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## Developments in Commonwealth–state financial relations since 2000–01

1 July 2000 saw major changes to Commonwealth–state financial relations, notably, the introduction of the goods and services tax and the payment of the revenue from this tax to the states. This Research Brief examines developments since the changes were implemented and some issues in Commonwealth–state financial relations.

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## Glossary

**Budget balancing assistance.** The difference between a state's guaranteed minimum amount and its goods and services tax (GST) related payment. Under the *Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations*, the Commonwealth undertook to make, for a transitional period, assistance payments if a state's GST entitlement were less than its guaranteed minimum amount. Budget balancing assistance is thus the means whereby the Commonwealth ensures that the state is no worse off than it was before the GST was introduced.

**Commonwealth Grants Commission (CGC).** The independent statutory authority responsible for recommending the distribution of GST revenue (and health care grants) among the states. The CGC bases its calculations of the relativities used in its recommendations on the horizontal fiscal equalisation principle.

**General revenue assistance.** Grants that the Commonwealth provides to the states (and local government) that the recipients can spend as they wish. Revenue from the GST is the main component of general revenue assistance. The other components are budget balancing assistance and National Competition Policy Payments.

**Guaranteed minimum amount.** In paragraph 10 of the *Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations*, the Commonwealth undertook that in each of the transitional years following the introduction of the GST, the Commonwealth would guarantee that the budgetary position of each individual state and territory would be no worse off than it would have been had the reforms set out in the Agreement not been implemented.

**Horizontal fiscal equalisation.** The provision of financial assistance to the states which, as assessed by the Commonwealth Grants Commission, is designed to provide each state with the capacity to provide services at a comparable standard with those of the other states but without requiring that state to impose a greater burden of taxation.

**Inefficient tax.** Efficiency refers to the desirability of a 'neutral' effect of a tax on economic behaviour such as decisions whether to consume or save. In general, efficiency can be improved by broadening the base on which the tax is imposed and by flattening its rate structure. Some state taxes fail the efficiency test because the bases on which they are imposed are narrow and the rates vary considerably.

**Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations.** The agreement between the Commonwealth and the states that governs Commonwealth–state financial relations. The Agreement was introduced mainly to take account of the introduction of the GST.

**Specific purpose payments.** Payments the Commonwealth makes to the states under section 96 of the Constitution for the purposes, and on such terms and conditions, as the Commonwealth may specify. An example is the grants to the states under the Australian Health Care Agreements to assist with the provision of public hospital services free of charge to eligible persons.

**Vertical fiscal imbalance.** The imbalance between the spending responsibilities of each tier of government and its own sources of revenue. Australia has a relatively high degree of fiscal imbalance compared with other federal systems: the states have relatively large constitutionally-assigned spending responsibilities but relatively few own-revenue sources while the reverse is true at the Commonwealth level. Inter-governmental grants are designed to provide the tiers of government with relatively large spending responsibilities but small own-source revenues with funds to enable them to provide services.

## Executive summary

The framework for Commonwealth–state financial relations is the [\*Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations\*](#) (the Agreement). This provides, among other things, that:

- the states can spend GST-related payments as they wish
- revenue from the GST is to be distributed among the states on horizontal fiscal equalisation principles
- the Commonwealth will, for a transitional period, ensure that no state is worse off under the new arrangements than under the old arrangements—the ‘guaranteed minimum amount’ undertaking
  - this undertaking is due to expire on 30 June 2006
- should a state’s guaranteed minimum amount fall short of its GST entitlement, the Commonwealth will make up the difference by providing ‘budget balancing assistance’ to that state
- the states will abolish certain taxes by specified dates, and
- the Ministerial Council for Commonwealth–State Financial Relations will, by 2005, ‘review’ the need to retain certain stamp duties.

Since 1 July 2000 when the GST was introduced, the main forms of Commonwealth financial assistance to the states have been GST-related payments, budget balancing assistance, National Competition Policy payments and Specific Purpose Payments. The Commonwealth makes National Competition Policy payments to the states for implementing National Competition Policy and related reforms, and makes Specific Purpose Payments to the states as a financial contribution to areas of state responsibility—such as housing—in pursuit of its own specified policy goals.

