COMMONWEALTH-STATE FINANCIAL RELATIONS, 2017-18

INTRODUCTION

1 All countries need to decide how to structure their revenue systems and how to deliver services to their residents. Federations, which are a common form of government in large countries, provide options that are unavailable in other systems. For example, federations allow the allocation of powers to the level of government best placed to respond to differing conditions across a country.

2 However, federations typically experience economic imbalances that may need to be addressed through the financial relations between their governments. There are two main causes of these imbalances. First, there are social and economic differences between different areas within a country that may lead to differing tax revenues and government spending requirements. These are known as **horizontal fiscal imbalances**. In a unitary state, these differences may be overcome directly as the government decides its revenue and spending policies and applies them across the whole country. In a federation, such direct geographical transfers do not occur automatically between different sub-national jurisdictions.

3 Secondly, there are often imbalances between the taxing and spending powers of the different levels of government. These are called **vertical fiscal imbalance**s. It is often efficient for the central government to collect most of the taxes on a common policy and administrative basis, while sub-national governments are often better placed to deliver services. In Australia, as in Germany and South Africa, revenue raising powers are highly centralised in the national government — they raise around 74% of total tax revenues. However, regional and local governments are generally responsible for service delivery of health, school education, public law and order, community services, intra-regional transport, power and water.

4 Both these imbalances can be addressed by payments between the levels of government. Australia has developed its Commonwealth-State financial relations framework to address both types of fiscal imbalance, as well as to serve other purposes such as the national coordination of policies.

THE AUSTRALIAN FRAMEWORK FOR FEDERAL FINANCIAL RELATIONS

5 The Australian federation is governed by a Constitution that, among other things, specifies the powers of the Commonwealth. These include defence and international affairs, interstate and international trade and commerce, banking, immigration, family law and social security payments to individuals. All residual (unspecified) powers remain with the States.[1] These include the delivery of services such as education, health, public law and order and intrastate transport. Local government, the third tier of government, is a State responsibility and has the service delivery and revenue raising powers given it by the States.[2]

6 The Constitution provides the Commonwealth with exclusive rights to impose customs and excise duties, the largest taxes at the time of federation, and the ability to impose other taxes. Over time, the revenue raising powers of the Commonwealth have been strengthened and now all the major taxes (personal and corporate income tax and sales and excise duties, including the GST) are imposed under Commonwealth legislation. This leaves the States with a narrow range of taxes on payrolls, land, certain transactions (such as land and other property sales) and gambling. They also impose royalties on minerals extracted in their jurisdiction, but royalties on most offshore resources accrue to the Commonwealth.

7 Table 1 shows the proportion of revenue collected under the laws of each level of government and the proportion of State revenue received from the Commonwealth.

8 The large vertical imbalance in the revenue raising and expenditure powers of the Commonwealth and State governments is a major and established feature of Australian federal arrangements. The amount of tax revenue raised by the Commonwealth is considerably larger than its own-purpose outlays. By contrast, the States' own-purpose outlays greatly exceed the revenue from their own taxes.

9 From time to time, action has been taken to address the vertical imbalance, including:

- transferring tax powers to the States (payroll tax was transferred in 1971-72)
- transferring expense responsibilities (the Commonwealth took financial responsibility for aged care services in 2011)[3]
- dedicating part or all of specified Commonwealth taxes to the States (since 2000-01, all revenue from the GST has been transferred to the States).

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1 In the rest of this report, the term State(s) means the States, the Northern Territory and the Australian Capital Territory, unless the context indicates otherwise.

2 Local governments are responsible for services such as local roads, building approvals and waste disposal. They raise revenue through rates on property in their jurisdiction and various fees and fines.

3 2015 in the case of Victoria and 2018 in the case of Western Australia. Western Australia retained aged care responsibilities, but began transitioning its Home and Community Care Services to the Commonwealth in 2018.

Table 1 Proportion of revenue collected under Commonwealth and State legislation

	Proportion collected under Commonwealth legislation	Proportion collected under State legislation	Proportion of all State revenue from Commonwealth transfers
	%	%	%
1901-02	41.0	59.0	36.7
1938-39	46.6	53.4	13.9
1946-47	84.9	15.1	46.1
1980-81	78.3	21.7	62.0
2000-01	77.8	22.2	46.2
2017-18	74.4	25.6	43.9

Source: 1901-02, 1938-39 and 1946-47 from Mathews and Jay, Federal Finance, Thomas Nelson Ltd, 1972; 1980-81 provided by Treasury; 2001-02 *Final Budget Outcome* and ABS *Government Finance Statistics, 2016-17*, 5512.0 and 2017-18 State annual financial reports.

