



Infrastructure**first**

Untangling the web of Commonwealth/State/Local government funding – what did your GST buy?

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Introduction

Problems associated with inadequate investment in physical and social infrastructure have received a good deal of attention recently, along with skill shortages that have been attributed to inadequate investment in human and social capital. Areas of particular concern have included transport infrastructure (notably ports and urban rail), electricity and water supply systems and social infrastructure such as health.

Discussion of infrastructure problems has taken place against a background of disputes between Commonwealth and state governments over a range of issues, including infrastructure. A central element of these disputes has been the Goods and Services Tax (GST), and the claim, made by the Commonwealth Government and others that the revenue ‘bonanza’ from the GST is not being properly used by the states.

It will be argued in this paper that claims about the fiscal benefits of the GST have been greatly overstated, and that a radical restructuring of the funding relationship between Commonwealth and state governments is required if problems of inadequate investment in infrastructure are to be assessed properly.

The paper is organised as follows. In Section One, the problem of vertical fiscal imbalance is described, and it is argued that this problem is worse in Australia than in other federal systems. In Section Two, the GST and the associated deal between the Commonwealth and the states is analysed.

It is shown, that contrary to many claims, the deal leaves the states no better off than before the GST was introduced. In Sections Three and Four, the problem of overlapping Commonwealth and state responsibilities is described and some possible responses are discussed. Finally, some concluding comments are offered.

1. Vertical fiscal imbalance

The core of the difficulty in relations with the states is the problem of vertical fiscal imbalance, that is, the fact that the Commonwealth raises the bulk of tax revenue, while the states' responsibilities for public expenditure greatly exceed their own revenue-raising capacity. The gap must be made up by grants from the Commonwealth to the states, some for specific purposes and some for general financial assistance. Payments from the Commonwealth (grants and GST) account for about 40 per cent of state revenue for New South Wales and Victoria, and up to 60 per cent of revenue for other states.

In an unbalanced relationship of this kind, the power of the purse is ultimately dominant. The Commonwealth government holds the whip hand, and its interests are best served by keeping taxes low, maintaining own-purpose expenditure and passing the burden of expenditure restraint on to the states.

The Fraser and Keating governments cut general purpose grants to the states by half as a proportion of GDP, and used conditional payments to exact compliance with Commonwealth policy. Despite promises to the contrary, the Howard Government has carried on this tradition.

Vertical fiscal imbalance is worse in Australia than in most other countries in a number of respects. First, the allocation of tax powers is more uneven. In most federal systems, state or provincial governments have the power to levy an income tax, a consumption tax or both.

In Australia (if we disregard the theoretical possibility that state income taxes could be revived) they have neither. Second, the proportion of state income that is received from Commonwealth sources, mainly the Goods and Services Tax and Financial Assistance Grants (FAG), is very high. Third, the states in general have higher levels of net debt than the Commonwealth, particularly relative to the tax base available to service that debt, and this disparity is again high by international standards

The GST was supposed to remedy the problem of vertical fiscal imbalance. A large proportion of the FAG payments were replaced by the GST, which was represented as a 'state tax', which could not be altered without the consent of all state governments. Hence, the GST was supposed to be a guaranteed source of growing revenue for the states. The fact that the tax was collected by the Commonwealth government on the basis of Commonwealth law was treated as a mere administrative convenience.

This position has now been repudiated by the Commonwealth government. During the course of a dispute over state taxes, Treasurer Costello asserted the right of the Commonwealth to withhold GST revenue from the states. Since the idea that the GST is a 'state tax' rests solely on the willingness of the Commonwealth to uphold convention, such an assertion, once made, cannot be unmade.

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The Commonwealth has the exclusive constitutional right to levy a consumption tax, and the Commonwealth Government is free to amend the tax at will, and to use the revenue as it pleases.

The effect of vertical fiscal imbalance is that Commonwealth pursues activities that yield political benefit, given the division of taxing and spending responsibilities.

The Commonwealth benefits more from its own-purpose spending than from transfers to the states, so it can be expected that Commonwealth areas of responsibility will be treated more generously than state areas of responsibility. Even more significantly, since the Commonwealth bears the political cost of income and consumption taxes, but receives only part of the political benefit from the resulting expenditure, the Commonwealth government will generally have a preference for tax cuts, and particularly income tax cuts

In addition, vertical fiscal imbalance creates incentives for *ad hoc* Commonwealth interventions in areas of state responsibility. These are typically high-profile initiatives that attract favourable media coverage. The result, in many cases, is that political luxuries are lavishly funded while less exciting, but more important, basic services are starved of resources.

2. The GST deal and its consequences

To discuss Commonwealth–state financial relationships properly, it is necessary to consider in detail the deal between Commonwealth and state governments that led to the introduction of the GST. The central elements of the deal were:

- i. The abolition of a range of state taxes, with further reductions to be considered when GST revenue exceeded a Guaranteed Minimum Amount (GMA);

- ii. Abolition of FAG payments from the Commonwealth to the states; and
- iii. Budget balancing assistance for any shortfall of GST revenue from the GMA.

