

GST as a secure source of revenue for the States and Territories

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Abstract

Goods and services tax (GST) revenues collected by the Commonwealth Government in Australia are provided in full as untied revenue grants to the State and Territory governments. The hypothecation of GST revenues in this way provides a reasonably secure foundation for federal financial relations in Australia. However, Australia's federation has been marked by continuing change in the vertical sharing of government functions, costs and revenues, and State fiscal security is potentially vulnerable in these changing circumstances. The advantages and disadvantages of the GST revenue arrangements have themselves changed over time since the GST was introduced in 2000, with implications both for the GST as a tax and for the evolution of the Australian federation. This article discusses these developments and some possible future directions.

Key words: Federal Financial Relations, GST, fiscal equalisation, revenue sharing.

* Former Chairman, Commonwealth Grants Commission; the views expressed in this article are those of the author alone and do not necessarily represent the views of the Commonwealth Grants Commission or any other entity.

1. INTRODUCTION

The introduction of the goods and services tax (GST) in Australia on 1 July 2000 combined a substantial tax reform with a more modest reform of federal financial relations.

The main tax reform had the orthodox feature of greater ‘tax neutrality’ – through a broadening of the tax base and flattening of the tax rate.¹ The GST base is equivalent to a little over one-third of Gross Domestic Product (GDP), much broader than the tax bases it replaced (mainly the wholesale sales tax exclusively levied on goods and not services), and the relatively low flat tax rate of 10 per cent generates revenues of around 3.4 per cent of GDP.² At least for a time, the introduction of the GST also provided for some overall tax mix switch from income to indirect taxes, although indirect taxes in Australia have long experienced trend decline.

The reforms to federal financial relations were relatively modest. The Commonwealth has long provided untied financial assistance to the States and Territories (hereafter ‘the States’), but there has equally long been controversy about the amount of that assistance. Under the new arrangements, the aggregate assistance was set to equate to the full revenue collections of the GST, net of collection costs.

The 1999 intergovernmental agreement for these arrangements included some other federal reforms as part of the overall policy package.³ These included:

- a role for the States in deciding any future changes in the rate or base of the GST, with substantive changes notionally requiring their unanimous agreement;
- abolition or reduction of a number of State business and financial taxes;
- providing first home owner grants as an offset to the price effects of GST on dwellings; and
- applying the GST to State government bodies, notwithstanding constitutional constraints on the Commonwealth levying taxes on States.

This article addresses the question: is the GST a secure source of revenue for the States and Territories? While that question raises some legal issues, these are not of great interest because, under the Constitution, the Commonwealth is alone sovereign in

¹ These features of reform which are ‘neutralising’ the effect of taxes on behaviour, are widely supported for bringing three advantages – greater economic efficiency through a reduced impact of taxation on resource allocation, greater horizontal equity as tax burdens vary less with different personal circumstances or preferences, and more robust revenue collection as tax avoidance behavioural changes are rendered more difficult.

² Australian Bureau of Statistics, *Australian System of National Accounts, 2017-18*, Cat. 5204.0 (26 October 2018), <https://www.abs.gov.au/ausstats/abs@.nsf/mf/5204.0>. Tax revenue data is sourced from Commonwealth Government Budget Papers (various years).

³ Council of Australian Governments (COAG), Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, https://www.coag.gov.au/sites/default/files/agreements/reform_of_commonwealth-state_financial_relations_PDF.pdf (and Schedule 2 to the *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999* (Cth)).

relation both to GST policy and Commonwealth payments to the States. In other words, the States receive grants based on GST revenues (or anything else) only for as long as the Commonwealth Parliament so decides. So the short answer as a matter of law is that the GST is a secure revenue source for the States for as long as, and no longer than, Commonwealth legislation so provides. For the States, the legal foundation is arguably quite flimsy.

But given that these arrangements have continued in place for nearly two decades, and look likely to continue for the foreseeable future at least in some form, the practical security of the GST revenues for the States may be more strongly established than the legal standing might imply. That suggests that whether the GST is a secure revenue source for the States owes more to political economy than legal considerations. In particular, what is perhaps more interesting is how the GST performs as a tax revenue source, and how it fits within the overall framework of federal financial relations. Accordingly, this article will focus much more on the political economy issues that arise in these areas.

2. AUSTRALIA AS A CONSTITUTIONAL FEDERATION

A federation is an arrangement whereby two levels of government, central and regional, have sovereign jurisdiction over the same populations or territorial areas, with their respective powers divided formally so that neither level is able unilaterally to alter or abrogate the powers of the other. This is distinguished from a unitary state (the more common form of jurisdiction), where only one level of government is sovereign. In unitary states, subnational governments such as regional or local government, if they exist at all and whether democratically elected or otherwise, are created merely by legislative act of the central government, which may alter, override, circumscribe or even abolish their powers.

The Australian federation was formed on 1 January 1901, with a formal division of powers set out in the Constitution, originally enacted in 1900 by the British Parliament. The Commonwealth of Australia was established as the central government, while the six States, each formerly a self-governing British colony, formed the second tier regional level. Late in the 20th century, two territories of the Commonwealth, which are not part of any State, were granted self-government by the Commonwealth (just as a unitary state might do, and the UK has done, for example, for Scotland) with substantially similar purposes and legislative powers as the constitutional States.

