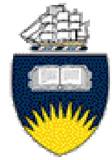
The South Australian
Centre for Economic Studies

Adelaide & Flinders Universities



Financing the Federation

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A Centenary of Federation project prepared by:

The South Australian Centre for Economic Studies

Funded by the:

South Australian Department of Treasury and Finance

September 2001

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National Library of Australia
Cataloguing-in-Publication data:

Hancock, Jim, 1964- .
Financing the federation.

Bibliography.
ISBN 0 9586395 3 1.

1. Intergovernmental fiscal relations – Australia- History.
2. Finance, Public – Australia – History. 3. Federal
government – Australia – History. 4. Australia – Economic
conditions – 20th century. I. Smith, J.P. (Julie P.). II.
South Australian Centre for Economic Studies. III. Title.

336.94

Contents

		Page
Preface		**(iii)**
Overview		**(iv)**
Chapter One:	**Introduction**	**1**
	1.1 Introduction	1
Chapter Two:	**From The Federation Debates To 1970**	**5**
	2.1 Introduction	5
	2.2 'Federating in the Dark'	6
	2.3 'Trusting convergence' – the federal financial problem to 1920	22
	2.4 Fiscal crisis of the States, 1920-1933	26
	2.5 Uniform Taxation and problems of federal surplus revenue revisited	34
	2.5 Summing up	37
Chapter Three:	**1970 to the Present**	**44**
	3.1 Introduction	44
	3.2 The Situation in the Early 1970s	44
	3.3 1973 to 1975	46
	3.4 1975 to 1981	48
	3.5 1981 to 1985	50
	3.6 1985 to 1990	53
	3.6.1 The Adoption of Full Fiscal Equalisation	53
	3.6.2 Fiscal Stringency	54
	3.6.3 The Self Report on Local Government	55
	3.6.4 The Grants Commission's Review of Efficiency Aspects of Fiscal Equalisation	56
	3.6.5 The Grants Commission's Review of Local Government	56
	3.7 1991 to 2000	57
	3.7.1 Real Terms Maintenance	57
	3.7.2 The Heads of Treasuries Review	58
	3.7.3 The National Competition Policy Agreements	60
	3.7.4 The *Local Government (Financial Assistance) Act 1995*	60
	3.7.5 The National Commission of Audit	61
	3.7.6 The High Court Strikes Down State 'Franchise Fees'	62
	3.8 2000 onward	62
	3.8.1 The ANTS Reforms	62
	3.8.2 Fiscal equalisation	66
Chapter Four:	**The Future of Federal Financial Arrangements in Australia**	**70**
	4.1 Introduction	70
	4.2 Vertical issues: the allocation of fiscal roles between the Commonwealth and State tiers of government	70
	4.2.1 Introduction	70
	4.2.2 Theory	71
	4.2.2.1 Devolution and efficiency	71
	4.2.2.2 The 'flypaper' effect	73
	4.2.2.3 Choice of tax instruments	75
	4.2.3 Analysis of Australian issues	75
	4.2.4 Conclusions	78
	4.3 Horizontal issues: the allocation of resources between the States	78
	4.3.1 Introduction	78
	4.3.2 Theory	79
	4.3.2.1 The Concept of Net Fiscal Benefits	79
	4.3.2.2 The distribution of net fiscal benefits	80
	4.3.2.3 Equity	83
	4.3.2.4 Efficiency and the allocation of resources between states	87
	4.3.2.5 An 'organic' view	91

Contents (continued)

Page

4.3.3 Implications for Australia 92
4.3.3.1 Description of Australia's fiscal equalisation arrangements 92
4.3.3.2 Do the Grants Commission's assessments correspond with the type of equalisation supported in the literature? 93
4.3.3.3 Variations in State distributive policies 94
4.3.3.4 Is grant design inefficiency present? 95
4.3.3.5 Is fiscal equalisation strictly observed? 95
4.3.3.6 Are the Grants Commission's recommendations aimed purely at horizontal equity? 96
4.3.3.7 Is fiscal equalisation equitable? 97
4.3.3.8 The organic rationale in Australian political debate 98
4.3.4 Conclusions 100

Appendix 4A: Does capitalisation overcome the need for equalisation? 105
Appendix 4B: Fiscal equalisation and feedbacks on state policies 107
Appendix 4C: The equivalence of Grants Commission equalisation and equalisation in the literature 109
Data Appendix: Shares of the Equalisation Pool 110

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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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We are very grateful for comments provided by Owen Covick, Keith Hancock, John Henderson, Peter Howell, Jonathan Pincus, Robert Schwarz, Cliff Walsh and Jim Wright. However, they do not necessarily share the opinions expressed in the paper, and of course the responsibility for any errors lies with us. We would also like to thank Anthony Kosturjak for assistance with data and Davina Dolman and Velice Hazelwood for formatting the material.

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.

Overview

This study explores the past, present and future of Australia's Commonwealth-State grant arrangements. 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 evolved from the 1970s to the present day. The third, also by Jim Hancock, reviews the current arrangements against criteria of efficiency, equity and federal cohesion, and then considers what the future may hold.

Two distinctive features of Australia's federal financial system are that it shows a high reading on statistical indicators of 'vertical fiscal imbalance' and that it has in place a highly comprehensive system of fiscal equalisation. At times it has been argued that these characteristics indicate fundamental flaws in the Australian system. However, this study concludes that those arguments are difficult to sustain. It is hard but to be agnostic about the evils of vertical fiscal imbalance, although the total exclusion of the States from the income tax base is probably undesirable. And there is a good case on grounds of efficiency and equity, as well as the more commonly recognised goal of federal viability, for a comprehensive system of fiscal equalisation. One should not assume that Australia would be better off by importing models that exist (often only by default) in other nations. In fact Australia's federal arrangements exhibit a considerable degree of sophistication.

Two issues that we will refer to during the course of the study are the growth in the size of government and growth in Commonwealth grants to the States since Federation. The Introduction illustrates these trends in graphical form. It also introduces some terminology that will assist the reader. Jargon is avoided where practicable, but a brief summary of some basic and recurring concepts at the outset should make the material easier for the reader.

From the Federation Debates to 1970

Julie Smith argues that there is a mistaken tendency to view Australia's fiscal equalisation arrangements as a compensating mechanism to offset the uneven burden of tariffs from State to State. In fact, she demonstrates, fiscal equalisation is more a product of basic financial need on the part of recipient States and widely held views in the community about common citizenship rights.

