

eJournal of Tax Research

Volume 10, Number 1

February 2012

Special Edition: State Funding Reform in the Australian Federation

CONTENTS

- | | |
|-----|---|
| 5 | Fiscal Federalism under Review (at <i>Speed</i>)
Neil Warren |
| 12 | The character of Australian federalism
Alan Fenna |
| 21 | International lessons in fiscal federalism design
Robin Boadway |
| 49 | Going beyond a zero-sum game: reforming fiscal relations
Hansjörg Blöchliger and Camila Vammalle |
| 65 | Own revenues in federations: tax powers, tax bases, tax rates and collection arrangements in five federal countries
François Vaillancourt |
| 88 | Sharing taxes and sharing the deficit in Spanish fiscal federalism
Violeta Ruiz Almendral |
| 126 | The way forward on state tax reform: an AFTSR perspective
Greg Smith |
| 138 | Solidarity and the design of equalization: setting out the issues
Bernard Dafflon |
| 165 | Fiscal equalisation and State incentive for policy reform
Neil Warren |

Editorial

Fiscal Federalism under Review (at *Speed*)

Neil Warren¹

Australian fiscal federalism is under challenge. At no time in the recent past has there been such a broad based and concerted questioning of fiscal federalism arrangements. When the Commonwealth announced a change in the taxation of mining rents in May 2010², discontent in the mining States (of Western Australia and Queensland) over what they saw as Commonwealth encroachment on State tax bases worsened already simmering resentment about how general grants were distributed amongst States.

With mining royalties being able to be offset against the liability for the new tax on mining rents, the mining States responded by announcing increases in their mining royalties, a position which saw the Commonwealth threaten to cut general grants to States based on their increased royalties revenue. At the same time there was growing concern about the growth in specific purpose grants, in particular proposals by the Commonwealth to assume the role of majority funder of health.

Not only were these developments of interest to States, but given the fact that many of these changes were being undertaken outside Commonwealth Parliamentary review through the Council of Australian Government (COAG)³, the Commonwealth Parliament also became more concerned. In response, in June 2010 a *Senate Select Committee on the Reform of the Australian Federation* was announced which, amongst other issues, sought to review financial relations between federal, state and local governments.

The Commonwealth Treasury(2010) also expressed concern about State reaction to Commonwealth policies and in a briefing note to the incoming Commonwealth government in August 2010, stated that 'The fiscal equalisation process does not promote reform' (p21). This outcome was especially evident throughout the second half of 2010 when the mining States joined with mining companies to publicly oppose the Commonwealth mining tax reforms while also arguing that there should be limits on how mining revenue is redistributed away from these States through general grants⁴.

¹ School of Taxation and Business Law, Australian School of Business, University of New South Wales, Sydney 2052 Australia. email: n.warren@unsw.edu.au.

² See various press releases at
<<http://www.futuretax.gov.au/content/Content.aspx?doc=mediacentre.htm>>

³ See various contributions in Kildea, Lynch and Williams (2012)

⁴ The most vocal critic was Western Australia which argued that there should be limits on the redistribution of their mining revenue to other States and Territories. See for example the discussion in
<<http://www.mediastatements.wa.gov.au/Pages/Results.aspx?ItemID=136383>> .

In early 2011, the Victorian Government (2011) also contributed to the chorus of concern with how general grants distribution arrangements are an inhibitor to the timely introduction of agreed State tax reforms because they are based on ‘what is’ current State taxation, not ‘what ought to be’ arising from any intergovernmental agreement (Warren 2010).

The Commonwealth responded to all these criticisms on 30 March 2011 by announcing that there would be a *Review of GST Distribution*. As Prime Minister Julia Gillard stated at the time, ‘Instead of States facing penalties for economic growth and rewards for economic underperformance, the GST distribution process should encourage economic reform and better delivery of services, and provide States with certainty’.⁵

With this renewed attention on fiscal federalism, the challenge was to ensure any debate on the issues was informed. However, the fiscal federalism debate in Australia is associated with a dearth of independent research; a situation which is in marked contrast to most other federations where funding sub-national governments is an issue actively researched. In an effort to stimulate and inform the Australian debate, it was concluded that the Australian discussion would greatly benefit from being exposed to the international debate on these issues.

To facilitate such a discussion, a *State Funding Forum* was organised in Canberra on 12-13 September 2011 involving some 5 international presenters and 5 Australian discussants. Reflections on the Australian experience were provided by 6 Australian presenters and the *Forum* concluded with a plenary session where the international presenters provided their ‘*speed*’ strategies for addressing those issues which will accompany any push to reform intergovernmental fiscal arrangements in the Australian federation.