10 Grants from the Commonwealth to the States, however, have been the main method of addressing vertical imbalances. Grants have been made every year, often in conjunction with other actions.

11 When grants and other revenue transfers are made, governments must consider:

- the total amount of grants and transfers to be made in each year
- the type of transfer — specifically whether they will be for general revenue or specific purposes, or a mix of both
- how the transfers will be distributed among the States.

12 In Australia, these issues are addressed in an intergovernmental agreement — the Intergovernmental Agreement (IGA) on Federal Financial Relations. Features of the current IGA that affect the Commission's work are summarised in Box 1.

Types of transfers and their size

13 Commonwealth transfers have been a large part of State budgets. These were 37% of State revenues in 1901-02, 14% in 1938-39 and around half since World War II.

14 Commonwealth transfers to the States take two main forms:

- transfers of general revenue funds which the States may use as they see fit
- payments for specific purposes (PSPs) where the Commonwealth seeks to achieve national aims in areas of State responsibility or provides funds for particular purposes.

15 A large increase in PSPs provided to the States in 2009-10 saw them rise to 54% of total transfers. PSPs declined to 47% of total transfers in 2017-18, with general revenue transfers accounting for the other 53%.

Box 1 Intergovernmental Agreement on Federal Financial Relations

During 2008, Australian Governments, through the Council of Australian Governments, negotiated a new IGA relating to federal financial arrangements and a revised agreement was signed in 2011. It provided for a system of general revenue and specific purpose payments to the States and Territories.

Some of the main features of the current IGA are:

- the GST is to be distributed among the States in accordance with the principle of horizontal fiscal equalisation, with the Commonwealth Grants Commission recommending to the Treasurer the allocation across States on this basis
- PSPs are provided to States in areas administered by the States, covering most functional areas of State activity
- the PSPs (except national partnership reward and facilitation payments) made to States are intended to affect GST shares because they provide budget support for State services, but the Commission has discretion to determine the treatment of individual payments consistent with fiscal equalisation.

16 ***General revenue transfers.*** The methods used to set the total amount of general revenue transfers have changed since the mid-1970s. Currently, the net proceeds of the GST are distributed to the States. This revenue replaced the previous financial assistance grants and the revenue from certain State taxes abolished when the GST was introduced.

17 ***PSPs.*** The Commonwealth provides payments to States for specific purposes in areas administered by States. National specific purpose payments (national SPPs) support State activity in skills and workforce development, disability services and affordable housing. The States are required to spend each national SPP in the relevant sector.

18 The Commonwealth also supports States through the provision of public hospital funding and through the provision of recurrent funding for all government and non-government schools.

19 National partnership payments are the key vehicle to facilitate reforms (including reward payments for States that deliver on the reform process) or support the delivery of specified projects.

20 To the fullest extent possible, payments are aligned with the achievement of project milestones and are made after the States have achieved the outcomes or outputs specified in the relevant National Partnership.

21 Table 2 shows the size of each type of transfer for selected years since 1980-81.

Table 2 Commonwealth transfers to States, selected years

	1980-81	1990-91	2000-01	2010-11	2017-18
	$m	$m	$m	$m	$m
General revenue transfers (a)	7 090	13 932	27 635	46 953	64 197
Payments for specific purposes (b)	5 683	14 638	19 207	48 207	56 254
Total	12 773	28 569	46 841	95 159	120 451

(a) The way the level of these transfers has been determined has varied over the years. In 1980-81, the main general revenue transfers were a proportion of Commonwealth tax revenue; in 1990-91 they were financial assistance grants and subject to guarantees in real terms; and from 2000-01 they have been the revenue from the GST.

