

II. TAXING, SPENDING AND SHARING IN FEDERATIONS: EVIDENCE FROM AUSTRALIA AND CANADA

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[From the book, *Fiscal Relations in Four Countries: Four Essays*, Paul Boothe, ed.
Ottawa: Forum of Federations, 2003]

PART 1: INTRODUCTION

In his 1963 classic work on federalism, K. C. Wheare argued that in order to exist, federations needed to satisfy three prerequisites. The first was that the communities concerned wanted a common government for some purposes, such as common defence, the reduction of trade barriers or to lessen the cost of providing some public services. The second was that the communities wanted to retain separate regional governments for other purposes, such as maintaining a distinct culture or language or advancing disparate economic interests. The third was that the communities must have the capacity to successfully operate a federation.

The subject of this short article is fiscal federalism: one of the key mechanisms that underpins the operation of federations around the world. In particular, I focus on two federations that have well-developed divisions of revenues and expenditures and ever-evolving systems for transferring resources to deal with imbalances between national and provincial governments as a whole and imbalances between individual provincial governments.¹

The remainder of the article is organized as follows. In the next two sections, I look at the division of expenditures and revenues in the two federations. This is followed by a discussion of how each federation deals first with vertical imbalances – those between the national government

and the provinces as a whole. A discussion of horizontal imbalances – imbalances between individual provinces – comes next. The article concludes with a brief summary.

PART 2: THE DIVISION OF EXPENDITURE RESPONSIBILITIES²

The division of spending and revenue-raising responsibilities is often laid out in a federation’s constitution. While the constitution usually has an important part to play, the roles of national and provincial governments are constantly evolving as a result of changing external conditions and, in some cases, changing interpretations of the constitution and conventions by the courts.

a) Australia

The Australian constitution gives the national government (the commonwealth) exclusive jurisdiction in areas such as foreign affairs, defense, immigration, trade, currency and a number of social programs including pensions, unemployment insurance and family allowances. Provincial governments (the states) retain jurisdiction over the matters they controlled before joining the federation, including public security, urban development, housing and transportation. Commonwealth and state governments share responsibility for funding health and education.

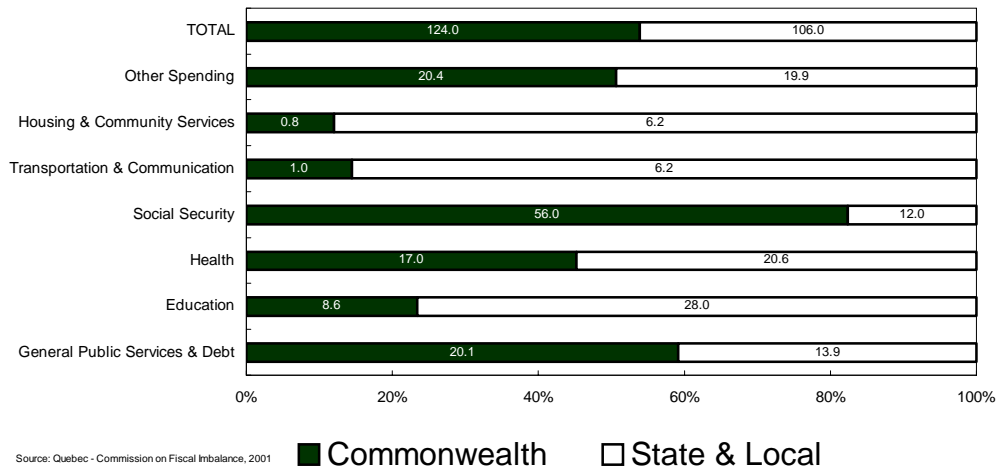
Australian courts have given a broad interpretation to the constitutional provision that allows the commonwealth to make grants to states under terms and conditions that it deems appropriate. This “spending power” is often used by the commonwealth to influence state spending priorities.³

In terms of direct program spending, the commonwealth spends about 54 per cent or \$124 billion (AUD) of the \$230 billion total, leaving 46 per cent or \$106 billion for the combined state and local governments. Breaking spending down into various components (Figure 1) we see that the commonwealth’s overall dominance in spending comes primarily from its expenditures in two categories: general public spending and debt and social security. State governments are responsible for more than two-thirds of spending in education, transportation

and communications, and housing and community services. Thus, in the main, actual spending patterns are reasonably closely aligned with the division outlined in the Australian constitution.