Beginning in 2002–03, the states, in aggregate, have benefited under the new arrangements in that the amount of GST payments they have received has exceeded the amount they would have received under the old system. However, these ‘gains’ have been distributed unequally, with Queensland gaining the most (in dollar terms) principally at the expense of NSW but also Victoria. The main reason for the uneven distribution is the application of the horizontal fiscal equalisation principle, on which the Commonwealth Grants Commission bases its calculations of the relativities used to determine each state’s GST entitlement.

A positive outcome of the new arrangements is that some economically inefficient state taxes have been abolished. The taxes were bed taxes, financial institutions duty, stamp duty on marketable securities, and debits tax. On the other hand, the abolition of state taxes has

reduced state own-source revenue and increased the states' reliance on the Commonwealth for revenue.

The review of stamp duties took place on 23 March 2005. The Commonwealth Treasurer contended that the intent of the *Agreement* was that the duties should be abolished and proposed a timetable for their abolition. The Treasurer also argued that the states could afford the proposals on the grounds that they would be better off even after abolition. The states rejected the Commonwealth's proposals. However, the Commonwealth agreed to consider a counter-proposal from the states. On 20 April 2005, the states—except NSW and WA—submitted a proposal that commits them to abolish, by no later than 1 July 2010, most of the duties. WA rejects what it says is Commonwealth interference in what is a matter for the state to decide but will consider abolishing business taxes after review. The Commonwealth has offered NSW additional assistance to encourage that state to abolish the duties. But NSW has decided not to abolish any of the duties, arguing that NSW is still expected to use all its GST gains to finance the abolition of the taxes, and that abolition would impose unsustainable costs on the NSW Budget. However, competitive pressure from the other states as they abolish duties may force NSW and WA to follow suit.

The *Agreement* states that the Commonwealth has no intention of cutting aggregate Specific Purpose Payments. But this undertaking does not commit the Commonwealth to not cut Specific Purpose Payments, and 'cutting' is not defined. Still, the Commonwealth is meeting its undertaking when measured in real per capita terms.

Over the years, the Commonwealth has used its power to provide Specific Purpose Payments to intervene in areas traditionally the preserve of the states such as health and education. The states complain that the conditions under which the Commonwealth provides Specific Purpose Payments are becoming increasingly inflexible. For its part, The Commonwealth argues that the states must become more accountable for the funds the Commonwealth provides.

The introduction of the GST has increased vertical fiscal imbalance, already the greatest of any federal political system. This is likely to reinforce the trend towards Commonwealth involvement in formerly state-only functions.

## Introduction

1 July 2000 saw major changes to Commonwealth–state financial relations, notably, the introduction of the goods and services tax (GST) and the payment of the revenue from this tax to the states.<sup>1</sup> This Research Brief examines developments since the changes were implemented and some issues in Commonwealth–state financial relations. References to the states should be read as the states and territories.

## Intergovernmental Agreement

The framework for Commonwealth–state financial relations is the *Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations* (the *Agreement*). It is a Schedule to [A New Tax System \(Commonwealth-State Financial Relations\) Act 1999](#), which governs Commonwealth–state financial relations. The *Agreement* provides, among other things, that:

- the Commonwealth will pay to the states all the revenue it collects from the GST (less administrative costs)
- the states can spend the GST-related grants as they wish
- the GST-related payments will be distributed among the states on horizontal fiscal equalisation principles
- the Commonwealth will, for a transitional period—that will expire on 30 June 2006—ensure that no state is worse off under the new arrangements than under the old arrangements—the ‘guaranteed minimum amount’ undertaking
- should a state’s guaranteed minimum amount fall short of its GST entitlement, the Commonwealth will make up the difference by providing ‘budget balancing assistance’ to that state
- the states will abolish bed taxes, financial institutions duty, stamp duty on marketable securities, and debits tax by specified dates, and
- the Ministerial Council for Commonwealth–State Financial Relations will, by 2005, ‘review’ the need to retain certain stamp duties.

## Grants to the states

Since 1 July 2000, Commonwealth financial assistance to the states has taken the forms of:

- payments of the revenue from the GST
- budget balancing assistance (BBA)
- National Competition Policy (NCP) payments, and
- Specific Purpose Payments (SPPs).

Payments of the revenue from the GST, BBA, and NCP payments are often called ‘general purpose payments’ because the states can spend them as they wish.