However, the formal constitution of a federation does not necessarily prescribe many of the important features of how it operates in practice. In particular, the functions of government in 1901 in Australia and elsewhere were much smaller and very different to what they were to become over the course of the 20th century, and the Constitution, even with some amendments, only indirectly addresses much of that change.

This article argues that the Australian federation today operates largely on the basis of evolving considerations of political economy, rather than solely in reliance on its constitutional foundations. As such, the Australian federation is a far more fluid arrangement than may have been originally intended, and remains open to considerable further potential change even without any change in formal powers. This is particularly so in relation to matters of finance, but through this route it is effectively so for a great deal more than finance.

Among the most important developments in the decades after federation, at least in the financial and economic spheres, can be encapsulated as a political transition, in common with other developed countries, which overlaid social democracy on liberal democracy. In essence, this involved a considerable expansion of the role of government, in particular (though by no means exclusively) in relation to education and social spending,⁴ with a large-scale expansion of the tax system both to provide the required revenues and to directly contribute to income redistribution.

Generally speaking, these developments were not anticipated at Federation. However, in one of the few significant changes subsequently made to the Constitution, in 1946 a referendum provided a new power for the Commonwealth in the following terms:

Section 51 (xxiiiA) the provision of maternity allowances, widows' pensions, child endowment, unemployment, pharmaceutical, sickness and hospital benefits, medical and dental services (but not so as to authorise any form of civil conscription), benefits to students and family allowances.

This very large addition to Commonwealth powers supplemented the original power in section 51(xxiii), invalid and old age pensions.⁵ Together these powers underpin the predominant central government role in Australia in that substantively 20th century invention, the 'welfare state', which refers to functions often combined as health, education and welfare ('HEW'). It is perhaps a hangover of this history, however, that the States remain as large-scale service providers in at least some of the HEW functions. But while they have kept a role in these functions, the 20th century tax revenues to fund them went overwhelmingly to the Commonwealth.

It is into this setting and context that the State-funding role of the goods and services tax (GST) in Australia can be considered. The GST is a Commonwealth tax, but the Commonwealth has agreed with the States and Territories that each year an amount equivalent to cash GST receipts (net of collection costs) will be granted to the States and Territories on an untied basis (that is, available to them to use for any purpose of their own choosing). It is perhaps ironic that the GST revenues are given to the States, since they are precluded by section 90 of the Constitution⁶ from levying a GST themselves, since a GST in part includes duties of customs or excise for which the Commonwealth from the outset had been given exclusive power.

3. FEDERAL FINANCIAL RELATIONS

The Australian Constitution constrains and influences, but does not fully determine, the financial relations between the Commonwealth and the States. To a large extent, therefore, federal financial relations in Australia have evolved through the practical

⁴ Public social spending generally encompasses general government health spending and welfare spending such as pensions, allowances, welfare services and family assistance. Education is generally identified separately. In discussion of the role of government, as in this article, they are often combined as 'HEW' – health, education and welfare.

⁵ Australian Constitution, s 51(xxiii).

⁶ Ibid s 90.

playing out of political economy considerations,⁷ rather than fully corresponding to any constitutional principles.

Federal financial relations are the joint outcome of three main sets of decisions. No one has ever set down a comprehensive, clear or generally-accepted statement of intent or theoretical framework for these decisions, and their ever-changing interaction means that few if any principles can readily be found to apply to them. To put it bluntly, in large measure these are just made up as all of the parties go along, responding to the exigencies of the day.

The three decision sets, not necessarily in any meaningful order, are discussed below.

3.1 Sharing of functions

First, the allocation of program responsibilities between central and regional government must be decided. This is perhaps where the Constitution has the most to say, in that it specifies Commonwealth roles in a range of areas, with the States retaining residual powers. It also prescribes a range of rules relating to the allocation of revenue powers. But nonetheless, a great deal of the detailed task of functional allocation, both on the revenue and spending sides, is left substantially unspecified. In the tax sphere, the incompleteness of the Constitution is best illustrated by noting that while the Constitution gives the exclusive excise power to the Commonwealth, the income tax is not mentioned. Yet since 1942 it has been exclusively a Commonwealth tax in practice.

In 2016-17, the States had a 41 per cent share of total general government recurrent and capital expenditures by all levels of government in Australia. Government Finance Statistics (GFS) operating expenses were about AUD 251 billion (of a total AUD 624 billion) while the States' net acquisitions of non-financial assets, mainly infrastructure investments, were AUD 16.6 billion in a total of such general government spending of AUD 26.3 billion.⁸

3.2 Sharing of costs

Second, whatever the allocation of program responsibilities, there may be a separate set of decisions on the sharing of program costs. In Australia, the Constitution provides that the Commonwealth may make payments to the States on such terms and conditions as Parliament thinks fit.⁹ The Commonwealth and the States have entered into a range of agreements under which the costs of State programs (and more recently even Commonwealth-led programs such as the National Disability Insurance Scheme) are shared, particularly in the health, education and welfare areas, and also for new transport infrastructure. Commonwealth cost sharing contributions are generally referred to as payments for specific purposes (PSPs).

⁷ The term political economy in this article has its general meaning, which is to link legal and political structures and outcomes (such as federal financial relations) to underlying economic and social conditions or forces.