Figure 1: Australia Expenditures

(1999-2000)



b) Canada

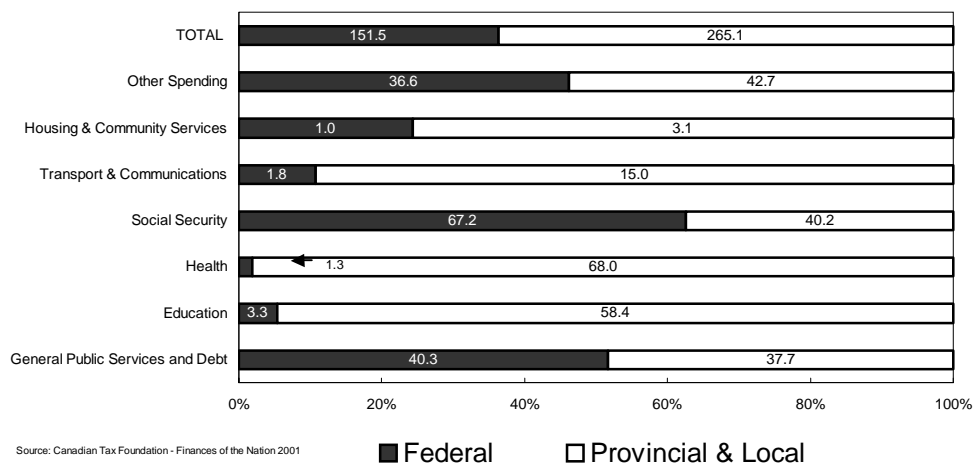
In Canada, the original constitution was established in 1867 and substantially revised in 1982. In the original constitution, the federal government was given responsibility for public debt, the regulation of trade and commerce, the postal services, national defence and currency and coinage. Provincial responsibilities included matters such as provincial borrowing, the management and sale of public lands (and hence control of natural resources), hospitals and education. Over time, the courts have affirmed the existence of the federal “spending power” that has allowed the federal government to become involved in areas of provincial jurisdiction such as health care.

One of the important revisions to the constitution in 1982 committed the federal and provincial governments to the reduction of regional disparities. Further, the federal government committed to the principle of making equalization payments to “ensure that provincial governments have sufficient resources to provide reasonably comparable levels of public

services at reasonably comparable levels of taxation.” This gives constitutional status to the requirement, by the federal government, to address fiscal imbalances between provinces.

An examination of the division of spending responsibilities in Canada shows a pattern where provinces are much more important actors than their Australian counterparts. In contrast to Australia, provincial and local spending is a much larger proportion of the total, comprising 63 per cent (see Figure 2). Looking at the individual components of spending, one sees that only in the area of social services is the federal government dominant – and then with approximately 36 per cent of the total delivered by the provincial and local governments.

Figure 2: Canadian Expenditures
(2000-01)



Provincial and local governments are overwhelmingly dominant in the areas of health and education. It is clear that the constitution writers of 1867 did not envision the modern welfare state and thus the importance of the spending responsibilities that were assigned to provincial governments and their “subsidiaries,” the local governments. In fact, the major deviation from the original constitutional assignment of spending responsibilities comes in the federal role in social services – largely transfers to individuals in the form of pensions, child benefits and unemployment insurance.

