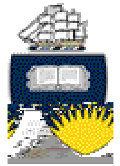

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Preface

This study was prepared to mark the Centenary of Federation. Financial support for the work was provided by the South Australian Department of Treasury and Finance.

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Disclaimer: This study, while embodying the best efforts of the investigators, is but an expression of the issues considered most relevant, and neither the Centre, the investigators, nor the Universities can be held responsible for any consequences that ensue from the use of the information in this paper. Any liability in respect of such use is expressly precluded. The views expressed in this publication are those of the authors. They should not be taken to represent the views of the Centre, the Universities, or the Department of Treasury and Finance.

While the assumption of 'convergence' may not have been universally accepted, it seems that no-one at that stage would have envisaged the growth in government that has occurred since federation, especially the growth in the role of the Commonwealth. The Commonwealth was intended to act as an agent for the States in a few narrow fields, and to fund its operations with customs revenues. Although it was not precluded from the income tax field, this was really only to allow it access in a time of national emergency. The States were intended to remain substantially responsible for their own revenue raising and to continue to make their own policies regarding most domestic matters.

The Commonwealth began to make grants to the States at Federation, with these grants amounting to a return of the unused part of the new national customs and excise collection to the States. However, the amount available to be paid to the States was eroded as early as 1908 when the Commonwealth began to reserve revenues for a new national pension scheme.

In 1910-11 the Commonwealth introduced a special grant to Western Australia and in 1912-13 a special grant was introduced for Tasmania, these additional payments being in recognition of the particular financial circumstances of those States after Federation. However, the basis for the special grants was essentially ad hoc. In the 1920s South Australia also sought special assistance from the Commonwealth.

By the mid 1920s the revenues available to the States had been severely eroded. There was also by that time open acknowledgment that the thesis of 'convergence' was unrealistic, and the Commonwealth was faced with persistent demands from the smaller States for special assistance. These calls for assistance were evaluated by a series of official inquiries of one type and another in the 1920s and early 1930s, and in 1933 the Commonwealth Grants Commission was established to fill this role.

The Commission quickly adopted a principle of fiscal need as its guiding principle, although not without internal dispute. At the political level it had often been argued that assistance should be provided to States to compensate them for disadvantages of Federation. The Commission dismissed this on the grounds of, first, practical difficulties in assessing such disadvantages and, secondly and perhaps more importantly, the importance of achieving the viability of the States in the Federation. As early as the Commission's third report in 1936, the principle of fiscal equalisation was espoused as the guiding principle to its assessments, and this principle is essentially unchanged today.

The equalisation principle was applied to States' claims for assistance under Section 96 of the Constitution. For the first few years of its assessments, the Commonwealth Grants Commission recommended 'penalties' to apply to claimant States, which had the effect of requiring them to raise their tax rates to higher levels than non-claimants or to reduce expenditures below average. By the end of World War Two, however, these penalties had been abandoned.

During World War Two the Commonwealth took over all State income taxes. Although the move was justified in terms of the war effort, at the end of the War the Commonwealth continued its exclusive occupation of the income tax field. The Commonwealth's takeover of

distributive principles adopted thus ran counter to the principles introduced for distribution of own purpose general revenue assistance to the States.

During the late 1980s the Commonwealth Government sharply reduced general purpose payments to the States. Between 1986-87 and 1989-90 Commonwealth general purpose payments to the States fell from 5.4 to 3.6 per cent of GDP. Although the States were to a degree cushioned from the changes by rising own revenues, the reduction in Commonwealth support made inevitable, eventually, some wrenching adjustments to State budgets. Had the States brought to fruition the opportunity a few years earlier to raise income taxes in their own right, their ability to control their fiscal positions at this time might have been greater. But, by the end of the 1990s they found their budgets under a high degree of stress.

By the late 1980s, the adoption of fiscal equalisation had greatly diminished the role of special deals in determining the pattern of general revenue assistance to the States. Compared with the situation at the beginning of the 1980s, New South Wales and Victoria were doing significantly better from the grant process. However, there was still manifest dissatisfaction within those States, on the basis that they would do better from an 'equal per capita' or 'contributions' based distribution. This dissatisfaction was of course exacerbated by the substantial reductions in Commonwealth grants to the States.

As a consequence of New South Wales' and Victoria's concerns with the fiscal equalisation process, there were two high-level reviews of aspects of fiscal equalisation. The first, by the Commonwealth Grants Commission, considered the impacts of fiscal equalisation on allocative efficiency, and concluded that, while there were some consequences, they were not sufficiently large to warrant any changes to equalisation. The second, by a Heads of Treasuries Working Party, recognised that fiscal equalisation was justified on equity grounds and probably had limited feedbacks on State policy design, but was unable to reach any consensus on the question of whether there were significant allocative distortions from equalisation. In the event, the Commonwealth response to these reviews was essentially to preserve the status quo, although there were some interventions in the form of quarantining of particular specific purpose payments.

The 1990s saw a more stable structure of grants to the States, albeit at reduced levels from the 1980s. In broad terms the Commonwealth escalated general revenue assistance in line with inflation and population growth. As a consequence, general purpose payments fell gradually as a proportion of GDP. In 1997-98 the Commonwealth introduced tobacco, petrol and liquor excises to replace State franchise fees which had been struck down by the High Court, with the proceeds provided to the States as 'Revenue Replacement Payments', a form of general purpose payment.

The major package of reforms under *A New Tax System* (ANTS), which the Howard Government implemented in mid 2000, launched a broad-based goods and services tax (GST) which permitted abolition of a range of inefficient State taxes and a reduction in income tax rates. An incidental consequence has been to increase the extent of vertical fiscal imbalance in the Australian Federation. However, the Commonwealth has promised the States a greater degree of certainty about general revenue assistance from the Commonwealth in years to come, as the States receive all of the GST proceeds and the FAGs payments have been abolished. This interpretation should be qualified in that the Commonwealth still has the power to unilaterally change the arrangements.

A seminal paper by James Buchanan in 1950 establishes that equalisation payments will generally be necessary to enable horizontal equity – by which is meant similar fiscal treatment of similar individuals – and efficiency across a federation. That this is so becomes more apparent when one takes into account that fiscal systems do not operate on a 'benefit' basis. To the extent that States differ in the extent to which they must support relatively dependent sub-populations, it is evident that the fiscal burdens falling on all residents in a State will vary. In the absence of fiscal equalisation, differences in dependency structures from New South Wales to Victoria, for instance, would mean that an individual in the Albury Wodonga area would face a different fiscal burden according to which State they chose to live in. Not only are differences such as this horizontally inequitable, they also distort choices between jurisdictions.

The confusion that is evident in the Australian debate partly relates to a simplistic interpretation of equalisation payments. There is a tendency to categorise above per capita payments as favouring locations in the States where they apply, and below per capita payments as disfavouring locations in States where they apply. In fact, as is shown in the ju1ionvrHoweevidente0(and)one tthe is a tnsi(ori7.6(ey)3(10(as)-1ey)acknowled(ori7.e9(onf)ey)tendl)-3den

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Chapter One

Introduction

1.1 Introduction

This study explores the past, present and future of Australia's Commonwealth-State grant arrangements. It is prepared as part of a series of Centenary of Federation projects sponsored by the South Australian Government.

The study is split into three parts. The first, by Julie Smith, explores the evolution of Australia's Commonwealth-State funding arrangements from the lead up to Federation through to the 1970s. The second, by Jim Hancock, explains how those arrangements have

again until it reached a peak of 30 per cent in the late 1980s, which is about the level it is at today.

Grants from the Commonwealth to the States can be considered in two broad classes. 'General purpose payments' are provided with no strings attached in terms of how the States spend them. 'Specific purpose payments' are passed from the Commonwealth to States subject to conditions which control the ways in which the States spend them. In general specific purpose payments occur in areas where the Commonwealth does not have constitutional authorisation to make expenditures in its own right; they are in substance close to being Commonwealth 'own' expenditures. Commonwealth payments to the State and local sectors occur in several forms, which are summarised in Table 1.1.

Table 1.1
The structure of Commonwealth payments to State and local governments

Name	Examples	Description
CURRENT GRANTS		
General Revenue Assistance	tax sharing grants special revenue assistance special grants financial assistance grants tax reimbursement grants GST revenue grants	Payments made to the States for the purposes of recurrent budget support with essentially no constraints as to manner of expenditure
Specific purpose payments - recurrent	Large number of payments in functional areas	Effectively Commonwealth own expenditures, but delivered through the States
CAPITAL GRANTS	general purpose capital/ specific purpose capital	Funds provided for capital purposes. General purpose discontinued now
ADVANCES	loans from Commonwealth to States payments for asset purchases	

Figure 1.2 shows the level of Commonwealth payments to the States since Federation. The thick line shows the sum of recurrent general revenue grants and debt assistance payments under the *Financial Agreement 1927* as a percentage of gross domestic product. These payments are the most flexible form of support provided to the States by the Commonwealth. Immediately after Federation they amounted to over 3 per cent of GDP, but fell away to levels as low as 1 per cent of GDP in the four decades following Federation. They jumped sharply as a result of the Commonwealth takeover of income tax during the Second World War, and then rose further, gradually, until reaching a peak at nearly 5 per cent of GDP in the mid 1980s. In the late 1980s and through the 1990s they fell, reaching a low a little under 3 per cent of GDP in 1999-2000. In 2000-01 the introduction of a broad based goods and services tax, and the associated replacement of a range of existing State taxes with Commonwealth grants, caused the ratio to rise back to around 4 per cent of GDP.

The thin line in Figure 1.2 shows all Commonwealth payments to the States – i.e. including specific purpose payments and capital funds provided including as loans – as a percentage of GDP. It suffers a major series break, which is probably mainly due to the omission of significant payments outside the States' consolidated accounts from the first half of the series. However, the omitted amounts were probably relatively small in the early years of Federation.

'Horizontal fiscal equalisation' is the practice of providing untied grants to the States in such a way as to equalise the fiscal capacities of the States. A situation of equal fiscal capacities exists when each State is able to provide the national average level of services to its residents

immediate solutions to the financial problems of federating the tariff, and it outlines how framers of the financial clauses of the Constitution planned to deal with the intertwined issues of the federal revenue surplus and its distribution.

The second section documents attempts to mould Commonwealth-State financial relations in the context of expanding Commonwealth progressive taxation and social security systems. It shows how continued diversity in the States' economic circumstances, and the emerging financial vulnerability of all State governments, was addressed with the 1910 *Per Capita Agreement*. This resolution of the issue was unsatisfactory to the States, but locked in the main features of federal financial relations until at least 1920.

The third section traces the evolution of Commonwealth-State financial relations through the 1920s and 1930s, when an absence of convergence in the fiscal capacity of States, the shrinking share of customs and excise revenues directed to States, and ideas of national citizenship translated into severe fiscal stresses for States from the mid 1920s. It explains federal fiscal developments in this period in terms of decentralised political institutions channelling demands for uniform social services and increased social security spending to State governments, a situation which became increasingly at odds with centralising economic pressures and unsuitable fiscal arrangements that greatly constrained State governments' ability to share in the expanding national tax base to fund social security or to redistribute through progressive taxes. It is argued that the birth of the Commonwealth Grants Commission, the move to uniform taxation and the creation of a National Welfare Fund were all responses to the inconsistency between the States' fiscal diversity and ideas of common citizenship rights to social services.

Section 4 relates the Commonwealth's unilateral implementation of a uniform income tax system from the Second World War onward. The States' diverse taxable capacities helped to entrench income tax centralisation from the 1950s. The States became more than ever dependent on grants from the Commonwealth, and connected with this needs based approaches to grants became the norm. Fiscal needs equalisation and ad hoc political deals each played a part as institutions for the distribution of funds.

2.2 'Federating in the Dark'

Negotiations on financial arrangements for the mooted federation began in 1891 at the

> we cannot do away with the solvency of the several States. If we do that those States die, and we have no longer a federation but a legislative union (New South Wales 1897, p. 203).

Despite potential risks to States' autonomy, it was agreed early in the debates - and for various reasons - that the Commonwealth must have unlimited powers of taxation. Victorian federalist

revenue surplus among them. At the same time, a common view was that the Constitution should not be too prescriptive.

At the outset, the main solution envisaged to the problem of the federal surplus revenue and its distribution was to transfer States’ debts to the federal government (Gilbert 1973). As one informed observer later commented, the smaller was the surplus the less bitter would be the struggle over its distribution (Black 1895). Imposing on the new Commonwealth government the responsibility for servicing colonial debts out of its ample revenues was also likely to improve States’ borrowing terms and relieve their debt service burden. At this time, the interest payable on States’ debts roughly matched the expected Federal surplus.