⁸ Australian Bureau of Statistics, *Government Finance Statistics, Australia, 2016-17*, Cat. 5512.0 (26 April 2018), <https://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5512.02016-17?OpenDocument>. At time of writing, the most recent comprehensive ABS data on government finances relates to 2016-17. Commonwealth payments data come from Commonwealth Budget Papers (various years).

⁹ Australian Constitution, s 96.

In 2016-17, payments for specific purposes were made to the States amounting to AUD 55 billion. Cost sharing then, by the Commonwealth, funded about 20 per cent of State general government spending.¹⁰

3.3 Sharing of revenues

Thirdly, in Australia and some other federations, revenue collections are predominantly made by central governments with some of the revenues then shared with the States. The key feature of such revenue sharing is that the funds are not specified for use in any particular program of the States – they are ‘untied’ grants. This may, or may not, be formalised in tax sharing arrangements set out in federal constitutions. In Australia they are not. Much the same outcome occurs for any basis of general revenue payment, even if formula rather than tax revenue based, as it has often been in Australia. The GST revenue is now the main legislated basis for revenue sharing payments.

In 2016-17, GST-based grants, as the predominant general revenue payments to the States, amounted to about AUD 60 billion, or about 23 per cent of total State general government revenues (and expenditures).¹¹

3.4 The interaction of three shares – functions, program cost and revenues

The States themselves then, overall, generate funding for about 57 per cent of their program spending, which means their revenues meet the costs of just 23 per cent of total general government spending (at all levels) in Australia.¹² They collect a narrow range of taxes, mainly on payrolls, land and property transfers, together with mining revenues mainly from royalties, and a considerable range of other non-tax revenues.

The changing operation of the three variables in federal financial relations – functional sharing, cost sharing and revenue sharing – are all prescribed or at least permitted by the Constitution¹³ but their particular changing patterns in large part were not specified or anticipated. The fact that fiscal outcomes depend on the joint operation of these three decision variables means that it is very difficult to form clear judgements about any one of them in isolation of the others. Inevitably, this means that there is endless political tension between the Commonwealth and the States on arrangements for all three, and adjustments or even broader reforms to one do not necessarily address those tensions for very long.

Over time, there has been a tendency for functional shares to shift towards the Commonwealth. In the case of social transfers, as noted in section 2 above, this was reflected in constitutional changes. Another factor has been the difficulty experienced by the States in meeting increased demand for a range of services. Health spending has for many years increased everywhere, in part driven by ageing of populations but also as a result of changing (more costly) technologies. Education has expanded everywhere, with higher participation and retention, and also with extensions in the years of

¹⁰ Australian Bureau of Statistics, *Government Finance Statistics, Australia, 2016-17*, above n 8.

¹¹ Ibid.

¹² Ibid.

¹³ These outcomes arise from the broad Commonwealth powers conferred by the Constitution. The scope of Commonwealth legislative, including taxing, powers are specified in section 51 while section 96 provides that financial assistance can be provided to any State on such terms and conditions as the Parliament thinks fit.

education both pre- and post-school. Some other social programs such as aged care, child protection and disability care have seen exceptional growth in recent years.

The Commonwealth has often come under political pressure to take, or seen political opportunity in taking, functions from the States, given its stronger fiscal capacity to meet them and given the likelihood that in doing so, the response will be delivered in similar terms across Australia, rather than develop piecemeal State by State. Examples have been university funding, aged care, disability care, child care and early education, and some non-HEW fields such as corporate and financial regulation.

Cost sharing has had a more mixed history. Although the States only infrequently reject assistance, cost sharing is often resented by them for a range of reasons. The States sometimes see this assistance as coming with Commonwealth policy interference in what might otherwise be areas of State functional responsibility. At times there have been attempts to simplify cost sharing agreements and to reduce policy prescription within them. At other times, diverse cost sharing agreements have mushroomed. Frequently, cost-shared services have co-developed with other forms of service delivery (public and private hospitals, government and non-government schools, and so on) and this has often come with complicating philosophical and policy agendas. Politically, it would now be very difficult for most voters in Australia to comprehend the respective roles of the Commonwealth and the States in areas such as health, education and transport infrastructure, so comprehensively are funding responsibilities (and policy decision making) shared in these areas.

Revenue sharing has also had a mixed history. The States were compensated by the Commonwealth when in 1942, amidst fears of foreign invasion, the income tax became solely a Commonwealth tax, never to return to the States. After years of bickering over resources, the Commonwealth transferred the payroll tax to the States in 1971, but this proved too little to resolve very much. The Fraser government in 1976 introduced personal income tax sharing with the States, but tax sharing was abandoned again in 1985, with a return to grant growth formulae as the basis for determining the general revenue assistance pool of funds.

In the 1990s, the States built up a considerable new revenue source in business franchise license fees. While these were designed to appear otherwise, they effectively were heavy excises imposed on tobacco, alcohol and fuel sales. In 1997 the High Court, in the *Ha* case,¹⁴ found them to be so, and hence in contravention of section 90 of the Constitution which gives the Commonwealth exclusive powers over customs and excise.

The Commonwealth introduced additional excises to replace the lost State revenues, but this was a temporary fix. The GST three years later provided the long term fix.

To say the least, this history reveals how messy federal financial relations have been. It also shows that it is not just the federal relations themselves that have created the tensions, but rather the underlying difficulties in finding fiscal means to meet expanding demands for government services, particularly in the HEW areas. The political economy of HEW is a core driver of the political economy of federal financial relations.

