

## **TREASURER**

### **PROVISION OF FAIRER AND MORE SUSTAINABLE COMMONWEALTH FUNDING**

#### **PURPOSE**

1. To recommend that you renegotiate the terms attached to, and the methods that determine, Victoria's share of Commonwealth grants.

#### **BACKGROUND**

2. Victoria will receive \$25.58 billion in 2015-16 from the Commonwealth government, which comprises approximately 46 per cent of revenue.<sup>1</sup>
3. Total revenue from state transactions and taxes are projected to increase by an average of 3.3 per cent and 2.9 per cent per year, respectively, over the forward estimates. However, Commonwealth grants for specific purposes are expected to increase by only 1.7 per cent in 2015-16, and to fall in 2016-17. The forward estimates are at Attachment 1.
4. The Commonwealth signalled in their 2014-15 budget that they will reduce the previously projected growth in their funding as part of the Health Reform and Schools funding agreements from 2017-18.<sup>2</sup>
5. GST revenue, however, is projected to rise by 6.3 per cent to \$12.8 billion in 2015-16 as both national GST collections and Victoria's share of that pool are expected to increase. GST revenue comprises about half of Commonwealth grants to Victoria.
6. This brief shows that Victoria is at a comparative disadvantage to other states in relation to Commonwealth government grants. It recommends that Victoria should attempt to renegotiate its financial relationship with the Commonwealth government through the Reform of the Federation White Paper process, future Council of Australian Government meetings, bilateral meetings with senior Commonwealth government ministers, and through a public information campaign.

#### **ISSUES**

7. State and local governments only raise about a fifth of total taxes yet account for about half of total government expenditure, and are dependent on the Commonwealth government for about half of their revenue.<sup>3</sup> Thus the ratio of Commonwealth payments to state-raised revenue is high, resulting in Vertical Fiscal Imbalance (VFI).
8. VFI occurs when the taxing capacity and revenue needs of two tiers of government are unbalanced,<sup>4</sup> which in Australia's case is due to the Commonwealth levying most major taxes such as income, company and sales taxes, while the states are dependent on revenue transfers to be able to provide expensive services, such as health and education. VFI in Australia is higher than most other comparable federations in the world.<sup>5</sup>
9. Australia is the only federation that attempts to systematically and fully equalise the revenue and expenditure capacity of the states in order to achieve Horizontal Fiscal Equalisation (HFE), which is done by redistributing the GST differentially.<sup>6</sup>

10. The Commonwealth Grants Commission applies a complex formula to account for the state's efforts to raise revenue from its own sources, the level of service delivery efficiency, the cost of delivering services to certain population groups, and wage pressures, among other factors. Since 1981, when the Commission moved to this system, the largest states of New South Wales and Victoria have always been 'donor' states, in that they receive less than their population share.
11. Victoria has never received its per capita entitlement, that is, if the distribution was based on each state's share of the Australian population, Victoria has always received less. Victoria's current proportion of per capita entitlement is just 91 per cent. This information is presented in Attachment 2. Only Western Australia is in a worse position.
12. In recent years Western Australia has been one of the most vocal critics of the current system, but it has only recently become a donor state and has long benefitted from higher than per capita shares. Yet in May this year Western Australia received an extra \$499 million in compensation for GST shortfalls. Victoria has never received such compensation.
13. Unlike other Commonwealth grants, which are 'tied' to specific policy areas or outcomes, GST revenue is 'untied' funding, meaning that it can be used for any purpose that the state chooses. Given that the smaller 'recipient' states receive a larger proportion of GST revenue, it means that they have more control and flexibility over their spending. Sixty-four per cent of grants to recipient states are untied, compared with only 52 per cent to donor states.<sup>7</sup>
14. GST and other sources of revenue to the states are not increasing at the same rate as spending demands. When the GST was introduced in 2000 the revenue was projected to grow by an average of 6 per cent per year.<sup>8</sup> While the first few years saw growth rates of well above 6 per cent, revenues fell by 2.7 per cent with the onset of the Global Financial Crisis and projections for future years are for growth below 6 per cent. Furthermore, over the first twelve years of the GST state expenditures grew at an average rate of 7.1 per cent per year.
15. The Commonwealth government has often tried to balance its budget by cutting grants to the states.<sup>9</sup> The Commonwealth has signalled that it intends to 'save' \$80 billion in hospital and schools funding.
16. In 2011 the Commonwealth and all states and territories agreed that there would continue to be joint funding of public hospital systems (which are the responsibility of the states), but that the Commonwealth would take a greater share of funding the growth in the efficient cost of services from 2017. The current indexation of hospital funding is over 6 per cent, but the Commonwealth is changing the rate to the Consumer Price Index (CPI), which is currently only 2.25 per cent.<sup>10</sup>
17. The National Plan for School Improvement included increased Commonwealth funding of 3 to 4.7 per cent until a Schooling Resource Standard is met. Again, the Commonwealth has indicated that from 2018 indexation will be tied to CPI, which is likely to be lower.
18. The Commonwealth government established a Commission of Audit to improve efficiency, productivity and savings. Among their recommendations were to distribute GST revenue on a per capita basis, with additional funding to ensure that no state is