Debt consolidation was embraced enthusiastically by many delegates as a practical and economical solution to the federal financial problem. For example, Deakin’s view was that:

> It certainly would be an enormous advantage in commending this measure to the people of the various colonies if, instead of their being asked to surrender an immense revenue, without any definitely determined return, they were shown that the revenue taken from them is at once applied to purposes in which they are immediately interested - that if, on the one hand, we deprive them of that source of revenue which keeps their coffers full, we, on the other hand, deprive them of liabilities which empty their coffers (pp 938-9).

It would have the benefit of requiring *‘the strictest scrutiny of every particular of public expenditure’*, imbuing in the Commonwealth government *‘habits of close economy’*. Campaigners against federation would be denied the bogey of a large federal surplus:

> I think we should have a good answer if we were to adopt this proposal, and that we should at the same time be giving to federation a great momentum. The desire of being relieved of a large measure of liability will operate as powerfully with the colonies in favour of federation as a design to deprive them of customs revenue may meet with resistance (Deakin p. 839).

Although an enabling clause was in the 1891 Bill, South Australian delegate Sir John Bray proposed an amendment making the Commonwealth liable for a fixed per capita amount of each State’s existing debt. Tasmanian Treasurer Bird agreed strongly that the handover of revenues should be matched with commensurate liabilities; *‘it is most dan*[illegible]

met from customs revenue and charged to the States on a population basis. However, the

Table 2.1
Australian Taxation 1896-97

	New South Wales	Victoria	Queensland	South Australia	Western Australia	Tasmania	All Colonies

The principle of per capita equality was a prominent principle in Canadian and US federal finance. However, it was contentious as a practical basis for Australian fiscal union. For one thing, it threatened increasing New South Wales taxation to finance revenue transfers to other States. Large differences in the per capita consumption of dutiable items between colonies also meant, for example, that wine-drinking South Australia would gain substantially from consumption of heavily-taxed spirits in other colonies such as Queensland or Western Australia. And a per capita distribution was unacceptable to Western Australia at that early stage of its fiscal development, relying almost totally on customs receipts for revenues, and with collections per capita far above those in the other States.

At the close of the debate, federalists from both larger and smaller States chided the *'pettifogging, parochial spirit of selfishness'* which would embody in the constitution *'whether Queensland drinks a little more whiskey than South Australia, or whether the populations of some of the larger and more settled states cloth themselves in costlier raiment'* (p. 825). South Australian representative Sir John Downer[14] also reminded the larger States that any such 'balance sheet' approach to federation had to account for the complex incidence of its broader economic and fiscal effects;

> The strong disposition of centralisation everywhere – the strong inclination of every one to go to the largest centre of the population … [meant that] the smaller colonies will obtain their goods, to a much larger extent than at present, from the larger centres. Therefore a large portion of the benefit of this arrangement must be reaped by the larger colonies; so that, even if they sustain some incidental loss, it will be much more than made up to them by their commanding positi.2(t)1y(h)-0.50.0247 Tw[(will Tw[(l(ng p(ei)16(m)1cus ew

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uncertainties, and yet 'final' enough to avoid pressures for tinkering for special advantage. According to Garran, of overriding importance for agreement on federal union was that the arrangements be fair to all of the federating States, not only at the date of the union, but in view of their probable growth and contingencies.

Garran's influential book on the federal issue (1897a), which examined the federal financial problem in some detail, had argued at the time of the Adelaide session that the best solution to the federal financial problem would be for States to hand over responsibility for their debts to the Commonwealth government at federation. The alternative of handing over a large surplus revenue to the States was open to grave objection. In the first place:

> The federal government, having control of a revenue far greater than it needed for its own expenditures, would be exposed to the temptation of gaining cheap popularity in two ways: either by embarking on a policy of extravagant expenditure, or by an equally reckless remission of federal taxation (p. 164).

It would be State, not Commonwealth, governments that would be hurt as a consequence, as their dividend from the federal surplus would decline;

> ... the effect on state finance would be apt to be demoralising. A great part of each State's revenue would come from a source wholly beyond the control of its government, and liable perhaps to fluctuations for which that government was nowise responsible. The blame of a state deficit could thus easily be shifted onto other shoulders; the Treasurer's financial responsibilities would be lessened, and the chief guarantee of economical administration be removed (p. 164).

Not only did debt consolidation provide for a more complete and satisfactory separation of central from colonial finances than any other method, it also promised savings to the national fisc. Garran noted that such an arrangement for Commonwealth government takeover of States' debts might well be a regular feature of federal finances, as a large federal surplus was likely to reappear at a future date. Providing for the Commonwealth to take over further liabilities from the States would obviate the need for undue direct taxation by State governments, and minimise risks to State government finances and autonomy.

The issue of consolidating the public debt of the colonies had become more pressing after the financial crisis of the 1890s sharpened both the public's demands for government economy, and the federalists' awareness of the need to win public support for federation if their vision were to become reality (Garran 1897a and 1897b, Macnf toryhe af05 Tw[(liaanies had Rf05lurplu

respected London banker (cited in 1897 by John Walker, [15] a Convention delegate and finance expert) was that consolidating the debt could save the colonies perhaps £1,500,000 per annum, the approximate additional cost of the new central government.

So debt consolidation returned to the forefront of debate at the 1897-98 Convention. Victorian Treasurer George Turner[16], who played a leading role on financial issues at the Adelaide session, proposed that the Commonwealth should take over existing State debts, paying the interest from the surplus revenue, and debiting or crediting States with the balances. However, after considerable debate, the proposal was blocked. The Convention concluded that the Constitution should also not require the consent of States for a debt takeover. Such a solution would be practicable when economic convergence had brought per capita debt levels more closely in line. So, despite New South Wales opposition, the Convention approved a clause (later S.105 of the Constitution) enabling the Commonwealth to take over States' debts after federation (Gilbert 1973). Key delegates to the Convention were later told, through New South Wales Premier Reid,[17] that such provisions for consolidation of the public debt threatened the financial interests of British investors, and that they would therefore be unacceptable to the Imperial Government (La Nauze 1972). Convention delegates were subsequently persuaded to turn their attention to alternative means of distributing the surplus (Gilbert 1973). By then, the financial problem was becoming increasingly difficult as a large federal surplus was inevitable (Garran 1897b; Gilbert 1973).

At the 1891 Convention, the 'contributory' principle had appeared more practicable in the short term than a per capita reimbursement of Federal tariff revenues. However, by 1897 it was evident that the immediate loss of revenues to some States would be excessive. While New South Wales and Western Australia made large gains, the 'contributions' basis imposed a major financial deficit in Victoria, Queensland and Tasmania (Nash 1897), due partly to the great variation among the States in the share of revenue from tariffs on internal trade.[18] Also, with the expected change in the pattern of trade after tariffs were abolished, some States would be unfairly deprived of revenues, while the States with the major ports, Sydney and Melbourne, would benefit. The 'contributions' distributional scheme was also criticised as inconsistent with the 'Federal' principle. Therefore the Adelaide Convention agreed to adjust

[15] See Walker (1897). John Thomas Walker (1841-1923) financier and politician, had close personal, family and professional

the basis for attributing revenues by accounting for changes in intercolonial trade – i.e. a 'derivations' basis.[19]

Commenting on criticism of the complexity of the Adelaide Bill, R. R. Garran, a close observer at the Convention, explained the thinking of those framing it. The aim he said, was to get *'as nearly as possible, an equal per capita distribution of the benefits and burdens of federation.'* The difficulty in the way was that at present the per capita level of customs and excise revenues raised in the several colonies differed greatly.

> It was assumed however, that the ultimate result of a uniform tariff - after say five years - would be to make this inequality disappear; that the effect of intercolonial free trade, aided by a Federal tariff specially designed to distribute taxation fairly throughout the Commonwealth, would be that the per capita contributions of the various States would be about equal (Garran, 1897b, p. 616).

Ultimately, it had been assumed, the fairest plan for distributing the Federal surplus was *'to credit each State with a per capita share of revenue, and debit it with a per capita share of expenditure'*. At the same time it would not be fair for the first few years after the establishment of a uniform tariff, *'because the equalising tendency of that tariff would take some time to work out its full effect'*. According to Garran, those framing the Constitution assumed that this inequality in fiscal and revenue capacity, due chiefly to the different fiscal histories of the different colonies, *'would under the influence of a Federal tariff and interstate free-trade steadily diminish, till it disappeared after about five years'.* The Convention therefore determined to postpone the complete adoption of the per capita basis till after the expiration of five years from the imposition of the uniform tariff. During those years of transition, 'bookkeeping' would allow revenues to be returned to States in accord with the revenue each contributed, while expenditures would be attributed on the more federal per capita principle. The Adelaide arrangement, including as it did complex provisions for 'bookkeeping', was admittedly inconvenient, but Garran judged it 'fair'. It was also preferable to the alternative of the *'forlorn hope to which Sir Samuel Griffith and others had been driven – the expedient of leaving the whole question to the Commonwealth Parliament to decide'*. Garran warned that this proposition was likely to be unacceptable – *'it asked all the colonies to federate in the dark'*.

By 1897 it was accepted that Tasmania and Western Australia would require special provision in order to enter the Federation. And indeed Western Australia was not generally expected to

of revenues to other States. It was thought that the implied transfers were unlikely to be acceptable to New South Wales citizens at the referendum (La Nauze 1972).

Although the 1891 Commonwealth Bill had specified sharing of Commonwealth direct taxation as well as customs and excise revenues, by 1898 the focus was entirely on guaranteeing States' access to sufficient customs and excise revenues after federation. Virtually no delegates contemplated the Commonwealth expanding its direct taxation to meet its revenue needs.[23] Concurrent powers to levy income and similar taxes were given to the Commonwealth only because limiting its access to finance in a national emergency was considered 'foolish' and 'unfederal'. The Commonwealth defence power implied as its counterpart an implicit unfettered Commonwealth access to income taxation, but it was not expected that this would be used under normal circumstances.

The framers of the Constitution's financial clauses expected that the States would expand income and land taxation after federation as their incomes and wealth expanded. All States bar Western Australia and Queensland had resorted to such taxes by 1897; in those two States it was debatable whether a general income tax was yet feasible or productive. In New South Wales introduction of income and land taxation had been a burning political issue throughout the 1890s (McMinn 1989). The level of those taxes was seen as excessive, particularly in the smaller States (Black 1895). Tasmanian taxation, for instance, was much heavier than in richer States. In Western Australia, the high costs of servicing the goldfields had resulted in very high customs and excise tax rates on a prosperous but itinerant population that was difficult to subject to income taxation. It was agreed that a large expansion of State income

The financial clauses were thus a compromise that enabled the implementation of a commonly held set of principles: to protect all States' finances sufficiently that they could join the union, and to allow sufficient flexibility to provide relief for a State that might otherwise find it financially impossible to remain within the union.

The smaller States, wary of special provisions, also accepted these generalised arrangements as at least better than the alternatives (May 1971). Quick and Garran said of the section 96 power:

> this section is not intended to diminish the responsibility of State Treasurers, or to inject a regular system of grants in aid. Its object is to strengthen the financial position of the Commonwealth in view of possible contingencies, by affording an escape from any excessive rigidity of the financial clauses. It is for use as a safety valve not as an open vent; and it does not contemplate financial difficulties, any more than a safety valve contemplates explosions (p. 871).

From 1897 delegates were increasingly persuaded that it was untimely for a permanent settlement of the financial issue because of the unknowns of federation itself and the level, structure and impact of the Commonwealth tariff remained major uncertainties affecting State financial security (Gilbert 1973). This had been the view of New South Wales since 1891, and from 1897 other States notably Queensland and more reluctantly, South Australia came to share and persuade others to that view (Gilbert 1973). Both Kingston[24] and Holder[25] were influential in the financial negotiations and in this gradual consensus for a deferred federal financial settlement (La Nauze 1972).

So the arrangements to apply in the medium to longer term were to a convenient degree left up in the air. As Sir Samuel Griffith[26] put it, the problem of distributing the surplus was *'at the present time insoluble, by reason of the want of the necessary data.'* In mathematical terms - and Griffith had first class honours in mathematics - there were more unknowns than equations.

