

White Paper on Federation – Background briefing on vertical fiscal imbalance

This is a short background paper prepared for the [Australian Institute of Risk Management](#) (a non-political non-profit policy body). It provides background about taxation issues for the coming Australian debate about its federal structure.

Prior to the Australian budget, most media commentators and political pundits wrote off the report of the National Commission of Audit. They confidently predicted that the Commonwealth Government would dismiss most of the recommendations and bring down a more politically palatable budget plan.

It is now clear that many of the recommendations of the Commission have been adopted. Against that background, regardless where you sit on the issue of the fairness of the budget and what might motivate it, it is time to go back to the Commission and see where the next two proposed Commonwealth reform directions (Taxation Reform and Federation) might lead.

The Canberra Times has [reported](#) that, at their meeting this weekend – Premiers and Chief Ministers (with the exception of Western Australia) called for the White Paper on Federation to be accelerated and that it be “progressed as a true partnership with the states and territories”.

Separation of Responsibilities

The Commission of Audit emphasised the separation of powers between the Commonwealth and State Governments.

“Governments should also operate at their natural levels. Policy oversight for national issues should go to the Commonwealth with responsibility for regional and local issues predominantly going to State and Territory governments.

Under the principle of sovereignty, as far as practicable, each level of government should be sovereign in its own sphere.”

Recommendation 7 of the Commission states:

Recommendation 7: Reforming the Federation – clarifying roles and responsibilities

There is significant overlap between the activities of the Commonwealth and the States. The Commission recommends that a comprehensive review of the roles and responsibilities between the Commonwealth and State governments be undertaken, informed by:

- a. the principle of ‘subsidiarity’ so that policy and service delivery is as far as is practicable delivered by the level of government closest to the people receiving those services;
- b. ensuring that each level of government is sovereign in its own sphere; and
- c. ensuring minimal duplication between the Commonwealth and the States and, where overlap cannot be avoided, ensuring appropriate cooperation occurs at all times.

Vertical Fiscal Imbalance

A key issue in whether this is achievable within the present federation is the imbalance between the revenue collecting capacities of the different tiers of government. A previous paper outlined the issue of [taxation imbalance](#).

The follow extract from the [report](#) of the Commission of Audit neatly summarises the problem. It is probable that the coming white papers will be devoted to exploring the issue.

This may involve exploring ways of direct- sharing revenue sources such as seeing a partial reduction in Commonwealth income tax rates and a reintroduction of State income taxes (perhaps bundled as a single tax, as at present).

Extract:

"A feature of the Australian Federation is the extent of the imbalance in the revenue raising capacities and spending responsibilities of the different tiers of government.

The vertical fiscal imbalance that exists reflects the fact that the Commonwealth Government raises revenues in excess of its spending responsibilities, while State governments have insufficient revenue from their own sources to finance spending responsibilities.

The amount of money provided by the Commonwealth to meet this revenue shortfall by the States is currently around \$96 billion per year.

Of this, \$51 billion comes from untied funds - passing over the \$50 billion proceeds of the GST which the Commonwealth collects, plus another \$1 billion in general revenue assistance. A further \$45 billion is in the form of direct grants, which can be tied to a general area of spending, or to meeting specific criteria, or to provide a very specific outcome.

Total Commonwealth funding to the States represents around one quarter of the Commonwealth Budget and 40 per cent of State revenue.

...As well as having to deal with vertical fiscal imbalance, the States have different capacities to raise revenue and deliver services. A form of fiscal equalisation occurs through separate arrangements which determine how the GST revenue pool is shared between them.

The Commonwealth Grants Commission decides how the GST should be allocated under a complicated formula. It determines adjustment to the shares that would otherwise prevail if an equal per capita formula for sharing was used.

Horizontal fiscal equalisation is intended to provide budget support to the less wealthy States so they can provide services that are comparable to the larger States.

...[T]he extent of horizontal fiscal equalisation currently represents around 9 per cent of the GST pool or around \$4.7 billion from a total GST collection of \$50 billion.

Peter Quinton

Palerang

May 2014