worse off compared to the existing system of equalisation (Recommendation 9), and to reduce tied grants to the states, to enable greater autonomy over spending (Recommendation 10).<sup>11</sup>

19. The Victorian government has three main options: (1) contain/reduce expenditure; (2) increase state-based taxes and revenue; and/or (3) negotiate an increase in Commonwealth grants.
20. Victoria already has a lean public sector, has been more reformist than other states, has an excellent credit rating and a budget surplus that is projected to continue in the forward estimates.<sup>12</sup> This is a superior position than other state in Australia, and in the last financial year Victoria was the only state in surplus. Victoria has already undertaken difficult reforms to contain expenditure.
21. Victoria currently receives less on average per household in combined Commonwealth and state social assistance and benefits, compared to every other state.<sup>13</sup>
22. At the last election the government pledged not introduce new taxes,<sup>14</sup> and has fewer assets left to privatise compared to other states.<sup>15</sup> Victoria has comparatively less to gain from the Commonwealth's Asset Recycling Initiative, whereby the Commonwealth provides 15 per cent of the sale price if the funding is used for new infrastructure. The government has already announced the privatisation of the Port of Melbourne, however it may not receive parliamentary approval.<sup>16</sup>
23. Victoria is currently losing about \$1.58 billion a year in GST revenue, that it would otherwise receive if allocated on a population basis. Furthermore, Victoria abolished many state taxes, as was agreed when the GST was first introduced. Other states reneged on this agreement, and as a result Victoria has lost an estimated \$140 million, while the other states have received more than \$750 million from those taxes.<sup>17</sup>
24. The Commonwealth is also insisting that the \$3 billion it allocated for transport infrastructure should be used for the suspended East West Link, rather than the Melbourne Metro underground rail project or other roads projects. Without this investment, Victoria will only receive 12 per cent of the Commonwealth's infrastructure spending, despite being home to one quarter of the population.
25. It is recommended that you continue to negotiate with the Commonwealth and to present of range of changes, while also engaging with the public to translate what these imbalances mean in terms of the taxes they pay and the infrastructure and services that they receive. This involves a combination of policy instruments, primarily policy through *advocacy* but also policy through *money*.<sup>18</sup>
26. The changes include:
  - a special GST compensation payment, like the one given the Western Australia;
  - the adoption of the Commission of Audit's recommendations, particularly distributing GST revenue on a per capita basis;
  - reducing the proportion of tied grants to enable greater autonomy, or least ensure that no state has less autonomy than another;
  - where funding is tied to a particular area, at least allowing the state government to allocate it to projects that they have received an electoral mandate to deliver;

- honouring funding commitments agreed to with previous Commonwealth governments so that all parties have certainly in planning and budgeting;
- compensating Victoria for fulfilling the agreement to abolish state taxes that other states have reneged on;
- compensating Victoria for previously privatising state assets, as the state is less able to benefit from the Asset Recycling Initiative to the same extent as other states; and
- rewarding Victoria for undertaking efficiency reforms in previous decades, rather than using Victoria's gains to effectively subsidise other poorer performing states.

