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Federal financial relations in Australia

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Abstract

Federal financial relations in Australia are characterised by vertical fiscal imbalance. To address this, in recent years the Commonwealth has made payments to the states and territories ('the states') approaching 50 per cent of total state revenue. These payments typically take the form of untied, general revenue assistance or conditional payments for specific purposes (to support service delivery in specific sectors like health, education, infrastructure and housing).

Recent reforms in Australia will shape the way the states' goods and services tax (GST) entitlement—the most significant source of general revenue assistance—is determined and how funding agreements between the Commonwealth and the states are developed.

The rhythm of intergovernmental relations quickened in 2020, as the Commonwealth and states engaged more frequently to coordinate economic and social responses to bushfires and the COVID-19

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pandemic, signalling a positive development in the evolving practice of inter-jurisdictional cooperation that has supported Australia's economic development.

Keywords: horizontal fiscal equalisation; federalism; intergovernmental agreements; vertical fiscal imbalance.

Introduction

Since Federation in 1901, the Commonwealth's ability to raise revenue has grown to exceed the demands of its expenditure responsibilities under the Australian Constitution, while the states and territories (referred to throughout as 'the states') bear responsibilities for service delivery that exceed their resources (Robinson and Farrelly 2013). Responses to vertical fiscal imbalance (VFI) as an existential fact of Australia's federal system have evolved over time but in recent years the Commonwealth has made payments to the states equivalent to just under 50 per cent of total state revenue.

Since the 1930s, the allocation of transfers from the Commonwealth between states has incorporated at least an element of horizontal fiscal equalisation (HFE)—that is, attempting to equalise states' fiscal capacity to deliver public services to their citizens. Australia has elected to target a higher degree of HFE than most federal systems (Productivity Commission 2018:Finding 2.1). Between 2001 and reforms legislated in 2018, the goods and services tax (GST)—the states' main source of general revenue assistance—has been distributed according to the principle of full equalisation.

Critiques of Australia's approach to HFE generally do not question that equality of access to services by Australian citizens, regardless of where they reside, is a worthy national objective. Arguments in favour of reforms advanced by the states are typically motivated not only by a concern for their own fiscal positions but also by uncertainty over future GST revenues because of the system's volatility, particularly in the face of economic shocks. The impact of the mining boom on state relativities (such that GST allocations changed more slowly than state fiscal positions) provided the impetus for significant changes to Australia's approach to HFE, agreed in 2018. Under reforms commencing in 2021–22, Australia will take a step back from full equalisation in a move designed to make the system more resilient to economic shocks and reduce volatility in state GST payments.

The economic shock precipitated by the COVID-19 pandemic has also brought about a change in how the Commonwealth and the states approach agreements under which payments for specific purposes are made. A new framework agreed in 2020 is notable for the emphasis it places on the collective role of treasurers as the gatekeepers for new funding agreements, states' primacy over service delivery and the importance of funding certainty in areas requiring long-term investment. This is not the first occasion that jurisdictions have attempted to streamline agreement-making and provide greater autonomy for the states in service delivery. However, alongside the recent HFE reforms, it demonstrates the capacity for Australia's system of federal financial relations to evolve rather than rupture in the face of ongoing challenges. This evolutionary capacity will continue to be tested in the future, given the ongoing presence of VFI and need for all levels of government to respond to new economic and social challenges.

The evolution of VFI

It is now 120 years since six self-governing British colonies federated to form the Commonwealth of Australia. Australia's federal system comprises a national government, six states and two self-governing territories. Australia's Constitution divides power between arms of government—the executive, parliament and judiciary—and levels of government—federal/Commonwealth and the states. Reflecting the prevailing political attitudes of the time, the bargain struck at Federation envisaged the states being the dominant player in this new federal system (Robinson and Farrelly 2013:308). From a fiscal perspective, the lived experience of federalism in Australia has turned out quite differently, with substantial VFI persisting to the present day (see Figure 6.1).

