There will always be a need for areas of shared responsibility. This means that a second approach needs to be taken to reallocation – not in relation to responsibilities, but in relation to allocating roles in managing those shared responsibilities. Better mechanisms for co-operation are also needed to avoid 'border issues', to ensure the coordination of government services and to avoid cost-shifting.⁴⁷

4.38 In their evidence, Twomey and Withers suggest that this reallocation could be achieved through constitutional reform, but it was not essential. Referred legislation could be an option.

4.39 Another model for reallocating roles was suggested in the submission from the Northern Territory Statehood Steering Committee. It was argued that the current push by the Statehood Committee for statehood represented a key opportunity to raise the allocation of roles between the federal government and the states. The Statehood Committee favours:

[a] process for clarifying the role through concerted policy action at the Council of Australian Governments level rather than a more abstract 'grand plan'. The principle that government is accessible and accountable to those affected by its decisions should have a key role to play in determining who is responsible for service delivery.⁴⁸

4.40 Not all commentators are as sanguine about the feasibility of reallocating roles. As seen in chapter one, Professor Galligan believes that coordinate federalism is an unsophisticated paradigm, one which is inappropriate for modern Australia. In

46 Mr N. Warren, 'Summary and key findings' in *Benchmarking Australia's Intergovernmental Fiscal Arrangements, Final Report*, May, 2006, NSW Government, p. xxx.

47 Dr Anne Twomey & Dr Glenn Withers, *Federalist Paper 1: Australia's federal future. Delivering growth and prosperity*. A Report for the Council of the Australian Federation, April, 2007, p. 47.

48 Northern Territory Statehood Steering Committee, *Submission 12*, p. 7.

reality the Commonwealth and the states or territories inextricably share roles and responsibilities.⁴⁹

4.41 Another option for reforming fiscal federalism, beyond that of reallocating roles between layers of government, would be to consider more holistic reform of the tax structure and tax levels. Twomey and Withers argue 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.

Reform could extend further to revisiting horizontal fiscal equalisation as well as vertical fiscal imbalance and the structure of taxation. The pursuit of such 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.⁵⁰

4.42 Other options for reform of the institutional arrangements include:

- an expanded *Federal Financial Relations Act 2009* subsuming the existing Commonwealth Grants Commission and acting as a framework 'for Commonwealth grants of financial assistance to the States, and for the indexation of those grants' as well as defining the parameters for agreements;⁵¹
- a formal tax-sharing agreement between the Commonwealth and States, based on proportion of Commonwealth tax revenue; and/or
- states setting their own income taxes (though still collected by the ATO); and
- both the Commonwealth and states setting income taxes, to help boost the proportion of revenue that is gathered directly by the states.⁵²

Committee view

4.43 The committee notes that, by comparison with all other federations, Australia has a high level of VFI. Over time, the VFI has severely undermined the capacity of

49 Professor Galligan, *Submission 46*, p. 13.

50 Dr Anne Twomey & Dr Glenn Withers, *Federalist Paper 1: Australia's federal future. Delivering growth and prosperity*. A Report for the Council of the Australian Federation, April, 2007, p. 49.

51 Professor A.J. Brown, *Submission 41*, p. 9.

52 Mr Bryan Pape, *Submission 20*, p. 1.

the states and territories to raise the revenue necessary to undertake their assigned constitutional responsibilities. The committee also notes that over many decades successive federal and states governments have developed an extensive range of mechanisms to address the problem. These mechanisms have certainly helped to manage Australia's high level of VFI but the problem continues to be one of the most controversial in federal-state relations.

4.44 The committee endorses the recent reforms to Special Purpose Payments, reducing their total number from more than 90 to just five. However, the committee notes the strong concerns expressed in evidence for the inquiry that the new arrangements under the IGA on Federal Financial Relations are not sufficiently meeting the objectives of reducing Commonwealth prescriptiveness and increasing state flexibility regarding service delivery. The committee cautions that the new arrangements must not become a new means for the Commonwealth to attach overly prescriptive conditions on the payments, and draws attention to the view of the OECD that measures to address VFI should avoid complexity and inflexible arrangements.

4.45 While existing mechanisms have improved fiscal arrangements, ultimately, however, they do not address the underlying fiscal imbalance itself. The committee notes that as VFI is addressed through Commonwealth grants, states are largely dependent on Commonwealth actions and policies. The committee notes, by way of illustration, the Commonwealth's consideration of withholding portions of the GST to fund national health reforms. This illustrates the potential uncertainty for the states that can arise where states are to a significant degree dependent on funding from the first tier of government.

4.46 A number of suggestions were put forward to address fiscal imbalance. These included reallocating roles between the first and second tier of Government. The committee considers that without radically reducing the states' responsibilities, it is unclear that adjusting the role of the Commonwealth and state governments would, on its own, address imbalances in revenue raising. Other proposals included holistic reform of taxation structures and levels. The recently announced review of GST distribution begins to address the issue around equalisation referred to above. But clearly a broader debate needs to occur in relation to taxation. The vertical fiscal imbalance in the Australia federal system needs to be redressed. On the basis of the material presented to the committee, the committee sees merit in a comprehensive assessment of the IGA on Federal Financial Relation 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. As noted, broader debate is required. The committee considers that the matter should be referred to the Senate Committee which Recommendation XX of this report will propose be created. The committee should draw on expert advice, for example from the Productivity Commission, the COAG Reform Council and the Commonwealth Grants Commission as required.

Recommendation 9

4.47 The committee recommends that the Joint Standing Committee proposed in Recommendation 17 of this report inquire into the need for adjustments to the IGA on Federal Financial Relations and to the level and structure of taxation in Australia to provide the states certainty regarding revenue raising and their capacity to meet their responsibilities. In considering this issue, the committee should inquire into any related matters that the committee determines are appropriate, including the roles of the state and federal governments, and seek advice from the Productivity Commission, the COAG Reform Council and the Commonwealth Grants Commission as required.