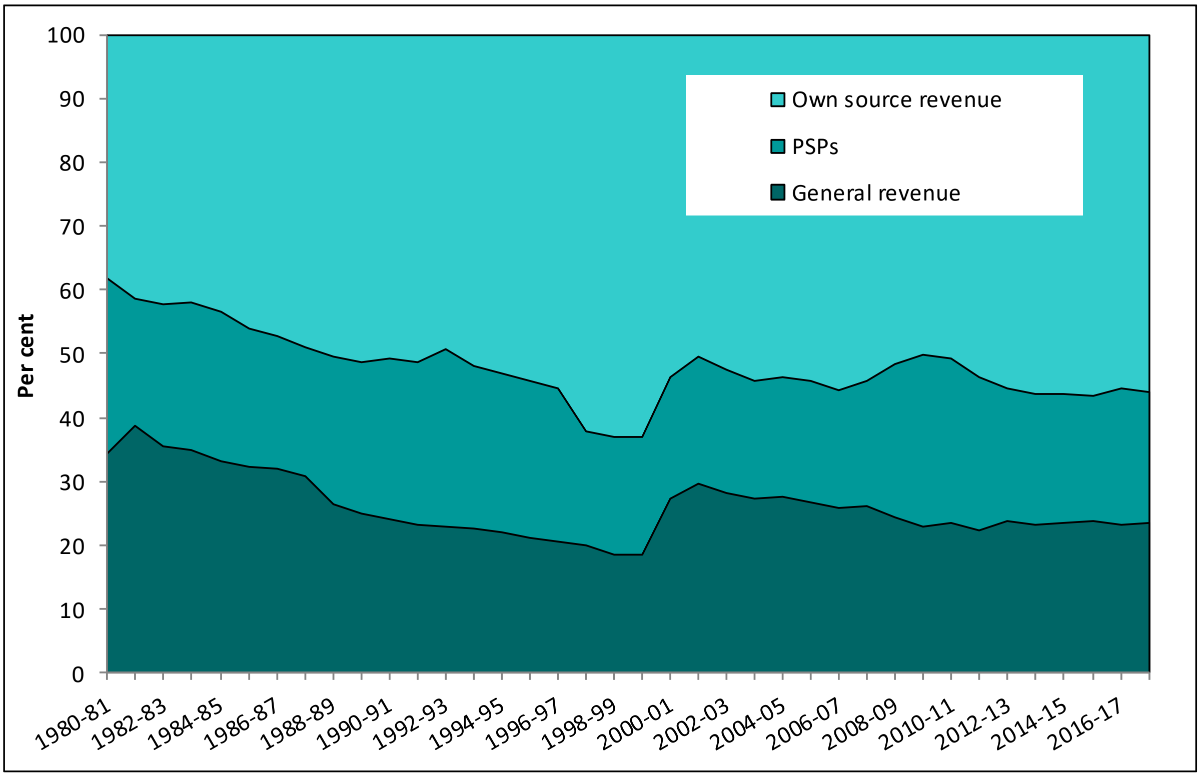
(b) Includes national partnership payments. Adjustments have been made to the accounting treatment of payments under the natural disaster recovery and rebuilding arrangements (NDRRA) for 2010-11 to 2017-18 to ensure consistency with earlier years.

Source: Australian Government Budget, Final Budget Outcome, various years.

22 Figure 1 shows the contribution of State revenue, general revenue assistance and PSPs to average State revenue and transfer revenue since 1980-81. From that time total transfers from the Commonwealth to the States have grown more slowly than State own source revenue. Total Commonwealth transfers were 62% of total State revenue in 1980-81 compared with 44% in 2017-18. The contribution of total Commonwealth transfers reached a low point in 1999-2000, the year before the introduction of the GST and the abolition of selected State taxes. While the contribution of total Commonwealth transfers has not fallen to the 1999-2000 level, the 2017-18 proportion was nonetheless below the long-term average. Between 1980-81 and 2017-18 most State revenue sources grew more quickly than total Commonwealth transfers with mining revenue, insurance taxes (including fire and emergency service levies) and land tax in particular making the biggest contribution to growth. For example, between 1987-88 and 2017-18, mining revenue, insurance taxes (including fire and emergency service levies) and land tax grew at annual average rates of 9.6%, 8.5% and 8.9% respectively, compared with an average annual growth rate of 5.5% for total Commonwealth transfers over the same period.[4]

[4] Disaggregated revenue data are only available from 1987-88. Between 1981-82 and 2017-18 total State revenue and total Commonwealth transfers grew by 8.0% and 6.2% respectively.