Key figures at the Convention, including Barton and Kingston, were anxious that neither the federal financial problem, nor even the free trade issue, should stand in the way of federation (La Nauze 1972). In these circumstances, the consensus emerged that the best solution was to accept the inconvenience of 'bookkeeping' during a transitional period, and trust to the Commonwealth parliament to negotiate a distribution scheme protecting the solvency of all States after federation. All agreed that Western Australia was a special case, and reflecting

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24 Charles Kingston (1850-1908) was a lawyer and Premier of South Australia from 1893 to 1899. Amongst the reforms implemented by his administration was the establishment of Australia's first conciliation and arbitration tribunal. He was a leading figure in the Federation debates, and played an important role in striking the compromise over the financial clauses. He was elected to the first Federal Parliament in 1901, and held the portfolio of Trade and Customs.

25 Frederick William Holder (1850-1909) journalist and politician, was South Australian Treasurer for ten years including the period April 1894 to December 1899. Active in the federal movement throughout the decade, he was a leading figure at the 1897-98 Convention, a member of the Finance Committee, and particularly influential on federal financial matters. Holder was responsible for the proposal for the bookkeeping period to be shortened to one year with a sliding scale of payment to the end of five years, when the federal surplus was to be distributed on a per capita basis.

26 Sir Samuel Walker Griffith (1845-1920) Chief Justice, and Queensland Premier, was a leading figure at the 1891 Sydney Convention and continued to advocate federation as Queensland's Chief Justice from 1893. In 1896-1900 he wrote extensively on federation, and played an important background role in the drafting of the 1897-98 Bill. His support for wider rights of appeal to the Privy Council caused bitter clashes with Deakin, Barton, Kingston, and Symon. As inaugural Chief Justice of the High Court of Australia from 1903, Griffith sat with Barton, and O'Connor on constitutional decisions limiting the effect of central over state powers, a line of constitutional interpretation which mainly prevailed until his retirement in 1919.

the serious concerns of Western Australian leader Sir John Forrest[27] about whether Western Australia could afford to join the Federation, it was later permitted to maintain its own tariff for 5 years after fiscal union (section 95) (La Nauze 1972).

By delaying the debate on a permanent scheme of Federal finance till some time sufficiently far off, delegates anticipated that the current difficulties would be more easily solved. So as to ease the adoption of federation, a convenient assumption was adopted; that State economies would expand, and their fiscal and economic capacity converge after federation under a uniform tariff. An equal per capita basis for distributing the surplus would then be both 'equitable' and sufficient for the needs of the smaller States, and more acceptable to New South Wales. The 'contributions' basis for returning the net surplus revenue would then equate to the more 'federal' per capita principle for reimbursement, while the implicit redistribution from the financial stronger to the weaker States would be within politically acceptable bounds. Agreement on federating State borrowing and debt would also be easier as their debt policies became more similar.

Three decades later, looking back on the Federation Debates, Giblin[28] observed :

> there is at the outset among the zealots for federation a willingness to forget as much as possible any disparity in the federating States. … the very possibility of federation is in the balance (p. 51).

Even at the time, informed observers acknowledged there was no objective basis for expecting natural economic and fiscal convergence. However, no scheme that showed New South Wales as a loser was acceptable. An unquestioned assumption of convergence was convenient, and, importantly, got the principle of per capita distribution past New South Wales (Giblin 1926). Looking at the issue more broadly, delegates also trusted that the High Court now required by the Constitution would protect States' rights (and therefore their

2.3 'Trusting convergence' – the federal financial problem to 1920

In the first decade after federation, continued divergence in economic and fiscal capacity

Commonwealth direct taxes, or the Commonwealth having the power to access State railway revenues. In addition, transfer of only pre-federation debt was insufficient for the needs of heavily indebted South Australia, Queensland and Tasmania. Transferring all debts including those incurred since federation meant the interest burden would exceed the revenue due to States under s. 87 and required the offer of further indemnity to the London financial market if the Commonwealth was to convert these debts on good terms.[31]

Substantial agreement along the lines the Commonwealth Treasurer suggested had been reached by the end of the 1904 Conference (New South Wales 1905; Turner 1905). However, some States remained uncomfortable about surrendering important public enterprise revenues and sovereign borrowing rights to the Commonwealth. After the intervening election injected new players into the Premiers' Conference, the fragile consensus unravelled in 1905 (Tasmania 1905).

Failing to reach agreement among themselves on a debt transfer, the States tried to force Commonwealth action by emphasising the effect of public opinion on the 'disastrous financial embarrassment' States would face if the Braddon clause were not extended. However, Commonwealth Treasurer Turner did not accept that the public necessarily expected the Commonwealth to accommodate the States in all their demands; he could argue against the States that one of the main reasons for federation had been to bring all debt under Commonwealth control. And in fact the Commonwealth was impatient to escape the complex financial constraints imposed by the Braddon clause and the requirement for monthly payments of any revenue surplus. Turner warned that the Commonwealth expected substantial defence and other expenses by the end of the decade. Labor members of the Commonwealth Parliament were exerting strong pressure for a national old-age pension scheme, a move that had wide parliamentary and public support. In fact, the prospect of a national old-age pension had been an important element of popular support for federation. Only financial stringency was delaying the Commonwealth Parliament exercising its constitutional power to legislate for invalid and age pensions. Consequently, Turner judged that the Parliament would not extend the Braddon clause without a new source of revenues to fund the pension.

The February 1905 Conference of Premiers in Hobart considered the question of national aged pensions in some detail. After federation New South Wales had moved promptly to introduce a State pension scheme, and Victoria and Queensland had followed. However, there were substantial difficulties and gaps in coverage arising from State residency requirements juxtaposed with the migratory and casual nature of the population at that early stage of Australia's industrial development. Prime Minister Reid argued that the existing arrangements were unfair to workers whose circumstances took them from one State to another, often with the result that they did not meet the eligibility requirements of any particular State. A national scheme would be fairer. However, the expanded eligibility would inevitably make it more costly.

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31 While the Commonwealth government could introduce direct taxes to meet the revenue gap, Turner noted general agreement that this source of revenues should be left to the States. He also considered it unwise to have both the Commonwealth and States taxing the same base.

fiercely contested, not only because of the fiscal implications but also because of the implications for States' land policies.

Hence, from 1910, the *Surplus Revenue Act* became the backbone of Commonwealth-State financial relations, and the Commonwealth government began to reap substantial revenues from land taxation.

The smaller States particularly resented these developments. They had favoured the principle of per capita distribution of the federal surplus, but their populations were draining to larger States. Conservative legislatures in these States viewed the age pension as a Commonwealth extravagance which was eating away the surplus customs and excise revenues, and although the remedy of raising direct taxes was available to them, federation had already forced heavy increases in direct taxation. Substantial remaining differences in the economic wealth and

the 1910 *Agreement*.[36] Recognising the uneven impacts of such a reform, the Commonwealth government offered to make special provisions for Tasmania, Western Australia and Queensland if direct taxes were reassigned. However, the Commonwealth's proposal was not sufficient to reassure the poorer States (Copland 1924). Reducing per capita grants and making room in the direct tax field was of dubious financial benefit to them, as they had relatively low taxable capacity. From their viewpoint, the existing system was preferable. Replacing per capita grants in the smaller States' budgets would have required very high income taxes compared with those in more affluent neighbouring States.

The Commonwealth government's special purpose grants for road building, instituted from 1923, also gave the less populous and rural States a further stake in arrangements under which the Commonwealth government had a strong revenue raising role and redistributed such revenues in a manner beneficial to them.

As Copland[37] pointed out in 1924, estimates of taxable capacity and tax severity showed very clearly how unevenly the burden of taxation was distributed among similarly-placed taxpayers in different States. This underlined the great difficulties of promoting uniformity in State taxation or arranging a general scheme for the delimitation of spheres of taxation between the Commonwealth and the States. Owing to the varying burdens of taxation, he concluded:

> any proposal, while offering relief to some States, will create hardships for others and the pressing financial needs of most States are at present an insurmountable obstacle to uniformity (Copland 1924, p. 393).

From 1923, the Commonwealth Nationalist/Country Party government under the influence of Treasurer Earle Page[38] adopted a policy of returning revenue raising responsibilities to the States, and ending their dependence on Commonwealth grants – what we now call 'vertical fiscal imbalance'. Page and his colleagues believed that the grant arrangements caused duplication and irresponsibility (Sawer 1972), and with a conservative business and rural constituency, Page was bent on reducing Commonwealth direct taxation to pre-war levels. However, the Commonwealth had incurred very heavy commitments for war debt and war-related social services including for veterans (Jones 1980). Cutting Commonwealth land and income taxes therefore required cutting Commonwealth payments to States.

By this time, academic and official opinion had increasingly come to recognise the economic and financial disadvantage of smaller States in the Federation, and the diverse nature of their difficulties. For instance, Professor Giblin, at that time the Tasmanian Statistician, used Commonwealth income tax data to show that the belief in convergence of taxable capacity was unfounded (Giblin 1924). The steeply progressive Commonwealth income tax of 1915 raised revenue disproportionately from wealthier States because of the higher average incomes of their citizens – it raised only half as much revenue per capita in Tasmania as it did in

[36] The course of these negotiations is summarised in Smith (1993), pp. 47-49.

[37] Douglas B Copland (1894-1971) academic, economist, bureaucrat and diplomat, commenced his academic career lecturing in economics at the University of Tasmania, and was appointed foundation Sidney Myer chair at the University of Melbourne in 1924. Copland was economic advisor to Tasmanian, Victorian and New South Wales governments at various times during the interwar years. As chair of a committee of economists and under-treasurers reporting to the Australian Loan Council on means of restoring financial stability in 1931, Copland's Plan became the Premiers' Plan, Australia's governments' joint policy response to the Depression.

[38] Sir Earle Christmas Page (1880-1961) politician and surgeon, was elected to federal parliament and formed the Federal Country Party in 1920, being the main architect of the long-lived coalition between it and the urban conservative parties.

wealthier States. The smaller States thus benefited from a substantial redistribution as a result of a progressive centralised taxation system and a grant allocation system with an equal per capita character. In a 1926 review, Giblin described it in these terms:

> The combination of Commonwealth direct taxation with per capita distributions to the States makes an adjusting factor of the greatest nicety. So long as the federal tax is uniform and uniformly administered in all States, it cannot go wrong. The State which is flourishing at the time (or more precisely in the previous year) will pay more than the average, and the State which has had a bad year will pay less. The adjustment is automatic (p. 57).

The May 1926 Premiers' Conference was unable to obtain the necessary unanimous agreement of States on reassigning taxes between the Commonwealth and State levels of government, as such proposals did not acknowledge the different taxable capacities of the States. State income taxes rose substantially during the 1920s, especially in States such as South Australia. The interests of the smaller States had increasingly come to lie in a system which centralised income taxation. The dynamics created by divergent taxable capacities and the redistributive fiscal activities of the Commonwealth government meant that there was no commonly agreed view among the States of the best (or even a jointly acceptable) direction of change.

Tasmania was also losing population to the mainland, and this increased the difficulty of providing public services while maintaining tolerable taxation burdens. Lockyer recommended annual grants to Tasmania of £300,000 for five years, the basis being the State's lower taxable capacity, its higher cost of providing necessary government services, and the cost of remedial measures proposed by the Commonwealth. The grants were conditional on the State reducing its taxation. Notably the recommendations were not based on a finding of 'disabilities of federation'. However, the 1927 *Financial Agreement* overtook the recommendation.[41]

The 1927 *Financial Agreement* provided for South Australia to seek special grants, which it did in 1928. The suggestion the same year that Queensland might also seek a grant raised the prospect of the Commonwealth assessing claims from four of the six States.

The Commonwealth set up a Royal Commission on 'the Finances of South Australia as Affected by Federation'. The State put forward arguments mirroring those put by Tasmania and Western Australia.[42] Its ground for such assistance was *'to enable it to maintain the standard of progress of the wealthier States'*. Evidence was put forward that it could not finance its most important operations, and it noted an implied promise that the weaker States would not be allowed to suffer through federation. Although the South Australian submission drew heavily on the approach of previous submissions by Tasmania, it was the first time a State had explicitly requested assistance on this basis. Although acknowledging an interest in maintaining the stability of the Federation, the Royal Commission did not accept that the existence of a budget deficit was itself justification for special assistance. Nevertheless, adopting the approach suggested by Tasmania in previous enquiries, it based its recommendation for grants on the State's budget deficits after adjusting for tax capacity and level of taxation, and other items, taking this as both the need and justification for assistance.