When the Constitution was formed, there was difficulty in reaching agreement on the financial clauses, including the issue of what Commonwealth revenues would be returned to the States, and how they would be divided. This issue was resolved by the adoption of an assumption of 'convergence': that federation would bring about an equalisation of the States' economies and fiscal capacities. The assumption did not have a strong foundation, but it conveniently set aside the vexed question of what were the appropriate long term arrangements regarding the allocation of grant funds. The Constitution itself is silent on this issue.

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 income tax was bitterly opposed by State governments, which objected to the changing balance of fiscal power that it entailed.

The transfer of the States' largest tax base to the Commonwealth made it necessary for the Commonwealth to make substantially increased grants to the States in the form of tax reimbursement grants. These grants were allocated between States on a 'historic receipts' basis for the first few years, but subsequently they were determined on the basis of weighted population relativities. States with fiscal incapacities continued to seek extra special revenue assistance, and their claims were assessed by the Commission. From the time of the introduction of uniform taxation in World War Two, Commonwealth general revenue assistance to the States showed a generally rising trend as a proportion of GDP until the beginning of the 1960s. Over this period the Commonwealth increasingly provided specific purpose payments to the States; these funds, being of a conditional nature, are in a sense Commonwealth determined expenditures via the States.

At the end of the 1950s the Commonwealth broke the (nominal) link between income tax collections and general revenue assistance to the States, replacing the tax reimbursement grants with financial assistance grants (FAGs). It also entered into favourable deals with Queensland and South Australia to take them out of claimancy. Claims for special assistance were assessed by the Commission according to the principle of equalising the capacities of claimant States with New South Wales and Victoria, but the Commonwealth could induce them out of claimancy by over-equalising them under the FAGs arrangements.

The situation that existed by the end of the 1960s can therefore be characterised as one under which smaller States were able to have their budget capacities equalised with the larger States. In addition, they could strike special deals with the Commonwealth on even more favourable terms to take them out of claimancy. Not surprisingly, assistance arrangements obtained a politically charged nature; it was difficult for Commonwealth Governments to turn away politically aligned State Governments, and at the same time there was resentment in the States that missed out. At a systemic level, the grant of funds according to the political colours of State and Commonwealth Governments had little to commend it. The existence of such a process in itself fed pressures for those special deals, at the same time as it undermined the integrity of the federal process. At an individual level, the special deals were also inequitable. So it was not surprising that academics such as Head, Jay and Mathews began to speculate about alternative, objectively based institutional arrangements. However, the necessary changes were to be slow and gradual.

1970 to the present

In 1972 a Labor Government under Gough Whitlam was elected, bringing to an end more than twenty-two years of Coalition Governments. Whitlam introduced fundamental and controversial reforms to Commonwealth-State financial relations, these being in the form of much increased Commonwealth payments to the States, particularly in the form of specific purpose payments, and the entry of the Commonwealth Government into the sphere of local government. A new statute enshrined the Grants Commission's fiscal equalisation principle in legislation, but this was in the main a continuation of the existing operating arrangements. However, States still had to 'claim' for special assistance, and the Commonwealth continued to enter into special deals with the States.

When the Fraser Government replaced the Whitlam Government in 1975, it introduced further changes to the vertical structure of the federal fiscal arrangements. In particular, the role of the Commonwealth in local government was wound back (although the Commonwealth continued to provide funds for local government), FAGs payments to the States were replaced with a set share of income tax collections and the States were given the power to vary the income tax rates that applied in their jurisdictions. The income tax reforms had the potential to restore to the States some of the fiscal independence that they felt they had lost when the Commonwealth took over income taxation. In the event, no State ever took advantage of the power to vary income tax rates, arguably because the Commonwealth did not do enough to facilitate a State move into the income tax arena — for instance by creating 'tax room' itself.

The Fraser Government also took the first steps down the path of instituting a system of full fiscal equalisation in Australia. In 1977 it issued the Commonwealth Grants Commission with a reference to assess relativities to apply to tax reimbursement payments for the States, with all of them to be considered under the fiscal equalisation principle. This was an important step: one that had been proposed in the academic literature and that seemingly had support in the bureaucracy as well. The power to dispense grants to the States according to patterns of political advantage — as had occurred under Governments of both political persuasions in the 1960s and 1970s — was not unambiguously a good thing; for every winner there was a loser. A more principled method which could meet more widely held views of equity and federal fairness had something to commend it.

In the event the Commission's first set of relativities under the new method presented a political headache for the Commonwealth. By an unhappy coincidence of events, the recommended relativities involved decreasing the shares of funds going to States with politically aligned governments and increasing the shares going to some States with governments aligned with the opposition. Such a change would inevitably be politically difficult, but it was more difficult in the environment of the time: worried about its own budget position, the Commonwealth was seeking to put the brakes on its formula driven grants to the States, a move which exacerbated the States' sensitivity to grant reductions for any other reason. The Commonwealth kept the idea of full equalisation alive but shied away from introducing it, instead seeking a further review by the Commonwealth Grants Commission.

In 1985 the Hawke Government accepted a set of relativities prepared on the full fiscal equalisation basis for application to the FAGs pool, although it continued to provide a small amount of transitional assistance to South Australia and Tasmania. The circumstances of the time were much more favourable than they had been three years earlier, as the Commonwealth Grants Commission's newly prepared 1985 relativities involved much smaller adjustments to States' grants. In addition, with five of the six States having Labor governments, and the three beneficiaries of the new relativities being Labor States, the political dynamic did not stand in the way of introducing full fiscal equalisation.

Paradoxically, after consideration of the findings of the National Inquiry into Local Government Finance, the Commonwealth at about the same time decided to phase out a fiscal equalisation based distribution of Commonwealth funds between States for local government. Instead, the distribution was to be equal per capita (although the States were still required to apply fiscal equalisation to the allocation of funds within their borders). The interstate

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.

An important feature of the ANTS reforms is the application of the fiscal equalisation principle. Payments to the States from the combined GST revenue and health care grants pool will be distributed according to fiscal equalisation relativities calculated by the Commonwealth Grants Commission. These relativities have been re-calculated to take into account the changed structure of State budgets. A minor qualification is that there are transitional payments which ensure that no State receives less under the new system than it would have under the old, and this does modify the distribution of funds away from the pure equalisation based allocation to a small degree.