This special edition of the *eJournal of Tax Research* includes papers delivered at this *State Funding Forum* by both the international and Australian presenters. Below, we provide an overview of the papers presented and ‘*speed*’ strategies recommended in the plenary session.

Professor Alan Fenna from The John Curtin Institute of Public Policy at Curtin University in Western Australia presented the opening paper at the *Forum*, speaking on ‘The Character of Australian Federalism’ including its constitution, politics and society since federation. He argued that the current issues of taxing powers, revenue distribution, policy jurisdiction and intergovernmental relations in today’s federation must be seen in the context of the ‘character’ of Australia’s federal system. That character is created by the interaction between constitutional design, judicial interpretation, economic and social change, and political processes over the 110 years of institutional evolution since Federation.

Designed for an earlier epoch, Australian federalism has undergone substantial adaptation to meet the needs of modern social and economic conditions, he said. As has been widely recognised, that adaptation has been profoundly centralising in its effect. He stressed that while Australia is not alone in this respect — indeed, such tendencies have been endemic in the established federations — this syndrome is particularly evident in the Australian case. Aspects of this particular character raise

⁵ See comments in

<<http://www.treasurer.gov.au/wmsDisplayDocs.aspx?doc=pressreleases/2011/028.htm&pageID=003&min=wms&Year=2011&DocType=0>>

continuing issues for resolution as well as impose severe constraints on what solutions might realistically be considered, he stated, all issues intended for consideration at the *Forum*.

Professor Robin Boadway, Department of Economics, Queen's University, Kingston, Ontario, Canada, began the presentation by international speakers with an overview of the 'International lessons in Fiscal Federalism Design'. His presentation reviewed and evaluated alternative ways of designing federal-state fiscal relations with a view to achieving accountability, efficiency and fairness in the financing and delivery of public programs to citizens of different states. The practices in other federations were drawn upon to illustrate the issues, highlighting in particular the case of Canada. Alan Henderson AM, Chairperson of the Commonwealth Grants Commission (CGC) was the discussant on Professor Boadway's paper.

Dr Hansjörg Blöchliger from the Economics Department in the O.E.C.D., Paris presented a paper which he and his colleague Camila Vammalle prepared on 'Going beyond a zero-sum game: Reforming fiscal relations'. Their paper identifies the political and economic factors that influence the design, adoption and implementation of changes to intergovernmental fiscal relations, based on reform episodes in ten OECD countries. While they said that some factors that determine the success of reforms are outside the scope of policy makers (such as basic constitutional provisions or economic and fiscal conditions), there are many which policy makers have scope to influence and help a reform succeed. Professor Richard Eccleston from the University of Tasmania was the discussant on this paper.

Professor François Vaillancourt, Dept Economics, University of Montreal, Montreal QC, Canada spoke on 'Own revenues in federations: tax powers, tax bases, tax rates and collection arrangements in five federal countries'. His presentation began with an examination of what tax bases best belong to various levels of government. Attention was then given to how to share tax bases when they have more than one owner: joint uncoordinated access, joint coordinated access, interaction between tax bases, while also making a distinction between taxation and using a tax base as a source of formula driven transfers. The use of tax bases in the federations in Canada and the USA were then examined along with the accompanying tax base and rate setting powers, concluding with a discussion of tax collection arrangements in various federations. Don Parker from the Victorian Department of Treasury and Finance was the discussant on this paper.

Professor Violeta Ruiz Almendral, Profesora Titular De Derecho Financiero y Tributario, Universidad Carlos III de Madrid Spain and Letrada (Advocate) Spanish Constitutional Court, presented on 'Sharing Taxes and Sharing the Deficit in Spanish Fiscal Federalism'. She indicated that since 1997, Spanish regions have been able to share the personal income tax equally with the centre, as well as establish tax rates and tax credits in their own region. In her presentation, she reflected on Spain's 14 years of experience with this arrangement, providing an assessment of its results from different perspectives. In particular, how has it impacted vertical fiscal imbalance, whether Communities have become more fiscally responsible and whether the Communities personal income tax share can grow. Rob Heferen from the Commonwealth Treasury was the discussant on this paper.

Professor Greg Smith, Adjunct Professor at the Australian Catholic University, a Senior Fellow of the Melbourne University Law School, and a director of the Centre for Policy Development, spoke on the 'The Way Forward on State Tax Reform: An

AFTSR Perspective’. This presentation reviews recommendations in the 2009 Report to the Treasurer on Australia’s Future Tax System relating to the future of state taxes in Australia. The Report proposes greater centralisation of tax collection, abolition of many state taxes, and reforms to others including land, resource and road-related taxes. Professor Smith outlined these proposals and their implications for federalism in Australia.