In 1929 the Commonwealth increased the tariff and lowered its income tax threshold to boost revenues, taking it into a part of the tax base that it had vacated to the States since 1923.[43] This provoked particular anger in the primary producing smaller States, notably Western Australia which had also been especially hard hit by falling commodity prices. Simultaneously the States faced massive revenue strains of their own as the Depression slashed land and income tax revenues.

With the arrival of Depression from 1929, Western Australia and Tasmania made more frequent claims for additional assistance. As Greenwood commented regarding the secession movement in Western Australia:

> The economic ills of the State were responsible for transforming secession from a goal favoured by a few extremists into a movement expressive of universal dissatisfaction with existing conditions (Greenwood 1946, p. 180).

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41 Arising from the 1926 negotiations was a study by the Development and Migration Commission of Tasmania's financial problems. It too, recommended grants to Tasmania, determined with regard to taxable capacity, the cost of providing essential government services, and other remedial measures.

42 Sir Leslie Melville (1901-) was Public Actuary of South Australia from 1924-1928, and appointed to the chair of Economics at the University of Adelaide from 1929-31. He gave evidence on federal finance to the Royal Commission on the Constitution in 1928 and as Public Actuary prepared South Australia's case for the parliamentary committee investigating the State's claim to a special grant. Melville was Chairman of the Commonwealth Grants Commission from 1966-1974.

43 The increasingly overlapping spheres of Commonwealth and State direct taxes led to the appointment of a Royal Commission on 'double taxation' in 1932.

At this time, conflict within the Federation came to be seen as possibly threatening the Federation itself. Anti federal feeling was now rife, with attention focussing on the so-called 'disabilities of federation'. As Brigden observed, *'it seemed that federation everywhere might become a casualty of the Depression'* (1934, p. 217). In late 1929, the arbitrariness and uncertainty of the special grants process became an election issue because of the Bruce-Page Government policy of attaching conditions to special grants (May 1971). Conditions attached to previous Tasmanian grants recommended by the Lockyer inquiry had been bitterly resented in that State. In 1929, the offer of a grant to South Australia provoked enormous controversy because it was conditional on transferring part of the State's railway system to the Commonwealth. And in the same year, the Commonwealth offered assistance to Western Australia if that State transferred its northwest portion to the Commonwealth. The political uproar over the Commonwealth's use of conditions emphasised the need to regularise

In 1943, the Curtin Labor government established the National Welfare Fund using revenues from Uniform Income Taxation and its 1941 payroll tax.[46] That year, the Commonwealth substantially increased taxation rates, especially on low-income earners, to provide for a national system of social security, including unemployment benefits, child endowment and widows pension. This expansion of Commonwealth social security benefits was, as in the first decade after federation, funded in part at the expense of revenues for the States.

During the War the 'fiscal need' basis of Grants Commission assessments was being shifted towards 'fiscal equalisation'. In its early reports the Commission had emphasised that there was not a 'scientific' basis for penalties, and it was for the Commonwealth Parliament to judge what level of 'penalty for claimancy' should be imposed and to what standard the claimant States should be raised. By 1945, the Commission's 'penalty for claimancy' and adjustment for additional tax effort - the most obvious formal differences between fiscal need and fiscal equalisation - had been abandoned (Head 1967). The decision reflected the loss of financial autonomy of the States in the wartime conditions,[47] and was associated with improved economic conditions from war spending (Brown 1952).

This suspension of penalties had long been sought by the claimant States. To the latter, these adjustments (combined with the balanced budget standard[48]) represented an unacceptable intrusion by the Grants Commission into State financial policies, and undermined State financial autonomy. In essence, the penalty clauses were seen as an abrogation of the federal principle. On the other hand, concerns were expressed that without the clauses, the claimant States would have less incentive to manage their finances without assistance from the Commonwealth.

After the War the Commonwealth decided to continue its monopoly on income taxation in spite of vigorous opposition from the States. In 1948 the Prime Minister, Ben Chifley, told the Premiers that:

> How much benefit the three claimant St(be)4.n-6e- of 1uaabrogT0.0001 Tcf 1u]TJT0.3008(St)4.ee(.1(S t(1(

When, in the early 1950s, the Menzies government sought to return some income taxing power to the States it was the smaller States that opposed it because of their lesser capacity to raise revenues from income taxation compared to the more affluent States and the Commonwealth as a whole (Binns and Bellis 1956).

After the War, the basis for distributing tax reimbursement grants was gradually shifted from the pre-war collections basis to an 'adjusted per capita' basis. The pre-war collections basis had the Commonwealth providing high levels of funds to States with high pre-war tax rates, but financed from uniform rate collections. Under the adjusted per capita model, phased in over the ten years to 1957-58, State population was adjusted for demographic structure, in an implicit recognition of the higher costs of providing services in the sparsely populated States. The method thus represented a continuation in principle of the approach that the Grants Commission had adopted in the 1930s – a method based on capacity and need rather than 'contributions' or 'disabilities of federation'.

At the same time, the additional tax reimbursement grants that the smaller States (South Australia, Tasmania and Western Australia) had received during the war were incorporated in an *ad hoc* way into the tax reimbursement grants base from 1947. Replacing previous additional assistance assessed by the CGC, supplementary grants were also made on an *ad hoc* political basis by the Commonwealth between 1947 and 1958.

By 1957-58 all general revenue grants had been moved to an adjusted population basis. New South Wales and Victoria were still deeply dissatisfied with the Commonwealth's takeover of income taxation, and mounted a High Court challenge against some of the grant conditions that the Commonwealth used to maintain its monopoly of the tax base. However, the High Court ruled that the Commonwealth could make grants conditional on States remaining out of the income tax field. Had the High Court ruled otherwise, there would appear still to have been significant practical obstacles to States re-entering the income tax field without Commonwealth cooperation.

South Australia, Tasmania and Western Australia continued to receive special grants according to the Grants Commission criteria of fiscal need. However, with pressures for expanding the role of the public sector in the post war period, and the relatively slower growth of tax reimbursement grants, such grants were increasingly out of balance with State functional responsibilities. In 1957, both Victoria and Queensland applied for special grants, forcing a general review of Federal/State finances.

As a result of the 1959 review the 'tax reimbursement' grants were replaced with financial assistance grants. The Commonwealth also had as an objective of the review to reduce the number of claimant States to two, and to reduce the quantum of funds flowing to States as special assistance.

So that South Australia would withdraw from claimancy, its 1958-59 special grants were built into its FAGs base. New South Wales, Victoria, Queensland, and South Australia each had their FAGs shares rounded up to the whole percentage point. Western Australia and Tasmania had their shares rounded down, but remained eligible for special assistance.[49, 50]

It is hard to find a compelling rationale for these reforms. FAGs were much more redistributive than the post-1942 tax reimbursement grants (Head 1967; Lane 1977). However, the transition from tax reimbursement to financial assistance grants was not based on any clear principles about relativities or the distribution of the surplus. FAGs relativities now reflected an arbitrary combination of adjusted per capita allocations, Grants Commission

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Chapter Three

1970 to the Present

3.1 Introduction

This chapter is concerned with the evolution of Australia's equalisation arrangements from the beginning of the 1970s to the present. The presentation is essentially chronological, but with some deviations from this rule where it helps the telling of the story.

An important backdrop to this is the development of the vertical structure of Australia's Commonwealth-State relations. Figure 3.1 shows trends in the ratio payments — general

formula. New South Wales had a 30.2 per cent share of FAGs plus special grants, compared with a 31.1 per cent share under the FAGs formula.

Table 3.1
State shares of 1974-75 grants

	FAGs	Special grants	FAGs plus special grants
New South Wales	31.1	0.0	30.2
Victoria	23.1	0.0	22.5
Queensland	17.5	38.3	18.0
South Australia	11.0	61.7	12.4
Western Australia	11.8	0.0	11.5
Tasmania	5.6	0.0	5.4
Total	100.0	100.0	100.0

Source: *Payments to or For the States and Local Government Authorities, 1977-98.*

Consequently the Whitlam Government implemented a system of grants through the States to local government; constitutional constraints limited the ability of the Commonwealth to make direct grants to local government. However, this initiative was in the face of some strong protests. Since Federation local government had been a matter for State Governments, and indeed were State creations.

Local government arrangements can be viewed as decisions by States about how to invoke federal principles within their own jurisdictions. Under the federalist model, States devolve powers to local government according to their views about, on the one hand, the ability of local governments to achieve decisions better tailored to local conditions and, on the other, the risks of adverse consequences such as spillovers, wasteful competition, complexity and duplication of effort. The fact that the roles and responsibilities allocated to local government, and their sizes, vary from State to State simply reflects the scope for diverse outcomes. Local government is seen as a delivery mechanism by which the States carry out their responsibilities. With this view of federalism in mind, the States regarded the Commonwealth's actions as an intrusion into their domain.

While Whitlam's local government reforms appear to have alienated some States-righters, they were not fundamentally 'anti-federalist' in character. Indeed they were in one sense (but not all senses) strongly aligned with the federalist principle of devolving power to lower levels of government — they increased the capabilities of local level governments to manage

mechanism, and because the larger two States were never claimants, the equalisation principle was not applied directly to a determination of their grants.

3.4 1975 to 1981

In 1975 the Fraser Coalition Government replaced the Whitlam Labor Government. In their election platform the Coalition Parties had announced a revised approach to Commonwealth-State financial relations. Mathews and Grewal say of the *New Federalism* policy that:

> There were important philosophical differences between the federalism policy of the new Government and that of the Whitlam Government … Arguing that powers and functions must be distributed among the three levels of government so as to provide a barrier against what they called centralist authoraina.001 Tm1l0(ti8l0.3(l.6(o)-03 j94ps)-0.ri)4.1(butl.6(o)or
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Hawke Government repealed the legislation under which the Commonwealth would collect income tax on behalf of the States.

An understanding reached between the Commonwealth and the States in 1976 provided that the initial relativities to be employed for allocation of the total States' tax sharing entitlement between the States would be the 1975-76 FAGs relativities. In future years, these were to be adjusted for population changes. The four less populous States remained free to apply for grants on the recommendation of the Commonwealth Grants Commission over and above their tax reimbursement grants. There was to be a periodic review of relativities based on advice from an 'independent body', with the first review to be made before the end of 1980-81. In addition, if the less populous States chose to implement a surcharge then equalisation arrangements were to be made so that they would obtain the same relative advantage from the surcharge as States with a broader tax base, with the assessment to be made by the Grants Commission.[58]

In the local government field the role of the Commonwealth Grants Commission (the prefix was returned) in allocating local government grants within States was abolished. This task was delegated to the States themselves and State Grants Commissions established under State legislation. Protests had been raised by councils which received nothing under the fiscal equalisation arrangement, and it was decided as a matter of policy that every council should receive something. Consequently new legislation introduced by the Commonwealth stipulated that at least 30 per cent of local government funds within each State be allocated 'per capita' with States then allocating the remainder according to the 'equalisation' principle.[59] Consequently the Commonwealth ceased to have a role approving regional organisations of local government. However, the Commonwealth continued to provide untied funding for local government via specific purpose payments to the States — and indeed these payments were calculated on a tax sharing basis as were the States' main general purpose funds.

The Commonwealth Grants Commission for a time retained a role making recommendations on the division of local government funds between States. In 1976 and 1977 it based its recommended relativities on an analysis of fiscal needs of individual local governments, with an aggregation for each State determining the State assessment. In 1978, it recommended that, for simplicity and transparency, the Commonwealth move to an equal per capita distribution between the States. However the Commonwealth Grants Commission (1995) reports that the 1977 relativities continued to be used until 1985-86. In 1986-87, the State's shares of the pool were reduced to make room for the Northern Territory, and then in 1987-88 a phased adjustment to the relativities commenced so that by 1989-90 the distribution was equal per capita.[60]

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58 James (1997) observes that in fact the set of relativities applied to the tax reimbursement grants was of little consequence, owing to the impact of the various guarantee clauses which were invoked. After payments under the guarantees, the pattern of gross payments bore little resemblance to the recommended relativities.

59 See Local Government (Personal Income Tax Sharing) Act 1976, s. 6. In fact the 'per capita' component could be modified to take account of population characteristics on the basis of agreement between the relevant Premier and the Prime Minister. Commonwealth Grants Commission (1995) says that the 'per capita' component was set at the minimum 30 per cent in three States but as high as 80 per cent in Western Australia. Mathews and Grewal (1997) report that in Western Australia the affluent metropolitan municipality of Peppermint Grove received an allocation twice as large as the metropolitan municipality of Stirling, which was assessed by the State Grants Commission as the council most needing assistance. See pp. 264-265.