The principle of fiscal equalisation is now enshrined in the *Inter-governmental Agreement on the Reform of Commonwealth-State Financial Relations,* and the Commonwealth maintains that a change will occur only if a consensus emerges among the States. There is little prospect of this occurring, but a different Commonwealth Government could make unilateral changes if it so desired. At the same time, the equal per capita distribution of local government financial assistance grants between the States is enshrined in legislation, and the Commonwealth recently excluded it from review on the basis of a lack of consensus for such a review among the States.

The Future

The fourth chapter considers the design principles for a federal financial system from the academic literature, and how closely Australia conforms to those design principles. Two broad themes are considered: the vertical structure of the federal financial system and the horizontal allocation of resources between States.

The vertical structure of Australia's federal financial arrangements is at times criticised on the grounds of a high degree of vertical fiscal imbalance – that is to say, a high reliance by the States on Commonwealth untied grants to fund the States' own purpose spending. The vertical fiscal imbalance arises from the dominance of the Commonwealth in the taxation field, while the States remain responsible for substantial spending. The reliance of the States on untied Commonwealth grants has been said, in recent Australian debate, to constitute a major structural flaw in the federal financial arrangements.

One of the primary economic arguments for a federal system is the scope that it offers to allocate revenue and spending decisions, according to their geographic fields of impact, to democratically accountable bodies with coverage of the relevant fields of impact. There is no reason to expect that the optimal allocation of spending functions between tiers of government will be exactly matched by the allocation of revenue powers. As a consequence, some degree of vertical fiscal imbalance is likely, with the outcome depending upon case by case decisions about expenditure functions and revenue bases.

It has been argued that vertical fiscal imbalance promotes wasteful spending by sub-national governments; in the jargon, fiscal illusion creates a 'flypaper effect', in that governments that receive grants spend them without due regard to the efficiency of their spending choices. However, the empirical evidence for failed public choice mechanisms is not conclusive, and there are strong in-principle grounds to question whether they could be present. In particular, so long as sub-national governments remain responsible for revenue raising *at the margin,* then the cost of an extra dollar of spending is an extra dollar of revenue effort.

Where different levels of government have some responsibility for revenue raising, it will be desirable that they have available to them efficient tax instruments. If sub-national governments have inefficient tax bases available to them, it may be preferable for the national government to raise revenues from its own efficient tax bases and on-pass the revenues raised to the sub-national governments as grants, rather than to have sub-national governments raise their own revenues from inefficient tax bases.

Although Australia does have a high degree of vertical fiscal imbalance, it is hard but to be agnostic about the extent of any problems caused. This does not mean that action to reduce the degree of vertical fiscal imbalance is a bad thing, but that there is not a compelling case for it. The appropriate federal structure is more appropriately determined as the result of case by case decisions about the allocation of revenue and spending functions. Vertical fiscal imbalance could be reduced by shifting revenue powers to the States, or it could be reduced by shifting spending powers to the Commonwealth.

In fact a reasonable case can be made for allowing the States some modest access to the personal income tax base, on the grounds that the States are at present still reliant on a set of taxes which are generally inferior to income tax, and that these could be replaced with income tax revenues. A small presence at the margin would appear to deliver most of the potential benefits, although with little or no change to the existing level of vertical imbalance.

A distinctive feature of Australia's approach to the horizontal allocation of fiscal resources is the implementation of a comprehensive system of fiscal equalisation. The fiscal equalisation system makes it possible for each State to produce average levels of service at average levels of revenue effort, a situation that is unlikely to prevail in the absence of an equalising mechanism.

Other federations around the world generally have less complete equalisation arrangements in place than does Australia. However, the degree of equalisation in Australia is comparable to that in the fiscal systems of unitary states, as their fiscal systems automatically implement equalisation processes.

As was demonstrated in Smith's chapter, Australia's equalisation arrangements grew out of the need to ensure viability of all the States in the Australian federation. Although it is sometimes alleged that the basis for these arrangements has been 'compensation' for the disabilities of federation – such as the uneven burden of tariffs – this ground for equalisation was rejected as long ago as the mid 1930s. In 1936 the Commonwealth Grants Commission adopted an equalisation principle based upon the objective of equalising the States' budgetary capacities, and this is its guiding principle to this day.

There has been considerable criticism within Australia of fiscal equalisation over recent years. Although there is general acknowledgement that some special payments are needed to support States with large fiscal disabilities — notably Tasmania and the Northern Territory but also to a lesser extent South Australia — it is alleged that fiscal equalisation causes inefficiencies in resource allocation and is inequitable. In fact these criticisms are not supported by the mainstream public finance literature.

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 work of Buchanan and subsequent authors in the field, the effect of fiscal equalisation is to neutralise any fiscal distortions between jurisdictions.

However, even when these insights are acknowledged, there is also a tendency to confuse the equalisation process with State governments' own within state redistributive decisions. For instance State government subsidies to communities in high cost locations, often delivered in-kind through the provision of government services, may over a long enough period of time encourage more people to locate in those high cost locations, and that may be regarded as inefficient. If the national government wishes to change this, the appropriate response is to cause the States to desist from those policies. However, the inefficiencies associated with those State policies are sometimes attributed to fiscal equalisation, when in fact there is no causal link.

Although equalisation is supported in the literature, an important question is whether or not the Australian system conforms to the theoretic ideal.

The literature provides strong support for interpersonal equalisation transfers across jurisdictions. These transfers may be delivered via state governments and will have their intended effects so long as state governments distribute them accordingly. In practice this requires that the distributive content of State government policies be the same. It is argued that this requirement is broadly observed in Australia. State governments all provide similar types of services, and draw on similar revenue bases.

In one important respect the Australian arrangement does deviate from the comprehensive form of equalisation that the literature supports. The point of difference is the treatment of the accumulated impacts of past policy choices on the States' fiscal positions. To the extent that differences in fiscal capacity exist as a consequence of past management decisions, they are not equalised away. The rationale for this approach is compelling – that it is preferable not to compensate State governments for episodes of profligacy because it would weaken the incentive for sound budgetary management in future. However, to the extent that differences in fiscal strength stemming from these factors do exist, they will distort jurisdiction choices and may involve inequity. There is no easy solution to this problem.