In addition, in 2000–01, the Commonwealth paid residual revenue replacement payments (RRPs).<sup>2</sup> From 2000–01 to 2004–05, the Commonwealth also paid special revenue assistance (SRA) to the ACT to compensate it for financial disadvantages it incurs as the nation's capital. In the 2004–05 Budget, the Commonwealth announced that SRA would cease from 1 July 2005.

Table 1 shows the amounts the Commonwealth has paid since 2000–01.

**Table 1: Commonwealth financial assistance to the states since 2000–01 (\$million)**

Year	General purpose payments						SPPs	Total
	GST	BBA	Deferred GST <sup>a</sup>	NCP	RRP	SRA		
2000–01	24354.9	2818.1		448.0	434.9	13.5	<b>28069.4</b>	<b>19098.0</b>
2001–02	26632.0	4093.8		733.3		14.2	<b>31459.1</b>	<b>20955.2</b>
2002–03	30479.1	994.0		739.9		14.7	<b>32213.0</b>	<b>21501.7</b>
2003–04	33218.7	68.8		578.5		15.0	<b>33881.0</b>	<b>22571.9</b>
2004–05	35322.7		219.4	724.4		14.2	<b>36280.7</b>	<b>24498.6</b>
2005–06	37340.0		127.0	799.2			<b>38266.2</b>	<b>26091.0</b>

Sources: Final Budget Outcome various years. Budget Paper No. 3 2005–06.

Notes: data for 2005–06 estimated. <sup>a</sup> compensation for GST deferral.

## Payments of GST revenue

GST-related grants are the main component of general purpose payments. Table 2 shows the grants paid to the states since 2000–01.

**Table 2: Payments to the states of revenue from the GST 2000–01 to 2005–06 (\$ million)**

	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	Annual increase (per cent)
NSW	7257.6	8132.0	9080.2	9667.1	9884.1	10426.7	7.6
VIC	5099.3	5593.1	6365.1	6961.0	7346.4	7864.5	9.1
QLD	4658.2	5018.6	5887.6	6552.8	7328.7	7721.1	10.7
WA	2374.6	2518.1	2910.2	3157.9	3623.9	3822.1	10.1
SA	2278.9	2476.6	2859.1	3146.4	3293.3	3449.0	8.7
TAS	988.1	1059.8	1246.7	1394.5	1435.5	1501.4	8.9
ACT	472.6	543.9	615.7	658.1	680.4	722.6	9.0
NT	1225.6	1289.8	1514.5	1680.9	1730.4	1832.7	8.5
<b>Total</b>	<b>24354.9</b>	<b>26632.0</b>	<b>30479.1</b>	<b>33218.7</b>	<b>35322.7</b>	<b>37340.0</b>	<b>9.0</b>

Sources: Budget Paper No. 3, 2005–06, p. 7. Final Budget Outcome various years.

Notes: data for 2005–06 are estimated. Cash basis.

Table 2 shows that while GST-related payments have risen at an average annual rate of nine per cent, the rate of increase has differed among the states with Queensland experiencing the fastest rate (10.7 per cent) and NSW the least rapid (7.6 per cent).

## Gains to the states

Beginning in 2002–03, the states have, in aggregate, benefited under the new arrangements in that the amount of GST they have received has exceeded the amount they would have received under the old system—the guaranteed minimum amount (see Box).

### Box: Guaranteed minimum amount

The method used to calculate a state's guaranteed minimum amount is set out in appendix C of the *Agreement*. The main components of the calculation fall into two broad categories: revenue the states have forgone, and compensation for additional expenditures that the states have incurred as a result of the *Agreement*. The former include financial assistance grants—which are roughly equivalent to about two-thirds of the total of the guaranteed minimum amounts—revenue replacement payments, revenue from the taxes abolished under the *Agreement*, and reduced revenue from gambling taxes. The latter include the cost of the First Home Owners Scheme (which the states took over from the Commonwealth) and GST administration costs.

The 'gain' to each state is the excess of its entitlement to GST-related grants over its guaranteed minimum amount. The gains are shown in Table 3.