60 pp. 126-128.

The Coalition's local government reforms thus continued some important aspects of the Whitlam reforms and also managed to address some of the States' objections to those reforms. In particular, the Coalition continued to have in place an arrangement whereby substantial resources were earmarked to local government, but returned the issue of local government boundaries entirely to the States ('approved regional organisations of local government' ceased to exist) and largely returned the issue of the intra-State distribution of grants to the States.

3.5 1981 to 1985

At the 1977 Premiers' Conference consideration was given to the review of relativities which was required to be conducted by 1980-81. It was agreed that:

> The review should be based on the principle that each State should be able to provide State Government services of a recurrent kind of the same standard as other States without imposing higher rates of taxes or charges; differences in revenue raising capacities and in the relative costs of providing comparable government services should be taken into account. [Payments to or For the States …, 1977-78 p. 17]

A subtle but important change had occurred. Fiscal equalisation was to be applied across all States rather than just to claimant States. Such a reform had been proposed in the academic literature and apparently had support in the bureaucracy as well. For instance, Russell

their parties.[62] It made good sense for the Commonwealth to distance itself from ad hoc decisions about distributions between States.

However, there was disagreement as to who should conduct the review of relativities. The Commonwealth favoured the Commonwealth Grants Commission, but some of the Premiers were opposed. The compromise reached was to have the review conducted by a special division of the Commission — special in the sense that it included one Associate member nominated by the two larger States and two Associate members nominated by the four smaller States, in addition to the Chairman and two members of the Commission.

In mid 1981, after extensive consultation and research, the Commission released the findings of its Review. The key finding, from the States' point of view, was that application of a pure equalisation principle (at least according to the Commission's judgement) required very large reductions in the funding allocations going to the less populous States, and increased allocations to the larger States. The second and third columns of Table 3.2 show the changes in general revenue assistance implied by the Commission's findings (in dollar terms and as a percentage of total State and local receipts for each State).

Table 3.2
General Revenue Grant Allocations Under Old Relativities,
Change Under New Relativities and Change as a Proportion of State Receipts, 1981-82

	Estimated grants, 'old'

In South Australia, there was reluctant acceptance. In fact the political debate focused upon whether or not the previous Government could have protected the State against such a situation by specifying the terms of the 'Railway Agreement' more closely. This agreement between the Whitlam (Commonwealth) and Dunstan (South Australian) Governments had transferred South Australia's railways to the Commonwealth under a deal which was financially beneficial to South Australia. The Grants Commission, applying its principle of fiscal equalisation scrupulously, found that the generous deal reached by the governments had significantly increased South Australia's financial capacity and correspondingly reduced its need for general revenue assistance from the Commonwealth. And the Commonwealth was not sympathetic to the argument that the payments should be regarded as over and above any needs assessment — in fact the Prime Minister, Fraser, had apparently wanted to dissolve the agreement for some time. Dunstan (who had by this time retired from Parliament) reported Fraser as previously telling him that South Australia had 'taken the Commonwealth to the cleaners'[63] with the deal.

The South Australian Premier, David Tonkin, said of the Commission's findings that:

> If the full recommendations of the Grants Commission were to be implemented by the Federal Government, South Australia would suffer an economic body blow'[64] [and] 'Quite frankly, there is no way we cansifica64

Commission clearly had the intention of implementing a system of pure equalisation (excluding policy differences). Among the implications of this was its refusal to treat certain State revenue sources as if they did not exist — for instance South Australia's railway payments.

The Commission's findings supported the view that the smaller States were, under the old relativities, being overcompensated for their disadvantages. Such a situation was perhaps not surprising given the structure of grant arrangements that had previously existed. Smaller States effectively had chosen between two types of existence — special assistance claims — 'claimancy' — via the Grants Commission and special political deals with the Commonwealth in which they were bought out of claimancy — presumably on terms that were at least as favourable as they could have expected under claimancy.

Even though the Commission had introduced a system of pure equalisation to its assessments (at least in concept, although some parties did dispute the accuracy of the assessments) this

However, the Commonwealth still did provide some assistance on a transitional basis to South Australia and Tasmania in respect of the new relativities. The Finance Minister at that time, Western Australian Senator Peter Walsh, has subsequently criticised the ongoing provision of transitional assistance in the following terms:

> To secure agreement from the States which had been disadvantaged by Grants Commission relativities review (sic), an extra $88 million was provided for South

Cuts on this scale were, as could be imagined, very stressful to the States. To some extent they were intended to be so — the Commonwealth apparently believed that re-focusing of State spending and reform of State trading enterprises were necessary microeconomic reforms that the States were more likely to engage in under financial pressure. From the States' point of view, however, the Commonwealth's unilateral reduction of the FAGs which had been intended to replace the States' guaranteed share of income tax revenue was inconsistent with a federal model in which the States had access with some certainty to revenues which allowed them to determine their own expenditures — even if they did not have the ultimate say over how the revenues should be raised. The States gained some relief in 1990 when the Commonwealth guaranteed real terms maintenance of general revenue grants for 1991-92 to 1993-94.

3.6.3 The Self Report on Local Government

The application of fiscal equalisation to the distribution of the States' FAGs and Hospital Funding Grants was an ongoing feature of this period. However, a quite contrary direction was taken in respect of local government. In 1986 the Commonwealth decided to phase the interstate distribution of local government assistance away from the 1977 relativities to an equal per capita allocation over the three year period to 1989-90. In addition, the Commonwealth required each State to submit to the Commonwealth for approval principles for the distribution of grants between their local governments, having mind to the objective of fiscal equalisation. The principles were also required to give effect to the policy that no local government receive less than it would if 30 per cent of the State's local government grant were allocated between local governments on a per capita basis. The rationale for these arrangements was that:

> … these new arrangements for increased involvement by the Commonwealth in oversight of the distribution of funds within each State are intended to achieve a greater degree of uniformity in distribution methodologies across States. However, it still leaves State Local Government Grants Commissions with considerable discretion in the detailed assessment of each council's relative need for assistance.[71]

The local government decision appears to have been based on the findings of the Self Report on Local Government Finance, which found that there was a case for some sort of interstate equalisation arrangement, but that the 1977 relativities were hopelessly outdated and that an equal per capita distribution would be a better alternative until a new set of relativities was assessed.[72]

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71 *Payments to or for ... 1986-87. pp 95-6.*

72 The Committee argued that because the quantum of funds likely to be redistributed was fairly small, cost considerations dictated a more simplified assessment process than was applied to interstate grants, but that the simplification need not be so

for 1991-92 because it had concerns about the appropriateness of its assessment methods and data quality.[75] The history goes on to say that:

> The Commission drew attention to several practical matters which governments would need to take into account in considering any change from the existing basis of distribution. They included the following:
>
> (i) The per capita basis of distribution was simple and predictable. An equalisation basis would be much more complex and would deliver less predictable outcomes, particularly in the early years.
>
> (ii) A change to an equalisation system would entail extra administrative costs for both the Commonwealth and the States.
>
> (iii) These costs had to be considered in relation to the relatively small size of the pool. A move to an equalisation basis would be very disruptive to local authorities in New South Wales and Victoria.

Given the somewhat equivocal attitude of the Commission to the question of whether equalisation could be applied adequately, and strong protests from New South Wales and Victoria, the Commonwealth decided to persist with the equal per capita arrangements. This was at odds with the earlier approach of phasing-in new relativities when they presented difficulties for States that lost out from changes. One wonders whether the decision would have been the same had the impacts been in the other direction. The Commonwealth probably had a degree of sympathy towards New South Wales and Victoria's complaints about fiscal equalisation, and this decision looks like a sop to them.

3.7 1991 to 2000

3.7.1 Real Terms Maintenance

By 1991 the States, disillusioned with the Commonwealth's heavy handed approach to federal financial relations and facing their own severe budgetary stress, made bipartisan representations — in the form of a joint approach by the South Australian Premier, John Bannon, and the New South Wales Premier, Nick Greiner — to the Hawke Government seeking to reintroduce a system of State access to personal income taxation. The issue became embroiled in the political struggle for leadership of the Labor Party and failed with the accession of Paul Keating to the Prime Ministership. Keating was strongly opposed to a devolution of such powers to the States, and in spite of occasional sympathetic noises from other Commonwealth Ministers about the desirability of an improved federal financial structure, the Commonwealth maintained a centralised approach.

However, the period of sharp cuts to grants was over. The Commonwealth implemented policies of maintenance of general revenue assistance in real per capita terms (subject to offsets from program transfers). Although the situation for States was more stable, the process of adjustment to these lower funding levels was still in progress, including cuts in staffing levels in State agencies and trading enterprises.

[75] See Commonwealth Grants Commission (1995), pp. 130-131.

3.7.2 The Heads of Treasuries Review

At the 1992 Premiers' Conference, it was recorded that the grant relativities prepared by the Commonwealth Grants Commission 'provided some difficulties for some States'. In particular, the new set of grant relativities had the effect, relative to the 1991 relativities, of reducing payments to New South Wales by $63m and payments to Victoria by $50m. Those two States responded negatively, questioning not just the Commission's assessments but the fiscal equalisation principle itself.

The sentiments of those two States were reflected in comments by the New South Wales Premier Greiner in the New South Wales Parliament:

> The people of New South Wales are subsidising the rest of Australia. That cannot go

The Review summarises the New South Wales/Victoria view as being that fiscal equalisation has efficiency costs in terms of mis-allocation of resources resulting from redistribution of income, transaction costs associated with the transfers, and incentive effects associated with the subsidisation of high cost producers of public services by low cost producers. They also rejected the idea that objectives of interpersonal horizontal equity could support a system of inter-governmental equalisation payments. In addition, even if the smaller States' theoretical rationale for fiscal equalisation were accepted, New South Wales and Victoria argued that the Grants Commission's processes could not be related to that theoretical rationale.

At an impasse in reaching a consensus on the consequences of equalisation, the Review placed most of its emphasis on the question of how effective the existing arrangements were in achieving equalisation of the States' fiscal capacities. For instance, was the scope of the Commission's assessments appropriate and were its assessments accurate? At stake were questions such as: whether the Commission's extensive use of judgement and pursuit of accuracy should be reduced, and more emphasis placed instead on simplicity and transparency; whether the Commission was effective in applying its principle of policy neutrality; whether the scope of the Commission's assessments was inadequate in that it excluded capital expenditures, local government, and State-type services provided by the private sector.

The Review then turned to a consideration of different grant allocations, essentially being various partial equalisation schemes. However, in the absence of much agreement on the appropriate principles for grant allocation, there was little in the way of principles to guide the Review in its response to some of the options considered. The alternative to first principles — judging the options in terms of dollar outcomes — was never going to produce a consensus as the States were effectively arguing about how to share up a fixed pool of funds.

In the end, the strongest conclusions to be agreed in the Report were that:

> The Report recognises that fiscal equalisation is justified on equity grounds, which requires a political decision, and about which economic theory can provide little guidance.

And that:

> … the potential of the fiscal equalisation process to create an incentive for a State or Territory to alter its revenue raising or expenditure decisions (grant design inefficiency) is difficult to assess and is probably minor. [79]

The Review was presented to the Premiers' Conference in 1994. In the Budget documents the Commonwealth Treasurer said that the Heads of Treasuries Report had been presented to the Premiers' Conference. The absence of consensus between the States on any recommendations was noted. The only action announced by the Commonwealth was that:

[79] Heads of Treasuries p. v.

Those options of a technical nature canvassed in the report, as well as issues of a similar nature raised by the CGC in its 1994 Update Report, will be considered further by the Commonwealth, in consultation with the States, in developing the terms of reference for the CGC'S 1995 update of the per capita relativities and for its next major review.[80]

3.7.3 The National Competition Policy Agreements

> Full horizontal equalisation within States aims to bring all to bring all councils in that State up to the same fiscal level. The effect of distributing grants between States on a per capita basis means councils in different States may be brought up to different fiscal levels.[82]

The Act also provides for roads grants, which were 'untied' in a 1991 amendment, to be

3.7.6 The High Court Strikes Down State 'Franchise Fees'

In August 1997 the High Court ruled that the tobacco franchise fee in new South Wales was an excise and contravened Section 90 of the Constitution. The reasoning in this ruling clearly extended to the other States, and also to State franchise fees on petrol and liquor. The States had thus lost an important revenue source, and in recognition of this the Commonwealth (which can impose excises) agreed to levy replacement taxes on tobacco, petrol and liquor, and to pass on the funds to the States as 'Revenue Replacement Payments'. Because the Commonwealth is, in general, constitutionally precluded from varying its tax rates on a geographic basis, differential State tax rates then had to be implemented by means of State Government subsidies to petrol prices.