Bernard Dafflon, Professor of Public Finance, Department of Political Economy, University of Fribourg in Switzerland, addressed the critical question of ‘Solidarity and the design of equalization: Setting out the issues. Professor Dafflon began by stressing that inter-jurisdictional differences originate from choices or from situation disparities and that equalization only refers to the latter. He indicated that how these disparities are responded to has moved recently to the adoption of separate disparate measures of revenue potential and expenditure needs through various formula-based vertical or/and horizontal financial transfers (whereas Australia uses a single combined measure). For revenue equalization a representative tax system (RTS) is commonly used but expenditure equalization has seen different concepts (such as needs or costs disparities) adopted to express disabilities associated with decentralized public expenditures and the need for equalization. The presentation explored these issues; questioned the possible criteria for these two aspects of equalization and produced guidelines for policy implementation. Professor Ross Williams, University of Melbourne was the discussant on this presentation.

Three presentations were subsequently given designed to provide reflections on fiscal federalism in Australia. Professor Ross Williams, University of Melbourne provided a brief historical overview of federal-state fiscal relations and the role and influence of the Commonwealth Grants Commission. He noted that attention has been given over time to the changing application of partial versus full horizontal fiscal equalisation, to the interaction between vertical and horizontal transfers, to timing issues and to the impact of grant design on efficiency.

Professor Jonathan Pincus, University of Adelaide, provided some reflections on fiscal equalisation in Australia. This presentation focused on equity and efficiency arguments used in the past to support the case for fiscal equalisation—including those relating to settlement patterns, to fiscal externalities and to risk sharing—and found them weak in contemporary Australia, with its low inter-jurisdictional variance of incomes and fiscal capacities, and low costs of interstate migration and trade.

Professor Neil Warren of the University of New South Wales presented a paper on ‘Fiscal equalisation and State incentive for policy reform’, arguing that how Commonwealth grants are distributed limits the scope for States to innovate and to risk-take, individually and collectively. He also explored the options available to change equalisation arrangements in a way which would enable States to be rewarded for efficiency improving policy reforms such as reforming inefficient State taxes.

In a world of blogs and Twitter, we are increasingly looking for ‘cut through’ strategies which quickly give us the essence of the argument. In the final session of the *State Funding Forum*, the international presenters were asked to offer their ‘speed’ strategies on bringing about change in the complex and difficult area of fiscal federalism in the Australian federation.

On the question of *speed* federalism design, Professor Violeta Ruiz Almendral proposed that the first imperative is to define authority in a clear, simple but flexible way – one that allows authority to evolve. Crucial too is making sure citizens know

who does what and who pays (and sharing taxes such as the personal income tax has the advantage of making that visible). Also, it is important to ensure that there is an institutional infrastructure to solve issues and foster cooperation (for example: an intergovernmental commission to address falling standards in Education). Critical to enduring success will be transparency and three key words are: explain, publish and tell argued Professor Ruiz Almendral.

Professor François Vaillancourt then turned his attention to *speed* tax design for a federation with a focus on tax powers, tax bases, and tax rates. A strong federation requires its subnational governments (SNG) to have access to a reasonable level of own revenues to ensure accountability to their SNGs and to get away from the 'I spend their money for your benefits' approach encountered for example in Scotland, said Professor Vaillancourt. He also stressed that the tax should be selected taking into account both the type of responsibilities of SNGs, the mobility of tax bases and administrative and compliance issues. Hence road type taxes are relevant if SNGs provide road services. In advanced federations, SNGs typically spend a large share of their budget on people oriented services (education, health, social services) and thus the personal income tax is a natural fit.

The tax base used should therefore be set at the national level, argued Professor Vaillancourt, to minimize administrative and compliance issues and to facilitate the attraction of foreign capital. SNGs are given a share of the tax base to tax, not as a transfer. A reasonable share ranges between 20 to 50%. In the case of tax collection, these he said should be carried out by a single agency (eg in Canada except Québec, and Spain), preferably managed jointly by both levels of government but reporting to one level (as this will usually work well) and with each Government paying the cost of collecting their taxes.

SNGs only get access to these tax revenues by explicitly setting a tax rate; the national tax rate does not apply by default (Spain before 2011). If the personal income tax is used, they can either set the rate as a surcharge on the central tax burden, thus adhering to national tax brackets and rates and thus progressivity (Canada before 2000), or set their own brackets and rates giving them a choice in terms of progressivity (Canada since 2000). They can grant personal tax credits but no exemptions or deductions since a common base is used, said Professor Vaillancourt.

