

Australia: Equity, Imbalance, and Egalitarianism

Alan Morris

Australian fiscal federalism is clearly defined by two distinguishing features: (1) the extent of vertical fiscal imbalance within the federation, and (2) a detailed and comprehensive approach to horizontal fiscal equalization, which guides the distribution of funding transfers between the federal, or Commonwealth, government and the states and territories. While the origins of fiscal federalism in Australia go back to the founding of the federation and the Constitution enacted at that time, these two features owe much more to the historical evolution of practice than they do to the original principles of the Constitution.

The Australian Constitution does not differ markedly from most federations with regard to the powers of the Commonwealth and state governments. As set out in the Constitution, defence, foreign affairs, international trade, customs, and currency are managed by the Commonwealth government. Matters not specifically vested in the Commonwealth government, such as health, education, and law and order, are the responsibility of the states. The Constitution also defines the respective revenue-raising powers of the Commonwealth and state governments - including the fact that the Commonwealth government may grant financial assistance to any state on such terms and conditions as it sees fit.

But since the enactment of the Constitution in 1901, the allocation of taxing powers has changed significantly. **As a result of decisions taken at times of historical crisis and a series of High Court rulings, the fiscal dominance of the federal government has greatly increased at the expense of the states.**

The Commonwealth government now raises substantially more revenue than it needs to meet its own expenditure obligations, while state and territory governments raise substantially less. This disparity between revenue-raising capacity and expenditure obligations produces what federal financial analysts call a situation of “vertical fiscal imbalance” between the two orders of government. Currently, the Commonwealth government raises about 80 percent of all government revenue, but requires only 61 percent of the pie to meet its own expenditure needs, while state and territory governments raise just 17 percent of all revenue, but require 33 percent - twice that amount - to meet their expenditure responsibilities.

The fiscal dominance of the Commonwealth government, and the way it has used its fiscal strength to intervene in areas that have traditionally been the prerogative of the states, has come to have implications for responsibility of government functions. In some areas, the roles and responsibilities of different spheres of government have become blurred, giving rise to duplication, overlapping, and cost-shifting.

Many think that the vertical fiscal imbalance in Australia is too large and has unwelcome implications for accountability, and weakens the motivation for fiscal reform. Tax bases are accessed almost exclusively by one sphere of government, with the Commonwealth government having access to the more important tax bases, most notably the direct tax bases of personal and company income. Suggestions for improvement include that the Commonwealth government make room to allow the states and territories to “piggy-back” on this tax base by reducing its own tax rate. Other changes that would make a positive contribution include reform and strengthening of state tax bases (particularly in the area of land tax) and harmonization of the relevant tax bases across the states.

The extent of vertical fiscal imbalance in the Australian federation raises the question of whether the concept of an optimum fiscal gap should be explored. While vertical fiscal imbalance in Australia might be considered undesirably large, some degree of centralization of tax powers provides a national fiscal capacity to undertake national objectives and priorities.

The large vertical fiscal imbalance means that the transfer of funds from the Commonwealth government to the states to enable them to meet their expenditure needs is a critical issue. The principle and practice of horizontal fiscal equalization under which the transfers of untied grants are made to the states and territories is the second distinguishing feature of Australian fiscal federalism. The objective is to equalize the fiscal capacities of the state and territory governments, and the current approach is based on a comprehensive assessment of their relative revenue capacities and expenditure needs.

These transfers are considerable, totalling about \$58 billion Australian dollars per year, and comprise, on average, over 50 percent of total state revenue, up from about 10 percent in the 1950s. They are critical to state budgets. A significant proportion of the transfers from the Commonwealth government to the states and territories, currently of the order of 40 percent of total transfers, take the form of Specific Purpose Payments (SPPs). These are tied grants for designated purposes, essentially to support specific national priorities in areas such as health and education, and typically come with strings attached. Some observers see this as undermining genuine subsidiarity, competitive federalism, and the development by the states of more efficient ways of funding and delivering services, and hence effectively undermining the benefits of federalism.

The untied transfers which, since the tax reform initiatives in 2000 and the *Intergovernmental Agreement on Reform of Commonwealth-State Financial Relations* between the Commonwealth and the states, have comprised the revenue raised from the goods and services tax (GST), can be spent by the states and territories in whatever way they choose. The size of the untied federal transfers raises the question of mutual obligation and accountability. There is no obligation on state and territorial governments to spend the grants in any particular way, or to justify the basis of that assessment in their expenditure decisions and priorities. There are indeed discrepancies between assessed expenditure needs and actual levels of spending in particular areas. The lack of monitoring of expenditures, even though this is fundamental in a system of untied grants, is a frequent basis of criticism of state spending choices.

While horizontal fiscal equalization is generally accepted as the guiding principle for the distribution of untied grants to the states and territories, its implementation continues to be sensitive and contentious. Some states argue that the process has become too complex and detailed, and that many of the differential assessments of state revenue capacities and expenditure needs do not reflect real, material differences in state circumstances.

The Australian approach to fiscal equalization indicates that Australians do not want the type and extent of regional disparities that exist in some other federations. This approach allows the various jurisdictions to determine their own local choices and preferences. It is a particular concept of equity that can perhaps best be described as aiming to deliver fairness rather than equality. And it is generally agreed that a fiscal federal system set in stone would not necessarily remain appropriate in another time.