Figure 1 Total State revenue by source, 1980-81 to 2017-18

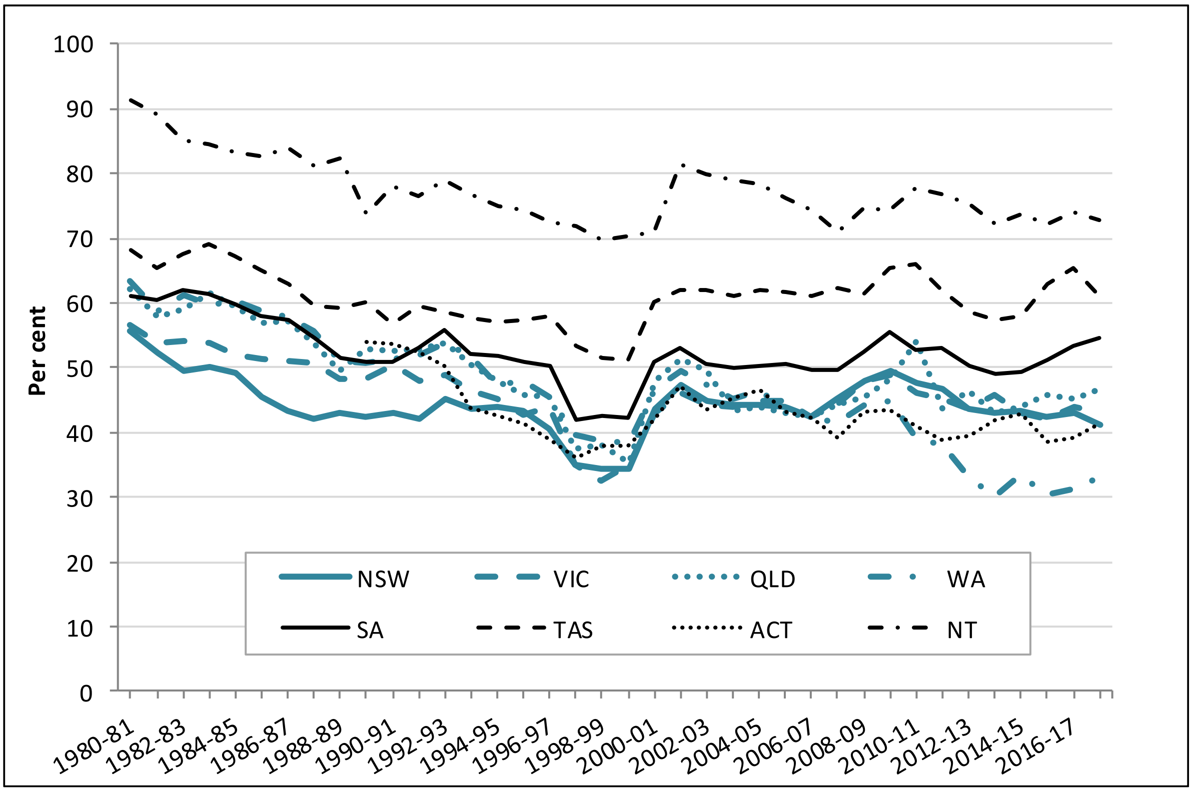


Source: Commission analysis of State budgets.

23 Figure 2 shows the contribution of all Commonwealth funding (general revenue assistance and PSPs) to total State revenue, for each State. It shows that:

- The States shared broadly the same experience in terms of the evolution of transfers from the Commonwealth. In 1980-81, Commonwealth funding made up 62% of total State revenue in all States. In 2017-18, this had fallen to 44%. The decline was slower in Tasmania and New South Wales, and more rapid in Western Australia and Queensland.
- The Northern Territory has, of all States, the greatest proportion of its revenue coming from Commonwealth funding.
- New South Wales had the lowest proportion of revenue coming from the Commonwealth in 1982-83, a position now occupied by Western Australia.

Figure 2 Commonwealth funding share of total State revenue, 1982-83 to 2017-18



Source: Commission analysis of State budgets.

24 Box 2 provides an overview of State budgets for 2017-18. It shows for each State, actual Commonwealth transfers and State own source revenues received in that year. It also shows each State's spending in the same year.

HORIZONTAL FISCAL EQUALISATION

25 Policies aimed at addressing horizontal fiscal imbalances directly are referred to as horizontal fiscal equalisation (horizontal equalisation). Equalisation, to a greater or lesser degree, is a feature of the financial arrangements in Australia and many other federal countries, including Canada, Ethiopia, Germany, India, Malaysia, Russia, Spain and Switzerland. Horizontal equalisation is not confined to federations. It is also a feature of countries where the national government delegates powers to regional (or local) governments, such as China, Indonesia, Japan, South Africa and South Korea. Australia also has arrangements to reduce the inequalities in the fiscal capacities of local governments.