3.8 2000 onward

3.8.1 The ANTS Reforms

In 2000, the Howard Government implemented a package of reforms to the taxation system and Commonwealth-State financial relations under the banner '*A New Tax System' (ANTS).* The package involved introduction of a new goods and services tax, abolition of a range of other taxes which were deemed to be inefficient or otherwise unsatisfactory, and reductions in personal income taxes and excise rates. There was a range of compensation measures intended to compensate, at least to some degree, people who were adversely affected by the changes. In addition, the introduction of the package was facilitated by a significant reduction in the overall level of taxes, this reduction being financed from the budget surplus.

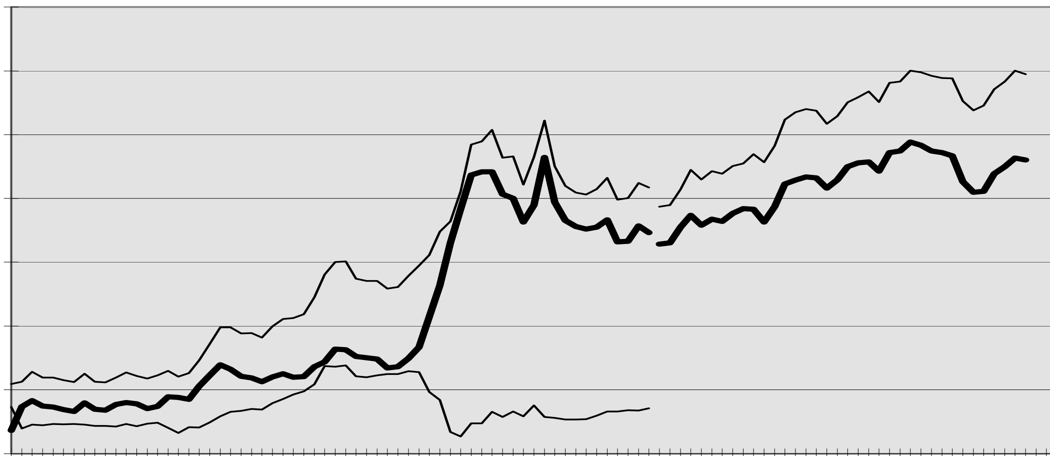
The arrangements between the Commonwealth and the States were formalised in the *Inter-governmental Agreement on the Reform of Commonwealth-State Financial Relations* in April 1999, which was subsequently modified in June 1999.[84] Upon announcing the *Agreement* Howard said that:

> The new arrangements will provide the States and Territories with a stable and growing source of revenu

- the Commonwealth would cease to make FAGs to the States;
- the States would abolish the following taxes: bed taxes, financial institutions duty (July 2001), stamp duty on quoted marketable securities (July 2001), and debits tax (July 2005); and
- the Commonwealth would distribute GST revenue grants among the States and Territories in accordance with horizontal fiscal equalisation (HFE) principles subject to transitional arrangements and other relevant provisions of the *Agreement*.

The new arrangements have the consequence of reintroducing a form of tax sharing to Commonwealth-State relations, but in this case the tax base provided to the States is the GST, and the States are to receive the entirety of the GST revenues net of collection costs. At face value, the reform has something in common with the tax sharing arrangements introduced by Fraser. The States have access to one of the two major broad tax bases (the other being income taxes, from which they remain effectively precluded), and importantly this base has the prospect of growing in line with the economy. Their vulnerability to arbitrary Commonwealth decisions would thus appear to be reduced, especially as the Commonwealth has agreed with the States that the GST rate will not be varied without unanimous agreement between the Commonwealth and the States. However, it needs to be recognised that the Commonwealth has a choice about whether or not it honours this agreement — it still has full legislative power to unilaterally alter the grant arrangements as it sees fit, and the only real constraint is political opprobrium. In addition, a major important difference from the earlier tax sharing arrangements is that the States do not have the capacity to vary the GST rate, either in their own jurisdictions or collectively on a national basis.

Figure 3.2
Taxation as a Proportion of GDP Since Federation



from 6.7 per cent of GDP to 5.3 per cent. Figure 3.2 shows levels of Commonwealth taxation, State and local taxation (combined) and total taxation since Federation.

The degree of vertical fiscal imbalance in Australia has sometimes been said to be problematic. In fact there is a credible argument that these concerns are misplaced or at least exaggerated; certainly the Commonwealth has not regarded the level of vertical imbalance as a constraint in this instance.

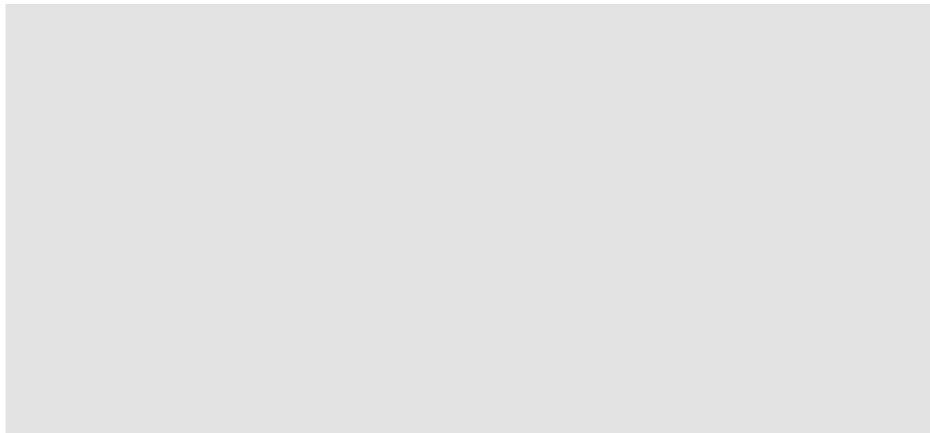
An important feature of the new arrangements is the continuation of fiscal equalisation. During a radio interview in 1998, Howard explained his views on the topic in the following terms:

> … there'll be an argument between the States as to who gets what share of the GST pie. Now I'm going to ask the Commonwealth Grants Commission to do that. That is an independent body that always has determined allocations of Commonwealth money between the States. Commonwealth money all goes into a pool and then the States get a share of the pool. Now the Grants Commission will decide how much Queensland gets, how much New South Wales and Western Australia get. I'm not interested in arguments between States about who's….I'm an Australian and as far as I'm concerned all Australians should be treated equally no matter where they live. I'm not interested in arguments from a State Premier that he's carrying somebody else's load. I

taken into account and this is the basis for the figures in the third column. In a similar vein there are some changes to expenditures, particularly in respect of the First Home Owners' Scheme, which have differential impacts on States and therefore need equalisation — these are shown in the fourth column.

Table 3.3

Figure 3.3
Distribution of Guaranteed Minimum Amounts, GST Revenue and Budget Balancing Assistance in 2001-02 — Per Capita ($)



> Well the current allocations of the GST revenue are done by an independent umpire – the Commonwealth Grants Commission. It's always been done that way. And since the beginning of Federation there have always been cross transfers from the larger States to the smaller States. But if any of the State Treasurers, if all of the State Treasurers want to agree on a new formula that'll be put in place. The Commonwealth will just pay out according to the formula agreed by the States. But if the States can't agree, we'll pay out on the independent umpire's decision.[88]

Meanwhile local government allocations of general purpose assistance between States continue to be composed of two components — a financial assistance component, allocated on a per capita basis, and a road funding component, allocated on the basis of historical relativities. A review of the Act is currently in progress, but the interstate distribution of financial assistance was specifically excluded from its attention. The Commonwealth Minister for Regional Services, Territories and Local Government explained the decision in these terms:

> I am conscious that some in Local Government would have liked wider terms of reference to allow a review of the interstate distribution of funding. I am also aware that there are some that do not want the interstate distribution reviewed at all. This has been a contentious issue between States for some time, and was extensively debated as part of the negotiations over the 1999 Inter-governmental Agreement on the Reform of Commonwealth-State Financial Relations. The Federal Government does not support re-examining this matter as part of this review. For those Councils or Associations wishing to pursue this matter I suggest you approach your State Government for appropriate attention.[89]

Thus it appears that for the near future at least the financial assistance component of local government funding will continue to be assessed on a per capita basis. The difference between the arrangements for the States and the local governments that they establish is anomalous. In essence, local governments are established by State Government to provide services which are in the ambit of local government. In the ACT, for instance, there is no local government and local government functions are performed by the Territory Government. The anomaly is all the more striking given the requirement in the *Local Government (Financial Assistance) Act 1995* that intrastate distributions of financial assistance be made on

Australia's federal financial system exhibits a high degree of 'vertical fiscal imbalance'. For instance James (2000) reports that *'... Australia is characterised by the highest degree of vertical fiscal imbalance of any other federal system'.*

Collins (2000) measures Australia's vertical fiscal imbalance by reference to State own-revenues as a proportion of State own-source expenditures – he reports a ratio of just 58 per cent in 1998-99 (balance would imply a ratio of 100 per cent). Unfortunately data deficiencies render it impractical to replicate this series since Federation. However, Figure 1.2 shows trends in Commonwealth untied recurrent grants (plus specific purpose payments in respect of

> preferences and cost differentials. To maximise overall social welfare thus requires that local outputs vary accordingly. (pp.1121-1122)

This argument is widely accepted in principle. Even nations which notionally have unitary systems of government often establish decentralised decision units with democratic input to allow better tailoring of local decisions to local costs and preferences.

Oates' analysis is in the classic public finance tradition, of which Richard Musgrave is a leading proponent (see for instance Musgrave 1959). Musgrave considers public finance questions in terms of three governmental functions – allocative, distributive and stabilising. Allocative functions relate to decisions about what goods and services should be produced; distributive decisions relate to the distribution of resources between people and organisations; and the stabilising role relates to the use of budgetary policy for macroeconomic management purposes. Musgrave argues that sub-national governments have a useful role to play in allocative decisions, but that distributive and stabilising roles will generally be best left to national government.

Oates' argument is couched in terms of efficient decisions about public good provision. It is not couched in terms of income distribution decisions. Nor does it necessarily involve a matching of intra-marginal revenue raising and expenditure responsibilities for each level of government. What it amounts to is an observation that, whatever the resources available to a particular sub-national government, there are decisions about public goods which will be better taken at the sub-national level than by a central planner at the national level (and the argument could extend to some private goods).

The appropriate extent of devolution is an empirical matter, with assessment taking into account that, in some instances, lower levels of government are better at creating value through public spending decisions, while in others economies of scale, the costs of duplication, and externalities mean that better decision making is achieved with a centralised process. In addition, the presence of separate sub-national governments may offer more in terms of policy innovation and experimentation, and this needs to be set against the extra costs associated with multiple governmental units.[90]

A decision about where to locate a school, for instance, might be most appropriately taken at a low t7f th7(ss9o2Tlr)-1o.8(n)1Aement 9o2a rivf tcatchment are
unlikely to be vf y efficient if made by a numbf tof separate governments with coverag of the same catchment — there are too many externalities. In reality many of the choices to be made are not so clear cut, and there is often heated debate about them. Should education spending be determined on a national basis? Should the national government involve itself in detailed choices about urban renewal at the local level? Although there is a set of underlying conceptual principles, the answers to these questions are inevitably judgemental.

With regard to distributive matters, Musgrave (1989) argues that differentiated distributive schemes from state to state may be tempting in terms of localised choice, but break down in the face of high population mobility, as people move to the state with the best scheme for them. Between nations, barriers to migration avoid this phenomenon. Musgrave notes that

[90] To the extent that differentiated state government policies are deemed desirable on grounds of knowledge spillovers, there may be a case for some pooling of the *ex post* deviations from *ex* ante costs and returns, rather than having each separate unit carry its own risks.

reflecting the community's tax/spending choices. Certainly econometric analyses that establish *correlation* do not necessarily establish *causation.*

Secondly, Brennan and Pincus (1996) show that if federal taxes are more efficient than state taxes then a combination of federal taxes and grants may justify state spending programs that are not justified when states must raise their revenue from less efficient tax bases. They conclude that one can find *'... a theoretical flypaper effect that does not rely on distortions in public choice mechanisms ...'* (p. 244).

