

PART 1: OVERVIEW OF AUSTRALIA'S FEDERAL RELATIONS

THE STRUCTURE OF AUSTRALIA'S FEDERAL RELATIONS

Australia's federal relations are characterised by three broad features:

- the financial arrangements are influenced by the large expenditure responsibilities of the States relative to their revenue capacities, so that they rely on transfers from the Commonwealth – referred to as vertical fiscal imbalance;
- the States have different capacities to raise revenue and deliver services – referred to as horizontal fiscal imbalance; and
- overlapping roles and responsibilities in many areas of government activity have led to areas of activity where regulation or services remain fragmented, with duplication of activities, lack of coordination and blurred accountabilities.

Vertical fiscal imbalance

Vertical fiscal imbalance is common to most, if not all, federal systems. It results when a level of government has expenditure functions that are not wholly financed through its own assigned tax bases.

In Australia, the States rely on Commonwealth financial assistance to meet about 40 per cent of their average funding requirement, but this is as high as 80 per cent in the case of the Northern Territory.

Commonwealth financial assistance comprises all GST revenue, plus a small amount of other general revenue assistance, and more than 90 different payments for specific purposes. General revenue assistance is available to the States to spend according to their own budget priorities, and is therefore more akin to State own-source revenue. Taking this into account, the level of vertical fiscal imbalance in Australia is broadly in line with other comparable federations.

It was always envisaged when the Constitution was being drafted that the Commonwealth would raise more revenue than it would need to perform its core functions. Consequently, explicit provisions were included to allow the Commonwealth to transfer surplus revenue in the form of general revenue assistance to the States.

Horizontal fiscal equalisation

It is usual among federations for States to have different capacities to raise revenue or deliver services. The practice of equalising revenue capacities and/or expenditure capacities between the States in a federation is also common. Australia has had various forms of fiscal equalisation since 1901.

Under Australia's current system of horizontal fiscal equalisation, the Commonwealth Grants Commission recommends state revenue sharing relativities (the GST relativities) to be used in calculating each State's share of GST payments such that, if each State made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each State would have the capacity to provide services at the same standard.

This does not necessarily result in the equalisation of government services – just the equalisation of the capacity of each State to provide the same standard of services. In calculating the GST relativities, the Commission takes into account differences in the States' capacities to raise revenues and differences in the costs the States would incur in providing the same standard of government services.

Horizontal fiscal equalisation provides the necessary budget support to the smaller States so they have the capacity to provide services at a comparable standard to the larger States, while the transfers are not so large that they would significantly distort economic behaviour and reduce productivity growth.

Roles and responsibilities

Federal systems of government can provide the community with significant benefits not available under other systems. In particular, federal systems can have the advantages of more responsive governments, more diversity in service provision, and competition between states to drive innovative approaches and higher levels of efficiency in service delivery.

However, federations work best when the roles and responsibilities of each jurisdiction are clear and good public accountability mechanisms allow the community to hold the appropriate government to account for the quality and efficiency of the services delivered and the outcomes achieved.

In Australia over the past few decades, the proliferation of small payments to the States, and the increasing Commonwealth prescription accompanying these payments, has been a source of increasingly blurred roles and responsibilities, duplication and overlap, higher administration costs and cost-shifting.

REFORM PRIORITIES

One of the main priorities for the Government is to implement a modern framework for federal financial relations that provides the States with the flexibility they need to deliver high quality services efficiently, while ensuring that they remain accountable to their electorates for the money they spend and the services they deliver.

Furthermore, many of the significant challenges facing the economy are issues that can only be addressed through effective cooperation between both levels of government. Consequently, the Government is working cooperatively with the States, through a reinvigorated COAG, to drive a new wave of economic and social reform.

A new framework for federal financial relations

COAG has agreed to implement a new framework for federal financial relations that focuses on reducing Commonwealth prescriptions on service delivery by the States in conjunction with a significant rationalisation of payments for specific purposes, a clearer specification of the roles and responsibilities of each level of government, and an improved focus on outcomes-based public accountability.

The reforms will result in:

- increased flexibility for resources to be allocated to areas where they will produce the best overall outcomes for the community;
- genuinely collaborative working arrangements, including clearly defined roles and responsibilities and fair and sustainable financial arrangements, to facilitate a long-term policy focus and reduce blame and cost shifting;
- stronger incentives for wide-ranging reforms;
- increased accountability of governments to the community; and
- reduced administration and compliance overheads.

