

# Fiscal Federalism: Theory & Practice in Australia

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# OVERVIEW

- Constitutional assignment of functions, tax powers and fiscal transfers
- The underlying principles of this assignment
- Australian federalism in practice today
- How this change has occurred
- Australian innovations in fiscal coordination
- Overall assessment
- How Australian experience may be of interest to Brazil

# CONSTITUTIONAL FEDERALISM IN AUSTRALIA

- Australia became a federation in 1901.
- Six self-governing British colonies agreed to establish a national level of government (Commonwealth); the two Territories gained the status equivalent to States (NT in 1978 and ACT in 1989).
- The Constitution assigned only a limited number of functions to the Commonwealth in Section 51 (e.g., Defence, Currency, Foreign Affairs & Trade), while the States retained the remaining functions.
- The method of amendment of the Constitution is prescribed in the Constitution (Section 128) and requires the Commonwealth to hold a referendum that must be supported by: (i) a majority of voters (ii) in a majority of States (i.e., 5 out of 8 States & Territories).
- Since 1901, the Constitution has been amended only six times.

# AUSTRALIAN FEDERALISM TODAY

- Australian federalism today is very different from its Constitutional origins
- Much of this change has also occurred without Constitutional amendment
- High Court interpretations of the Constitution have narrowed State tax powers, excluding them from taxation of incomes and consumption. This has created a severe VFI in Australia, making States highly dependent on fiscal transfers
- Nearly half of fiscal transfers are for general purposes and are distributed on the principle of horizontal fiscal equalisation
- The rest are for specific purposes, such as health, education and infrastructure, that are distributed according to specific intergovernmental agreements.
- Australian Labor Party believes in a strong role for national government and has been opposed in the past to the federal model

# TAX REVENUE BY LEVEL OF GOVERNMENT

Commonwealth	States	Local
Total tax receipts 2016-17 \$382.8b (80%)	Total tax receipts 2015-16 \$79.1b (16.5%)	Total tax receipts 2015-16 \$16.6b (3.5%)
Composition of respective total 'own' tax revenue		
Personal Income Tax = 51%	Land & nat. resources = 41.7%	Property taxes = 100%
Company incomes tax =18%	Payroll tax = 28.7%	
GST = 16%	Insurance, and other service taxes = 15%	
Customs & excise duties = 10%	Gambling, motor vehicle use, stamp duties = 14.6%	

# CURRENT SHARES OF TAX REVENUE

Level of government	Share of tax revenue (% of total)
Commonwealth	81
States and Territories	15
Local government bodies	3
Corresponding figures for Brazil: Federal (65%); States (27%) and Local government (8%)	

# TAXATION STRUCTURE: INEFFICIENT & COMPLEX

- Australia raises 90% of taxation revenue from 10 taxes.

These include: personal and company income taxes; GST, Payroll tax; Fuel excise; Local property rates; conveyance stamp duties; Superannuation tax; Land tax and Tobacco excise.

- The remaining 115 taxes together raise only 10% of tax revenue.

Many of these are levied by the States.

- Tax reforming is needed to improve government accountability, and reduce system complexity and business compliance costs.

# FISCAL TRANSFERS AND EQUALISATION

- Fiscal transfers of around 21% of Commonwealth revenue are made to the States, nearly one half for general purposes ('untied') and rest for specific purposes ('tied').
- The general purpose transfers have been distributed on fiscal equalisation principle since 1936 to support less populous States of Queensland, SA, Tasmania, NT and ACT.
- Commonwealth Grants Commission (CGC), established in 1933, developed its methodology to ensure that:
  - revenue-raising capacity is equalised to enable all States to provide equivalent range and standard of public services; and
  - differences in per capita costs of services due to dispersion, Aboriginality and age composition of population are also equalised.
- Germany and Canada also have revenue capacity equalisation schemes, but Australia goes further by also equalising costs of government services.



