Tax Facts

A knowledge-based series by the Tax and Transfer Policy Institute

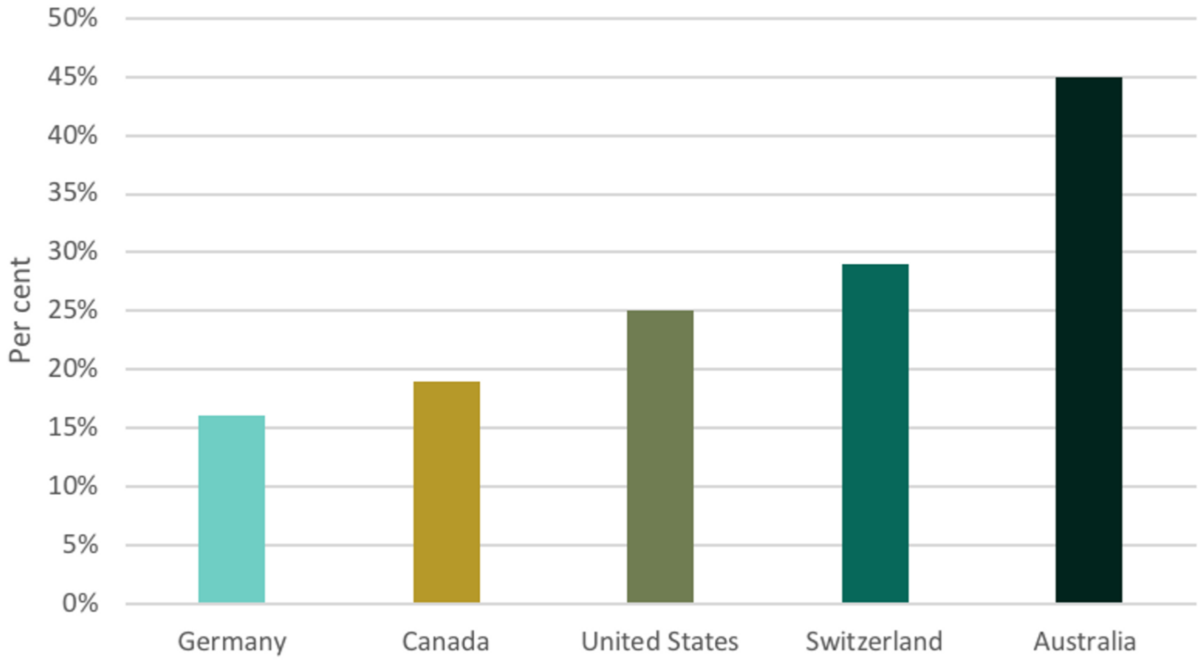
Australia's Tax Policy: Raising and Sharing Tax Revenue

The Australian Government raises the majority of tax revenue in the federation. Yet the States and Territories ('the states') have primary responsibility for the delivery of most services. This imbalance, known as vertical fiscal imbalance (VFI), makes it necessary to share revenue. But how does revenue sharing currently take place? What are the policy trade-offs inherent in a federation with a high degree of VFI?

Why share revenue?

Australia has a high degree of VFI (see Figure 1). That is, the revenue raising undertaken at different levels of government is not linked to their spending responsibilities.

Figure 1. Vertical fiscal imbalance in selected federations



Source: ***Reform of the Federation White Paper****, COAG and Federal Financial Relations Issue Paper 5, February 2015, Commonwealth of Australia.*

The Australian Federal Government collects around 81% of the total tax take through personal income tax, company tax and the goods and services tax (GST) [1]. In spite of their broad constitutional power to tax, the state and local governments raise only about 19% of total revenue, mostly through payroll tax, stamp duties and property taxes [1]. Yet the states are responsible for most service delivery, including on important and costly areas of social spending such as hospitals, education, and infrastructure. This mismatch has been a longstanding feature of the federation and is the legacy of historical factors. The most notable example being the Australian Government taking control of income tax to finance the Second World War.

How is revenue shared?

In 2019-20, the states will only raise around 54% of the revenue required to finance their expenditure [2]. The remaining shortfall (46%) is financed through grants from the federal government. There are three main types of payments used to facilitate this transfer:

- Untied general revenue assistance (GRA). Largely made up of GST entitlements, funding is shared based on the principle of Horizontal Fiscal Equalisation (HFE). Individual states have different capacities to raise revenue or deliver services. HFE aims to ensure that each state gets a share of the GST revenue such that they are all able to provide the same level of services to their residents. The states receive GRA funding without any spending conditions. In 2019-20, total GRA grants amounted to $69.1 billion [**2**].

