

COMMONWEALTH-STATE FINANCIAL RELATIONS: THE GOOD, THE BAD, AND THE UGLY

NOTES BY PETER EMERY FOR THE FEDERAL RELATIONS AND TAX REFORM WORKSHOP AT THE ADELAIDE UNIVERSITY 28-29 AUGUST 2017 **For Panel Discussion session**

It is over 50 years since I became interested and closely involved in Commonwealth-State financial relations and related topics. Following study at this University I joined the Commonwealth Treasury in Canberra in 1967 and transferred to the South Australian Treasury in 1979. I was privileged to be CEO (Under Treasurer) of the latter in the 1990's. I later became an independent consultant. One way or another throughout most of this period I was involved quite heavily in policy and administration in Commonwealth-State relations. I have written many hundreds, possibly thousands, of pages with the great bulk of them issued in the names of other people including various Prime Ministers and Premiers, Commonwealth and State Treasurers etc. taking the form of Budget Papers, proposals circulated at what used to be called Premiers' Conferences and Loan Council meetings, letters between senior people, Press Releases and so on. As a now retired person and believing that I have already put in a fair effort what I now offer is in the form of some very brief notes. This is not necessarily a disadvantage, most of the issues, in my view, being straightforward. Following are some notes on what might be regarded as some of the principal issues.

The concentration of tax powers at the Commonwealth level

The concentration of both personal and company income taxes and the GST at the Commonwealth level is a good thing. It contrasts in particular with the situation in the United States. It contributes to economic efficiency, equity and administrative simplicity across Australia. The transfer of what used to be called franchise taxes (tobacco, petrol and alcohol) from the States to the Commonwealth following High Court decisions on the meaning of the term "excise" has worked in the same direction

There has been only one significant and lasting move in the other direction namely the transfer of payroll tax from the Commonwealth to the States in the 1970's. This was initiated by myself and my then immediate superior in the Commonwealth Treasury. The proposal was rejected by then Prime Minister Gorton but then successfully put to the States by his successor Bill McMahon. It took the then State Premiers about five minutes to accept the proposal and about the same time to agree to increase the rate of tax. This tax may be regarded as imperfect but the States would be in a very poor position without it.

The concentration of tax powers in the Commonwealth has, of course, led to large transfers of funds from the Commonwealth to the States. This is sometimes referred to as 'vertical fiscal imbalance' as it can be taken as implying that there is something wrong in the system which needs to be corrected which I do not accept so long as the Commonwealth recognises its national responsibility in a national tax system and there is practical scope for autonomous tax decisions by States at the margin.

The Commonwealth seems to have been disinclined to take up the suggestion by the SA Premier of a GST equivalent tax being implemented on the finance sector, and the most recent development in State taxation recently has been the introduction of legislation in South Australia to impose a tax on banks in a form introduced by the Commonwealth on its own account. This is being resisted by the banks and has yet to pass the Legislative Council. For myself I welcome this assertiveness on the part of the Government here in South Australia.

The determination of the aggregate level of general purpose (untied) grants from the Commonwealth to the States

Since the introduction of the GST these payments have been determined, by legislation, as equal to the Commonwealth's revenue from the GST. This may have been a good thing in terms of helping to get the GST accepted but has no particular logic beyond that. In the somewhat distant past the level of these payments has been determined by reference to Commonwealth revenue from income tax or total taxation.

For many years we had a more logical approach. The grants were referred to as financial assistance grants and were determined each year by increasing the grants in the previous year by State populations, average wages in the economy as a whole and a so-called betterment factor which reached as high as three percent. It is known that the States have been disappointed by GST in recent times. I would advocate a return to the old system of financial assistance grants. The Commonwealth would then have the freedom and enhanced motivation to manage the GST with integrity whether it is incorporating the financial sector, digital imports etc.

The Commonwealth's involvement in State activities through specific purpose grants or direct service provision

For many years the Commonwealth has been making numerous tied grants to the States. Some details can be found in Commonwealth Budget Paper No. 3 (previously No. 7).

In 1984/85 I was a member of the National Inquiry into Local Government Finance appointed by the then Commonwealth Government. Its Report was commonly referred to as the Self Report after its Chairman who was an academic from the United Kingdom. The Report recommended quite numerous changes in the arrangements for Commonwealth funding of Local Government many of them in the direction of increasing the degree of Commonwealth involvement through more detailed terms and conditions. The Report included a Minority Report prepared by me which, amongst other things criticised this general direction of thought; following is an extract from my Minority Report:-

“The Commonwealth Government of Australia, like national governments everywhere, is surely faced with challenges enough in those fields for which it has direct and clear responsibility – defence, national security, foreign affairs, macroeconomic policy, the regulation of the banking and finance system,

tariffs, social security and taxation. In few, if any, of these areas can outstanding success be claimed – indeed, in some of them, ‘crisis’ would be the best short-hand description of the current state of affairs. None of them is problem-free.

Given inherent limitations on the time, the intellectual and other resources and the moral standing available to political and administrative leadership in the Commonwealth, there is a strong case for any change to be in the direction of confining, rather than extending, the range of affairs in which the Commonwealth involves itself.”