¹⁴ *Ha v New South Wales* [1997] HCA 34; 189 CLR 465 (5 August 1997), High Court.

The central issue for this article is whether the GST is a secure source of revenue for the States. Given that revenue sharing is just one of the variables in federal financial relations, little can be meaningfully secure for States about the GST revenues if changes in those other variables have adverse or offsetting fiscal consequences for them. It is only in the combined outcome of all the elements that any concept of fiscal security, such as it ever can exist without constitutional prescription, may be delivered.

Somehow, the arrangements that have developed provide an outcome that persists, albeit with periodic change. To understand what might be driving that pattern it is perhaps necessary to look behind the three decision variables themselves and look more fundamentally at what States do. This provides an insight into the likely forces at work. The next section explores this question to see what it reveals about the political and economic forces that drive these outcomes.

4. WHAT STATES DO – THE DRIVERS OF FEDERAL FINANCIAL RELATIONS

Whatever intentions may have existed at the time of Federation, or whatever views may have developed since, to make sense of our federal financial relations it is probably better to simply start with the facts as they now are and to see if any underlying logic in political economy terms might apply to them. Earlier theories do not seem to have driven the evolving form of our federation, but some other forces undoubtedly have. We more likely would benefit from having a theory that fits and explains those forces rather than trying to fit events to the old theoretical models.

The federations in the world have long had two broadly different styles. The US model, developed in the 18th century and representative of one style at least for much of its history, is largely of competitive, autonomous, self-funding states, with substantial differences claimed to exist state-by-state in preferences for public services and taxes that justify a decentralised model of government. In contrast, the more modern German model, adopted post-World War 2 although built partly on 19th century Bismarckian traditions, is essentially one of a strong central or national perspective on government, with a cooperative structure allowing for only modest degrees of subsidiarity.¹⁵ The main public services are established and funded as national programs but the advantages of decentralised service delivery are provided under negotiated, cooperative agreements with the Länder (states).

The US model is largely indifferent to substantial fiscal inequalities across regional jurisdictions. In contrast, the central dominance of the German model typically includes substantial horizontal equalisation (a challenge greatly increased in Germany's case when the unification of East and West Germany brought together Länder of very different levels of economic development).

While the Australian Constitution clearly began with much of the nomenclature and appearances of an American style model, there has been in the major spending areas a comprehensive shift over time towards features of the German model.¹⁶ In Australia's case, however, the protections of the fiscal powers of the States that are provided for in

¹⁵ Subsidiarity refers to the principle that decision-making on service delivery should be decentralised as far as is practicable.

¹⁶ This is not to say that Australia has copied Germany or vice versa. Rather it is to observe that the style of federation evolving in each country is often similar, perhaps because the underlying forces driving change are also similar, despite their radically different specific courses of history.

the post-war German Constitution are missing (notably that the upper House in the German national legislature is appointed by each Länder government, giving them considerable influence over federal tax policies), but the functional directions are broadly similar.

Perhaps the key point to observe about the States is that a relatively few functional areas account for the great bulk of their spending. At the same time, however, those high-cost areas are by no means exclusively State functions, but rather are component parts of broader national public programs shared with the Commonwealth. In these areas, the Commonwealth in fact is often the greater spender than the States, particularly when account is taken of the fact that the Commonwealth shares in meeting the cost of State programs.

In political economy terms, it can be said that these areas have come to be seen in Australia more as national public goods than local public goods regardless of which level of government provides or funds them. That is to say, they are less the subject of a competitive model of federation, where what each state does would differ considerably from the others reflecting different local preferences, but rather reflect a shared national set of policy expectations with state service delivery favoured only as a means of achieving greater proximity and responsiveness to local characteristics at the point of service delivery.

The main areas of program sharing are of two types. The largest is the HEW (health, education and welfare) grouping which became the dominant field of government expenditure in developed countries in the 20th century.¹⁷ The national public good element in these is perhaps largely one of a national set of expectations about income distribution (or 'fairness'), reinforced in some areas by the mobility of the population across States and, at least in the case of education, the links with the national economy and national labour market. The second is transport infrastructure, mainly roads and rail. One national element here is that much of the transport system, particularly freight movement, operates as part of a jurisdictionally seamless national economy.

In 2016-17, States spent AUD 158 billion on HEW. While this was 60 per cent of their total spending, the Commonwealth spent much more in these areas – AUD 265 billion (including AUD 43 billion in payments for specific purpose in these areas made to the States).¹⁸

In each of these areas, the Commonwealth role has been expanding. In health, the Commonwealth has major roles in the universal cover provided by Medicare and pharmaceutical benefits, support for private health insurance, and acceptance of a share of the costs of public hospitals provided by States. State spending on health, particularly concentrated on public hospitals, net of Commonwealth cost sharing, is now about 42 per cent of total public sector health spending.¹⁹

In education, the Commonwealth has played the major role both in the expansion of non-government provision and the extension of education participation. It has taken the main financial responsibility for both pre-school and post-school education, including

¹⁷ For a comprehensive survey, see for example Peter H Lindert, *Growing Public: Social Spending and Economic Growth since the Eighteenth Century, Vol. 1* (Cambridge University Press, 2004).

¹⁸ Australian Bureau of Statistics, *Government Finance Statistics, Australia, 2016-17*, above n 8.