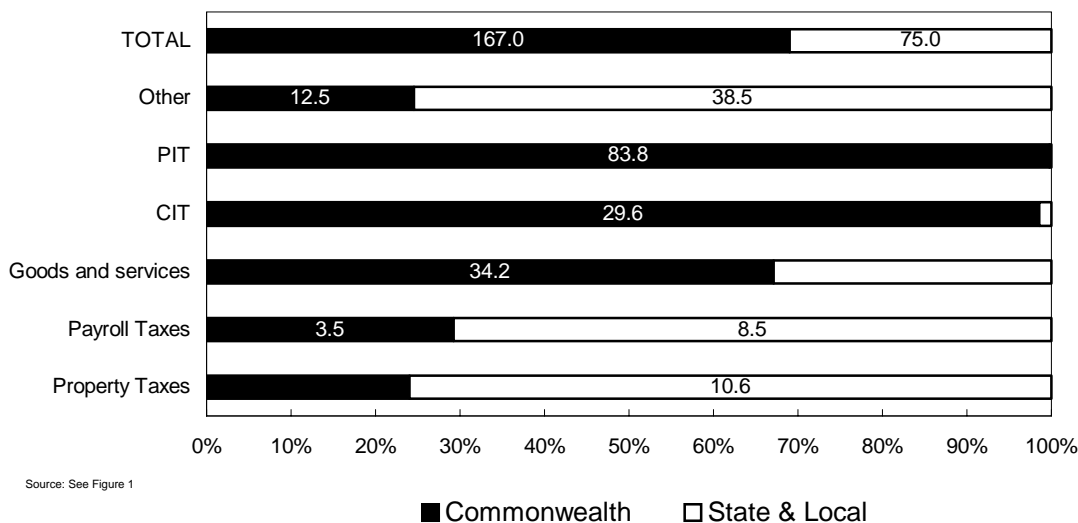
PART 3: THE DIVISION OF REVENUE RESPONSIBILITIES

Federal constitutions also often lay out the division of revenue responsibilities between national and provincial governments. Revenue responsibilities too can evolve over time because of external changes, convention or judicial decisions.

a) Australia

When compared with other mature federations, Australia’s revenue collection is highly centralized. The commonwealth collects most of the revenues in the country (69 per cent; see Figure 3) and shares them with the states through conditional and unconditional grants. The commonwealth is sole occupant of the personal income tax and corporate income tax fields. Interestingly, state governments are not prohibited by the constitution from collecting personal income taxes. Rather, they transferred this power to the commonwealth at the time of World War II in return for grants from the commonwealth.

Figure 3: Australian Revenues
(1999-2000)

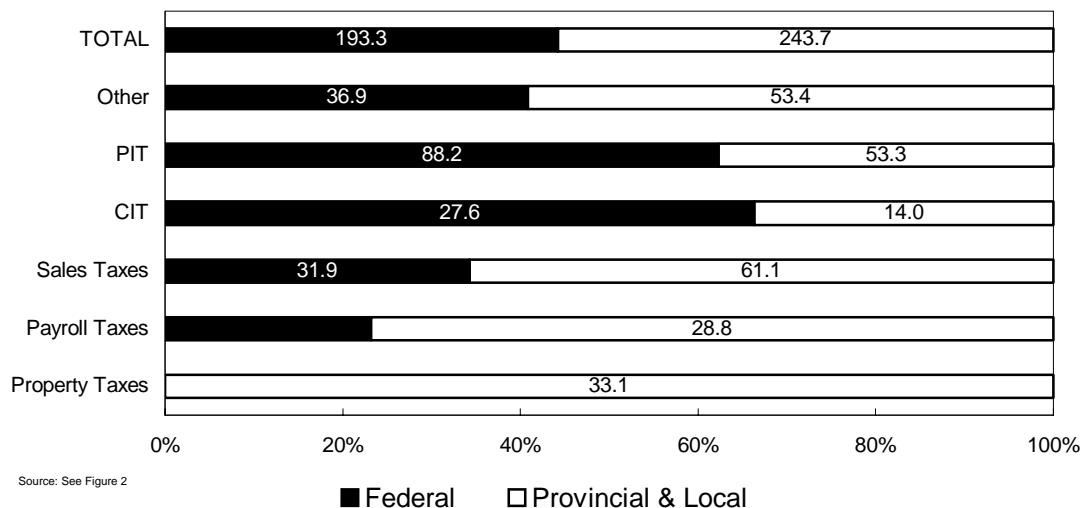


As part of the 2000 tax reform, the goods and services tax is collected by the commonwealth (for constitutional reasons) and then transferred to the states. State and local governments are sole occupants of the property-tax field and dominant in payroll taxes. Revenue from the sale of natural resources belongs to the states, except where the resources are on commonwealth lands or offshore.

b) Canada

While the Australian federation is highly centralized in revenue collection, the Canadian federation has one of the most decentralized revenue collection systems of any mature federation. Indeed, more than half (53 per cent; see Figure 4) of all revenues are collected by provincial and local governments. The federal government is dominant in the collection of both personal and corporate income taxes, while provincial and local governments are dominant in the fields of payroll and property taxes. The sales-tax base is shared between federal and provincial governments even though sales-tax systems and collection are not fully harmonized for seven of the ten provinces. Revenue from the sale of natural resources is included in the other revenue category and belongs to provincial governments if the resources are found on provincial lands, and the federal government if the resources are found on federal lands or offshore.