In the 30 years or so since this Report Commonwealth involvement in areas for which the States are or have been responsible has continued to increase either through Section 96 payments or through direct provision or funding of services. The most recent and arguably the most important of these areas is disability with the formation of the National Disability Insurance Scheme. It is probably too early to judge the success or otherwise of this Scheme but I would suggest there is already evidence that the Commonwealth has bitten off rather more than it can chew. It has quite recently been accepted by the Commonwealth that the funding for this Scheme is inadequate and an increase in tax has been proposed to meet this issue.

As a reasonably close observer over many years of the Commonwealth Parliament and Commonwealth Government there is no doubt in my mind that the Commonwealth has over stretched itself. The current Premier of South Australia Jay Weatherill has formally proposed that most of the Commonwealth’s specific purpose (tied) payments to the States be absorbed into general purpose funding. Without going into the details of Mr Weatherill’s proposal (which was partly related to a short lived and now irrelevant idea about personal income tax) the conversion of term limited tied funding to ongoing general purpose funding remains an excellent suggestion. It would lessen the burden on the Commonwealth Government, simplify decision making at the State level and produce substantial administrative savings. This kind of proposal would not rule out national policy agreement such as for free public hospital treatment, NAPLAN testing etc. We know how we got here historically and politically but the logic of the Commonwealth dominating funding of private schools and the States Government schools is not readily apparent. Equally it is not apparent to all of us that it is appropriate for the Commonwealth to give a financial incentive to the States to privatise through a so-called asset recycling program. It is regrettable, though not at all surprising, that the Premier’s suggestion has not been pursued. It would, by the way, fit in with the idea proposed above that the link between GST revenue and general purpose grants to the States be abolished. There is no logical reason why general purpose grants to the States could not be larger than the GST revenue.

Fiscal equalisation

Australia has had a principled and sound system of fiscal equalisation between the States at least since the Third Report of the Commonwealth Grants Commission back in the 1930s. For many years the system worked through applications to the Commonwealth for what were called special grants by the less financial advantaged States, variously South Australia, Tasmania, Western Australia and Queensland. In

the early days the Commission made its calculations by first adjusting the budgets of the so-called claimant States to make them comparable in terms of budget structure and tax and expenditure policies with New South Wales and Victoria and then equalising the budget results (surplus or deficit) between the claimant and standard States in per capita terms. The special grants were the subject of annual legislation which was passed by the Parliament without question and with little discussion.

As a Commonwealth Treasury officer I initiated, through oral and written submissions to the Commission, a proposal that this indirect method of comparisons of budget results between the States be replaced by a system which identified the areas of difference in taxable capacity and expenditure need and calculated in a far more direct way the amounts which were required to compensate for these differences. This was after some delay accepted by the Commission I think partly as a result of influence by Professor Russell Matthews who had been newly appointed to the Commission. This basic methodology with many changes of detail has been used by the Commission since and has proved very successful.

The other major change which I initiated was eliminating the claimant State system in favour of an arrangement under which a fixed total of grants was distributed between all the States on the basis of comparisons between all of them. Amongst other things this change had the effect of bringing the more populous States into the discussion and eliminating a bias in favour of the claimant States which was inherent in the original system.

As mentioned above the aggregate of general purpose grants has been determined by reference to the Commonwealth revenue from the GST since the introduction of that tax by the Howard Government. As also mentioned above it would now make sense for the aggregate of grants to be determined in a way which was more directly related to those factors affecting the financial requirements of the States. Whether this suggestion has any chance of being accepted I do not know but I would like to see it taken up.

In the meantime the water has been muddied by continuing arguments from the Western Australian Government that the current system is flawed - its "evidence" being that the ratio of grants to Western Australia relative to GST incurred by State residents is well less than one hundred percent. Its proposal is that there should be a minimum ratio of some kind or some other change which has a similar effect. This approach has no validity whatsoever in terms of the long-accepted principles of fiscal equalisation. The aggregate of grants is determined in a particular way and the distribution of those grants is based on an unrelated set of principles and methodology.

Most unfortunately the views of the Western Australian Government appear to have attracted some sympathy on the part of recent Commonwealth Ministers, the current leader of the Opposition and some journalists and commentators. Commonwealth Government representatives have mentioned that they have paid extra money to Western Australia in a different form (infrastructure) in recognition of this matter. It is not clear to me to what extent all this is due to lack of appreciation of equalisation principles by Western Australian spokespersons, to the desire of the two main political parties to retain or gain Federal seats in Western Australia, to the lack of

sufficiently strong or clear explanation by the Commonwealth Treasury to Ministers or to other factors. It is possibly a mixture of all these things. It is very sad that such an excellent and long standing unique feature of our Federation has been spoiled in this way. It is not clear to me what can be done about this in addition to continuing representations from the other States and Territories and informed independent observers. I note that the proposal made above that the level of aggregate grants be determined quite independently of GST revenue or any similar aggregate might help in this regard. It might help also if someone were to put together data showing for States, Local Government authorities, electorates and regions the relationships between tax collected and Commonwealth payments made by way of grants and social security benefits, public services provided etc. Any such data would show huge differences in the relationships due to differences in revenue capacity and expenditure needs. These disparities would represent good features of our public finance system.

Concluding comment

I am very well aware that the matters mentioned above and many others could be discussed, and no doubt will be discussed, at much greater length but I hope the comments I have made will be of some interest to some of the participants in this Workshop.

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