These considerations suggest that Australia's fiscal equalisation system performs fairly well on efficiency and equity grounds. It also has attractions in terms of the political process, notwithstanding frequent objections from New South Wales and Victoria and, more recently, since an equal per capita system has become relatively more advantageous, Western Australia. Interestingly, those objections relate not so much to the fiscal equalisation principle, but rather to an organic view of governments as competing entities in their own right. State officials sometimes regard interventions in the equalisation process as attractive in terms of their ability to redirect population between States. This is in spite of the fact that equalisation tends to neutralise distortions to jurisdiction choices, and thus to allow jurisdiction choices to occur with reference to underlying benefits and costs.

There are considerable attractions to the Commonwealth in retaining the current system where an independent body is responsible for the allocation of funds between States. Dispensing political favour to aligned State governments is hardly a constructive national approach to policy. In addition, the politics of State grants has never been easy for the Commonwealth and while there is from time to time a pressure to accommodate one State or another, the more that one does so the greater are the expectations that one will do so in the future. Of course it is possible to imagine other distributive principles — such as 'per capita' or 'contributions' — that are at a political arms length. However, when one considers in addition the Commonwealth's presumed objective of maximising national living standards subject to an equitable distribution of taxation burdens and government services across the community, it becomes apparent that those two alternatives are inferior. An independent organisation which can get the distribution right, or at least as close to right as possible given the uncertainties that exist, has considerable attractions from a whole of nation point of view.

It is common to compare Australia's institutions with overseas practices, and to assume that Australia's differences equate to deficiencies. However, a key message of this paper is that, at least within the bounds of what is knowable, Australia's federal financial system has strong foundations in first principles.

Chapter One

Introduction

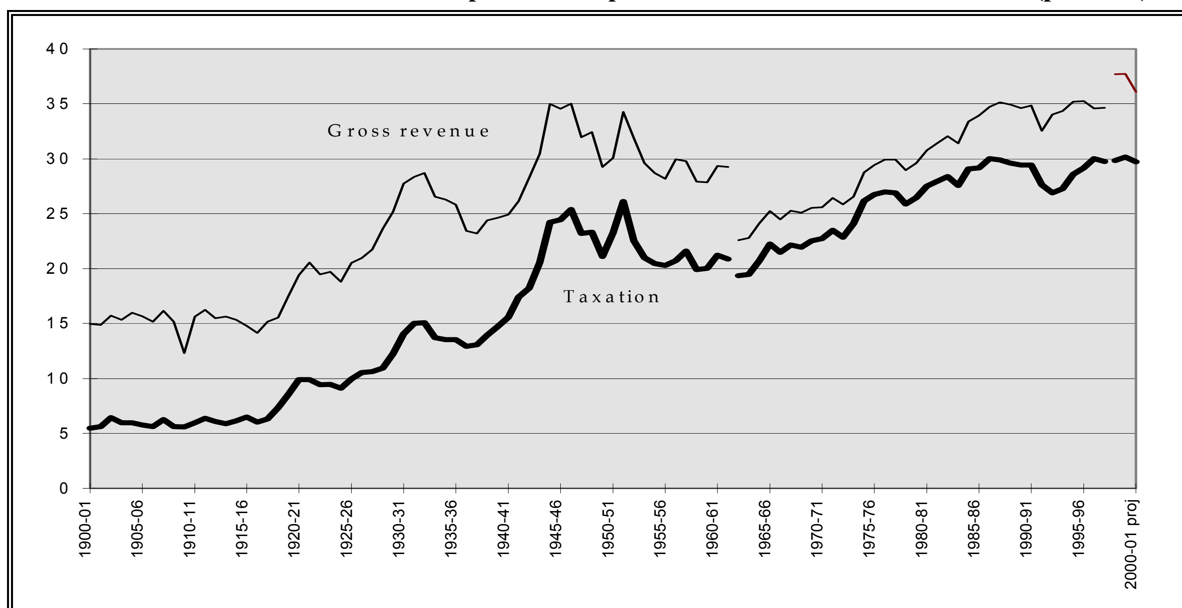
1.1 Introduction

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 evolved from the 1970s to the present day. The third, also by Jim Hancock, reviews the current arrangements against criteria of efficiency, equity and federal cohesion, and then considers what the future may hold.

Two issues that will be referred to during the course of the study are the growth in the size of government and growth in Commonwealth grants to the States since Federation.

Figure 1.1
Gross Revenue and Taxation Receipts as a Proportion of Gross Domestic Product (per cent)



Source: See Data Appendix. Series break in 1962-63 is due to revised collection methods for public finance data. Series break in 1998-99 is due to introduction of accrual accounting. Gross revenue estimates prior to 1962-63 include, in addition to taxation receipts, dividends from government businesses, land sales proceeds, interest receipts, some Commonwealth payments to State authorities which did not pass through the States' Consolidated Funds, etc.

Figure 1.1 shows the growth in the size of government in Australia since Federation according to two measures — the proportions of taxation and gross government revenues to gross domestic product. A major part of the rise occurred between the end of the First World War and the end of the Second World War. In 1915-16, for instance, total taxation amounted to 6 per cent of GDP, but by 1944-45 this had risen to 24 per cent of gross domestic product (GDP). There was a modest decline in the 1950s, but in the 1960s the ratio began to move up