# DISTRIBUTION OF GENERAL PURPOSE PAYMENTS: 2016-17

Shares of population (%)		Equalisation shares (\$M)	Equal per capita shares (\$M)	Difference (\$M)
NSW	[31.98]	17335	19138	-1803
VIC	[25.61]	13959	15326	-1367
QLD	[20.03]	14055	11987	+2068
WA	[10.53]	1914	6301	- 4388
SA	[7.04]	5979	4213	+1766
TAS	[2.13]	2267	1275	+992
NT	[1.00]	3182	598	+2584
ACT	[1.67]	1155	999	+156
TOTAL		59845	59845	0.00

# SPECIFIC PURPOSE PAYMENTS 2016-17

Purpose	\$ million
Education	19,612
Health	19,779
Transport & communication	7,394
Social security & welfare	2,113
Housing & community amenities	1,791
Agriculture, forestry & fishing	400
Other	4,039
<b>TOTAL SPECIFIC PURPOSE PAYMENTS</b>	<b>55,128</b>

# ECONOMIC PERSPECTIVES ON FEDERALISM

Main Contributors	Key Messages	Possible indirect insights into Evolution
<b>TRADITIONAL THEORIES OF FISCAL FEDERALISM</b>		
<i>Public Goods Theory</i> C. Tiebout, A. Breton, W. Oates, and M. Olson Jr.	Hierarchical system of governments matching hierarchy of public goods	Changing spatial boundaries of public goods may impact on the rise and fall of centralisation
<i>Coordination Costs Theory</i> A. Breton & A. D. Scott	Fiscal decentralisation would raise coordination costs	Periodic reassignment of functions may be necessary to keep coordination costs low
<i>Public Choice Theory</i> J. Buchanan, G. Tullock & G. Brennan	Federalism reduces coercion by constraining centralisation of power over taxation	Centralisation of taxation power breeds coercion. Voters can escape coercion via fiscal decentralisation
<b>SECOND GENERATION THEORIES OF FISCAL FEDERALISM</b>		
<i>Market Preserving Federalism</i> B. Weingast; Qian & Weingast	Competition and hard budget constraints are key sources of efficiency	Search for greater efficiency should lead to lower VFI and lower fiscal transfers
<i>Incomplete Contracts Theory and Federalism</i> Hart, Seabright, Grewal & Sheehan	Contractual uncertainty impacts on governments' objective functions and increases the benefits of fiscal control.	Power over taxation is a potent source of power over spending and political influence

# HARD BUDGET CONSTRAINTS FOR EFFICIENCY

- The public goods theory and public choice theory of federalism do not say much about the incentives generated by fiscal transfers.
- Fiscal transfers are not favoured by the market preserving federalism (MPF) because transfers can produce fiscal dependency.
- Accordingly, MPF theory advocates that all governments must face hard budget constraints and no government should expect to be bailed out by another.
- In reality, however, fiscal transfers for horizontal fiscal equalisation would still be required to assist fiscally weaker states, but in such a manner that fiscal discipline is not undermined.
- If fiscal transfers are rule-based, rather than discretionary, and if the threat of 'no bailouts' is credible the possibility of perverse incentives can be minimised.

# INTERGOVERNMENTAL CO-ORDINATION: IMPORTANT FORUMS

- Australian Loan Council since 1927
  - For co-ordinated government borrowing
- Premiers' Conference -> COAG since 1992
  - For co-ordination across entire range of functions
- Commonwealth Grants Commission since 1933
  - For horizontal fiscal equalisation
- National Tax Summit in 1985
  - For taxation reform
- Special Premiers' Conference 1990-91
  - For fiscal federalism reforms

# INTERGOVERNMENTAL CO-ORDINATION: AUSTRALIAN EXPERIENCE

- Intergovernmental co-ordination in Australia is mostly vertical co-ordination
  - It involves the Commonwealth Government
  - This is because there is not much of horizontal co-ordination among the States alone
  - States have a history of antagonism which still casts it shadow on co-ordination efforts (e.g., for the management of interstate waterways)
  - Co-ordination always has the risk of becoming too intrusive and cumbersome
  - There is also the real risk of co-ordination degenerating into centralisation

# CO-ORDINATION CAN BECOME TOO MUCH OF A GOOD THING

- The National Commission of Audit was established in 2013 to make recommendations about the roles, responsibilities and duplication in functions of Commonwealth and States.
- It found that COAG architecture had become cumbersome.
- There were more than six National Agreements with States, 51 National Partnership Agreements and 230 Implementation Plans.
- The National Health Reform Agreement alone included 22 outcomes, 26 measures, 15 outputs, 70 indicators, and 7 performance benchmarks for reporting.
- After the NCA recommended, the COAG Reform Council was abolished from 30 June 2014, with residual monitoring functions shifting to the Productivity Commission.