In 2021–22, Commonwealth payments to the states totalled AUD163.9 billion, comprising AUD86.4 billion in general revenue assistance (or untied funding that states can use for whatever purpose they choose) and AUD77.5 billion in payments for specific purposes (or tied funding that must be spent in a certain way, is underpinned by a funding agreement and is often conditional on the achievement of milestones; see Commonwealth of Australia (2022)). The payments for specific purposes typically support state delivery of services like hospitals, schools and the provision of infrastructure. In recent years, these Commonwealth payments represent just under half of total state revenue (see Figure 6.2).

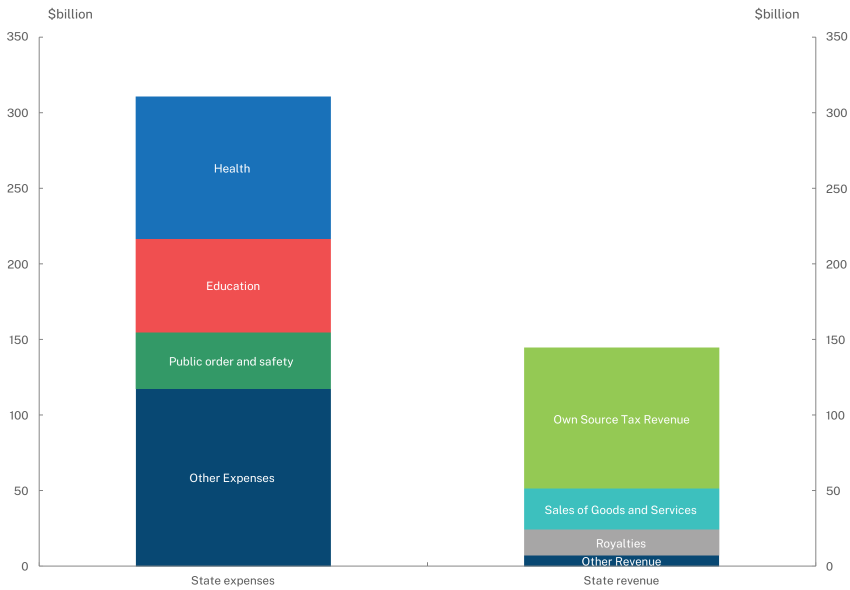

Figure 6.1: VFI, across states, 2020–21.

Source: ABS (2022); Commonwealth of Australia (2022).

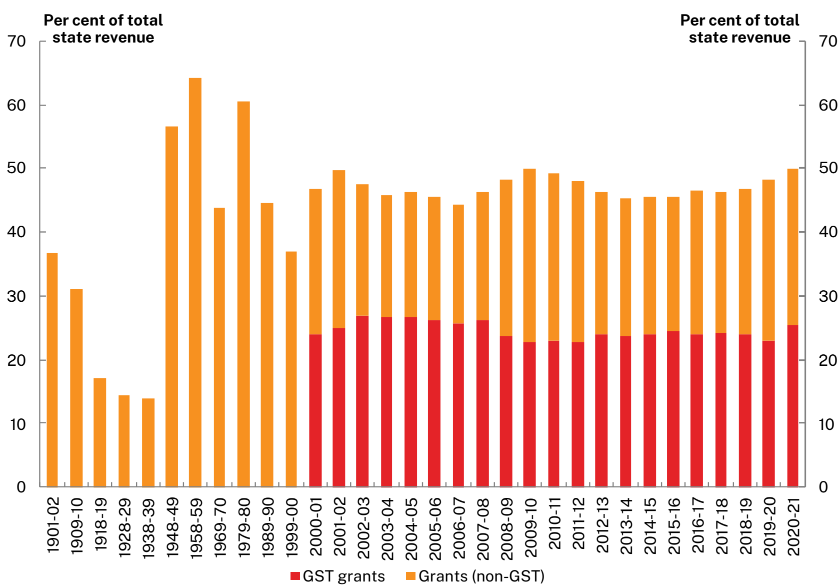

Figure 6.2: Commonwealth Grants as a per cent of total state revenue.