On the issue of *speed* equalisation Professor Bernard Dafflon said that since equalization is about solidarity, which is foremost a political issue, a reform of the equalization system must clearly and explicitly distinguish between decisions and choices that are in the competence of politicians, and the political economy of equalization which is in the competence of economic experts. Here, economic experts must contribute to the coherence of the political choices, but they do not assume the responsibility for those choices. Also important is that the origins of the fiscal disabilities to be equalized needs to be duly established and informed, but SNGs' own choice must not be equalized.

Revenue equalization must be founded on RTS he said. Central and state governments must make a common decision on which taxes to consider, for how many years and with which weight. Since RTS is based on the relative position of SNGs, a common decision is also required on the amount of equalization and its vertical and/or horizontal funding.

Expenditure cost equalization should not be considered owing to the paramount difficulties in measuring effective costs disabilities (versus choices and X-

inefficiencies). Professor Dafflon proposed that expenditure-needs equalization is possible under the following sequence: select the functions to be equalized, effective expenditures must not serve as benchmark if they are already modified through equalizing payments (return to the causality criteria); there must be a plausible relation between the explicative variables and the disabilities; if a synthetic index of expenditure needs is estimated, the weight given to each variable must correspond to the proportion of functional expenditures taken into consideration.

On the all-important issue of the reform process, Dr Hansjörg Blöchliger proposed five points which he said were key to a successful reform strategy. These were to firstly clearly name the problem (which equals a common understanding that the status quo is untenable); secondly to agree on a common proposal to amend the problem (such as less horizontal fiscal equalisation or more tax autonomy); thirdly, find allies, incorporate their demands, in order to find a majority (bundling) and agree on transitional compensation mechanisms. Fourth was to wait for a good moment (depending on the reform, either a growth period or a crisis) and finally and most importantly, ‘communicate, communicate, communicate’ he said.

The *State Funding Forum* was an important, timely and well attended event, involving Treasury officials from all States and Territories and from the Commonwealth. Also in attendance were representatives of the Commonwealth Grants Commission, industry and professional organisations and from a number of community organisations and other government agencies. The *Forum* was universally acknowledged as doing much to expose the key participants in the Australian debate to those issues which have been the focus of the international debate and enlightening them on how Australia might be able to benefit from lessons learnt in other federations when reforming their intergovernmental fiscal arrangements.

It was also considered that the proceedings would do much to ensure the deliberations of the *Review of GST Distribution* would be informed by international precedent and that the debate on these issues at the 4-5 October 2011 Commonwealth *National Tax Forum* in Canberra, would likewise be informed. Most importantly, by publishing the proceedings of the *State Funding Forum* in this volume of the *eJournal of Tax Research*, the broader community will now have ongoing access to an important resource which will enable them to better understand fiscal federalism issues in Australia and the available reform options given international precedent.

REFERENCES

- Commonwealth of Australia 2010, *Australia's Future Tax System: Report to the Treasurer December 2009*, (AFTS)
<http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm>
- Commonwealth Treasury 2010, *Treasury Incoming Government Brief - Red Book Part 1*, <http://www.treasury.gov.au/documents/1875/PDF/01_Overview.pdf>
- Senate Select Committee on the Reform of the Australian Federation, <http://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Committees?url=reffed_ctte/index.htm>
- Kildea P., Lynch A. and Williams G. (eds) 2012 *Tomorrow's Federation: Reforming Australian Government*, Federation Press: Sydney

Victorian Government 2011, Victoria's response to the CGC 2011 Update of GST relativities, Economic Research Papers
<[http://www.dtf.vic.gov.au/CA25713E0002EF43/WebObj/ResponsetoCGCGST2011/\\$File/ResponsetoCGCGST2011.pdf](http://www.dtf.vic.gov.au/CA25713E0002EF43/WebObj/ResponsetoCGCGST2011/$File/ResponsetoCGCGST2011.pdf) >

Warren, N.A. 2010, 'Intergovernmental fiscal arrangements as a constraint on State tax reform under Henry', in *Australia's Future Tax System: The Prospects After Henry*, eds Evans, C., Krever, R. and Mellor, P., ThomsonReuters: Sydney, pp305-364.

Warren, N.A., 2012a, 'Designing Intergovernmental Grants to Facilitate Policy Reform' in Kildea P., Lynch A. and Williams G. (eds) *Tomorrow's Federation: Reforming Australian Government*, Federation Press: Sydney, pp 131-51 (and as *UNSW Law Research Paper No. 2011-23*
<http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1903623>)

Warren, N.A., 2012b, 'Fiscal equalisation and State incentive for policy reform', *eJournal of Tax Research*, 10(1):165-81.
<<http://www.asb.unsw.edu.au/research/publications/ejournaloftaxresearch/Pages/default.aspx>>