

Defending the idea that states should be permitted to raise their own income tax, Prime Minister Turnbull [said](#) that if we were “starting from scratch” designing our taxation arrangements, “we would have a system where each government – each parliament – raised all the money that it spent”.

To mangle a phrase from another federation, we may call that principle “no representation without taxation”. At first sight it appears to be a reasonable guide to the allocation of taxes between the Commonwealth and state (and territory) governments.

That is, until we consider the risk of a “race to the bottom”, as pointed out by Helen Hodgson in her [Conversation article](#) . It's more than a theoretical outcome: she reminds us, for example, that interstate tax competition in the 1970s resulted in the abolition of inheritance taxes.

In the United States we see the consequence of tax competition writ large, as poor states with weak tax bases become even poorer because they're unable to fund the public services needed in a modern competitive economy. The problem is particularly manifest in school education, where schools are funded by local government taxes. Poor cities have poor schools, meaning education gaps and therefore income gaps go on widening.

Among prosperous developed federations Australia stands out for its [strong centralisation](#) of taxes. The Commonwealth collects around 80% – a point noted in the 2015 Reform of Federation [discussion paper](#) , with the hint that it should be lower.

Fortunes can change quickly

But perhaps what we should ask is, if we were starting from scratch, would we have a federal or a unitary government? There aren't many federations in the world. Some, such as Germany and Switzerland, were cobbled together from long-established states with a high degree of autonomy and distinct cultural differences. Ours was cobbled together from a set of distant colonies.

Shortly after federation, in the 1920s, there was political pressure for revenue sharing among the states. This resulted in the establishment in 1933 of the [Commonwealth Grants Commission](#), guided by the fiscal equalisation [principle](#). The principle involved “the transfer of payments or grants across jurisdictions with the aim of offsetting differences between a jurisdiction’s revenue raising capacity and expenditure needs”. That has generally resulted in a transfer from NSW and Victoria (and in the recent mining boom years from Western Australia) to other states and territories.

A Senate with equal state representation has been one factor supporting fiscal equalisation. It also recognises that in a nation so dependent on commodity exports regional fortunes can change quickly. And there is a general belief that in a country with interstate mobility there should be some uniformity of government services. When people are mobile between regions, centralisation of taxation makes good sense.

The Commonwealth has never been legally required to follow the Commission’s recommendations, but it has done so with untied grants or “general revenue assistance”, specifically funds collected by the GST.

When it was introduced in 2001, premiers greeted the GST enthusiastically because it was seen as a “growth tax”, but it has not entirely lived up to that promise. In 2001-02 GST was 3.73% of GDP; by 2014-15 it had fallen to 3.35%.

That may appear to be a small difference, but had it stayed at its original percentage, states would now be collecting an extra A\$6 billion a year. Not only has the growth of private consumption fallen as the mining boom has wound down, but also items exempt from GST, health and education in particular, have been taking more of consumers’ expenditure.

State services are labour-intensive

Compounding the problem for states is the fact that state governments are responsible for labour-intensive human services. Hospitals, school education and policing absorb about 60% of stat

es' recurrent expenditure, and while there are undoubtedly opportunities for productivity improvements, the cost of delivering such services is bound to rise in line with incomes for skilled and professional workers (a phenomenon known as the [Baumol Effect](#) .)

So it is hardly surprising that premiers have called for a better revenue base. Naturally, the poorer states want to retain the principle of fiscal equalisation. As policy makers think through the problems of a race to the bottom and the entrenchment of regional disadvantage, proposals to allow states to set their own income tax rates will probably slide off the table.

The problem remains that states need more revenue, and their own revenue bases depend on administratively costly and economically inefficient taxes. They need more revenue from nationally collected taxes – a higher GST, higher income tax, the removal of superannuation and capital gains concessions or some other tax. While South Australia Premier Jay Weatherill and NSW Premier Michael Baird [have led the push](#) for a better deal for the states, Victoria Premier Daniel Andrews has raised the [bi-gger issue](#) : we need more public revenue.

Turnbull has a point in wanting states to take more ownership of taxation, but there is no need to abandon fiscal equalisation. This tradition has helped protect us from the regional disparities that have afflicted the United States. While, for administrative reasons, the Commonwealth should collect taxes on behalf of the states, such taxes should be earmarked (as is the case with the GST), and publicly identified as state taxes. If they were seen as “their” taxes premiers would be saved the indignity of a mendicant relation with the Commonwealth.

Our arrangements pragmatically combine aspects of centralisation and federalism. We don't need to abandon them. Rather we should ensure that the voting public understand where their taxes are going.

Ian McAuley does not work for, consult, own shares in or receive funding from any company or organization that would benefit from this article, and has disclosed no relevant affiliations beyond the academic appointment above.

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