

Three areas to reform federal-state financial relations

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While this week's [draft report](#) from the Productivity Commission didn't recommend a major overhaul of how GST is allocated among the states, it did recommend "a longer term goal of reform to federal financial relations".

Three areas of Commonwealth-state financial relations warrant reform.

The first is to broaden the GST base to provide adequate funds for projected growth of state outlays on health and education. The second is to improve the incentives and rewards for states to reform their distorting taxes. The third is to reduce the overlaps and duplication of Commonwealth and state governments in the supply of health, education and other services.

These and other reform ideas were flagged in background papers for the proposed [Reform of the Federation White Paper](#), which was disbanded in 2015, and by many others.

Read more: [What an equitable GST reform package should look like](#)

A key characteristic of the financial relations between the Commonwealth and state governments in the Australian federal system is the dominance of the Commonwealth as the collector of taxes. It receives over [80% of all tax revenue](#), while the states spend [about 45%](#).

On average, the states depend on Commonwealth transfers for nearly half of their funds. [About half](#) of these transfers involve redistribution of the GST as untied grants to the states.

The distribution of the GST funds between the states is designed to be equitable. A higher per

capita share goes to states with relatively high costs of providing services (because of, for example, sparse populations) and relatively lower capacity to raise their own taxes (due to less mining activity or lower property values, for instance).

The Commonwealth provides the [other half](#) of the transfers – on average about a quarter of state funds – as tied grants to the states for specified programs in health, education, housing, infrastructure and others.

1) Broadening the base

A looming structural budget problem for the states is that GST revenue is projected to [increase at a slower rate than national income](#)

. At the same time, the funding required to maintain current education, health and other programs is likely to rise faster than national income.

The relatively slow growth of GST revenue arises because the current GST tax base exemptions, particularly for health and education, are growing as a share of household expenditure. An additional short-term risk is that the household savings rate will increase as interest rates rise, reversing the recent rapid growth in household debt, to meet higher mortgage interest rates.

Read more: [What can other countries teach us about GST reform?](#)

Reforming the GST by adopting a comprehensive tax base with minimal special exemptions, [along the lines of the New Zealand model](#) (which has a broader base and a higher rate), would provide a larger and more robust supply of funds for growing state expenditures.

Some of the additional revenue raised will be required to increase social security rates and reduce income tax rates so that the overall tax burden remains roughly the same. At the same

time, a comprehensive GST base will contribute to national productivity by removing tax distortions to household spending decisions and by funding reductions in income and other more distorting taxes.

2) State tax reform

Many of the current state taxes heavily distort decision-making, which results in lost productivity. For example, conveyance duties (also known as stamp duties) on property sales deter some households and businesses from selling and buying property when circumstances change – when they change jobs, family size etc.

[Numerous reviews](#) have identified state tax reforms to reduce these distortions. Examples include replacing conveyance duty with a broad-based property tax and broadening the payroll tax base. An annual property tax would remove the disincentive to buy and sell property, but would collect roughly the same revenue.

Other proposals require reform across both tiers of governance. These include [replacing the Commonwealth fuel excise and state taxes on motor vehicles](#), with explicit charges for road use, congestion and pollution. These better signal the costs of travel to motorists and result in better use of the transport network.

Read more: [Reforming GST is the key to productivity growth](#)

Effective reform of state taxes is more likely under the banner of cooperative Commonwealth and state negotiations than reliance on the initiative of individual states. As noted in the Productivity Commission [draft report](#), if individual states replace conveyance duties with a broad-based property tax, this will likely reduce the share of GST allocated to the reforming state. This is a disincentive to change.

As a general point, some of the benefits of a larger and more productive economy driven by

reform of state taxes accrue to the Commonwealth as a larger corporate and personal income tax base.

3) Expenditure decision-making

Intervention by the Commonwealth in state expenditure decisions (on education, health, housing and infrastructure) leads to inefficient and more costly decisions, a lack of accountability to the electorate, and wasted public service talent in blame-shifting and game-playing.

Simply reforming the allocation of the GST among states is not going to change the adverse effects of current Commonwealth-state financial arrangements.

Fundamental reform of the federation should reduce the overlap of decision-making on government expenditure, and more broadly reconsider the allocation of expenditures and responsibility for expenditures between the different levels of government.

For example, responsibility for education, health and housing should be given to a specific level of government. Tied Commonwealth grants, which restrict decision-making by states, should be phased out. These could be replaced, for example, with states getting a share of income tax as happens in other federations.

Read more: [*Broader base, not a higher rate the answer for GST reform*](#)

In the end, there are many opportunities to reform Commonwealth-state financial relations, to re-energise the Australian economy to generate higher living standards for all. But we should start by broadening the base of the GST (New Zealand style), reforming state taxes, streamlining expenditure responsibilities across governments, and providing states with a share of income tax revenue.

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