## **RECOMMENDATION**

27. That you:

- approve the inclusion of some or all of the above changes to be included in Victoria's submission to the Commonwealth's Reform of the Federation White Paper process.
- approve the inclusion of some or all of the above changes to be included on the agenda of future Council of Australian Government meetings and other meetings with senior Commonwealth government ministers.
- approve the inclusion of some or all of the above changes in a public information campaign.
- note that you will be provided with further briefings on each of the above proposals for approval prior to their actioning.

**Jane Smith**

**Policy Adviser**

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<sup>1</sup> State Government of Victoria 2015. *The 2015-16 Victorian Budget: For Families*, <http://www.dtf.vic.gov.au/State-Budget/2015-16-State-Budget>

<sup>2</sup> Australian Government 2015. *Budget 2015*, <http://budget.gov.au>

<sup>3</sup> Stewart, M. 2011. 'Australia', in G. Bizioli and C. Sacchetto (eds), *Tax Aspects of Fiscal Federalism: A Comparative Analysis*, IBFD, Amsterdam, 137h 185.

<sup>4</sup> Summers, J. and Lowe J. 2009. 'The Federal System', in D. Woodward, A. Parkin, J. Summers and J. Lowe (eds), *Government, Politics, Power & Policy in Australia*, 9<sup>th</sup> edn, Longman, Melbourne, 85h 112.

<sup>5</sup> International Monetary Fund 2008. *Government Finance Statistics Yearbook 2008*, IMF Statistics Department, Washington D. C., <https://www.imf.org/external/pubs/ft/gfs/yearbook/2008/gfsy08.pdf>; United States Census Bureau 2011. *State and Local Government Finance*, U. S. Department of Commerce, Washington D. C., [http://www.census.gov//govs/local/historical\\_data\\_2011.html](http://www.census.gov//govs/local/historical_data_2011.html); Watts, R. L. 2008. *Comparing Federal Systems*, 3<sup>rd</sup> edn, McGillh Queen's University Press, Montreal and Kingston.

<sup>6</sup> Garnaut, R. and FitzGerald, V. 2002. *Review of Commonwealth State Funding Final Report: A review of the allocation of Commonwealth grants to the States and Territories*, Committee for the Review of Commonwealth State Funding, Governments of New South Wales, Victoria and Western Australia, Melbourne.

<sup>7</sup> State Government of Victoria Government 2011. *Submission to the GST Distribution Review*, Department of Premier and Cabinet, Melbourne, [http://www.gstdistributionreview.gov.au/content/submissions/downloads/supplementary\\_ip/vic.pdf](http://www.gstdistributionreview.gov.au/content/submissions/downloads/supplementary_ip/vic.pdf)

<sup>8</sup> Ibid.

<sup>9</sup> Robinson, M. 1996. 'The Case Against Balanced Budgets', *Australian Journal of Public Administration*, 55, 1, 48h 62.

<sup>10</sup> Australian Broadcasting Corporation 2014. 'Fact check: Does the federal budget cut \$80 billion from hospitals and schools?', ABC Fact Check, <http://www.abc.net.au/news/2014-07-03/does-the-federal-budget-cut-80-billion-from-schools-hospitals/5562470>

<sup>11</sup> Australian Government 2014. *First Report of the National Commission of Audit*, National Commission of Audit, Canberra, [http://www.ncoa.gov.au/docs/NCA\\_TERMS\\_OF\\_REFERENCE.pdf](http://www.ncoa.gov.au/docs/NCA_TERMS_OF_REFERENCE.pdf)