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

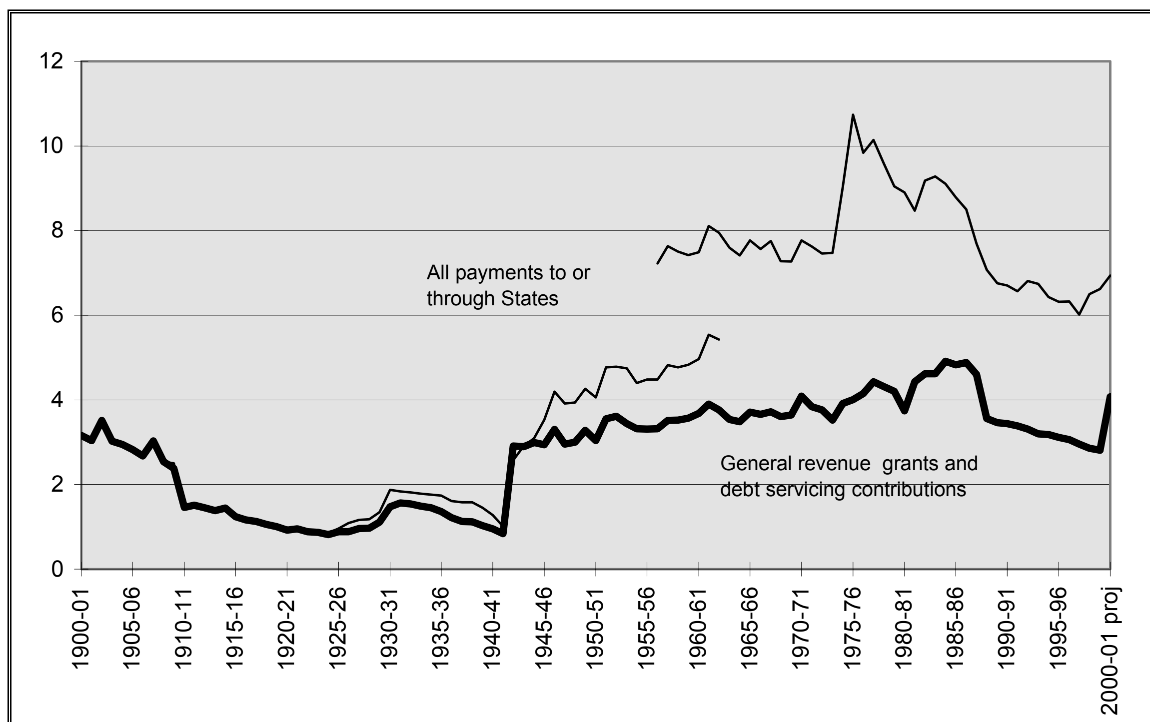
Name	Examples	Description
CURRENT GRANTS		
General Revenue Assistance	tax sharing grants special revenue assistance special grants financial assistance grants tax reimbursement grants GST revenue grants	Payments made to the States for the purposes of recurrent budget support with essentially no constraints 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.

Consequently, in spite of the discontinuity in the series, a comparison of the situations at the beginning and end of the century is probably broadly accurate. The data indicates that total payments at the beginning of the century amounted to a bit over 3 per cent of GDP, but had reached nearly 7 per cent of GDP by 2000-01. The increase is largely due to rises in Commonwealth specific purpose payments – general purpose capital payments were non-existent at the beginning and end of the century, although they were substantial from the late 1940s until the late 1980s when the States resumed full responsibility for their own debt raising.

Figure 1.2
Commonwealth Payments to/through the States as a Proportion of Gross Domestic Product (per cent)



Source: See Data Appendix. Series break in 1962-63 is due to revised coverage of data.

It is common practice to refer to matters relating to allocation of taxing and spending powers and grants between the national and sub-national government as 'vertical' aspects of the federal financial structure. The reliance of the State tier of governments upon the Commonwealth for funds is known as a situation of 'vertical fiscal imbalance' ('VFI'). The degree of vertical fiscal imbalance in the Australian federal system is high compared to other nations with federal systems.

Matters relating to allocations of resources between governments on the same tier are referred to as 'horizontal'.[1]

[1] However, the terms 'vertical' and 'horizontal' are also used in a different sense to discuss interpersonal equity concepts (and this is discussed in Chapter 4). Attempts have been made to minimise the degree of potential confusion from the two usages, but readers should be aware of the distinction.

'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 at national average tax rates. Because the per capita costs of providing average levels of services and tax bases vary from State to State, the per capita grant payments from the Commonwealth need to vary on a State by State basis to bring about equalised capacities.

Horizontal fiscal equalisation excluding policy factors — the Australian system — is a fiscal equalisation system in which the impacts of States' past policy choices and mistakes are not equalised away.

Fiscal equalisation is at present implemented by means of Commonwealth payments of GST revenues and Health Care Grants to the States. Table 1.2 below shows the per capita payments on a fiscal equalisation basis and compares them with the national average payment. New South Wales, Victoria and Western Australia presently receive less than they would under an 'equal per capita' distribution. Queensland receives fractionally more than it would under equal per capita, and the smaller States and the Territories receive significantly more.

Table 1.2
Per Capita Shares of the Equalisation Pool, 2000-01

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Total
Per capita $	1,638	1,557	1,785	1,710	2,097	2,667	2,039	7,146	1,776
Proportion to State/Terr average	92.2	87.7	100.5	96.3	118.1	150.2	114.8	402.4	100.0

Source: See Data Appendix. Figures refer to GST revenue plus Health Care Grants.

The fiscal equalisation assessments are carried out by the Commonwealth Grants Commission, an independent body established by Commonwealth statute.

The degree of equalisation practiced in Australia is relatively high, compared with other federations such as Germany and Canada. However, it is not greater than the degree of equalisation (implicitly) practiced in many countries with unitary systems of government, where common revenue and spending policies apply across the nation and are financed from a centralised budget.

Chapter Two

From the Federation Debates to 1970

2.1 Introduction

When the Australian colonies began negotiations on federation in 1891, the great majority of their revenues came from customs and excise, which they planned passing over to the new Commonwealth government. Progressive land and income taxes were a novelty, and government expenditures were minimal. Social security was non-existent. Over the next several decades, the role of government changed dramatically, especially in its redistributive aspects. Progressive income taxation became the dominant source of tax revenues. National age and invalid pensions, and later, child endowment, widows pensions and unemployment benefits were established.

Accompanying the expansion of the government's redistributive role were dramatic changes in the relationship between the Commonwealth and the States. No longer was the Commonwealth a mere agent of the States, carrying out only functions States were unable to efficiently conduct themselves. By the end of the 20th century, the Commonwealth was the dominant financial partner in the Australian federal system, collecting all income taxation and most indirect taxation. Using its superior taxing powers, the Commonwealth government also gained significant influence over States' borrowing and loan expenditures through the Loan Council, and could use both tied and untied grants to States to influence their spending policies. Meanwhile, the Commonwealth Grants Commission evolved as an institution which was central to the effective and equitable conduct of intergovernmental financial relations.

This chapter explores the evolution of Commonwealth-State financial arrangements over the period from 1890 to 1970, questioning why they adapted to the changing role of government in this way. Because the fiscal and economic diversity of the colonies was central to difficulties in negotiating the Constitution's financial clauses, it considers how this shaped Commonwealth State financial arrangements after federation. As an impetus for federation was that 'capital and labour had federated' (Norris 1975), this chapter also investigates the impact of economic integration on the subsequent development of Australia's institutions of fiscal federalism after federation. In particular, it explores the historical development of the CGC arrangements, and Australia's high degree of fiscal centralism and imbalance of taxing powers, and the connection between them.