Hines and Thaler (1995) also note a range of potential deficiencies in the econometric evaluations, although they conclude that '... *the explanations based on econometric misspecification apply only to certain studies, yet flypaper effects are observed elsewhere'*(p. 222). They suggest that there are individual behavioural phenomena which explain the presence of the flypaper effect – such as loss aversion and lack of fungibility (for instance as is revealed in different household responses to equivalent increases in cash wages and net wealth in superannuation funds). They go on to point [(wep9 -1.18)ci.6(Tuativo0indon 7so0indon)u(thar

4.2.2.3 Choice of tax instruments

An optimal set of tax instruments for a given revenue yield and distributive outcome will be one which minimises the costs associated with those taxes. These costs include readily apparent elements such as administrative and compliance costs, and induced avoidance costs.

decision makers are not obviously distorted by the existence of vertical fiscal imbalance. If electors believe that a State government has wasteful spending programs, there is always room for another party to campaign on a pledge of reduced spending and State taxes.[96]

The traditional arguments in favour of decentralised government relate to better knowledge of specific local constraints and preferences, and these issues are likely to be most important in government spending decisions on a case by case basis. A state of vertical fiscal imbalance per se does not apparently undermine the decentralised choice and inter-jurisdiction competition benefits of sub-national jurisdictions, while still achieving the benefits of an optimised taxation structure.

Perhaps a more fundamental motivator of criticisms of vertical fiscal imbalance is that it changes the balance of power between the Commonwealth and States. This interpretation is

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4.2.4 Conclusions

Criticisms are often levelled at Australia's degree of vertical fiscal imbalance (and its primary cause, the centralisation of high quality revenue bases), and the degree of centralisation of governmental functions to the Commonwealth (manifest in the extent of Commonwealth own spending and specific purpose payments).

The recent ANTS reforms amount to centralisation of revenue raising, with that centralisation being justified on the tenets of optimal taxation structure. The scope for further revenue centralisation in Australia is limited, and further centralisation of a structural type is unlikely.[98] On the other hand, there appears to be scope for devolution of revenue raising without introduction of inferior tax mechanisms, for instance by allowing States access to a part of the personal income tax base. But for this to happen, one would need to convince the Commonwealth and the States that it is a desirable change. The advantage for the States is that they could have greater flexibility in their own budget management, and less vulnerability to Commonwealth intervention. Yet this may not be appealing to the Commonwealth, which has actively used State funding as, inter alia, an instrument of fiscal policy. An additional benefit would be the potential to see Australian governments, collectively, use a better tax mix. But without agreement between the Commonwealth and the States, a partial return of income tax powers to the States is highly improbable.

Ultimately the question of what is the most efficient degree of devolution is an empirical one. However, in the absence of much hard empirical evidence, most of the Australian debate relies on assertion. Although there is broad agreement that a federal system is in principle a good thing, there is not much convergence of thought on the appropriate degree of governmental centralisation. The Commonwealth, by virtue of its powers, tends to dominate the outcome. Sceptics attribute this to malign motives, and supporters attribute it to benevolent motives. So it is hard but to remain agnostic on the evils of the current degree of governmental centralisation. Although the Australian arrangements seem centralised when compared to other federations, the same cannot be said in contrast to nations with unitary systems.

4.3 Horizontal issues: the allocation of resources between the States

4.3.1 Introduction

Federal financial relations have important impacts upon the distribution of resources between States. These impacts can occur by means of national level budgetary actions, such as tax and spending decisions, and decisions about grants to state governments. There are also instances outside of Australia of grants between states (for instance in Germany).

The distinguishing feature of Australia's federal financial arrangements is the application of a comprehensive fiscal equalisation process to State budgets. This is done by means of Commonwealth general purpose assistance to the States, which is divided between the States so as to make it possible for each State to provide a like level of services at like level of effort. Federal flexibility is achieved by leaving with the States the discretion to choose whether to provide services and taxes at average levels or whether to vary them.

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98 Statistical indicators may show a further centralisation of revenue raising, as the GST is believed to be a growth tax in the longer term.

This section considers the design principles from the public finance literature for the allocation of resources between States. The conceptual discussion is quite complex, but unavoidably so. It then considers Australia's fiscal equalisation system, its important role as an instrument to equalise budget capacity, and some of the contemporary debate about the role of fiscal equalisation.

4.3.2 Theory

4.3.2.1 The Concept of Net Fiscal Benefits

The impact of the fiscal system upon an individual can be considered in terms of a 'net fiscal benefit', this being the difference between the cost of unrequited benefits provided to the individual by government and the unrequited contributions extracted from the individual. Unrequited benefits include direct cash transfers to individuals and also the cost of services provided by government on a non-recouped basis, such as education, roads and defence. Contributions include taxes levied on the individual (e.g. income tax) and taxes which ultimately are borne by the individual (e.g. excises). Where government creates artificial monopolies, and allows those monopolies to create transfers between individuals and government and between individuals, these transfers should also be included as unrequited contributions and benefits.[99]

Obviously the task of assessing an individual's net fiscal benefit is a substantial one, with significant practical obstacles.

First, the assessment needs to be conducted in terms of the ultimate incidence of fiscal impacts, rather than the legal incidence. The two may be the same in some cases — personal income tax being a possible example. However, there are many instances where they will not be the same: a tax on tobacco retailers largely has its incidence on smokers. In fact, in many instances the incidence will be shared between bustagrs should .2(m2scal berms of sca,.00 be)d .2(m2Tc0.rl

to assess the impact of governmental redistributive activity, via net fiscal benefits, in terms of equity and efficiency.

The discussion maintains generality and realism by considering a world in which the fiscal system is used actively by governments for redistributive objectives. The redistributive content of government policy is captured in the distribution of net fiscal benefits that its policies bring about.

The net fiscal benefit is an important component in a comprehensive – i.e. all-encompassing – measure of individuals' incomes. 'Comprehensive income' consists of private cash income, private non-pecuniary income and net fiscal benefits; the sum of the three can be referred to as 'comprehensive income'. The total of these three components, rather than any one component alone, represents the income constraint on an individual's consumption and lifestyle opportunities and thus plays a key role in determining the individual's well being. Individuals then have choices to make about how they allocate their comprehensive income, and do so to maximise wellbeing according to their own preferences and the trade-offs[100] that are available to them in markets and in their household production functions.

4.3.2.2 The distribution of net fiscal benefits

Distributive outcomes of fiscal decisions

It is readily observed that governments deliberately choose to vary the net fiscal benefit amounts received by different classes of individuals. An obvious example is progressive income tax. There is as well a vast array of other policy choices with redistributive consequences, the pattern of those choices being conditioned by community perceptions of

The role of fiscal equalisation

Buchanan went on to consider the possibility of action to offset these accidental variations in net fiscal benefits. The most direct approach would be to conduct interpersonal equalisation,

In the fiscal federalism context, a potentially contentious question arises with respect to jurisdiction of residence: Is it valid to dismiss jurisdiction of residence as a factor in the comparison of individuals? Some would argue not — that in essence individuals who are identical in every respect but resident in different jurisdictions are in fact different. Others would argue that jurisdiction of residence is really no more than an administrative matter, and that equal treatment is an essential federal principle.

If one accepts that jurisdiction of residence is an intrinsic personal attribute that cannot be dismissed — that otherwise identical individuals **are different** because of their jurisdiction — then one might allow individuals to bear the consequences of variations in states' fiscal capacities. The national government would still need to take into account differences in net fiscal benefits for the even application of its own distributive policies. It might, for instance, want to incorporate the state to state variations in net fiscal benefits into income tax assessments, as they are a form of income. Petchey and Walsh (1993) describe an equity objective of this type as 'narrow-based horizontal equity', following a nomenclature that was introduced by Boadway and Flatters.

It is worth clarifying the narrow-based view further. What it would mean, for example, is that if there were a gas discovery in Queensland which increased Queensland Government royalties, then residents of Coolangatta could enjoy a cut in taxes while residents of Tweed Heads could not, in spite of the fact that they form one urban agglomerate. It would also mean that (say) formation of a new State in the New England area by secession from New South Wales would change tax levels in Albury and Tweed Heads but not Wodonga or Coolangatta. Effectively, the redrawing of jurisdictional boundaries far distant would create incentives for people and businesses to change sides of the Coolangatta/Tweed Heads main street.

If, on the other hand, one rejects the idea that jurisdiction of residence ought affect the net fiscal benefits of residents in a federation, then the appropriate national level policy response is to equalise any differences in State level net fiscal benefits. This objective of 'broad-based horizontal equity', as discussed previously, could be achieved via a system of interpersonal transfers or via a system of equalisation payments to States.

An important qualification is that inter-governmental transfers will be effective only so long as States have similar distributive policies. If States pursued different distributive policies,

implemented. But this is peripheral; the fundamental question in the current context is not whether there is **any** capitalisation of fiscal distortions, but whether the capitalisation process is such as to completely neutralise any impacts on mobile resources' choices of jurisdiction.[104]

On the first count, it clearly is the case that at least some state policies are potentially efficiency reducing, but certainly not all. For instance, subsidies to remote area living may increase the extent of remote area living above the efficient level, and are to that extent efficiency reducing. On the other hand, subsidies to the elderly under long established pay as you go arrangements cannot affect the number of people who are elderly (although interstate policy differences may cause them to migrate from one state to another).

If the existence of some inefficiency is established, one needs to turn to the second matter — whether the policy mix chosen by the states is inappropriate. If it is deemed to be broadly appropriate, then the distributive scheme and its inefficiencies are to be accepted, and fiscal equalisation is simply an adjunct that removes cross-jurisdiction distortions.

On the other hand, if the vertical distribution is regarded as creating excessive inefficiencies, then a mechanism to attenuate the redistributive activity and thus the inefficiencies is desirable. The first-best response will be to override the states' distributions. Abolition of fiscal equalisation is a second-order response, and is inferior at the least because it introduces interstate distortions and at worst because it simply will not work at all. It is an untargeted policy, and introduces across the board migration from fiscally needy to non-needy jurisdictions. The efficiency gains associated with this are dubious. The issue is explored further in Appendix 4B.

Fiscal equalisation and human settlement patterns

Fiscal equalisation is not fundamentally a centralist or a decentralist policy with respect to settlement patterns. Its role is to neutralise accidental fiscal signals which vary according to jurisdiction.

This is not to deny that governments — state or national — may implement other policies to favour or oppose decentralised regional development. If a government felt that there were negative externalities associated with remote area settlement (for instance because the costs of servicing remote area populations are higher than the costs of servicing urban settlements), it could use the tax/transfer system to create incentives for urban settlement and against remote settlement (a centralist policy). Or a government might feel that urban areas suffer significant congestion costs, and choose to implement a decentralist policy.

However, in neither case can the policy be conceived of as a product of equalisation. A policy of population decentralisation can be implemented by governments with or without equalisation between states. Nor is equalisation a vehicle to deliver any particular outcome in terms of centralisation/decentralisation of settlement patterns. In fact, the implications of fiscal equalisation from an efficiency perspective are no more than to neutralise any distortions to decisions about location across jurisdictions. Although fiscal equalisation payments depend upon the structure of the different states, they do not determine the redistributive policies chosen by states.[107]

To illustrate, one can compare the towns of Albury and Wodonga, which form a virtually unified urban centre and certainly are part of a common labour market, but straddle the border between New South Wales and Victoria. New South Wales has more remote communities than does Victoria and a product of this, other things equal and absent fiscal equalisation,

[107] A national government could use a specific purpose payment if it wanted to do this.

would be to force New South Wales to set higher average tax levels or lower average service levels. Residents of Albury would receive lower net fiscal benefits than residents of Wodonga. Fiscal equalisation seeks to prevent differences of this type arising. Although the required equalisation transfers are a product of the average of the States' distributive policies, fiscal equalisation does not determine what those policies are.

Therefore the national interest in fiscal equalisation, in terms of efficiency, arises from the benefits that it brings in terms of allocation of resources across jurisdictions, not from any interest that the national government may have in centralisation or decentralisation of settlement patterns. It is possible that national government has a view about intrastate settlement patterns — either for or against decentralisation — but fiscal equalisation cannot implement it.

Interstate fiscal competition

Tiebout (1956) considered the interaction of sub-national governments and free migration between jurisdictions. He developed a model in which people choose between jurisdictions according to their view of the 'value' that they get from governments in each jurisdiction. To the extent that people's preferences for public goods differ, there would be a tendency for individuals with like preferences to co-locate.