<sup>12</sup> Australian Bureau of Statistics 2012. *State and Territory Statistical Indicators*, 1367.0, ABS, Canberra; State Government of Victoria 2015. *The 2015-16 Victorian Budget: For Families*, Department of Treasury and Finance, Melbourne, [http://www.dtf.vic.gov.au/Publications/Stateh\\_Budgeth\\_publications/2015h\\_16h\\_Stateh\\_Budget/2015h\\_16h\\_Budgeth\\_Papers](http://www.dtf.vic.gov.au/Publications/Stateh_Budgeth_publications/2015h_16h_Stateh_Budget/2015h_16h_Budgeth_Papers)

<sup>13</sup> Australian Bureau of Statistics 2013. *Household Income and Income Distribution, Australia, Government Benefits, Taxes and Household Income, Detailed Tables, 2011-12*, 6523.0, ABS, Canberra.

<sup>14</sup> Australian Labor Party (Victorian Branch) 2014. *Labor's Financial Statement 2014*, [http://www.danielandrews.com.au/wph\\_content/uploads/2014/11/Laborsh\\_Financialh\\_Statementh\\_2014.pdf](http://www.danielandrews.com.au/wph_content/uploads/2014/11/Laborsh_Financialh_Statementh_2014.pdf)

<sup>15</sup> State Government of Victoria 2015. *The 2015-16 Victorian Budget: For Families*, Department of Treasury and Finance, Melbourne, [http://www.dtf.vic.gov.au/Publications/Stateh\\_Budgeth\\_publications/2015h\\_16h\\_Stateh\\_Budget/2015h\\_16h\\_Budgeth\\_Papers](http://www.dtf.vic.gov.au/Publications/Stateh_Budgeth_publications/2015h_16h_Stateh_Budget/2015h_16h_Budgeth_Papers) 5

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<sup>16</sup> van Duyn, P. 2015. 'Why port privatisation plans are in deep water around the country', *The Conversation*, <https://theconversation.com/why-port-privatisation-plans-are-in-deep-water-around-the-country-43774>

<sup>17</sup> Australian Broadcasting Corporation 2014. 'Treasurer Michael O'Brien calls for GST reform after Victoria loses at least \$140m', ABC News online, <http://www.abc.net.au/news/2014-03-27/treasurer-calls-for-gst-reform-after-victoria-loses-24140m/5348744>

<sup>18</sup> Althaus, C., Bridgman, P. and Davis, G. 2013. *The Australian Policy Handbook*, 5<sup>th</sup> edn, Allen & Unwin, Sydney.

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**ATTACHMENT 1: GENERAL GOVERNMENT SECTOR REVENUE**

	<i>2014-15 revised</i>	<i>2015-16 budget</i>	<i>2016-17 estimate</i>	<i>2017-18 estimate</i>	<i>2018-19 estimate</i>
State taxation and other revenue	28 958.1	29 949.2	30 804.3	31 529.0	32 573.7
Tied C'wlth grants	12 571.4	12 809.6	12 738.1	13 106.3	12 762.9
Untied C'wlth grants	12 012.9	12 769.9	13 351.5	14 401.3	15 842.5
<b>Total revenue</b>	<b>53 542.4</b>	<b>55 528.7</b>	<b>56 893.9</b>	<b>59 036.6</b>	<b>61 179.1</b>

Source: State Government of Victoria 2015. *The 2015-16 Victorian Budget: For Families*, Department of Treasury and Finance, Melbourne, <http://www.dtf.vic.gov.au/Publications/State-Budget-publications/2015-16-State-Budget/2015-16-Budget-Papers>

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**ATTACHMENT 2: GOODS AND SERVICES TAX DISTRIBUTION IN 2013-14**

<i>State</i>	<i>Population</i>	<i>Proportion of Per Capita Entitlement (%)</i>
New South Wales	7 386 994	97
Victoria	5 766 257	91
Queensland	4 699 864	106
Western Australia	2 531 150	45
South Australia	1 671 669	127
Tasmania	515 689	162

*Source: Commonwealth Grants Commission*