Source: Supplied by Australian Treasury, updating Figure 2.5 from the Productivity Commission 2018 inquiry report.

The Commonwealth's powers to tax and spend

Responsibility for excise duties was ceded to the Commonwealth at Federation, and until 1910 at least three quarters was distributed to the states. This was replaced in 1910 with a system of per capita grants and the ability for some states to make claims for special grants. Commonwealth assistance in relation to state debts and tied grants for specific purposes also emerged as tools for addressing VFI in the early dates of the federation.

In the 1926 'Roads Case',[2] the High Court established that it was permissible for the Commonwealth to make grants to the states under section 96 of the Constitution in areas of exclusive state responsibility. This opened an avenue by which the Commonwealth can—and to this day still does—pay the states to undertake activities that are beyond its defined constitutional competence.

From 1915, both the Commonwealth and the states had collected income tax. A single uniform system of income tax was introduced in 1942, withstanding a High Court challenge. While intended to be a temporary wartime measure it was retained and to this day remains the Commonwealth's largest source of revenue. In the 1970s, as part of the Fraser Government's 'New Federalism' policy, states were given the ability to impose a surcharge on income tax collected within their state. No state took up this option and it was eventually abolished.

In 1953, the Commonwealth handed back to the states the ability to levy land taxes and in 1971 allowed the states to levy payroll taxes (in exchange for a reduction in financial assistance grants). Neither proved, or were ever likely to be, a panacea to the fiscal challenges besetting the states. A further blow to the states came in 1997 with the High Court concluding that certain business franchise fees imposed by the states were in fact excise, which could only be collected by the Commonwealth.[3] It was against this backdrop that the introduction of the GST in 2000 was negotiated, resulting in the *Intergovernmental Agreement on Federal Financial Relations* (with much of its GST-related content retained by a superseding agreement in 2009).

2 *Victoria and Ors v Commonwealth* (1926) 38 CLR 399.

3 *Ha v New South Wales* (1997) 189 CLR 465.

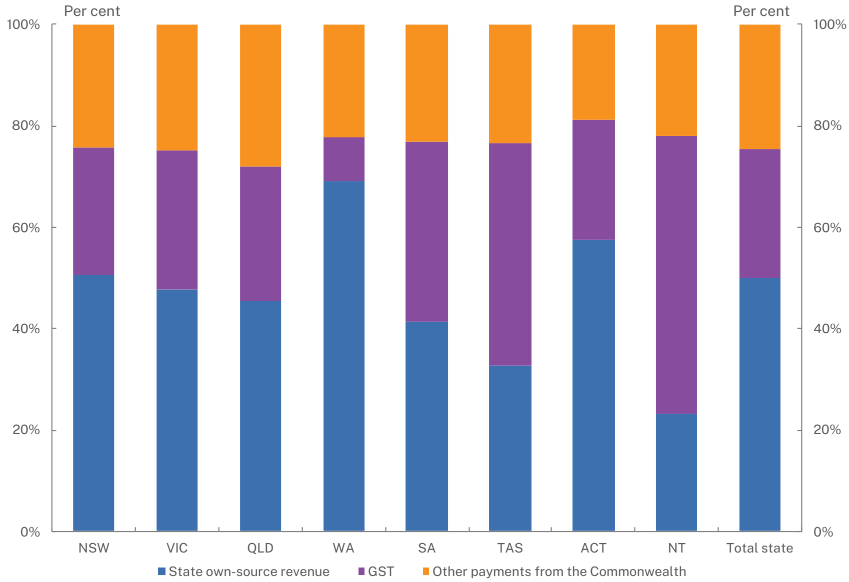

Figure 6.3: State own-source revenue, GST and other payments from the Commonwealth as a proportion of total state revenue, 2020–21.

Note: Totals may not sum due to rounding.

Source: ABS (2022); Commonwealth of Australia (2022).