Claims that the states are reaping a 'bonanza' from the GST are based on the fact that, as of 2004-5 (the first year for which this is true); GST revenue exceeds the GMA for all states.

It is therefore crucial to consider how the GMA was calculated. The GMA was derived primarily from estimates of the tax revenue foregone by the states and projections of Financial Assistance Grants, with some offsets for putative efficiency dividends from the GST. Foregone tax revenue was projected to grow roughly in line with nominal GDP, but the projected FAG payments grew at rates of three to four per cent each year.

That is, the baseline for comparison was one in which Commonwealth payments to the states were held roughly constant in real per capita terms. Under the baseline projection, Commonwealth FAG payments to the states, considered as a proportion of GDP, were projected to decline steadily. A more neutral baseline would be one in which FAG payments grew in line with nominal GDP.

Even with this conservative baseline, GST revenue for the states, after five years of operation, only modestly exceeds the GMA. The demand from the Commonwealth treasurer for further cuts in states' taxes implies that any benefit relative to the GMA will be further reduced.

It is only because of the boom in state revenues from land taxes and stamp duties that the effective reduction in payments associated with the GST deal have not caused greater difficulties for the states.

In effect, far from handing the states a GST bonanza, the Commonwealth has been able to capture for itself a substantial share of the benefits of growth in the remaining revenue streams available to the states.

This is not particularly problematic as long as the boom in land values continues. But there is already evidence of a downturn. Once the boom in land tax and stamp duty revenue subsides, it will become apparent that the underlying fiscal position of the states has actually deteriorated, with demand for services outweighing sustainable growth in revenue.

3. Overlapping responsibilities

Most infrastructure services involve a mixture of federal and state spending and responsibility.

Road, Rail and Ports

Most responsibility for road and rail transport falls to state governments. However, the Commonwealth plays a role through national highway funding and through a variety of initiatives in the rail sector. (The Commonwealth formerly operated some rail services, but these were sold in 1997, and Commonwealth-owned track was merged into the Australian Rail Track Corporation.

The biggest problem in this sector is the absence of consistent treatment of road and rail. Rail services are operated by private firms and corporatised enterprises owned by state governments which are, except in relation to urban passenger transport, generally expected to operate profitably, including the achievement of a commercial return to capital.

By contrast, there is no coherent system of charges for roads and road users. Comparisons between revenue from fuel taxes and expenditure on roads do not take account of the capital stock inherent in roads, and the land they occupy, and the return to that capital that would be required under a market-based system of road user charging.

The result is that comparisons between roads and rail are inherently biased, normally in favour of roads, although offsetting biases in favour of rail are sometimes introduced. These biases make coherent evaluation of alternative investment strategies very difficult.

Ports are mostly state-owned or state-regulated, but have been subject to *ad hoc* Commonwealth intervention, notably in relation to the 1998 waterfront dispute and the recently established committee of inquiry into infrastructure provisions.

Electricity, gas and water

In the case of electricity, gas and water, national markets have been overlaid on a historical basis of service provision by state governments. The national electricity market is the most fully developed example. Despite the name, it is really a set of links between state-level generation and transmission systems, with only partial interconnections between the states. Meanwhile, until the Australian energy regulator begins operation, distribution systems are regulated at the state level.

The problems with the electricity system are illustrative of broader failings in the infrastructure system. State governments have, in large measure, withdrawn from responsibility for ensuring adequate investment in generation and transmission, and have only an indirect role in relation to distribution. The result has been generally inadequate investment, and an increased cost of capital.

Since most electricity systems had excess capacity in the mid-1990s, when reform began, problems have only emerged relatively slowly. However, there are now shortages of generation capacity and problems with distribution networks in a number of states.

Owners of regulated assets are demanding higher rates of return, typically amounting to a 50 per cent increase in the weighted cost of capital compared to the pre-reform situation when investments were financed by the issue of bonds.

This is part of a more general pattern. Since the end of direct state government involvement in large parts of the infrastructure sector, investment has been weak, and required rates of return have been high. Despite large reductions in employment, there have been only modest reductions in the cost of services, and households have generally faced increasing costs.

Social infrastructure

The problems of inadequate investment, and the incoherent allocation of responsibilities between state and national governments are most evident in relation to social infrastructure, particularly health and education services, though many of the same issues arise in relation to local government.

In the case of health care, state governments have primary responsibility for hospitals. The Commonwealth handles much of the rest, including Medicare, the Pharmaceutical Benefits Scheme, nursing homes and the training of doctors (registered by states, but needing a Commonwealth Medicare provider number to practise). The division of responsibility between the Commonwealth and the states gives rise to various forms of cost-shifting, particularly between Medicare and the hospital system.

The situation in education is similarly confused. The states operate, and provide most funding for, public schools and technical and further education (TAFE), and also give significant funding to private schools.