The aim of this chapter is to identify the problems of federal finance which were anticipated and planned for by those who drafted the financial clauses of the Australian Constitution, and to show how the different fiscal capacities of States, ideas of national citizenship, and economic changes interacted with this Constitutional framework from 1901, creating and shaping Australia's own unique federal financial institutions and arrangements.

The first section, 'Federating in the Dark' highlights that political debate on the federal tariff was not just about the future direction of State and Commonwealth taxation powers, but also had to leave open possibilities for the future implementation of protectionist or free trade agendas and highly contested policies on taxation of land and incomes. It looks at how the colonies' diverse economic and fiscal situations and the tax politics of the time prevented

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 Australasian Convention in Sydney. Protecting the States' autonomy within the federation was fundamental to designing the federation agreement, and was intrinsic to negotiations during the 1890s (Norris 1970; 1975; La Nauze 1972). As Barton[2] would remind the Sydney session of the Convention:

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[2] Sir Edmund Barton (1849-1920), federalist, first Prime Minister, and judge, urged that the territorial rights of the colonies remain intact. By 1897, Barton was said to be the acknowledged leader of the federal movement. His work for federation was aided by 'young disciples' Robert Garran, Thomas Bavin, and Atlee Hunt. After the Melbourne Federal Convention in 1898, Barton stood against New South Wales Premier Reid in the general election, his platform including cancellation of the 'Braddon' clause in federal finance. After Reid won important concessions at the January 1899 conference of premiers, Barton joined Reid in the second, successful New South Wales referendum campaign. As Australia's first Prime Minister, Barton was elected with a platform of moderate protection to raise sufficient money for the States and the Commonwealth, and resort to direct taxation for funds in an emergency. He favoured old-age pensions. Appointed judge of the High Court from 1903, Barton sat with Griffith and O'Connor and endeavoured to preserve autonomy for the States.

> 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 and Protectionist[3] Deakin[4] was persuasive in the view that *'it was impossible to cast the duty of defence on the government of the commonwealth without giving them unlimited taxing power'*. In the case of a blockade, customs revenues would be minimal:

> One of the foremost of its duties, that in fact which created this Convention, was to provide for the common defence of Australasia, and it may be necessary to devote not only the last ship, but the last shilling to that object. (p 675).

His argument was supported by the New South Wales Free Trader McMillan.[5]

> We are going into this federation with the hope that the central power will be animated by a sense of justice to the whole of the colonies, and it would certainly be a step backwards and we should at the same time practically stultify the whole of our work, if we were to stop short of the sovereign power necessary to the creation of a state (p. 671).

The South Australian delegate Playford[6] also pointed out that the extent of the Commonwealth's taxing powers might determine whether free traders would support federation:

> If you take away the general power, and draw the line at customs and excise duties, then those who believe in a free-trade policy will have no hope whatever of being able to give effect to that policy. We want the people of these colonies to be perfectly free so far as taxation under the commonwealth is concerned to decide what form or mode of taxation they will adopt for the raising of the necessary revenue. If you limit the power of the commonwealth in the way suggested, those who hold free-trade views will never be able to give effect to them (p. 672).

Although the Convention was warned that taking away State taxing powers without taking over their debts would result inevitably in the bankruptcy of several colonies, Deakin responded that Commonwealth tax powers would not hinder States' taxation. While there was a certain point at which the taxable resources of the community will cease, *'that is a point at*

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3 At the turn of the century, the two major political parties were Protectionist and Free Trade. Protectionists favoured the use of tariffs, which tend to protect domestic manufacturers, whereas Free Traders favoured low tariffs, and this was the major dividing issue in parliamentary politics.

4 Alfred Deakin (1856-1919) barrister, journalist and Australia's second, fifth and seventh Prime Minister was elected to the Victorian Parliament in 1879. Prominent in the protectionist movement and in early federalist organisations, he played a significant part in making and shaping the Constitution as well as contributing to the popular phase of the Federation movement. Upon Federation Deakin was elected to Parliament as a Protectionist and appointed Attorney-General in Barton's ministry.

5 Sir William McMillan (1850-1926) merchant and politician, was a recognised authority on commercial matters and representative of Sydney importers' interests. As president of the Sydney chamber of commerce, he played a leading part in establishing the Free Trade Association of New South Wales. Although nervous at the possible tariff implication of federation, McMillan under the tutelage of Sir Henry Parkes became a keen federationist. His contribution at the 1890 Federation Conference and the 1891 National Australasian Convention was through discussion on 'practical issues'. At the 1897 Convention he was appointed to chair the difficult finance committee. McMillan had wide ranging business interests and contacts, including with the local and London banking and mining sector.

6 Thomas Playford (1837-1915) farmer and market gardener, elected to the South Australian Assembly in 1868. He was Premier of South Australia 1887-89 and 1890-92. After Federation in 1901 he was elected to the Senate and served in the first and second Deakin Ministries.

which we are never likely to arrive.' He argued that concurrent tax powers did not give the federal tax-gatherer priority, and the priority in time would have been gained by the States:

> owing to the transference of the customs revenue to the central government, the several colonies, or some of them, may be brought face to face with the question of direct taxation long before such a question is likely to be raised in the parliament of the commonwealth [and] the direct taxation will be in existence in the colonies before it can be imposed by the commonwealth (p. 675).

Representatives of the smaller States were still sceptical. They urged that the wide power of taxation should not be given without handing over to the Commonwealth more of the colonies' financial responsibilities. For instance, the South Australian Sir John Bray[7] put the question in the following terms:

> How is it possible to get away from the fact that in this clause it is proposed to grant to the commonwealth power to take away from the colonies every penny of the revenue they now derive from customs? [If] you take away from the several colonies the means of paying their debts, it is evident that you put them in a position of being unable to meet their liabilities. Being unable to raise taxation sufficient to pay the interest on the money they have borrowed, they will, as my hon. colleague suggested, be reduced to a position of bankruptcy (p. 672).

Another strand of this debate was the Federationists' fear that the threat of higher State taxes would defeat the federation goal. Tasmanian MHA William Burgess urged the Convention to require commensurate relief of States' financial responsibilities before handing over State tax powers.