Consistent with the agreement, the GST is now collected by the Commonwealth and distributed in full to the states (less costs of administration) without conditions. It is levied at a rate of 10 per cent on a broad, though not complete, base to most transactions for the sale of goods or supply of services. On the introduction of the GST, the states agreed to abolish a number of sales taxes and to the removal of financial assistance grants. Over time, the GST has become an important source of revenue for the states (see Figure 6.3).

A brief history of HFE in Australia

The early years

Increased demands for support through the Great Depression, and secessionist sentiment in Western Australia, led to the formation of the Commonwealth Grants Commission (CGC) in 1933 with a mandate to inquire into state requests for assistance and make recommendations to the

Commonwealth. The early reports of the CGC focused on financial need—seeking to assess the grant needed to lift a state to 'about as good a position as other States' (Productivity Commission 2018:71)—not equalising fiscal capacity to deliver economic or social outcomes. Subsequent CGC reports up until the late 1970s retained that basic standard but argued that special grants were only justified where a state was experiencing financial distress (Productivity Commission 2018:71).

From the mid-1940s to the mid-1980s, transfers between the Commonwealth and the states took the form of specific purpose payments (tied), distribution of a share of tax revenues (untied) and general financial assistance grants (untied) according to a formula. Claims for special grants diminished in significance. While the formula for calculating the distribution of financial support changed several times, a significant shift came in the late 1970s with the CGC given the task of determining per capita relativities. For the first time, these relativities were to take into account differences in the ability of states to raise revenue and differences in the cost of states providing comparable services, with the objective of enabling each state to provide services not appreciably different to those provided by other states.

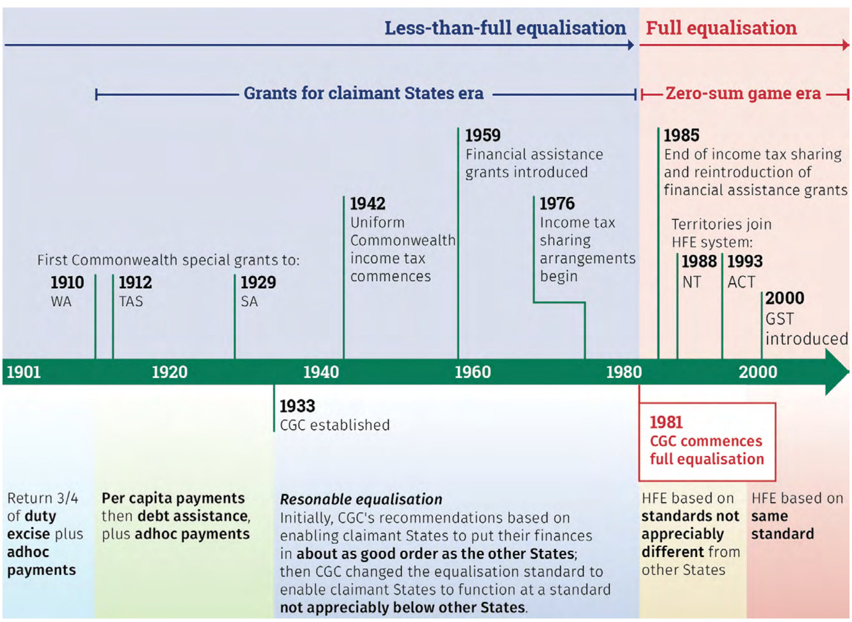

Figure 6.4: Approaches to HFE since Federation.

Source: Commonwealth of Australia (2018).

The post-2000 approach to HFE

Under the pre-2018 reforms to the HFE system, the GST was distributed to the states in a way that aimed to ensure that all Australians were able to receive the same standard of services, regardless of the intrinsic characteristics of the state in which they live. This is also known as 'full equalisation'. Under this approach, the CGC made a recommendation to the Commonwealth Treasurer—typically presented as a set of relativities that show how much each state would receive of its per capita share—that seeks to give all states the same fiscal capacity to deliver public services and associated infrastructure to the same standard. To do this, the CGC took into account factors—so-called 'disabilities'—that affect a state's ability to raise revenue or demands on its expenditure that are perceived as being beyond the state's control. A simple way to conceptualise this (as proposed by the Productivity Commission in 2018) is that, having assessed each state's fiscal capacity, the CGC first equalised to bring each state up to the fiscal capacity of the strongest state. This has traditionally been Victoria and New South Wales (who together account for over 55 per cent of the Australian economy: see ABS (2021)), but since 2008–09 has been Western Australia, which has benefited from the resources boom. Any funds left remaining are then distributed on an equal per capita basis.