- Largely-untied National Specific Purpose Payments (NSPPs). These payments are linked to major areas of state activity. The chief requirement is that funds are spent in a prescribed sector. Major NSPPs cover health care via the National Health Reform Agreement, education via the National Schools Reform Agreement, and housing and homelessness via the National Housing and Homelessness Agreement. In 2019-20 total NSPP grants amounted to $46.8 billion [**2**].

- National Partnership (NP) payments fund specific projects and services. NPs have various degrees of conditionality attached and cover a variety of sectors. They are often used for specific purposes, such as payments in exchange for agreeing to implement economic reform. In 2019-20 total NP grants are $11.5 billion [**2**].

Policy trade-offs resulting from a high degree of vertical fiscal imbalance

The extent to which different taxes are assigned to states or to a national government ultimately reflect the weight policymakers place on achieving particular policy objectives. On one hand, if a country's primary goal is a simple tax system, then a high degree of VFI may be warranted. But, if efficiency and accountability are more important, then a decentralised tax system may be more appropriate. History also shapes the jurisdiction of specific taxes.

Australia's high degree of VFI has a number of advantages:

First, principles of efficient taxation support some degree of VFI [see our related tax fact on **Principles of Tax System Design**]. Levying income and consumption taxes at the national level is simple, fair and consistent.

Second, assigning sole responsibility for personal income and company taxes to the national level of government prevents horizontal tax competition – states cannot use the carrot of lower headline rates to encourage individuals or businesses to migrate across the border. Zero-sum tax competition between states tends to be a feature of federations with lower degrees of VFI, such as the United States, where income tax is levied by both state and national levels of government.

Third, high degrees of VFI can be efficient if taxes assigned to states are those that apply to immobile tax bases. The Henry Tax Review examined the optimal types of taxes that should be assigned to each level of government and found that the taxes states have access to now, including land tax and payroll tax (albeit to a lesser extent) are consistent with this principle [**3**].

However, the efficiency gains achieved from high levels of VFI, by assigning immobile tax bases to states, can only be realised if the tax bases are exploited effectively in practice. In Australia, these immobile tax bases are not being exploited to the degree they should be. For example, stamp duties on property transactions discourage people from moving to better jobs by imposing large costs each time a family moves. In addition, owner occupied homes are excluded from land tax, significantly reducing the tax base (and tax revenue). Efforts to reform these taxes, such as replacing stamp duties on property with a more efficient land tax, have proved elusive. Some observers argue that a high degree of HFE discourages this reform [**4**].

High levels of VFI also come with certain costs:

First, when a government is not accountable for the revenue it raises, it may be less disciplined when it comes to expenditure. This is known as the 'soft budget constraint' problem and is a form of moral hazard. Further, states faced with long-term cost pressures may have weaker incentives to reform in a high-VFI system, as spending restraint weakens the case for future increases in transfers from the national government.

Second, high levels of VFI result in overlap and duplication. Co-funding service delivery across a wide range of government functions blurs accountability. In addition, imposing conditions on the use of funding limits states' autonomy, making reform more difficult.

TTPI appreciates the research assistance provided by Prasad Giribalan for the preparation of this Tax Fact.

[1] 5506.0 Taxation Revenue Australia, 2017-18, Australian Bureau of Statistics, Canberra.
[2] Federal Financial Relations Budget Paper No. 3 2019-20, Budget 2019-20, Commonwealth of Australia, Canberra.
[3] Henry, KR et al (2010) Australia's Future Tax System: Report to the Treasurer, Part Two, Detailed Analysis, Volume 2, Commonwealth of Australia, Canberra.
[4] For a detailed discussion see Productivity Commission 2018, Horizontal Fiscal Equalisation, Report no. 88, Canberra.

Cite as: TTPI (2019), *Australia's Tax Policy: Raising and Sharing Tax Revenue,* Tax Fact #13, Tax and Transfer Policy Institute, Canberra.

More information

Contact the director at robert.breunig@anu.edu.au | Contact us at tax.policy@anu.edu.au
https://taxpolicy.crawford.anu.edu.au/
Visit our other Tax Facts at https://taxpolicy.crawford.anu.edu.au/taxpolicy-publications/tax-facts