> Taxation through customs is the sheet-anchor of all our colonial finance; and if we hand over all rights in connection with customs and excise, it will be a matter of extreme difficulty, to put it in mild language, for some of the colonies, more particularly those colonies that have already had to resort to direct taxation, to carry on their respective governments (p. 678).

Deakin argued that the representative character of the Commonwealth parliament guaranteed that combined Commonwealth and State taxation would not be unnecessarily heavy;

> We have not to protect the people of the federated states against themselves, and there is certainly no one else to protect them against in this regard. The commonwealth consists of the people; and this power of taxation can only be exercised by and with the consent of the people (p. 676).

With understandings that direct taxation would be resorted to by the Commonwealth only in times of national crisis, safeguarding the solvency of the federated States depended either on ensuring that a sufficiently large federal revenue surplus was available for distribution to States or, alternatively, providing sufficiently for financial relief to States' budgets by transferring existing spending responsibilities to the federal government. Thus a solution that was fair to all required a 'sufficient' distribution to States, as well as a 'fair' distribution of the

7 Sir John Bray (1842-94) legal practitioner and politician, was Premier of South Australia for nearly three years from 1881 and held office in several later ministries. His premiership saw the unsuccessful proposal for a land and income tax bill in 1883, and passage of the Married Women's Property Act and a Crown Lands Act granting concessions to selectors. He was one of seven South Australian representatives at the first Federal Convention, and was president of the board of directors of the SA Branch of the Australian Natives Association. He was a popular politician, noted for his geniality, tact, persuasiveness and administrative skill.

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 dangerous to leave in the hands of the commonwealth such a large surplus as there will be unless these debts are handed over to it'* (p. 846).

Debt consolidation was particularly appealing for the smaller States, which had an interest in ensuring all possible economies of federation were exploited, as they would make large interest savings from a centralised debt conversion. However, the South Australian proposal was fiercely opposed by New South Wales, represented by Dibbs[8] and McMillan. As Dibbs

[8] The early career of George Richard Dibbs (1834-1904) politician, was notable for his involvement in Sydney's mercantile life, representing shipping interests, and his election in 1874 as a supporter of Sydney business and city interests and of 'national, compulsory, secular and free' education for every child. To support land law reform in 1883, Dibbs as Treasurer had suspended New South Wales land sales. This left him with a reputation for extravagance. As country support of the Protectionists left them cautious about a land tax, Dibbs was unable to pass direct taxation, creating pressures for a more protectionist fiscal policy and leaving the colony in fiscal disarray. Dibbs never looked generously on other colonies, and was cool about the federal question. He was praised for bold and decisive action during the 1893 banking crisis, and had family and personal connections to the banking industry.

stated flatly, *'the Parliament of New South Wales is not at present prepared to federate its debt'* (p. 842).

There was less in debt consolidation for the larger States and Western Australia. Western Australia was disadvantaged by a scheme for a per capita takeover of debt because, although sparsely populated, it was incurring large development costs. New South Wales could already borrow on fine terms. While supporting such a scheme as a longer-term solution to the problem of federal finance, Dibbs insisted a compulsory transfer of State debts required transferring the corresponding State assets:

> Our liabilities at present are secured on our assets; and if the commonwealth takes over the liabilities, they want something more than the revenue derived from customs duties to cover the liabilities … property will have to be taxed considerably to make up the deficiency.

Thus, Dibbs argued, the proposal also raised the threat of Commonwealth meddling in State rail construction and pricing policies and implied Commonwealth control over States' future borrowing and land development.

Other delegates questioned these objections, and noted that the Commonwealth's ample taxation powers were sufficient security for investors. However, Victorian delegates recognised that New South Wales would not accept the proposal, and the influential former Premier Duncan Gillies urged it not be pressed:

> Although great results might be accomplished by the proposal - and I can quite well understand some of the views which have been urged in support of it - I feel perfectly certain that the time is not ripe to enable us to carry out anything of the kind. I think it is better, under the circumstances, not to say too much on the subject, because I feel confident that all we might say would be quite in vain (p. 848).

For the reasons alluded to by Dibbs – fear of expanded direct taxation - the debt transfer proposal was objectionable to New South Wales Protectionists. Quick[9] and Garran[10] noted that the proposal was also unpalatable to New South Wales for a reason which was only hinted at, but which they saw as the deciding factor:

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9 Sir John Quick (1852-1932) politician, lawyer and author, was a prominent advocate of federation. At the 1893 Corowa conference which marked the start of the popular movement for federation, he hammered out his famous resolution which set the guidelines for dealing with the federal question. Quick was also prominent at the Bathurst Convention in 1896, and was elected as a Victorian delegate to the 1897-98 Convention. In 1901 he published, with Sir Robert Garran, *The Annotated Constitution of the Australian Commonwealth*, confirming his authority on constitutional questions. He was a Member of the Commonwealth Parliament until 1913, known mainly for his chairmanship of the Royal Commission on the Commonwealth Tariff.

10 Robert R. (later Sir Robert) Garran (1867-1957) lawyer and public servant, was an active participant in the federation movement. He attended the 1897-98 Convention as secretary to Reid, and at Barton's request became secretary of the Drafting Committee. With Sir John Quick, he wrote the first history of Australian federation and commentary on the Constitution. His father Andrew Garran, was active in the Australian Economic Association, and both father and son contributed commentary and analysis on federal financial issues in *The Australian Economist* over the period. After federation, Garran entered the service of the Commonwealth government as parliamentary draftsman and secretary of Deakin's Attorney General's department. Appointed in 1916 to the new statutory position of Commonwealth Solicitor-General, he retired from the public service after 31 years as a permanent head. In 1934, after his retirement, Garran with three others wrote 'The Case for Union', a reply to 'The Case for Secession of the State of Western Australia'. Described by Eggleston (chair of the Commonwealth Grants Commission from 1933-1941) as the greatest of all Commonwealth public servants, Garran played a leading role in federal constitutional issues over the next half century, including in the area of federal finances.

> To saddle the Commonwealth with the interest on the public debts would practically have meant imposing on the Federal Parliament the duty of raising a large amount through the Customs, and would have placed the Free Trade party at a disadvantage in federal politics. It was seen that the amendment was on dangerous ground, and it was accordingly negatived without division (Quick and Garran (1901), pp. 140-1).