Payments from the Commonwealth made outside of the GST distribution pool—for example, the specific purpose payments under National Partnership Agreements—are generally taken into account in the equalisation process. In rare cases, the Commonwealth Treasurer may direct the CGC to exclude consideration of a specific payment in determining a state's relativity.

As the GST pool, or the amount of revenue collected via GST, is fixed, its distribution has to date been a zero-sum game. In any given year, some states will have relativities of less than one, indicating that they will receive an entitlement that is smaller than their per capita share of the GST pool. To balance this, other states will receive relativities of more than one, indicating that they will receive more than their per capita share. This (somewhat inevitably) leads to tensions between those states who feel they gain from equalisation and those that would, at least on the face of it, be better off under a simpler per capita distribution model. While this tension reflects scarcity of fiscal resources, the particular model for addressing the

underlying goal of HFE highlighted 'losers' as well as 'winners'. The states were understandably focusing on each marginal dollar of revenue the system provides; more is always preferable to less.

Recent challenges, critiques and reforms to HFE

The greatest challenge to Australia's approach to HFE since the GST's introduction has been in response to the mining boom,[4] felt most acutely in Western Australia. This introduced a degree of unprecedented volatility into the GST distribution, which is challenging for state budgets. As mining royalties increased, Western Australia's GST entitlement fell to 30 per cent of its per capita share. The Northern Territory experienced an almost 20 per cent fall in its share of the GST over just two years causing the Commonwealth to step in to provide top-up payments. Over this period, the share of the GST pool not distributed on a per capita basis also grew substantially, heightening perceptions of who 'wins' under HFE. In 2000–2001 around 8 per cent of the GST pool was redistributed according to HFE, growing to around 12 per cent in 2015–16 (Productivity Commission 2018:92). Discontent with outcomes over a number of years prompted a series of independent reviews of Australia's approach to HFE, most notably a review in 2012 conducted by an eminent panel including former state premiers and an inquiry by the Productivity Commission in 2018.[5]

Critiques of Australia's approach to HFE

A critique tested by both the 2012 review and the 2018 Productivity Commission inquiry was that, while the CGC's methodology 'mostly adjusts for fiscal disadvantages that are out of States' control' (Productivity Commission 2018:163), it effectively penalises them for undertaking significant economic reforms that pay fiscal dividends, despite the commission's stated principle of policy neutrality. Whereas the 2012 review could not identify any conclusive evidence to support the argument

4 The Government's interim response to the Productivity Commission's HFE inquiry defined the mining boom as taking place from 2004–05 to 2013–14.

5 The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians.

(Commonwealth of Australia 2012:Finding 9.1), the Productivity Commission considered this was a key justification for its recommendation for reform (Productivity Commission 2018:167).

As the CGC itself has subsequently reasoned, while changes in a state's tax mix have the potential to affect the CGC's distribution of GST revenue, offsetting the revenue benefits of the changes to the state, a number of considerations militate against this being an issue in practice. Where tax reform has the effect of increasing a tax base then the state may be assessed as having strong fiscal capacity and a lower GST requirement, especially where the state acts unilaterally. This is likely to be most particularly the case for reforms that reduce reliance on inefficient taxes and shift towards more efficient ones. However, any state tax reform—particularly of any significance—is likely to be implemented over multiple years and the impact on the state's GST revenue would be diminished by the CGC's practice of averaging state fiscal capacities over three years. Further, the terms of reference given to the CGC could require it to take steps to mitigate the impact of significant state tax reform in any given year (Commonwealth Grants Commission 2021). This was also the conclusion of the 2012 *GST Distribution Review* (Commonwealth of Australia 2012:Finding 9.1).