Table 3: Gains to the states (\$ million)

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
2000–01	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2001–02	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2002–03	0.0	0.0	76.2	0.0	0.0	0.0	0.0	9.8	86.0
2003–04	0.0	126.6	503.5	156.6	99.2	69.5	38.8	111.6	1105.8
2004–05	208.5	296.0	769.0	249.9	175.2	106.1	55.6	140.9	2001.2
<b>Total</b>	<b>208.5</b>	<b>422.6</b>	<b>1348.7</b>	<b>406.5</b>	<b>274.4</b>	<b>175.6</b>	<b>94.4</b>	<b>262.3</b>	<b>3193.0</b>

Source: Final Budget Outcome: 2000–01, p. 49; 2001–02, p. 47; 2002–03, p. 55; 2003–04, p. 55; 2004–05, p. 61.

Note: a zero indicates that the state received only its guaranteed minimum amount, that is, the state's GST entitlement was less than its guaranteed minimum amount so the Commonwealth had to pay budget balancing assistance.

## Horizontal fiscal equalisation

Table 3 shows that the gains have been distributed unequally, with Queensland the first to gain and NSW the last. Consequently, NSW's aggregate general purpose payments (that is, including GST) have grown more slowly than those of the other states.<sup>3</sup> The main reason for the uneven distribution lies in the application of the horizontal fiscal equalisation principle.<sup>4</sup>



The Commonwealth Grants Commission, which calculates the relativities that are used to determine each state's GST entitlement,<sup>5</sup> bases its calculations on the horizontal fiscal equalisation principle, which it defines thus:

State governments should receive funding from the pool of goods and services tax revenue and health care grants such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.<sup>6</sup>

The states have different revenue-raising capacities and different spending needs. For example, Western Australia and Queensland currently have a relatively large capacity to raise revenue from the mining industry compared with, say, Tasmania, while Queensland's rapid population growth means that that state has a relatively strong demand for associated services. The application of fiscal equalisation results in redistributions of resources from states with above-average capacity, to provide services to the other states. NSW and Victoria have long been 'donor' states in the sense that they have distributed resources to the other states.

Application of the relativities that the Commonwealth Grants Commission calculates to the revenue from the GST results in a difference between the amount of GST paid to a state and the amount the state would receive if GST were distributed on an equal per capita basis. Table 4 shows the estimated redistribution, per head of population, of the revenue from the GST (and health care grants) resulting from fiscal equalisation in 2005–06.

**Table 4: Effect of horizontal fiscal equalisation: per capita redistribution 2005–06 (\$)**

NSW	VIC	QLD	WA	SA	TAS	ACT	NT
-290.1	-274.5	97.5	55.7	449.5	1222.1	316.4	7217.3

Source: Budget Paper No. 3, 2005–06, p. 12.

Table 4 shows, for example, that each person in NSW is expected to redistribute resources worth \$290 to the other states. At the other end of the spectrum, each person in the Northern Territory is expected to receive resources worth \$7217.

Another way of indicating the redistribution of resources is to compare the amount of GST each state generates with the amount it receives back. The estimate of the resource transfer for 2005–06 that the NSW Treasury calculated is shown in Table 5.

**Table 5: GST generated and GST grants received, by state, 2005–06 (\$ billion)**

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT
Generated	13.2	9.6	6.7	3.4	2.6	0.8	0.7	0.3
Grants	10.4	7.9	7.7	3.8	3.4	1.5	0.7	1.8
<b>Cross subsidy</b>	<b>(2.8)</b>	<b>(1.7)</b>	<b>1.0</b>	<b>0.4</b>	<b>0.6</b>	<b>0.7</b>	<b>0.0</b>	<b>1.5</b>

Source: NSW Budget Paper No. 2, 2005–06, p. 8–17.

On 24 February 2006, the Commonwealth Grants Commission [released](#) the 2006 update of the relativities. The Commission found:

Over the five years examined in this update, the Commission's calculations have tracked a significant shift in the relative fiscal capacities of the States. Notable has been a strengthening of the capacity of Queensland and Western Australia. Indeed, by the end of the update period, those two States join New South Wales and Victoria in needing a less than average per capita share of the GST pool to provide average services to their residents.