Box 2 Overview of State revenues and expenditures

State revenues and spending, 2017-18

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
	$pc	$pc	$pc	$pc	$pc	$pc	$pc	$pc	$pc
State taxes	3 955	3 591	2 668	3 329	2 637	2 210	2 945	2 581	3 378
Mining royalties (a)	223	16	881	2 002	137	80	0	1 380	486
Other revenue (b)	2 169	2 163	2 698	2 263	2 324	2 221	4 682	2 591	2 342
PSPs	2 174	1 964	2 427	2 608	2 424	2 497	2 210	4 608	2 265
GST	2 239	2 380	3 028	1 151	3 670	4 598	3 140	12 940	2 592
Revenue	10 759	10 115	11 703	11 353	11 192	11 607	12 977	24 101	11 062
Expenditure (c)	10 942	10 894	11 750	12 158	11 758	11 628	13 179	27 041	11 488

(a) Mining royalties does not include grants in lieu of royalties. These are included in Other revenue.
(b) Includes other State own source revenue including fees and charges and other Commonwealth funding, for example, grants in lieu royalties and Commonwealth own purpose expenses.
(c) Includes the net acquisition of non-financial assets.
Source: Commission calculation using data provided by the States and Commonwealth *Final Budget Outcome* 2016-17.

The table indicates Western Australia raised $5 331 per capita in taxes and mining revenue. This is 38% above the national average and reflects the strength of its revenue bases. In mining revenue, Western Australia raised $621 per capita more than the second highest State, the Northern Territory, and more than four times the national average.

The Northern Territory received the highest revenue from PSPs, almost 103% above the national average. Western Australia, Queensland, South Australia and Tasmania also received above average revenue from this source.

Despite receiving 56% below average GST, Western Australia had total revenue of $11 353 per capita (3% more than the average).

The Northern Territory had by far the highest level of spending followed by the ACT and Western Australia. The high level of per capita spending for the ACT is largely because it includes local government expenditure.

26 The level of equalisation sought by each federation varies. Full equalisation, which offsets interstate differences in revenue raising capacity and the costs of providing services and acquiring infrastructure, has been the objective in Australia. Germany's processes go a long way towards equalising revenue capacities and also include small allowances for some differences in expense needs across regions. Canada has partial revenue equalisation (provinces with low revenue capacity receive extra resources with no adjustment for those with a high capacity) and there is no allowance for

differences in a Province's expense needs.[5] Equalisation in China, like that in Australia, allows for differences in revenue raising capacity and costs of services but the funds available for equalisation are small relative to the large differences between provinces.

27 Full equalisation does not necessarily mean more resources are redistributed. The amount redistributed under a system of partial equalisation can be greater than under a system of full equalisation if revenue raising advantages (or disadvantages) are partly offset by higher (or lower) service costs.

28 The Constitution of Australia makes no requirement to address horizontal inequities between States, but still allows for fiscal transfers from the Commonwealth to the States (through Section 96). Concerns about the fiscal weakness of some States arose shortly after federation and arrangements for equalisation have evolved since then. In 1910, the Commonwealth began providing special grants that aimed to give the weaker States a fiscal capacity comparable to the stronger States. Special grants were paid to one or more States in every year between 1910-11 and 1980-81. For much of the time, the main general revenue transfers were also distributed differentially among the States reflecting a historical accumulation of allowances for some expenditure needs (such as interstate differences in wage rates) and other agreements.

29 Major changes in Commonwealth-State financial arrangements were agreed in 1976. As part of the changes, the Commonwealth and the States agreed to replace the general revenue transfer and special grant processes with arrangements which aimed to equalise the financial capacities of all States. Those arrangements involved sharing a proportion of personal income tax revenue among the States to offset differences in State capacities to raise revenue and the expenses required to provide comparable services. Those equalisation objectives were defined and included in the related Commonwealth legislation.

30 While the method of determining the total general revenue assistance has changed several times since then, most significantly with the introduction of the Goods and Services Tax (GST) in July 2000, the aim of distributing it to achieve full equalisation remained. That aim was reaffirmed in later Intergovernmental Agreements.