Other critiques argue that while the CGC's approach to equalisation is well regarded for its rigor, it is overly complex leading to a lack of transparency which ultimately undermines community confidence in the 'fairness' of the system (Productivity Commission 2018:164). While perceptions of the CGC's methodology and processes are undoubtedly relevant to ongoing community acceptance of its role, there is no 'simple' way of achieving the kind of approach to HFE that Australian jurisdictions have committed to. The assessment of fiscal capacities and state-specific challenges in expenditure is inherently a complex process. Whatever a seemingly straightforward per capita distribution model might have to offer in terms of simplicity and transparency as to how the GST pool is allocated, it raises a plethora of questions that are not easily answered. Such questions include how a degree of HFE—partial or otherwise—might be achieved and whether any attempt to equalise capacities for service delivery to Australian citizens could command a political consensus across the federation.

Ultimately the critiques of Australia's approach to HFE advanced in the context of the mining boom were fundamentally about the predictability of general revenue assistance received by the states. While relevant to the extent of equalisation the system targets and the way it is achieved, it is a somewhat different fiscal objective.

Stepping back from full equalisation

In its final inquiry report, the Productivity Commission recommended that Australia step back from full equalisation to instead adopt a 'reasonable' standard. Acknowledging that there is a range of approaches that may meet that standard, the commission recommended equalisation to the average of all states (rather than to the strongest state as occurs under full equalisation). The commission acknowledged this approach would result in a material redistribution of the GST between states and the need of a transition to the new system (Productivity Commission 2018:236).

In its interim response to the Productivity Commission inquiry, the Commonwealth said that, while it agreed with the need for 'reasonable equalisation', it would seek the agreement of the states to a different approach. Instead of equalising to the strongest state overall, the CGC may be asked to equalise to that of either New South Wales or Victoria (whichever is strongest). These have historically been the fiscally strongest states since the introduction of the GST and they are the two most broad-based economies within the federation and least subject to terms of trade shocks. To give states further confidence in the resilience of the system to economic shocks, a GST relativity floor would also be introduced (a minimum per capita share of GST revenues). Where a shock was significant enough to push a state's relativity to the floor, the CGC would not be permitted to recommend a lower relativity. To help smooth the transition, the Commonwealth proposed to top up the GST revenue pool to ensure no state would be worse off (in transition) than it would have been under the old system (with that transition to commence in 2021–22 and last for six years).

The Commonwealth also agreed to a 'no-worse off' guarantee, specifying that it would compensate the states if they were disadvantaged by the reforms, as well as a Productivity Commission review of the reforms to ensure they are operating efficiently, effectively and as intended by the end of 2026. Prior to this new arrangement commencing, the Commonwealth would make short-term funding available to Western Australia to bring it up to the proposed relativity floor of 0.70 (rising to 0.75) and to the Northern Territory to ensure it keeps at least a predetermined share of GST revenue. These changes were legislated through the passage of the *Treasury Laws Amendment (Making Sure Every State and Territory Gets Their Fair Share of GST) Act 2018* (Cth), and the transition to the new approach commenced in 2021–22.

Changes to intergovernmental funding agreements

General revenue assistance—as delivered through the distribution of GST revenues—is only part of the fiscal relationship between the Commonwealth and the states. Almost the same amount is transferred from the Commonwealth to the states under specific purpose payments. Legislation provides that, if the Commonwealth wants to make a payment for specific purposes to one or more states, the payment and its conditions must be outlined in a written agreement. While this has made accountability for service delivery more challenging, it has also required all Australian governments to work together in pursuit of national economic and social objectives.