The change in annual fiscal capacities is reflected in the fiscal capacities of the States averaged over the five years (the method used to calculate relativities and to allocate the GST pool). The relativities of Queensland and Western Australia move closer to the Australian average, though still above it, and closer to those of New South Wales and Victoria. As a consequence, Queensland and Western Australia should receive smaller shares of the GST pool in 2006-07 than they did in 2005-06. The convergence in relativities also means that the proportion of the GST pool needed to achieve horizontal fiscal equalisation is falling.<sup>7</sup>

## Abolition of state taxes: state of play

The states abolished bed taxes, financial institutions duty, stamp duty on marketable securities, and debits tax as required by the *Agreement*; in 2004–05, the estimated revenue forgone from these taxes exceeded \$2.4 billion.<sup>8</sup>

As noted, the *Agreement* also provides for a 'review' of the need for the states to retain stamp duty on certain transactions. The duties are those on:

- non-residential (that is, business) conveyances
- non-quotable marketable securities
- leases
- mortgages, bonds, debentures and other loan securities
- credit arrangements, instalment purchase arrangements and rental arrangements, and
- cheques, bills of exchange and promissory notes.

The review took place at the Ministerial Council meeting (also called the Treasurers' Conference) on 23 March 2005. The Commonwealth Treasurer, the Hon. Peter Costello, contended that the intent of the *Agreement* is that the duties should be abolished and proposed the following timetable for abolition:

- on 1 July 2006, the abolition of duty on non-quotable marketable securities; leases; mortgages, bonds, debentures and other loan securities; credit arrangements, instalment

purchase arrangements and rental arrangements; and cheques, bills of exchange and promissory notes, and

- on 1 July 2007, the abolition of duty on business conveyances other than real property (land).<sup>9</sup>

The Treasurer also proposed that the duty on business conveyances of real property cease from a date to be determined by the Ministerial Council on the basis that no state would be worse off in any year. To encourage the states to adopt these proposals, the Treasurer further proposed extending the transitional period for the guaranteed minimum amount for another two years, that is, from 30 June 2006 to 30 June 2008.<sup>10</sup>

The Treasurer argued that the states could afford the proposals on the grounds that they would be better off even after abolition. According to the Treasurer, the gains to the states—that is, the excess of their GST entitlements over their guaranteed minimum amounts—over the five years from 2005–06 will be about \$16 billion while the revenue the states forgo would be \$8.8 billion, leaving them better off by about \$7.5 billion.<sup>11</sup>

The states rejected the Commonwealth's proposals. However, the Commonwealth agreed to consider a counter-proposal from the states. On 20 April 2005, the states—except NSW and WA—submitted a proposal that commits them to abolish, by no later than 1 July 2010, duties on non-quotable market securities; leases; mortgages, bonds, debentures and other loan securities; credit, instalment purchase, and rental arrangements; and cheques, bills of exchange and promissory notes.

With regard to business conveyances, the same states proposed the retention of duty on conveyances of real property but the abolition of duty on other (that is, non-real property) conveyances, for example, goodwill and intellectual property. Victoria, for example, does not support different treatment of residential and business real property and so supports retention of stamp duty on the latter.<sup>12</sup> The main reason for the position with respect to real business property conveyances is that this duty is a major source of revenue.

The proposals are summarised in Table 6. Note that some jurisdictions have already abolished or do not impose some of the duties listed for review, and that the timeframes differ among the states according to their perceived financial needs.

**Table 6: Timetable for the abolition of stamp duties**

Tax	VIC	QLD	SA	TAS	ACT	NT
Non-quotable marketable securities	1 July 2002	1 Jan 2007	50% 1 July 2009; 100% 1 July 2010	Already abolished	1 July 2010	1 July 2006
Leases	1 Apr 2001	1 Jan 2006		Already abolished	1 July 2009	1 July 2006
Mortgages, bonds, debentures, and other loan securities	1 July 2004	50% 1 Jan 2008; 100% 1 Jan 2009	33.3% 1 July 2007; 66.6 % 1 July 2008; 100% 1 July 2009	50% 1 July 2006; 100% 1 July 2007	Abolished 1 Sep 1987	Already abolished
Credit, instalment purchase, and rental arrangements	1 Jan 2007	<sup>a</sup> 1 Jan 2006; 1 Jan 2007 <sup>b</sup>	33.3% 1 July 2007; 66.6 % 1 July 2008; 100% 1 July 2009	Already abolished	1 July 2007	1 July 2007
Cheques, bills of exchange and promissory notes	Not imposed	Abolished 1 Jan 1994	Abolished 1 July 2004	Abolished 1 Jan 1985	1 Sep 1987	Already abolished
Business non-real property conveyances	Not imposed	50 % 1 Jan 2010; 100% 1 Jan 2011	50% 1 July 2009; 100% 1 July 2010	1 July 2008	1 July 2006	1 July 2009