In addition, the Commonwealth will provide National Partnership payments to the States to support the delivery of specified projects, to facilitate reforms or to reward those jurisdictions that deliver on national reforms. The new financial arrangements provide a solid foundation for far-reaching economic and social reforms to be undertaken as part of COAG's economic and social reform agenda.

Implications for payments of the new federal financial framework

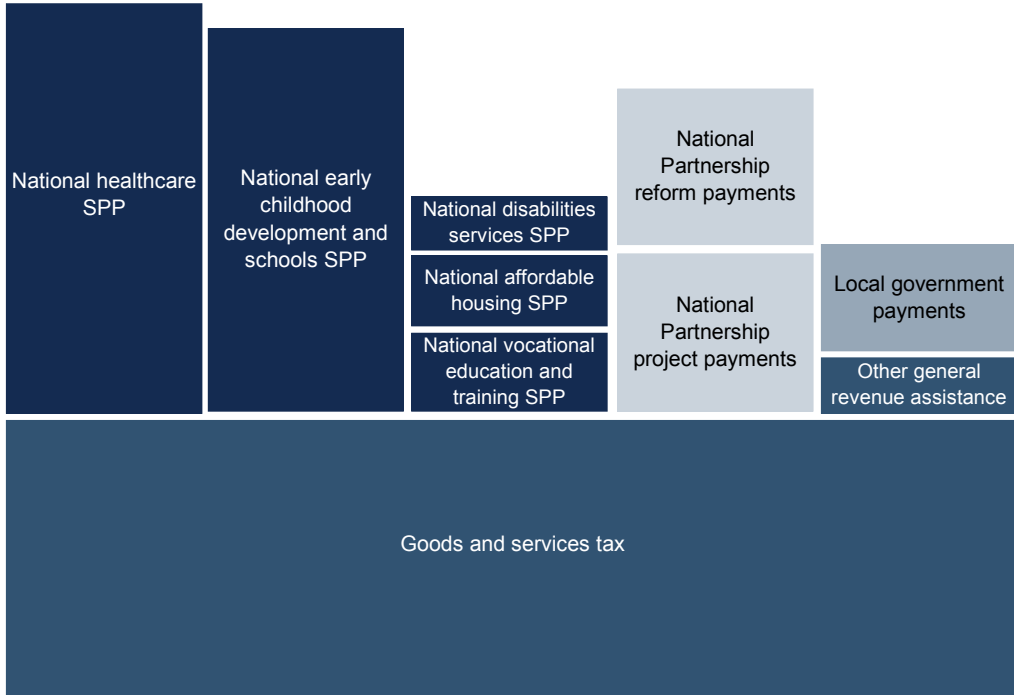
The Commonwealth will reduce significantly the number of payments for specific purposes, without reducing the overall quantum of payments. The States will continue

to receive all GST revenue, but payments for specific purposes (which currently number more than 90) will be rationalised into:

- five or six new specific purpose payments (SPPs) supported by new national agreements in the areas of:
 - healthcare;
 - early childhood development and schools;
 - vocational education and training;
 - disabilities services; and
 - affordable housing;
- some general revenue assistance in respect of payments where there are no compelling national objectives associated with the payment;
 - these include payments without conditions, such as payments to Western Australia and the Northern Territory for offshore petroleum royalties and mining royalties respectively;
- National Partnership payments to:
 - support the delivery of specified projects (such as land transport projects through AusLink);
 - facilitate reforms; or
 - reward the achievement of reform-based performance benchmarks; and
- continuing financial support for local governments.

The new framework for federal financial arrangements will commence from 1 January 2009 with the reform of payments for healthcare to be implemented by 1 July 2009. The new framework is shown schematically in Chart 1.1.

Chart 1.1: Schematic of payments to the States in the new financial framework



Developing a new wave of economic and social reform through COAG

COAG's reform of the framework for federal financial relations will provide the platform to drive a new reform agenda, including:

- pursuing ambitious reforms in the delivery of preventative health, Indigenous healthcare, primary care, hospitals and aged care;
- reforming our education and training systems to provide quality learning opportunities for all;
- addressing the challenges posed by climate change and water scarcity;
- ensuring the efficient provision of adequate infrastructure;
- accelerating business regulation and competition reform;
- improving affordability of, and access to, housing; and
- addressing social inclusion and closing the gap on Indigenous disadvantage.

These reforms will improve the productive capacity of the economy and deliver better services to the community.

ESTIMATES OF PAYMENTS TO THE STATES

The States receive significant financial support from the Commonwealth. In 2008-09, the Commonwealth will provide the States with general revenue assistance, including all GST revenue, of \$45.5 billion and payments for specific purposes of \$33.1 billion, totalling \$78.6 billion, as shown in Table 1.1. This represents a 5.0 per cent increase compared with 2007-08.