Figure 4: Canadian Revenues
(2000-01)



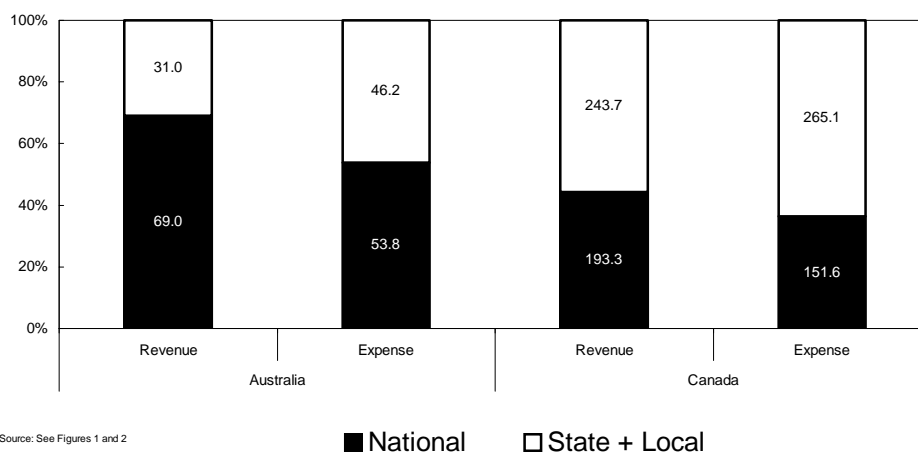
PART 4: DEALING WITH IMBALANCES BETWEEN NATIONAL AND PROVINCIAL GOVERNMENTS⁴

It is a fact of life in modern federations that the division of expenditure and revenue responsibilities is never such that both orders of government are fully self-financing. Indeed, there are many political and economic factors that must be considered in determining the actual division. When one order of government collects more revenue than it needs for its own expenditure responsibilities, a vertical imbalance is said to exist. Fiscal transfers from one order of government to another are used to deal with vertical imbalances. In some federations, specific transfers are designed to deal with both vertical imbalances and imbalances between provinces, i.e., horizontal imbalances.

a) Australia

As a result of the centralization of revenue responsibilities with commonwealth, Australia has a relatively large vertical imbalance (see Figure 5). Transfers to deal with vertical imbalances take two forms: conditional grants (called Specific Purpose Payments in Australia) that have specific conditions attached to how they can be spent, and unconditional grants (called Federal Assistance Grants). Total commonwealth transfers dealing with vertical imbalances were roughly equally split between conditional and unconditional grants. Since the tax reform of 2000, the unconditional grants have been replaced with an allocation to each state of a portion of the proceeds of the commonwealth-levied goods and services tax.

Figure 5: Vertical Fiscal Imbalance



b) Canada

Given the relative importance of revenue raising by provinces, vertical imbalances are much smaller in Canada than Australia (see Figure 5). The most important program dealing with vertical imbalances is the Canadian Health and Social Transfer (CHST), which is meant to contribute to the financing of health care, post-secondary education and social assistance programs. Although it is notionally targeted by the federal government, the program imposes few conditions on provinces and is often considered an unconditional grant program. The federal government also has a large number of smaller, conditional cost-share programs that deal with agriculture, transportation, housing and other issues. All require provincial participation and may or may not result in transfers rather than direct spending by the federal government.

PART 5: DEALING WITH IMBALANCES BETWEEN PROVINCIAL GOVERNMENTS

Imbalances between provincial governments may arise because of differences in revenue-raising capacity (fiscal capacity) or expenditure needs. These differences lead to horizontal imbalances. Transfer programs dealing with horizontal imbalances are an important part of many, but not all, mature federations. Australia and Canada are two federations that have well-developed “equalization” systems in place to deal with horizontal imbalances.

a) Australia

In Australia, the federation attempts to deal with differences among states that arise both because of differences in fiscal capacity and expenditure need. This is done by modifying allocations that each state receives from the proceeds of the GST relative to the amount of GST that is collected in each state. The Australian system of equalization is a “net” scheme, i.e., states’ transfers are equalized both up and down to reach the desired amount of equalization.