Sources: ACT: Budget Paper No. 3, 2005–06, p. 8; NT: Budget Paper No. 2, 2005–06, pp. 36 and 64; QLD: Budget Paper No. 2, 2005–06, p. 81; SA: Budget Paper No. 3, 2005–06, p. 3.5; TAS: Budget Paper No. 1, 2005–06, p. 111; VIC: Budget Paper No. 2, 2005–06, p. 79; NSW Treasury, *Interstate Comparison of Taxes* 2005–06.

Notes: <sup>a</sup> credit business duty; <sup>b</sup> hire duty.

As noted, WA and NSW did not sign the counter-proposal. WA rejects what it says is Commonwealth interference in what is a matter for the state to decide.<sup>13</sup> However, WA will consider abolishing business taxes after it has reviewed them.

NSW has decided not to abolish any of the taxes under review. NSW argues that it cannot afford to abolish the duties without additional Commonwealth assistance on the grounds that it has the least financial capacity of any state to do so.<sup>14</sup> At the Treasurers' Conference, the Commonwealth offered NSW \$330 million budget balancing assistance over 2006–07 and 2007–08. NSW rejected the offer on the grounds that the duties are expected to generate revenue of around \$900 million in 2006–07, resulting in a net cost to its Budget.<sup>15</sup>

In the 2005–06 Budget, the Commonwealth boosted its offer to NSW. This entails increasing assistance to \$563 million over the three years 2006–07 to 2008–09.<sup>16</sup> However, the increase in assistance was due to parameter changes, which resulted in the estimates of GST revenue in the Commonwealth's Budget being lower than the estimates presented to the Treasurers' Conference. NSW also rejected the revised offer on the grounds that NSW is still expected to

use all its GST gains to finance the abolition of the taxes, and that the revised offer still imposes unsustainable costs on the NSW Budget.<sup>17</sup>

It remains to be seen how long NSW and WA can maintain their positions. The proposed abolition of taxes by the other states will put pressure on NSW and WA to do likewise, so it may be only a matter of time before NSW and WA are forced to yield ground as they compete to attract business.

## Specific Purpose Payments

The Commonwealth makes Specific Purpose Payments (SPPs) under Section 96 of the Constitution, which states:

During a period of ten years after the establishment of the Commonwealth and thereafter until the Parliament otherwise provides, the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit.

Examples are grants under the Australian Health Care Agreements and for land transport under AusLink.

Paragraph 5 (v) of the *Agreement* states:

The Commonwealth will continue to provide Specific Purpose Payments (SPPs) to the States and Territories and has no intention of cutting aggregate SPPs as part of the reform process ...

Several points about this undertaking are noteworthy.

First, it does not actually commit the Commonwealth not to cut SPPs. Second, ‘cutting’ is not defined. Cutting can be measured in several ways, for example, in nominal (dollar) terms, in real terms (that is, after adjusting for inflation), and in per capita terms (nominal and real). Finally, whilst it might be assumed that the undertaking is on a year-to-year basis, the undertaking does not prevent the Commonwealth from cutting aggregate SPPs in any one year on the presumption that it will make good the shortfall in later years.

When measured in nominal terms, the Commonwealth has met its undertaking in each year as shown in Table 7.

**Table 7: Specific Purpose Payments 1999–2000 to 2005–06 (\$ billion)**

Year	Total SPPs	Increase	Per cent increase in SPPs	Per cent change in price deflator for gross non-farm product
1999–00	17.71			
2000–01	19.10	1.39	7.84	4.5
2001–02	20.96	1.86	9.72	1.7
2002–03	21.50	0.55	2.61	3.4
2003–04	22.57	1.07	4.98	3.6
2004–05	24.50	1.93	8.54	4.6
2005–06 est.	26.09	1.59	6.50	4.0

Sources: Final Budget Outcome various years. Budget Paper No. 3, 2005–06.

Note: est.: estimated.