# CO-OPERATIVE FEDERALISM OR CENTRALISATION?

- There are many examples of beneficial outcomes of intergovernmental cooperation in Australia and other federations. But, cooperation between unequal partners does not always have a happy ending.
- After a careful review of Australia's experience, Justice French (later Chief Justice of the High Court, concluded in following terms:
- “Essentially co-operative federalism is extra constitutional” and “driven by political imperatives”. “It yields results on a consensual basis which go well beyond those achievable by the exercise of Commonwealth legislative power and the separate exercise by the States”
- “although cooperative, it contributes towards centralization”
- *“The pressure seems to be in one direction only. ...*
- “For, every topic which is treated as national becomes potentially a matter which, somewhere along the line, it can be argued is best dealt with by a national government.”

(Justice Robert French, 2008)



# FIXING THE VERTICAL FISCAL IMBALANCE

- The NCA reported in 2014) that the best option for removing duplication and overlap was to remove the vertical fiscal imbalance by providing States access to personal income tax.
- NCA also noted that the Commonwealth-State Working Party on Tax Powers had reported to the Special Premiers' Conference in 1991 that the States should be given access to income taxes and that the Commonwealth should reduce its income tax rate to make 'tax room', so that overall tax burden does not change.

[Note: I had the privilege of being a member of this 1991 Working Party.]

# POWER OVER REVENUES

- Speaking against the proposal to give the States power over income tax, Mr Paul Keating, a former Prime Minister and Commonwealth Treasurer of Australia, said this about the power over revenue:

“Economic management has had to develop from the Commonwealth’s power over revenue and the creation of a monetary authority. The national perspective dominates Australian political life because the national government dominates revenue raising and only because the national government dominates revenue raising.” (Keating, *Address to the National Press Club*, October, 1991)

- As a result of such opposition, Commonwealth Government withdrew its support from the proposed reform of VFI.

# INDEPENDENT RESEARCH ON FEDERALISM

- Like some other countries, Australia also established in 1973 a dedicated centre at the Australian National University for undertaking research on federalism. The CRFFR produced large volume of monographs, reports and books until it was abolished in 1995.
- Also set up in 1978 was the Advisory Council on Intergovernmental Relations (ACIR) in Hobart. This too was closed by the Commonwealth Government in 1990s.
- As a result, Australia now has no research centre or institute that is dedicated to undertaking research on federalism.
- As the entire expertise in this field now resides in Commonwealth or state government departments, its impartiality on certain issues cannot be guaranteed.

# OVERALL ASSESSMENT

- Australia's federation started in 1901 with a weak Commonwealth Government and stronger States. Within the first fifty years, the States had lost legislative authority over income tax and sales taxes and had become heavily reliant on Commonwealth financial assistance.
- From 1942 onwards, the Commonwealth has become more involved in State functions, partly to occupy the policy space for social services, but also because States have inadequate revenues.
- Hard budget constraints are mostly observed by all levels of government now, but the principle of subsidiarity has suffered.
- Intergovernmental co-ordination has generally worked well, although duplication of roles results has resulted in loss of accountability and waste.
- No dedicated institute or centre for research on federalism since mid-1990s.

# RELEVANCE TO BRAZIL

- VFI and State taxation
  - Thanks to VFI, Australian States have been forced to rely on inefficient taxes, such as stamp duties, gambling taxes, and payroll taxes.
- Fiscal equalisation
  - Australian equalisation system is unnecessarily complex
  - Equalisation of costs of government services can create perverse incentives
- Tied Grants
  - SPPs in Australia have become a breeding ground for wasteful duplication of roles and opaque accountability.
- Co-ordination
  - Intergovernmental co-ordination must be encouraged, but it also tends to favour centralisation.

# CONCLUSION

- Federations are best examples of economic democracy.
- Federal constitutions always evolve over time and the trajectory of such evolution is shaped by both internal and external factors.
- The nature of ‘public goods’ also changes over time, requiring appropriate responses from federal or subnational governments.
- Revenue adequacy of each level of government plays a crucial role in sustaining the federal structure over the longer term. It can also improve the quality of intergovernmental coordination.

# THANK YOU

COMMENTS AND SUGGESTIONS ARE WELCOME

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