¹⁹ Ibid.

Australia's very large university sector. State spending on education, net of Commonwealth cost sharing, is around 45 per cent of total public education spending, and is concentrated mainly on public primary and secondary schools.²⁰

In welfare the Commonwealth dominates in almost all fields, particularly income support and other cash transfers. From the States it has taken primary responsibility for aged care, and more recently for disability care. The States are left mainly with some role in disability care, child protection services and social housing and homelessness programs. However, their spending on social security, welfare, housing and community development is now only about 15 per cent of all public spending in these areas.²¹

The predominant, and apparently growing, national character of HEW in Australia creates a strong tension in the federation. The result has been that the Commonwealth and the States are fully entangled in the funding and delivery of HEW, so that much the same issues arise politically in the parliamentary electoral processes at each level. The Commonwealth and the States each have 'democratic voice' for these entangled fields of policy.

Jurisdictional entanglement then combines with the complex interplay of functional sharing, cost sharing and revenue sharing between the Commonwealth and States. It may seem logical that if HEW are largely national public goods, this entanglement and interplay could be cut through by shifting substantially or even fully financial responsibility for HEW to the Commonwealth, which already takes the larger share. That this has not happened is traditionally ascribed to subsidiarity arguments for certain types of service delivery. But it perhaps reflects also another underlying political preference that can arise and persist in federations – people may prefer to have two avenues for democratic expression on what governments do, rather than one, expressing themselves on similar issues both at federal and state level. That is, for many perhaps, the real reason they may prefer federation over unitary government – a type of 'balance of powers' argument in an environment generally of low trust in government.

Apart from HEW, entanglement is also well entrenched in Australia in the area of transport funding. State transport spending, both current and capital, in total amounted to about AUD 35 billion in 2016-17 which is about 13 per cent of total State general government spending. Commonwealth road and rail infrastructure grants to the States were about AUD 6.7 billion (excluding grants to local government) which accounted for more than half of net new additions to State transport assets.²² Of course, the Commonwealth collects fuel excises from road users, amounting to about AUD 10 billion per year (after allowing for excise tax credits).²³ Since fuel excise is the most substantive road user charge in Australia, its exclusive collection by the Commonwealth directly entangles road funding and policy.

The revenue and funding arrangements for road and rail transport in Australia have long been ripe for reform – in common with most other countries – with most interest in using new technologies to replace fuel-related taxes with economic-cost based user charges and to more closely link investment to economic valuation. The jurisdictional

²⁰ Ibid.

²¹ Ibid.

²² Ibid.

²³ Refer Commonwealth Budget Paper No. 1, *Budget Strategy and Outlook* (various years). Petrol and diesel excise collections are reported in Statement 4 while fuel tax credit payments are reported in Statement 5.

entanglement of existing arrangements is likely one of the barriers to this reform, although there are many others, practical and political, as well.

Again, as for HEW, future reform could release States from relying on discretionary vertical fiscal transfers for transport infrastructure funding, but there appears little impetus for such reform.

What is left of what States do if HEW and transport are set to one side? Since HEW and transport in combination amount to almost three-quarters of what States spend, at an aggregate level (and leaving aside issues that might arise in relation to fiscal equalisation) the States could readily fund their other functions from existing own-account taxes and other revenues. Those other functions involved spending in total of only about AUD 64 billion in 2016-17.²⁴

The largest of those other functions are the justice-related functions (police, courts and correctional services) where Commonwealth engagement has increased in recent times but remains relatively limited.²⁵ Others are regulatory and legislative services, including oversight of local government, industry promotion and assistance, government business enterprises, arts and culture, sports, all the central administrative functions, national parks and a wide variety of planning, land use and water resources programs, provision of community utilities or infrastructure, and environmental regulations and programs. The Commonwealth delves into many of these, seemingly at will, but perhaps most often to take opportunities for political credit for initiatives while avoiding if it can being caught with ongoing functional responsibility.

It is therefore possible to see the States in two parts. One is a largely self-contained and self-funded part where perhaps the original expectations of the US-style Constitution continue to prevail, and where competitive policy innovation may well be working effectively. HEW, and at least for now transport infrastructure, are a second, much larger, part mainly made up of deeply entangled programs with the hallmarks of a German-style cooperative federalism.

The fiscally larger entangled part of the federation is where it is particularly important to look to understand the role of the GST as a revenue source for the States in Australia. Gaining an understanding of it requires not just looking at its role as the main means of delivering general (untied) revenue sharing, but also the two other decision variables – function and cost sharing within the federation.

5. THE POLITICAL ECONOMY OF GST HYPOTHECATION

The revenues from the GST are hypothecated to, and form almost all of, the pool of untied grants for the States. Hypothecation is often opposed by finance ministries because it reduces budget flexibility. However, this objection had little weight in the case of the GST, because inflexibility was a political objective. The government was keen to create an impression that the rate of the GST, and as far as possible its base, would not easily be altered in years to come. Equally, there was no desire to vary the GST for macroeconomic, countercyclical purposes.

²⁴ Australian Bureau of Statistics, *Government Finance Statistics, Australia, 2016-17*, above n 8.

²⁵ Ibid.

On the other hand, hypothecation is often politically attractive as a means for offsetting the political unpalatability of any tax. A major factor against the GST is that it is a regressive tax, at least in the short run. This is because the household savings rate rises with income, and hence the proportion of income paid in any consumption tax commensurately falls.