To ensure that the Commonwealth is abiding by the undertaking, the states have established a monitoring process (the Commonwealth has not officially endorsed this process). At the July 2004 Heads of Treasuries meeting, the states agreed that the undertaking should be measured in real per capita terms using the consumer price index to remove the effect of inflation. WA coordinates an annual report on the SPP undertaking. The most recent report found:

... the Commonwealth's SPP commitment has been comfortably met in each year to 2003–04, and is also expected to be met in 2004–05 and 2005–06 ...<sup>18</sup>

These conclusions should be treated cautiously if only because there is no 'correct' index that can be used to deflate SPPs. Further, even if the Commonwealth meets the undertaking in aggregate terms, a state could lose in real per capita terms depending on how SPPs are distributed among the states.

Over the years, the Commonwealth has used its power to provide SPPs to intervene in areas traditionally the preserve of the states such as health and education. The states complain that the conditions under which the Commonwealth provides SPPs are becoming increasingly inflexible. For its part, the Commonwealth argues that the states must become more accountable for the funds the Commonwealth provides.<sup>19</sup>

## National Competition Policy payments

While the Commonwealth had not agreed to make National Competition Policy (NCP) payments beyond 2005–06, it identified \$1.6 billion in the Budget estimates for 2006–07 and 2007–08 for that purpose.<sup>20</sup> However, during the 2004 election campaign, the Coalition indicated that it would instead apply this \$1.6 billion to the Australian Government Water Fund.<sup>21</sup> The states, for their part, complained that the decision pre-empted an undertaking that the Council of Australian Governments made in 2000 to review NCP payments.

## Vertical fiscal imbalance

Vertical fiscal imbalance refers to the relationship between the relative spending responsibilities of a tier of government and its capacity to raise revenue. In Australia, the states have relatively large constitutionally-assigned spending responsibilities but relatively few own-revenue sources while the reverse is true at the Commonwealth level. Before the GST was introduced, Australia had the greatest degree of vertical fiscal imbalance of any federation with the Commonwealth raising about 75 per cent of total general government revenue but being responsible for about only 60 per cent of total expenditure on government programs.<sup>22</sup> The degree of vertical fiscal imbalance has since risen: in 2003–04, the Commonwealth raised about 78 per cent of total government revenue and was responsible for about 65 per cent of total government expenditure.<sup>23</sup> In 2001, the comparable figures for Canada were 79 per cent and 77 per cent.<sup>24</sup>

The advent of the GST and the abolition of some state taxes contributed to the rise in the degree of vertical fiscal imbalance. A consequence is that the Commonwealth is becoming increasingly involved in policy formulation and funding of areas traditionally the preserve of the states. Indeed, the states frequently complain that the shift in revenue-raising power to the Commonwealth and their lack of own-source revenue have increasingly led to a situation where the Commonwealth is virtually able to dictate to the states the terms of SPPs.

On the other hand, it could be argued that the Commonwealth is, in effect, merely acting as an agent who collects the GST on the states behalf; that this is tantamount to shifting some revenue-raising responsibility back to the states (in the order of four per cent of gross domestic product); and that this rolls back somewhat the shift in vertical fiscal imbalance in the states' favour.

## Conclusions

Overall, the states have benefited from the new arrangements in that the GST has delivered more revenue than they would have received under the previous system. In dollar terms, Queensland has been the largest beneficiary; Queensland was also the first state (along with the Northern Territory) to receive more GST than its guaranteed minimum amount. At the other end of the spectrum, it was only in 2004–05 that NSW, for the first time, received more GST than its guaranteed minimum amount. This unequal distribution of gains has led to calls from NSW (and Victoria) for modification of the fiscal equalisation principle but the Australian Government has indicated that it will not change the application of the principle.

A positive outcome of the new arrangements is that many inefficient state taxes have been or are scheduled to be abolished. On the other hand, the abolition of state taxes has reduced state own-source revenue which, together with the introduction of the GST, has increased vertical fiscal imbalance. While this paper does not canvas the arguments for and against vertical fiscal imbalance, it suggests that there may be a case for re-examining the assigning of more

revenue-raising responsibility to the states, subject to Constitutional constraints, to counter the increasing centralisation of financial power with the Commonwealth.<sup>25</sup>