The Commonwealth funds private schools and universities and provides some funding for state schools and TAFE along with various *ad hoc* interventions on issues such as curriculum and assessment, commonly with the aim of achieving national uniformity, though without any strong argument as to why such uniformity is necessary. In the 2004 election campaign, the Commonwealth also proposed to establish its own network of TAFE colleges.

4. Options for a more consistent approach

Would it be possible to establish a more consistent approach to the provision of physical and social infrastructure? Several options have been put forward.

Regional governments

The idea that Australia should abolish our eight state and territory governments and replace them with a larger number of regional governments (say 20) has been discussed for many years, and promoted by prime ministers Whitlam and Howard. This idea sounds appealing enough in the abstract, which is how it is normally presented. In practice, however, it is unworkable.

To begin with, it is necessary to define regions with natural boundaries. It is obvious, at a minimum, that each of the existing State and territory capitals must have its own region. Moreover, Geelong clearly belongs with Melbourne, Wollongong and Newcastle with Sydney, and the Gold Coast and Sunshine Coast with Brisbane.

At this point, only three urban centres with a population of more than 90,000 are left — Townsville, Cairns and Launceston, suggesting North Queensland and Northern Tasmania as new regions. The 10 regions described so far include urban centres accounting for more than 75 per cent of the population of Australia. When their immediate hinterland is taken into account, the figure is probably between 85 and 90 per cent.

It is simply nonsense to suggest that the remaining two or three million people in rural Australia could be divided up into 10 sustainable regions, as the 20-region idea would suggest. Road, rail and air transport networks all radiate from state capitals, which are also the headquarters for most businesses. Any regional government formed in rural Australia would have little option but to base many of its operations in the existing state capitals.

Rural and regional Australians feel neglected by governments based in faraway coastal cities, and often with good reason. But under the current system, country voters frequently exercise the balance of power, and can punish governments that are too focused on the interests of the metropolis.

In a system of regional governments, this influence would be lost. The regions would still depend on the former capitals for transport hubs, teaching hospitals, major universities and a host of other services, but would no longer have any political leverage over them. In dealings between say, a government of Greater Sydney and a government of Greater Wagga, it is not hard to imagine who would lose out.

Unitary national systems

The simplest approach to the problem of inconsistent public policy on infrastructure planning and provision is to adopt a unitary national approach, with the Commonwealth Government taking undivided responsibility. An attractive feature of this approach is that any transfer of responsibility from the states to the Commonwealth reduces vertical fiscal imbalance. On the other hand, capacity to respond to local variations in conditions, political preferences and so on is reduced.

One area where a unitary national approach seems particularly attractive is that of health services. Crucial elements of the health system, particularly Medicare and the Pharmaceutical Benefits Scheme are inherently national, and cannot easily be separated from currently state-run aspects of the system, particularly hospitals. The only satisfactory solution, it would seem is for the Commonwealth to accept responsibility for public hospitals and other aspects of the health system currently run by the states.

Another area where a unitary national system would be desirable is post-secondary education. Having entered the TAFE field, the Commonwealth should offer to take it over completely, and develop a consistent national policy aimed at ensuring that post-secondary education (TAFE or university) is available to all young Australians, and that the proportion undertaking such education is increased in line with the growth in demand for skilled workers.

Return of activities and tax powers to the States

Other things being equal, it is better for the control of public services to be the responsibility of local and State governments rather than national governments, since these governments are closer to the voters to whom such services are provided.

One area where the States ought to take full responsibility is that of school education. Commonwealth involvement in this field dates back to sectarian disputes over state aid to Catholic schools in the 1960s, and is no longer justified.

The big problem with any increase in state responsibilities is that it exacerbates the problem of vertical fiscal imbalance. It is therefore necessary to consider the possibility of an offsetting transfer of tax powers to the states.

The most radical option would be the reintroduction of a state-level income tax. This would inevitably be similar to the GST in that it would be administered by the Commonwealth, and would rely on the Commonwealth tax act for definitions of income, anti-avoidance propositions and the like.

In effect, the state tax would be something like the Medicare levy, with a rate that would be decided by the states and implemented by the Commonwealth. A levy at a rate of five per cent would eliminate the current vertical fiscal imbalance (at least if GST is treated as a state tax) and would also provide some possibilities for removing existing state taxes.

Co-operative Federalism

In many cases, it is not possible for problems to be dealt with entirely at one level of government. The best response in such cases is co-operative federalism. Co-operative federalism has worked quite well in many cases, notably including the management of the Murray–Darling Basin over the 90 years since the formation of the River Murray Commission in 1915. However, it is prone to breakdown where substantial sums of money are involved. In fact, the national water initiative, an important example of the process, is currently in limbo as a result of a dispute about its funding.

Co-operative Federalism, then, is the best available option in many cases, but is less satisfactory than a clear-cut assignment of separate spheres of state and Commonwealth responsibility.

Concluding comments

Australia is suffering from the lack of a coherent approach to investment in physical and social infrastructure. The fiscal imbalance between Commonwealth and state governments is a major part of the problem and the introduction of the GST has, if anything made the problem worse. The best solution would be a clearer division of responsibilities between state and Commonwealth governments.

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