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**Special Edition: State Funding Reform in the Australian Federation**

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## Editorial

# Fiscal Federalism under Review (at *Speed*)

Neil Warren<sup>1</sup>

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 2010<sup>2</sup>, 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.

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'.<sup>5</sup>

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 intergove



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 noted these

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,

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.

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