

Federal Financial Arrangements: State Revenues

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Some Interrelated State Budget Policy Issues

- Expenditure
 - Demands running faster than revenues
 - Interference from commonwealth, SPPs and NPPs
- Revenues
 - High dependence on commonwealth, VFI
 - Allocation of commonwealth grants across state, HFE
 - Some state taxes are the most inefficient taxes, and require reform
- Budget bottom line
 - Deficit fetish
 - Limits on borrowing for capital projects

Road Map

- Overview of state budgets
- State taxes: case for reform and reform options
- Vertical fiscal imbalance (VFI)
- A strategy to reform taxes and adverse effects of VFI
- Deficits and borrowing

Non-financial Public Sector Revenue and Expenditure: State and Territory Governments

Revenue Source	\$billion 2011-12	Share of total revenue (%)	Share of Comm. Grants (%)
Own tax	55.8	22.9	
Commonwealth grants	85.9	35.3	
-general purpose			49.5
-SPPs			28.0
-NPPs			22.4
Sales of goods/services	66.9	27.5	
Other	34.7	14.3	
Total (\approx operating exp.)	243.3		

Net borrowing of \$28.9 billion

Responsible for about 40% of total public expenditure

State Taxes: 2009-10 revenue (ABS) and distortion costs (AFTS)

Tax	Revenue (\$ billion)	Marginal cost per dollar of revenue (cent/dollar)
Payroll	16.8	41
Land	5.8	8
Stamp duty on conveyances	12.3	34
Taxes on insurance	3.1	67
Motor vehicle taxes		
-stamp duty	2.1	38
-registration	3.2	37
Gambling	5.1	
Total	54.5	

Generally Agreed Desirable State Tax Reforms

- Comprehensive broad base and flat rate
 - Land tax
 - Payroll tax
- Restructure taxation of use of motor vehicles
- Replace stamp duties on
 - Insurance
 - Property conveyance
 - Motor vehicles

Challenges to Reforming State Taxes

- Uncertainty about net revenue and other effects
- Most of the productivity gains accrue to the commonwealth
- Confused and multiple views on equity effects
 - Final versus statutory incidence
 - Better assessed in total tax system context

Vertical Fiscal Imbalance (VFI)

- Current story
 - Commonwealth provides 35% of states revenues, and a half of this as tied grants
 - VFI more marked in Oz than most other federations
 - But, all federations have VFI
- Some VFI seems inevitable given:
 - Subsidiarity principle on allocation of spending
 - Tax base mobility and allocation of taxation
 - Lack of coincidence

Reduced VFI Problems with a Hard Budget Constraint

- A hard budget constraint: last \$100 million of expenditure (+ or -) by state funded by changes of \$100 million of its own taxes.
- Requires
 - States have control at the margin over spending decisions
 - States have ability to change tax rates to alter tax revenues to fund marginal expenditure

Institutional Design for Reform (The NCP precedent)

- Assess reform options in a wider national context requiring serious involvement of both the commonwealth and the states
- A cooperative arrangement to
 - Clarify national objectives, and then relative roles and responsibilities
 - Minimise overlaps on expenditure programs
 - Commonwealth help fund state tax reforms generating national benefits
 - Provide financial rewards for agreed reforms
 - Independent body to monitor, assess and public report
- Leave states with a “hard budget”

Budget Bottom Line Issues (1)

- Deficit fetish on operating account
 - Yet, face cyclical own tax and sales receipts and uncertainty on commonwealth tide grants
- Suggests potential value of a strategy which balances the budget over the cycle and provides a limited automatic stabiliser (akin to commonwealth)

Budget Bottom Line Issues (2)

- Funding investment in infrastructure involves
 - Upfront outlays, and
 - A future stream of returns
 - extra state sales for much transport, water, etc infrastructure
 - higher national income and wellbeing for much social infrastructure
- Argument for limited restraint on borrowing if establish
 - Market failure in support of government investment
 - Project passes an explicit, transparent and public benefit cost assessment

Conclusions

- There are compelling arguments to maintain a federal system
- But, there are great opportunities to enhance national productivity:
 - Reform state taxes
 - Clarify state spending responsibilities and remove current overlaps
 - Recognise VFI, but provide a hard budget constraint
 - Reconsider, and formalise, longer term more flexible rules on state budget deficits and the rights to borrow for infrastructure
- All of these reforms require a new cooperative approach between the commonwealth and the states