Hypothecating the regressive GST to State budgets provided a very neat offset, because State expenditures are highly progressive given the predominance of outlays on health (mainly public hospitals), education (mainly public schools) and welfare (including social housing). While there may not have been full community trust in the compensation arrangements offered for the price effects of the GST, the link to State programs provided a second political bow.

Given that the GST did not really add much if anything to funding for State expenditures, this was something of a sleight of hand, but its political impact was sustained by a secondary consideration – that of engaging and recruiting to some degree support from State governments for the overall reform package.

What was done, or said to be done, for the benefit of the States thus had a political *quid pro quo* in also being of benefit for the political case for introducing the GST as a centrepiece of tax reform.

5.1 The advantages of the GST for the States

The States knew this of course. For them there were probably three main benefits.

First, they were able to share in some tax reform themselves, with revenues provided by the Commonwealth to fund the abolition of some inefficient State financial taxes.

Second, the States had recently lost, as a result of the High Court decision in the *Ha* case²⁶ in 1997, access to their own indirect tax base in the form of franchise license fees. These had been applied mainly to sales of tobacco, alcohol and fuels. While the Commonwealth had covered this loss with a quick and temporary fix of increased excises provided to the States as revenue replacement payments, the result did not look entirely stable and carried some obligations to provide politically incongruous offsetting subsidies. The GST reform was a potential opportunity to move beyond these problems.

Thirdly, a tax base linked fairly closely to consumption, and hence general economic growth, looks more secure than grants determined by governments of the day, and there had been several examples in history, including in the then recent past, where the revenue and cost sharing grants to the States were cut unilaterally by the Commonwealth. Even though the previous attempt, by the Fraser government in 1976, to link untied grants to tax collections had not survived long (being abandoned in 1985) the GST agreement had such comprehensive coverage and interactions with State commitments that it appeared more likely to prevail for a longer period of time.

The States may also have expected that the GST would prove a robust tax base – whether this is so is discussed in section 6.

²⁶ *Ha v New South Wales* [1997] HCA 34 (5 August 1997), High Court.

5.2 The disadvantages of the GST for the States

The GST is a Commonwealth tax and as such must be imposed on a uniform basis across the nation. Since it is imposed in part on goods, it is in part an excise and so also cannot (under section 90 of the Constitution²⁷) be imposed by the States.

This means that the GST cannot play the same role as was envisaged for tax sharing, at least in principle, under Fraser federalism. Under that scheme, a second, never implemented, leg was to allow the States each to vary the rate of tax and hence the revenue yield within their own borders. This restriction to the GST is either an advantage or a disadvantage of the GST as a base for State revenue, depending on one's perspective about such flexibility.

For those who still believe in competitive federalism, perhaps as a potential source of fiscal discipline on governments, the lack of revenue flexibility for individual States is a disadvantage. Others see the new arrangements as another manifestation of the centralising dynamic of the Australian federation in practice.²⁸ However, if the major part of State expenditure relates to national public goods, as posited in this article, then the loss of flexibility is likely of relatively little importance. State by State differences in expenditure on these major areas (after equalisation of fiscal capacities) are likely to be small and any such differences that may emerge can be reflected in other parts of the State revenue or expenditure budgets.

A second potential disadvantage of hypothecating the GST to State grants is that it adds a constraint on future changes to the GST itself. There is little reason to imagine that the preferred future revenue yield of the GST, particularly relative to other taxes, would or should reflect the revenue needs of the States. Of course, it is not particularly difficult to break the 100 per cent link. Already, the Commonwealth has agreed to add additional amounts to the GST pool for payments to the States. It could readily strike any number of possible future variations to the arrangements – paying as grants a greater or lesser percentage of revenue collections than 100 per cent. This might, for example, be necessary if ever the role of the GST was to be increased in the context of a tax reform – it is quite likely that some of the revenues would need to be paid by the Commonwealth as compensation payments to low income earners, or otherwise applied to other purposes.

All this is to say, nonetheless, that hypothecation is not much of a constraint on policy simply because it can be wholly or partly undone, though of course that might present some form of political challenge in the process.

6. IS GST REVENUE ROBUST?

The tax arrangements that included the introduction of the GST were designed from the outset to provide approximately the same net fiscal position for the States as already existed. This required that the GST revenues would not only replace the previous financial assistance grants and revenue replacement payments, but also the abolished or reduced State taxes and the fiscal costs arising on the outlays side of the States' budgets.

²⁷ Australian Constitution, s 90.

²⁸ David Hamill, *The Impact of the New Tax System on Australian Federalism* (Australian Tax Research Foundation, 2006).

Indeed, the arrangements were so closely matched that there was a risk of shortfalls for one or more States, and so a guarantee was provided that supplementary payments, termed budget balancing assistance, would be made where any State fell short of the pre-existing position. As it turned out, these additional payments were required for the first four years of the GST, and indeed were revived in 2008-09 when the GST revenues fell sharply after the global financial crisis (GFC).

It had been hoped that the GST would prove to be a robust base for the determination of untied financial assistance to the States. Once the initial budget balancing assistance years had passed, for a time this appeared likely. But things have not worked out quite as well as hoped.