31 Following a review of Horizontal Fiscal Equalisation by the Productivity Commission in 2018, the Government decided to change the objective from achieving full equalisation (so-called equalising to the fiscally strongest State) to achieving 'reasonable' equalisation (equalising to the fiscal capacity of the stronger of New

5 Canada's Territories are not included in the equalisation program, instead federal funding is provided thorough the Territorial Formula Financing (TFF) program. The TFF program recognises a Territory's expenditure need and capacity to raise revenue.

South Wales and Victoria). Box 3 illustrates the transition to the new equalisation objective will occur in two phases:

- between 2019-20 and 2021-22, the Commonwealth will provide short term funding assistance in addition to GST revenue
- between 2021-22 and 2026-27, the equalisation system will transition to the reasonable equalisation objective and will include a permanent boost (or top-up) to the GST revenue pool.

Box 3 Transitioning to a new equalisation system

In 2017, the Australian Government asked the Productivity Commission to conduct an inquiry into Horizontal Fiscal Equalisation. The Productivity Commission's final report was handed to the Government in May 2018 and the Government released its interim response to the report in July 2018. The Government passed legislation amending the *Commonwealth Grants Commission Act 1973* and the *Federal Financial Relations Act 2009* to give effect to the Government's policy of:

- providing short term funding assistance between 2019-20 to 2021-22
  - during this phase, States will be entitled to a minimum level of general revenue assistance (GST revenue plus top up payments)
- between 2021-22 and 2026-27, transitioning to the new arrangements
  - a within-system relativity floor
  - additional Commonwealth assistance to permanently boost the GST revenue pool
  - transitioning the HFE system from full equalisation to 'reasonable' equalisation
  - a guarantee that, over this transition period, each State will receive funding that is at least the better of the current distribution system or the updated distribution system
- at the end of the transition period, the Productivity Commission will conduct an inquiry to assess whether the updated distribution system is operating efficiently, effectively and as intended.

ROLE OF THE COMMONWEALTH GRANTS COMMISSION

32 The Commission's main role is to provide advice on how the GST revenue (and pool top-ups from 2021-22) should be distributed among the States to equalise their fiscal capacities.[6]

33 The Commission was established in 1933 to provide independent advice to the Commonwealth on the special grants that should be provided to the fiscally weaker

6 These fiscal capacities are also the basis for determining reasonable equalisation.

States. The establishment of the Commission as an independent body, akin to the Tariff Board (now the Productivity Commission), reflected the often contentious nature of the various ad hoc processes and criteria used to set special grants in previous years.

34 The Commission's first task was to devise principles for assessing the special grants. Its third report said special grants should enable a State 'by reasonable effort to function at a standard not appreciably below that of the other States'.

35 After governments agreed in the mid-1970s to full and comprehensive equalisation for all States, the Commission was given the task of advising on how this could be achieved. It continues to have that role. Successive Intergovernmental Agreements have recorded the view of Commonwealth and State Governments that GST revenue should be distributed among the States to achieve horizontal fiscal equalisation based on the advice of the Commission.

36 During each year of the transition period, the Commission will be responsible for verifying States' entitlements to additional financial assistance under the guarantee arrangements.

37 Following the transition period commencing in 2021-22, and subject to the outcomes of the Productivity Commission review at the conclusion of the transition period, from 2026-27, the Commission will be responsible for advising the Commonwealth on the distribution of GST revenue in accordance with the new reasonable equalisation objective.

THE COMMISSION'S 2020 REVIEW OF ITS METHODOLOGY FOR DISTRIBUTING THE GST

38 From time to time the Commission has been asked by government to review its methods for achieving equalisation. The latest Review is to be completed in February 2020.

39 The terms of reference for this review, received in November 2016, ask the Commission to consider whether the supporting principles remain appropriate, including whether different weights should be given to different supporting principles. They also ask the Commission to consult regularly with the Commonwealth and the States during the review, to provide a draft report in 2019, to advise of any substantive changes in the revised methodology following the draft report and to complete the review by 28 February 2020.

40 In reviewing its assessments, the terms of reference ask the Commission to aim to have assessments that are simple and consistent with the quality of the available data, use the latest available data and ensure robust quality assurance processes.

41 The new methodology will be used to formulate the recommendations for the GST distribution in 2020-21. For more information on the Commission's 2020 Review see the Commission's website (www.cgc.gov.au).