The total size of the transfer to all states is limited by the size of the GST proceeds.⁵ The division of the proceeds is determined by a complex (but well-defined) process of comparing forty-one expenditure and eighteen revenue categories in calculating the “relativity” of each state. This “pie-dividing” process is governed by a non-partisan body called the Commonwealth

Grants Commission, which ensures the accuracy and fairness of the process and reviews the methodology every five years.

b) Canada

Unlike Australia, the equalization program in Canada deals only with differences in provinces' revenue-raising capacity. This is done by comparing provinces' fiscal capacity in thirty-three revenue categories against a standard made up of five of Canada's ten provinces (the middle five in terms of revenue-raising capacity). Provinces that are below that standard fiscal capacity are given cash transfers from the federal government to raise their fiscal capacity up to the standard. Provinces that are above the standard do not receive equalization transfers. Thus, in contrast to the Australian system, the Canadian equalization scheme is a "gross" scheme – that is provinces below the standard are equalized up, but provinces above the standard do not have any corresponding reduction in transfers.

The distinction between gross and net equalization schemes has important implications for the fiscal "risk" faced by the national government. In a net scheme like Australia's, the size of the program is limited by the size of the proceeds of the GST and the equalization scheme is simply designed to divide the pie among the states. Canada's gross scheme determines both the size and division of the pie and is inherently more risky for the federal government. Specifically, if disparities between provinces grow, the size of federal equalization transfers also grows, increasing pressure on the federal treasury. In Australia's net scheme, increased equalization for one state is exactly offset by reduced equalization for another.

To deal with this risk, the Canadian federal government has put in place ad hoc measures to limit the growth of the program (the ceiling) and has moved from an all-province to a five-province standard, which has the effect of excluding the main energy-producing province. To offset revenue risks to the provinces, the program includes a floor provision that limits the amount that equalization transfers can drop in any one year.

Formally, the equalization program is the responsibility of the federal government and the program and its corresponding legislation is reviewed every five years. In the interim, officials from the federal government and the provinces meet on a regular basis to review the

working of the program and to conduct ongoing research on possible modifications that may be discussed when federal and provincial ministers of finance meet.

PART 6: SUMMARY

The main findings of this brief essay are easily summarized. The division of spending and revenue responsibilities in mature federations are primarily determined by the federation's constitution and influenced by convention and the history of judicial interpretations. As Australia and Canada demonstrate, successful federations can operate with very different divisions of spending responsibilities and degrees of revenue centralization.

If revenue responsibilities are relatively centralized and spending responsibilities are not, significant vertical imbalances will exist. Imbalances between national and provincial governments as a whole are corrected with transfers that can take the form of conditional and unconditional grants. In Canada, where vertical imbalances are relatively small, such transfers (i.e., CHST) are generally unconditional. In Australia, where vertical imbalances are relatively large, such transfers are both conditional (i.e., Specific Purpose Payments) and unconditional (i.e., proceeds of the GST).

Horizontal imbalances, imbalances between provincial governments, are also an important issue in federations. Both Australia and Canada have well-developed schemes to address horizontal imbalances and such schemes are professionally administered and regularly reviewed. A key difference between the two schemes is the fact that Australia's is a net scheme while Canada's is a gross scheme. This difference has significant implications for the amount of "fiscal risk" faced by the national government. To deal with the extra risk inherent in a gross equalization scheme, the Canadian federal government has put in place a number of ad hoc features.

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1. Different federations use different names for national and regional governments. In this article I use the general term “provinces” to denote regional government.

2. A number of reference works were used in the development of this section. See Boadway (1999), Boothe (1996) and Commission on Fiscal Imbalance (2000).

3. See Watts (1999) for a discussion of the spending power in federations.

4. For a discussion of the Canadian transfer system, see Rosen et al. (1999), chap. 6. Serle (2002) gives an up-to-date account of the Australian system.

5. The 2000 tax reform also gave the states guarantees that transfers would not fall below specified levels.