Streamlining and centralising agreement making

The 2009 *Intergovernmental Agreement on Federal Financial Relations* (IGA FFR) brought about a step change in how payments for specific purposes were agreed and managed. Some 90 agreements were consolidated into 6 core National Agreements (payments to achieve national objectives) and around 16 National Partnership Agreements (payments to fund the delivery of specific reforms or projects). The intention was to give states greater autonomy in *how* to undertake an activity, while imposing clearer accountability as to the achievement of agreed objectives and outcomes (COAG 2009:Part 2(b)). Despite some initial success, agreements once again tended to proliferate, arguably diluting the emphasis on outcomes and constraining states' autonomy over the means to achieve them. However, changes announced in the context of the COVID-19 pandemic demonstrate a (re)commitment to the original intention.

In May 2020, all jurisdictions agreed that the Council on Federal Financial Relations (CFFR)—the ministerial council of treasurers—would be responsible for all Commonwealth–state funding agreements, including reviewing the agreements process (Morrison 2020). The first order of business has been a streamlining of agreements and payments under those agreements through a new Federation Fund Agreements (FFA) framework announced in August 2020. Payments to the states are now facilitated through schedules to the FFAs with all schedules attached to one of five

overarching sectoral FFAs, covering housing and community services, education and skills, environment, health and infrastructure. Existing agreements have been consolidated into one of these five agreements.

The framework also includes principles for the negotiation and content of new agreements that emphasise: the importance of agreements achieving strong economic, social and fiscal outcomes; the need to recognise and balance government priorities at all levels of government; and avoiding the proliferation of low-value agreements. The principles notably highlight the desirability of providing states with budget autonomy as well as flexibility to allow them to deliver services in a way they consider will most effectively and efficiently improve outcomes. It also acknowledges the importance of providing funding certainty ('where possible'), particularly in contexts and sectors with long-term funding needs where short-term agreements may lead to inefficient delivery models (CFFR 2020). While the principles highlight CFFR's pre-eminent role in agreement making, they also reassure portfolio ministers (at all levels) that they will be involved. Finally, the principles acknowledge the need for performance reporting and transparency to underpin accountability.

Putting these principles to work in practice is a task that lies ahead of treasurers and their departments (and portfolio ministers who are to be involved, along with their departments). However, they represent a fresh attempt to achieve a step change in the conduct of federal fiscal relations outside of the HFE system. Built into the new framework is also a review mechanism, providing opportunities for learning and reflection on the extent to which the CFFR is effective in its role in agreement making and if the new framework has resulted in better outcomes.

The central role of treasurers

The role of treasurers in this process is not without its critics (Podger 2020). The framework itself acknowledges that the involvement of relevant portfolio ministers will continue to be critical to agreement making. This centralisation of responsibility reflects both the inherently fiscal nature of the challenge that states face and should bring a whole-of-economy perspective to agreement making, consistent with the extent to which Australia is now—120 years on from Federation—an integrated national economy.

While contested, there are also signs that institutional arrangements necessitated by the COVID-19 pandemic may provide the basis for more sustained and impactful cooperation. In early 2020, jurisdictions agreed that a National Cabinet, comprising the first ministers of the Commonwealth and the states, would replace the Council of Australian Governments (COAG) as the pre-eminent forum for intergovernmental discussions and negotiations, with a focus on meeting more frequently, reducing the bureaucracy associated with the COAG meeting cycle. National Cabinet initially agreed to meet every two weeks, with CFFR convening on a similar tempo in a similarly informal fashion. CFFR has now settled into a regular quarterly meeting cycle.

This approach has facilitated information-sharing in a time of great uncertainty and helped the coordination of policies across both levels of government. For example, the Commonwealth and the states agreed to share the burden of a pandemic disaster leave payment that would provide AUD1,500 to residents of most states of Australia who are unable to work because they have been asked to quarantine, self-isolate or care for someone who has COVID-19. It has also driven reform. In August 2020, CFFR also agreed to prioritise implementation of a uniform scheme to support widespread occupational mobility via automatic recognition of a range of occupational licenses, subject to the passage of legislation in individual jurisdictions. A uniform scheme will make it easier and less expensive for businesses, professionals and workers to move or operate within jurisdictions and across Australia, with positive implications for job creation, competition and innovation, and lower prices for consumers and businesses. The aim of the reform is to ensure that workers can take up new job opportunities wherever they arise as the economy recovers from COVID-19.