## Endnotes

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1. For a history of the development of Commonwealth–state financial relations, see Denis James, ‘Federal-State Financial Relations: The Deakin Prophecy’, *Research Paper*, no. 17, Parliamentary Library, Canberra, 1999–2000 at: [Hhttp://www.aph.gov.au/library/pubs/RP/1999-2000/2000rp17.htm](http://www.aph.gov.au/library/pubs/RP/1999-2000/2000rp17.htm)H
2. Most states levied franchise fees on the sale of petroleum products, alcohol and tobacco. A High Court ruling (in *Ha and Lim v. New South Wales* and *Walter Hammond & Associates v. New South Wales*) cast doubt on the constitutional validity of the fees. To protect state finances, the Commonwealth, among other things, increased excise on these products and paid the additional revenue to the states as ‘revenue replacement payments’. They ceased on the introduction of the GST.
3. NSW Budget Paper No. 2, 2005–06, p. 8–3.
4. The uneven distribution also reflects the impact of the abolition of state taxes as required by the *Agreement* and the relative reliance of each state on own-source revenue such as state taxes and royalties.
5. The Commission updates the relativities annually and reviews its methodologies regularly.
6. Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2004 Review*.
7. Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities 2006 Update*.
8. Final Budget Outcome 2004–05, p. 61.
9. Hon. P. Costello (Treasurer), *Taxes in six states and territories to be abolished*, press release no. 33, 20 April 2005 at: [Hhttp://www.treasurer.gov.au/tsr/content/pressreleases/2005/033.asp](http://www.treasurer.gov.au/tsr/content/pressreleases/2005/033.asp)H
10. Hon. P. Costello (Treasurer), *Australian Government proposal to eliminate further indirect taxes*, press release no. 23, 23 March 2005 at: [Hhttp://www.treasurer.gov.au/tsr/content/pressreleases/2005/023.asp](http://www.treasurer.gov.au/tsr/content/pressreleases/2005/023.asp)H
11. *ibid.*
12. Victoria, Budget Paper No. 2, 2005–06, p. 79.
13. Western Australia, Budget Paper No. 3, 2005–06, p. 142 at: [Hhttp://www.dtf.wa.gov.au/cms/uploadedFiles/200506\\_bp\\_3.pdf](http://www.dtf.wa.gov.au/cms/uploadedFiles/200506_bp_3.pdf)H
14. Budget Paper No. 3, 2005–06, p. 8–10 at [Hhttp://www.treasury.nsw.gov.au/bp05-06/bp2/pdf/bp2\\_8.pdf](http://www.treasury.nsw.gov.au/bp05-06/bp2/pdf/bp2_8.pdf)H
15. NSW, Budget Paper No. 2, 2005–06, p. 8–10.
16. Budget Paper No. 3, 2005–06, pp. 1 and 3.
17. NSW, Budget Paper No. 2, 2005–06, p. 8–10.
18. WA, Budget Paper No. 3, 2005–06, p. 152.



19. In 1998, the Australian National Audit Office released a report titled *The Management of Performance Information for Specific Purpose Payments-State of Play*, which reviewed practices of Commonwealth agencies seeking to ensure that the states abide by agreements with the Commonwealth. The report is at:  
[Hhttp://www.anao.gov.au/WebSite.nsf/Publications/4A256AE90015F69B4A2569040014F029#Summary](http://www.anao.gov.au/WebSite.nsf/Publications/4A256AE90015F69B4A2569040014F029#Summary)H
20. The states were not automatically entitled to receive NCP payments. Receipt depended on whether the state had adhered to its undertaking to introduce reform as assessed by the National Competition Council.
21. The amounts were contained in the Contingency Reserve. See Liberal Party of Australia, *Securing Australia's Water Future*, 13 September 2004, at:  
[Hhttp://www.liberal.org.au/default.cfm?action=plaintext\\_policy&id=2129](http://www.liberal.org.au/default.cfm?action=plaintext_policy&id=2129)H
22. Denis James, op. cit.
23. Parliamentary Library estimates.
24. OECD, 'Fiscal relations across levels of government', *OECD Economic Outlook* 74, 2003, pp. 14–160.
25. For a summary of the issues in the debate over vertical fiscal imbalance, see Richard Webb, 'Public Finance and Vertical Fiscal Imbalance' Department of the Parliamentary Library *Research Note*, no. 13, Parliamentary Library, Canberra, 2002–03, at:  
[Hhttp://www.aph.gov.au/library/pubs/rn/2002-03/03rn13.htm](http://www.aph.gov.au/library/pubs/rn/2002-03/03rn13.htm)H

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