One can extend Tiebout's model to allow for feedbacks on governmental decisions; the threat of migration may act as a discipline on governments pursuing policies that electors do not want.

Fiscal equalisation is not inimical to this form of fiscal discipline; fiscal discipline is maintained so long as States are not compensated for inefficiency in their public spending decisions (inefficiency could include excessive or insufficient production of tax funded goods and services). The implication is that it is quite consistent with fiscal competition to equalise for capacity differences to the extent that they are not a product of policy choices.

Feedbacks on state policies — 'grant design efficiency'

The analysis of efficiency so far has essentially taken State policies as a given. However, it is possible to imagine a system in which a State is able to influence its grants by changing its policies. This would be the case if, for instance, the national level government simply compensated States for any expenditures that they made and for any revenues that they chose

4.3.2.5 An 'organic' view

Courchene (1984) and Petchey and Walsh (1993) advance a 'federal rationale' for equalisation. Their argument is that, to the extent that discontinuance of equalisation would threaten the smooth operation of the Federation and the benefits arising from it, then the benefits of federation need to be attributed to the equalisation process. Those threats to the operation of the Federation could be of an extreme form — disintegration of the Federation and autarky. Or they could be in the form of some less fundamental threat to the gains from

Petchey and Walsh (1993) put emphasis on the existence of a 'federal compact'. They observe that the literature has traditionally treated a federation as analytically equivalent to a unitary system, modified (by central government) to allow some devolution of decision making. They themselves argue that in fact the character of a federation differs from this, and that the difference is a neglected but relevant factor. The formation of a federation, it is argued, involves a compact conferring certain rights on the sub-national jurisdictions. For instance, there might be an implied right to exist for member states.

Arguments about the existence of a federal compact are probably stronger the more they are grounded in the rights of the individual citizenry. The reality is that citizens of States often do have a sense of local identity and would, without any prior knowledge of future events,

between States there will be differences in average net fiscal benefits from State to State even after equalisation.

Variations in net fiscal benefits arising from past mistakes and successes are an unavoidable product of the requirement that States live with the consequences of their policy choices. Yet these accumulated fiscal impacts, which are potentially large, are just as distorting to jurisdiction choices as variations from any other source. Allowing historical mistakes to accumulate ad infinitum, as is implied under the policy neutral focus of assessments, can ultimately influence patterns of activity in inefficient ways. Possible solutions to this are:

- to establish financial penalties and rewards for interstate migrants so that their location decisions remain independent of past bad and good policy decisions;
- to set common net wealth benchmarks for each State fisc, and to return to the benchmark immediately any deviation becomes apparent — i.e. immediate privatisation of any unintended outcomes — again so that migration decisions remain independent of those outcomes; or
- ad hoc payments of a 'special assistance' nature from the Commonwealth.

The first of these is probably barred under the Constitution, and is certainly politically and administratively difficult. The second also has political and administrative obstacles, although on a lesser scale.[111] The third has the advantage of being feasible, but is to a significant degree undesirable because of the risks that it poses to sound administration by the States. The practice of the Commonwealth seems to be to give a limited degree of assistance in respect of large 'policy' mistakes. However, the approach certainly is not systematic.

The end result of the 'non-policy' equalisation payments is a system in which State Governments do have varying fiscal capacities, stemming from past policy mistakes and successes, but with variations stemming from non-controllable factors equalised away. There are corresponding variations in net fiscal benefits at the personal level from State to State, with consequences for the efficiency of jurisdiction choices and interpersonal equity.

4.3.3.3 Variations in State distributive policies

Buchanan's arguments support a system of equalisation payments at the governmental level, but with an ultimate objective of interpersonal equalisation. However, if distributive policies vary from State to State, then inter-governmental equalisation fails to achieve that objective.

Casual observation suggests that the Australian States' distributive policies are broadly similar: all the States to a greater or lesser extent support the aged via health spending and community services, families with children via education services, residents in rural areas via provision of high cost services, small businesses via payroll tax exemptions, etc. Although some States tend to be lower taxing and lower spending than others, the broad trends in terms of distribution probably still stand.

[111] The introduction of a State Deficit Levy in Victoria in the first half of the 1990s has some similarities with the second measure.

There are also instances of Commonwealth overrides of State policies in cases where States have indicated an intention to pursue markedly different distributive policies — e.g. in respect of funding of Aboriginal communities and private schools.

4.3.3.4 Is grant design inefficiency present?

It has been argued that the Australian system does create incentives for States to redesign policies so as to maximise grants. Those incentives would lead States to increase taxes on bases where they were deemed to be weak, and to increase service standards above average for those population groups which were over-represented. The argument is an 'in principle' one, and appears to have little practical relevance. It requires that State Governments act as grant maximisers, and be willing to inflict potentially controversial distributive outcomes on their electors to maximise the aggregate grant. Furthermore, a brief empirical analysis of major revenue and expenditure categories does not unearth any significant relationship between revenue capacity and effort, or expenditure needs and level of service. So perhaps it is not surprising that in this regard the Heads of Treasuries Working Party (1994) said that:

> … the potential of the fiscal equalisation process to create an incentive for a State or Territory to alter its revenue raising and expenditure decisions (grant design efficiency) is difficult to assess and is probably minor … (Executive Summary)

4.3.3.5 Is fiscal equalisation strictly observed?

The Grants Commission's assessments are of course not the final word on grant allocations, and at times the Commonwealth makes moderate adjustments to the recommended outcomes — for instance at present, with the use of Guaranteed Minimum Amounts in the transition to the *ANTS* reforms.

Other Commonwealth adjustments to the Grants Commission's recommendations could be characterised as deliberate 'forgiveness' to particular States for policy mistakes — for instance a relief payment of about $600 million to South Australia in the early 1990s to assist with sinking the State Bank losses of over $3 billion, and more recently payments of nearly $1 billion per annum to the Victorian public sector in respect of a tax hedge arrangement with Bass Strait energy producers which (in the absence of these compensating transfers) would have proved detrimental to the Victorian energy consumer. Forgiveness of mistakes such as this is quite consistent with fiscal equalisation, although it may be bad for the policy discipline of State governments and electorates.

Other adjustments might reflect a genuine view on the part of the Commonwealth Government that the Grants Commission's assessments are in some detail wrong, but one suspects that this is rarely the case and that a more likely cause is a willingness on the part of the Commonwealth to favour one State or other for reasons that are outside the Terms of Reference of the Grants Commission.

4.3.3.7 Is fiscal equalisation equitable?

Although the Grants Commission's equalisation process is horizontally equalising, this is only so to the extent that there are not entrenched disadvantages or advantages arising from past policy choices. Whether or not it is equitable that State residents bear the consequences of past decisions is not clear cut; the lower the degree of interstate mobility, the more equity there may be in making State residents carry the burden of mistakes.

Furthermore, the question of whether or not inter-jurisdictional horizontal equity matters much in the equity calculus is not one to which there is a scientific answer. Buchanan said that it *'is essential as a guide to the operations of a liberal democratic state, stemming from the same base as the principle of equality of individuals before the law'*. In addition, it is interesting to observe the States' own 'answers' to the question as was revealed in their own policies toward local government before the Commonwealth required them to implement fiscal equalisation. The most vociferous opponents of equalisation in the current climate — New South Wales and Victoria — both opted to have a significant degree of equalisation applied to funds that they passed on from Commonwealth to local governments in their jurisdiction even when they were not compelled to do so.

One set of reforms proposed in recent years involves a move away from the assessment of revenue base cicant deg fe.v211(nt y)2assation cicant deg JT0 Te.v211(iiuals)cu cee ic0.000ek

give significant weight to efficiency and equity objectives. Equalisation has a continuing place in the set of instruments to achieve those objectives.

4.3.4 Conclusions

There is a strong case for a type of fiscal equalisation on grounds of efficiency and on a broad

Furthermore, the Commission's relativities are not the last word. The Commonwealth may decide that the burden of past policy mistakes should from time to time be lifted from States, so as to gain the most from Australia's resources. But there needs to be caution about forgiveness such as this because it risks removing discipline from current State decision making processes.

The case for continued equalisation is reinforced when one considers the historical experience, which suggests that the absence of a strong commitment to fiscal equalisation tends to put grant decisions more into the political domain. For instance, Mathews and Grewal (1997) report that in the mid 1970s the three smaller States were all being over-equalised as a result of special deals with politically aligned Commonwealth Governments (p.271), and in 1981 and 1982 the Fraser Government found it difficult to implement changes in relativities which had adverse effects on State Governments of similar political persuasion. More recently, an econometric study by Worthington and Dollery (1998) has found that the allocation of specific purpose payments between the States over the period 1981-82 to 1991-92 was influenced by political considerations.

States could make different choices about how to distribute net fiscal benefits within their own jurisdictions, there is in fact a broad concordance of State distributive policies. While an appropriate equalisation system is a necessary but not a sufficient condition for attainment of broad-based horizontal equity, it appears that the current system makes an important contribution to horizontal equity objectives.

References

Australian Bureau of Statistics (2000), *Government Finance Statistics, 1999-2000.*

Appendix 4A

Does capitalisation overcome the need for equalisation?

The relationship between location and capitalisation can be considered by means of a model of a market for residence in a particular location represented in terms of simple demand and supply analysis.[116] The price variable in this market is the dollar cost of living for a person. Because people are heterogeneous in terms of the pecuniary and non-pecuniary benefits of being in Location A vis-à-vis their next best alternatives, the demand schedule for residence in Location A will be downward sloping.[117]

The triangle ABC represents a dispersion of part of the aggregate transfer BCFD. The meaning to attach to this depends on the relationship between private and social costs and benefits. If the D_0 and S_0 are both reflective of social benefits and costs of residence in Location A, then triangle ABC represents a deadweight loss associated with the fiscal transfer. On the other hand if D_1 and S_0 represent the social benefits and costs, then triangle ABC represents a deadweight gain.

The key theme of this section is that if government provides locationally differentiated payments to people according to the regions that they live in, and if migration is free, then those differentiated payments will change the pattern of settlement from what would occur with payments equal across locations. Higher payments to residents of a particular location will boost population, and lower payments will deplete population. Some capitalisation effects may exist, but for capitalisation effects to offset differentiated payments from government, quite implausible assumptions would need to be satisfied

Appendix 4B

Fiscal equalisation and feedbacks on state policies

There is a well established case in the literature for equalisation transfers to offset distortions to jurisdiction choices. The need for equalisation arises because of, inter alia, state redistributive policies. It is sometimes suggested that these state policies are undesirable – in the sense of striking an inappropriate balance between efficiency objectives and redistributive objectives – and that fiscal equalisation supports their continuation.

Such an argument starts with the (possibly implicit) presumption that the redistributions carried out by states are undesirable and involve an acceptance of excessive levels of inefficiency — e.g. in intra-state location decisions. This is an important presumption that should not be glossed over. A key issue at the outset is to consider whether the balance which states strike between distributive objectives and efficiency losses is unacceptable to the national government.

Data Appendix

Shares of the Equalisation Pool

Figures are from Commonwealth Treasurer (2001) and refer to sum of GST revenue and Health Care Grants.

GDP estimates

The GDP measure is an expenditure based estimate throughout. For the period 1962-63 to 1999-2000, ABS data from the September quarter 2000 *Australian National Accounts* is used. The projection for 2000-01 is calculated as the ABS 1999-2000 estimate factored up by 7.12 per cent — based on the Commonwealth Treasurer's (2000) projected 4 per cent real increase in GDP and 3 per cent increase in the non-farm GDP deflator. Data for the period 1900-01 to 1961-62 is a spliced series based on the series ANA 129 appearing in Butlin (1987). The splicing factor is based on the ratio between the two series for the five years 1959-60 to 1963-64, and leads to an across the board increase in the ANA 129 series of about 9 per cent. The divergence between the two series is believed to arise from increases in estimates of historic GDP levels since Butlin's work was published. These increases have been driven by conceptual changes in the coverage of GDP — for instance modifications arising from the introduction of SNA 93 — and also by changes in ABS measurement methods. Our splicing method embodies the assumption (for want of better) that the revisions would have boosted Butlin's estimates by the same amount.

Public finance series

Data on gross revenue, gross expenditures and total Commonwealth payments to the States from Federation to 1961-62 are from Barnard (1987). Data on untied grants is from various Commonwealth Budget papers and a South Australian Treasury database.

There is a major series break in the 1962-63 financial year, when the public finance collections were placed on a National Accounts basis with coverage of a broader range of

References