It remains to be seen whether the combination of the new FFA framework and the recent step-up in dialogue and cooperation between treasurers will ultimately produce a new era of financial cooperation between the Commonwealth and the states sustained beyond the initial impetus of the pandemic. The range of fiscal, economic and social challenges that all jurisdictions face going forward provides at least a compelling rationale for further cooperative action.

Future challenges

The reforms to Australia's approach to HFE agreed and legislated in 2018 deal with how the GST revenue pool is distributed, not the adequacy or sustainability of the pool itself. In addition to concerns raised by some states about the impact on their share of the GST pool from these reforms, the economic challenges of recent years have prompted revisions of the growth of the GST pool. There have been spurts of public discourse about raising the rate of the GST and revisiting those goods and services excluded from the base. For example, in 2020 the NSW Government commissioned a Review of Federal Financial Relations which, while stopping short of making specific recommendations, recommended that all jurisdictions explore options to lift the rate and broaden the base (NSW Government 2020). The agreement of all states and the Commonwealth, and passage of legislation through the Commonwealth Parliament, would be required to make such changes. The application and collection of GST also tends to provoke a more visceral reaction from the community than its distribution between states.

While it is tempting to write off the prospects of change as simply too difficult, the 'no change' counterfactual is also not without cost. Demands on all levels of government continue to grow to lift service quality, availability and affordability in areas such as aged care, health care and disability services. At the same time, Australian governments face structural and geopolitical changes in the Australian and global economies will shape the ongoing efficiency and efficacy of Australia's tax system. The practice of fiscal federalism in Australia, as this chapter has attempted to outline, is that greatest change emerges at points where crisis galvanises all Australian governments to action.

The fiscal demands of the COVID-19 pandemic have led to a substantial increase in borrowing by all Australian jurisdictions. The challenge of servicing this debt while also continuing to meet their ongoing financing task will necessarily be a focus of governments in coming years, particularly for treasurers. The evidence to date is that the states have been able to continue to access domestic and international capital markets throughout the pandemic, supported by the actions of the Reserve Bank of Australia in purchasing semi-government bonds to lower funding costs and support liquidity (Finlay et al. 2020). This represents a key difference between now and the context which led to the creation of the Loans Council much earlier

in the life of the federation to regulate borrowings by the states. At that time, international capital markets were far less diversified, Australia's own financial architecture was still very nascent (with no central bank) and there were pre-existing concerns on the part of creditors about the sustainability of Australia's sovereign debt levels (McLean 2013:150).

That is not to say that the level of debt accumulated during the current pandemic is of no consequence. The level of debt is greater than Australia has faced since World War II and sustained effort will be required to service it and to rebuild the capacity to address any future economic downturns or shocks. While the Australian economy as a whole is expected to grow more quickly than interest rates, that reinforces the importance of policy choices by all jurisdictions being supportive of future growth (Brennan 2021). So far, as Australia recovers from the worst of the COVID-19 pandemic, the economy has been facing levels of unemployment not seen for decades, far below the latest estimates for the non-accelerating inflation rate of unemployment (NAIRU; Ruberl et al. 2021). In an economy that has structurally reached 'full employment', there should be a heightened focus on the opportunity cost of government interventions that do not add to the economy's productivity capacity. Of course, while that level of unemployment may be achieved, its composition—in terms of gender, geography and socio-economic characteristics—has important economic and social consequences and will necessarily be an ongoing focus for all Australian governments.

Conclusion

Recent reforms to Australia's approach to HFE and to arrangements for intergovernmental funding agreements demonstrate the capacity for Australia's system of federal financial relations to evolve rather than rupture in the face of challenges. The last year has also seen unprecedented levels of cooperation between the Commonwealth and the states. This evolution reveals a capacity that will need to be fostered as the system faces fresh challenges from issues that remain contested and the challenging economic and fiscal context that all Australian jurisdictions face in the light of the COVID-19 pandemic.

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