Table 1.1: Commonwealth payments to the States

\$million	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
2007-08									
Payments for specific purposes	10,370	7,219	6,315	3,942	2,487	819	468	506	32,127
General revenue assistance	12,034	9,328	8,596	4,097	3,947	1,677	856	2,219	42,753
Total payments to the States	22,404	16,546	14,911	8,040	6,434	2,496	1,324	2,724	74,880
2008-09									
Payments for specific purposes	10,636	7,316	6,571	3,829	2,716	864	493	713	33,137
General revenue assistance	13,020	10,196	8,686	4,335	4,144	1,731	926	2,420	45,458
Total payments to the States	23,656	17,512	15,257	8,164	6,859	2,595	1,419	3,133	78,595
2009-10									
Payments for specific purposes	11,066	8,058	6,709	3,463	2,721	812	534	619	33,982
General revenue assistance	14,452	11,086	9,025	4,704	4,433	1,821	1,016	2,596	49,134
Total payments to the States	25,519	19,144	15,734	8,167	7,155	2,633	1,550	3,215	83,116
2010-11									
Payments for specific purposes	11,380	8,365	7,002	3,583	2,791	828	558	659	35,166
General revenue assistance	15,577	11,862	9,335	4,575	4,648	1,890	1,073	2,782	51,741
Total payments to the States	26,956	20,227	16,338	8,158	7,439	2,717	1,631	3,441	86,907
2011-12									
Payments for specific purposes	11,999	8,936	7,360	3,709	2,903	868	593	495	36,864
General revenue assistance	16,554	12,675	9,815	4,540	4,890	1,978	1,120	2,903	54,475
Total payments to the States	28,553	21,611	17,176	8,250	7,793	2,846	1,713	3,398	91,339

Payments for specific purposes

In 2008-09, the States will receive \$33.1 billion in payments for specific purposes, an increase of 3.1 per cent compared with the \$32.1 billion the States will receive in 2007-08. This mostly reflects the Government's decision in March 2008 to provide an up-front payment of \$500 million in additional healthcare funding in 2007-08 to enable the States to invest in their hospitals immediately. Abstracting from this bring forward of funding for hospitals, the increase in payments for specific purposes is 4.8 per cent.

Part 3 of this Budget Paper provides further information on payments for specific purposes to the States.

General revenue assistance

In 2008-09, the States will receive \$45.5 billion in general revenue assistance, including GST payments. This is an increase of 6.3 per cent compared with the \$42.8 billion the States will receive in 2007-08.

Part 4 of this Budget Paper provides further information on general revenue assistance to the States.

Total payments to the States

Total payments to the States as a proportion of GDP averaged 6.8 per cent over the period 1999-00 to 2006-07. Over this period, general revenue assistance averaged 4.0 per cent and payments for specific purposes averaged 2.8 per cent as a proportion of GDP.

For 2008-09, total payments to the States as a proportion of GDP are estimated to be 6.4 per cent. General revenue assistance is estimated to be 3.7 per cent and payments for specific purposes 2.7 per cent of GDP.

Table 1.2: Total payments to the States

\$million	Existing payments for specific purposes	National SPPs	National Partnership payments	GST	Other general revenue assistance	Total	Growth	Per cent of GDP
1999-00	17,916	-	-	-	24,681	42,597	-	6.6
2000-01	19,207	-	-	24,355	3,715	47,277	11.0	6.9
2001-02	21,458	-	-	26,632	4,841	52,931	12.0	7.2
2002-03	21,781	-	-	30,479	1,734	53,994	2.0	6.9
2003-04	22,940	-	-	33,219	647	56,806	5.2	6.8
2004-05	24,795	-	-	35,323	944	61,062	7.5	6.8
2005-06	26,904	-	-	37,182	1,039	65,124	6.7	6.7
2006-07	28,549	-	-	39,552	-	68,101	4.6	6.5
2007-08(e)	31,914	-	213	42,630	123	74,880	10.0	6.6
2008-09(e)	23,497	6,224	3,415	45,280	178	78,595	5.0	6.4
2009-10(p)	3,433	23,720	6,913	48,260	874	83,200	5.9	6.5
2010-11(p)	4,235	25,001	6,015	50,880	861	86,992	4.6	6.5
2011-12(p)	4,458	26,411	6,080	53,670	805	91,424	5.1	6.5

(e) Australian Treasury estimates.

(p) Australian Treasury projections.