The GST is notionally a tax on a large share of private consumption. However, it varies from that in two main respects. First, the tax base does not include some key items of consumption expenditure, either because they are fully exempt (GST-free) or input taxed. In general these items have had an increasing share of total consumption. Secondly, the final tax base includes one item of capital investment – investment in dwellings. The first consideration has created a trend decline in GST collections relative to GST, while the second is one source of volatility in collections.

6.1 Trend base decline

The trend increase in the spending share on fully exempt items, particularly health and education, and the often input taxed items (involving a lower effective rate of tax) on rent and financial services, has meant that over time the tax base has weakened relative to total consumption and to GDP.

Over the 15 years from 2002-03 to 2017-18, the share of household final consumption spending on health and education increased from 8.4 to 11.3 per cent. Rent and financial services increased from 25.2 to 28.5 per cent. In total therefore, the consumption share of fully exempt or more lightly taxed categories increased from 33.6 to 39.8 per cent. Since in the same time the increased savings rate resulted in a small fall in the private consumption share of GDP, the GST collections grew much more slowly than GDP.²⁹

Apart from these trend movements in the base of the GST, it is also usual for tax avoidance opportunities to gradually erode any tax base. In the case of value added taxes, as for income taxes, the improvement in technologies that facilitate international transactions has probably provided the main tax avoidance opportunities. Actions have been taken to stem these losses, but it is likely that the revenue gains from these actions have merely offset the losses that had been occurring. The overall yield of the GST, expressed as a share of GDP, remains somewhat lower now than it was in the initial years. In broad terms the loss represents around 15 per cent of total revenues, with a fall from a peak in the early 2000s of about 4 per cent of GDP to about 3.4 per cent or less in recent years.³⁰

²⁹ Australian Bureau of Statistics, *Australian System of National Accounts, 2017-18*, above n 2.

³⁰ See Commonwealth Budget Paper No. 1, *Budget Strategy and Outlook*, Statement 4 (various years).

6.2 Base volatility

The tax on dwelling investment has imparted an element of revenue volatility, since dwelling investment is often more cyclical than consumption spending.

At the same time, a consumption tax base will vary with the pattern of household savings. This has been markedly volatile in the first 20 years of the GST. Three periods can be distinguished. At the time of introduction of the GST, and until the Global Financial Crisis (GFC) in 2008, household savings rates were extremely low, and even negative in some years. This corresponded to high GST collections.

The GFC brought a sudden and very substantial increase in household savings rates, peaking at around 9 per cent and persisting above 7 per cent for several years. In these years, the GST yield fell appreciably. In broad terms, while the GST yield had peaked at nearly 4 per cent of GDP in 2003-04, it fell as low as 3.1 per cent in the high-savings years after the GFC.³¹

The third period, dating from around 2015, has been one of some recovery in GST collections to about 3.4 per cent of GDP, associated with a period of falling household savings rates together with growth (until 2018) in dwelling investment.³² Whether these trends will continue in the period ahead is far less certain – indeed a considerable decline in dwelling investment has been underway and may bring a further weakening in GST collections.

However, the States did not experience great fiscal stress as a result of this somewhat disappointing GST yield. Perhaps the main reason for this has been the mining boom which occurred largely at the same time as the weakness in GST unfolded. The mining boom was heavily concentrated in one State, namely Western Australia, with one or two others participating to a lesser degree (mainly the coal States of Queensland and New South Wales), but the distribution arrangements for the GST meant that all States fiscally benefited from it. This is explained in the following section.

7. STATE REVENUE EFFECTS OF HORIZONTAL EQUALISATION

Following the first attempt at formal tax sharing, introduced by the Fraser government in 1976 by designating a fixed State share of personal income tax collections (the vertical distribution), it was understandably decided that the allocation of the shares of total grants among the states (the horizontal distribution) should also be placed on a more formal footing. Up to that point, the State shares had largely developed over time in a series of bilateral arrangements without ongoing independent formal assessment of relative fiscal needs.

The Commonwealth Grants Commission, which hitherto had the more limited role of assessing special grants for individual States facing fiscal hardship, was asked to determine a set of per capita relativities for the allocation of tax sharing grants among all States. The basis for these relativities was the longstanding principle of horizontal fiscal equalisation (HFE), which means the distributional objective is equalisation of

³¹ For household savings rates see Australian Bureau of Statistics, *Australian System of National Accounts, 2017-18*, above n 2, Analysis of Results. For GST collections see n 29 above.

³² *Ibid.*

the fiscal capacities of the States.³³ The new relativities were introduced in the early 1980s, albeit with some transitional concessions to some States in the earliest years, and the Northern Territory (1988) and Australian Capital Territory (1993) were brought into the scheme later when each was granted self-government.

The fiscal equalisation arrangements have been substantively maintained over the subsequent decades, and continued to be applied even when tax sharing gave way to formula based grant pools in 1985, and then again when the GST revenues became the basis for the grant pool in 2000-01.³⁴

In recent years, a period of particularly low relativities for Western Australia arose because Western Australia became by far the fiscally strongest state in Australia. The mining boom, associated particularly with the emergence of China as the world's largest real economy, resulted in a more dramatic increase in mining revenues (mainly royalties) for Western Australia than for other States. Western Australia now has more than half of Australia's mining production including nearly all of the production of iron ore.

The low Western Australian relativities due to high mining revenues in Western Australia have resulted in higher GST grants for the other States, representing a transfer of about AUD 5 billion per year in recent years.³⁵

Through this mechanism, the fiscal positions of all States have benefited similarly from the approximately six-fold increase in total State mining revenues (from a little over AUD 2 billion per year to over AUD 12 billion) since the GST was introduced. The surging mining revenues have provided no doubt welcome supplementation to State budgets in the face of some disappointment in the rates of growth of aggregate GST revenues and perhaps some State own-source revenues.

While the taxation of the frequently strongly growing property sector has also operated to boost State revenues, over time this has had more a cyclical than structural effect on GST shares, particularly since property tax bases are more evenly distributed among the States, at least relative to mining activity.

8. OBSERVATIONS ON POSSIBLE FUTURE DEVELOPMENTS

Will the GST be a secure source of revenue for the States in the future? The linking both by agreement and in legislation of most untied Commonwealth payments to the States to GST revenues will likely continue to provide a more certain untied revenue pool than the more discretionary alternative of annual grant determination. But any meaningful fiscal security for the States can only be understood in the full context of federal financial relations, where the sharing of functions, costs and revenues all combine in a

³³ The current interpretation of HFE allocates funds so that each State has the same fiscal capacity to provide services and their associated infrastructure at the same standard, if each makes the same effort to raise revenues from their own sources, operates at the same level of efficiency and maintains the same average per capita net financial worth (see CGC, <https://www.cgc.gov.au/>).

³⁴ For a history of the arrangements, see Commonwealth Grants Commission, *Equality in Diversity, History of the Commonwealth Grants Commission* (Australian Government Publishing Service, 1995) and Commonwealth Grants Commission, *The Last 25 Years* (CGC, 2008).

³⁵ Recently, through a combination of budget measures since 2018 and legislative changes to apply from 2021-22 until 2026-27, a part of the fiscal cost of these transfers has been, or will be, shifted from Western Australia to the Commonwealth.

complex interplay to determine fiscal outcomes for the States. These broader fields of decision making remain subject to considerable long term uncertainty, and so whether relative certainty for the untied grant pool translates into overall fiscal certainty when all aspects of financial relations are considered remains unclear.

The practice of Australian federal financial relations seems likely to continue to respond to continually changing underlying social, political and economic forces more than to any clear theory of federation or strong overarching intergovernmental agreement on arrangements. At this point, after 118 years of this practice, there is little sign that the Australian federation will be the subject of sustained broad-scale reform efforts, at least not of a kind that would greatly reduce the policy entanglement that has long prevailed. On the contrary, as suggested in this article, the federal entanglement of health, education and welfare and some other government functions may well have its own logic in terms of sustaining democratic voice in relation to complex and increasingly *national* public goods, and so any efforts at simplifying or rationalising arrangements could well stir considerable political resistance.

At the same time, there is little in Australia's history to suggest that existing arrangements will prove entirely stable, persisting indefinitely in their particular current form. The ongoing tensions arising in the three interrelated fields of function, cost and revenue sharing, in the face of relentless underlying pressures on expenditure in all of the main areas of public spending, are likely to continue to cause pressures for adjustment, which have been seen repeatedly over time. To this can now be added new tensions that have arisen from changes in the relative fiscal strengths of the States, associated particularly with the structural shift in the economy towards the mining sector which is concentrated in one or two States. Underlying this, of course, is that in Australia, unlike in unitary states and some other federations, mineral resource endowments are owned and largely taxed at the State level.

Whether tax reform, as it did in 2000, drives a change in federal arrangements through a change in the desired scale or role of the GST in the overall tax architecture, is another matter. The Australian GST is perhaps a relatively low rate tax, at least in comparison with Europe and many of Australia's major trading partners such as China, India and New Zealand. While there is little sign of change pressure on this at present, in the longer run the tax architecture is certain to be stressed by increasing fiscal demands from multiple sources (and not perhaps just those addressed in intergenerational reports³⁶).

The faltering robustness of the GST base itself may prove a factor in this. While it is not possible to be certain that trends for decline to date will continue, equally they may. The question then is whether the link between GST revenues and grant arrangements for the States hinders or aids future tax policy adjustment.

If there are limited signs of change impetus coming directly from either federalism or immediate tax architecture perspectives, there remains a third possibility for driving reform, which could have implications for State revenue arrangements. Arguably among the main sources of future fiscal pressures will be the issues arising in each of

³⁶ The Commonwealth government releases an Intergenerational Report every five years 'that assesses the long-term sustainability of current Government policies and how changes to Australia's population size and age profile may impact on economic growth, workforce and public finances over the next 40 years': see Australian Treasury, 'Intergenerational Report', <https://treasury.gov.au/intergenerational-report>.

the major functional areas described in this article as ‘what States do’. The big five – health, education, welfare, transport and justice – and perhaps also in future some now relatively less costly, traditionally State-dominated areas such as land use, housing, urban design and the environment, all potentially face rising demand pressures that could create significant future challenges for federal financial relations.

They also will, and already do, involve tensions and opportunities for reforms relating to the relative role of public and private provision and decision-making. So any significant federal financial relations reforms in these areas will need to come through holistic policy attention to the entire strategic public policy approach to them. Changes to the GST, and State payments, may well arise in that context at some time, but whether it brings comprehensive reform is at best uncertain given the pattern of for the most part piecemeal attention invested in these questions to date.