With the intense New South Wales reaction threatening progress on the broader issue of federation, delegates were persuaded that it was 'going too far' at this stage to impose a debt takeover arrangement, and they backed away from the South Australian proposal to compel a takeover. The 1891 Commonwealth Bill thus simply provided for, as a matter for parliaments, a Commonwealth takeover of States' debts:

> The Parliament of the Commonwealth may, with the consent of the Parliaments of all the States, make laws for taking over and consolidating the whole or any part of the public debt of any State or States, but so that a State shall be liable to indemnify the Commonwealth in respect of the amount of a debt taken over, and that the amount of interest payable in respect of a debt shall be deducted and retained from time to time from the share of the Surplus Revenue of the Commonwealth which would otherwise be payable to the State (p. 960).'

With the debt transfer on hold as a solution to the problems of federal finance, attention then focussed on how the federal revenue surplus should be distributed. The Australian colonies were all very dependent on customs and excise revenues, making it impractical at least in the relevant future to replace the revenues handed over to the Commonwealth with direct taxation. The per capita revenue from customs and excise duties in each State also varied enormously, so it was unclear whether surplus revenues should be distributed on a population basis or according to the contribution of each State to aggregate revenue collections. As Quick and Garran described the problem:

> Should revenue be credited to the several States in proportion to their populations, or in proportion to their contributions? Should expenditure be charged against the several States in proportion to their populations, or on the basis of services rendered? So far as revenue was concerned, the population basis of adjustment showed that the consumption of dutiable articles varied greatly in the different colonies, and it was anticipated that even under a uniform tariff considerable differences might continue. The contributions basis seemed fairer, but less federal: and it was open to the objection that with inter-colonial freedom of trade it would be difficult to ascertain accurately what share of dutiable articles was consumed in each State. Here at the outset, was the whole financial difficulty which was afterwards to cause so much trouble (Quick and Garran (1901), p. 134).

Drafting of the 1891 Commonwealth Bill saw much to-ing and fro-ing over whether to distribute the federal surplus revenue to States according to a per capita principle, or on a collections basis (La Nauze 1972). Allocating surplus revenues proportionally to the population of the States was in keeping with the 'federal spirit', and was the accepted long-term goal. The alternative was to at least temporarily distribute revenues according to each State's share in total collections, that is, according to a 'contributory' principle.

In the early stages of drafting the Bill, the Finance Committee had concluded that the surplus revenue might be fairly distributed among the States according to population once the uniform tariff was in operation. In the interim, when State tariffs still applied, the surplus should be distributed in proportion to the amounts contributed by them and federal spending would be

met from customs revenue and charged to the States on a population basis. However, the Constitutional Committee reversed this recommendation, providing for the return of surplus revenue to be in proportion to revenues raised in the various States, apparently in perpetuity and with no distinction between the period before and after introduction of a uniform federal tariff. They also made this the basis of charging federal expenditure to the States.

Difficulty reaching consensus on the principle for distributing surplus revenue reflected the different ways the competing proposals affected the diverse State budgets. It also arose from uncertainty about the eventual fiscal policy of the Commonwealth parliament, and the implications for competing taxation philosophies.[11] The matter was further complicated by debate on how the expenses of the Commonwealth government should be shared among the States.[12] Central to the conflict between the Finance Committee recommendation for a per capita distribution and the Constitutional Committee's drafting based on the 'contributory' principle was the need to accommodate future federal direct taxation. As Sir Samuel Griffith put it:

> We were bound to deal with the possibility that they should raise revenue from other sources than customs and the only way in which we could see it was fair to return direct taxation was in proportion to the amount raised (p. 807).

Around federation, an average of three-quarters of colonial revenues came from customs and excises duties. However, the tariff policies and fiscal structures of each of the colonies were distinctly different (see Table 1). Direct taxes such as income taxes were becoming more common (Smith 1993) but some States relied more on customs revenue than others.

Differences in colonial tariffs were also linked with differing political attachments to protection or free trade. Free trade New South Wales had relied heavily on land for revenues and was now contemplating its replacement with direct taxation; Victoria was proudly protectionist. Varying degrees of protectionism also influenced revenue yields. For instance, as a result of diverse rates of customs duties and differences in the items subject to duty, the average tariff level varied dramatically between, for example, free trading New South Wales and protectionist Victoria.[13] However, these differences were not just a matter of political preference. They also reflected the varying stages of economic development of each colony at that time, the diverse levels of economic wealth and fiscal resources, and differences in consumption patterns (Mathews and Jay 1972). Some needed high tariffs more than others – Western Australia, for instance, was almost entirely dependent on customs and excise duties and faced significant practical difficulties with income taxes on a migratory population.

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11 One issue was the level and structure of the federal tariff. The other was the extent and incidence of Commonwealth direct taxation. While there was some argument that the incidence of a uniform federal tariff would be uneven between the States, it was generally accepted that the incidence could be assumed to be roughly equal across the Commonwealth. With regard to direct taxation, however, equal incidence could not be assumed. For example, a gold tax would bear more heavily on WA than other States. A tax on pastoral rents would be collected mainly in Queensland. While Free Traders were concerned to provide the powers of direct taxation to the Commonwealth so as to avoid revenue pressures for a protectionist tariff, others were concerned that a Commonwealth Parliament dominated by Free Traders might reduce the tariff and rely on expanding direct taxation, including income or land taxes.

12 The general view was that colonies should contribute to the expenses of the new government in proportion to population. However, there were concerns that, in conjunction with a per capita basis for distributing surplus revenues, this might be excessively generous to South Australia. There was also a view that the same principle must apply to both the distribution of revenues as to the charging of expenses.

13 The evolution of tariff policy in the Australian colonies during the 19th century is documented in Patterson (1968).

Table 2.1
Australian Taxation 1896-97

	New South Wales		Victoria		Queensland		South Australia		Western Australia		Tasmania		All Colonies	
	$m	%	$m	%	$m	%	$m	%	$m	%	$m	%	$m	%
Customs and Excise Duties	3.0	63	4.0	77	2.5	86	1.3	65	2.2	96	0.7	78	13.8	76
Income Tax	0.6	13	0.4	8	0.1	3	0.2	10	na	na	0.1	11	1.3	7
Probate and Stamp Duties	0.7	15	0.6	12	0.2	7	0.3	15	0.1	4	0.0[a]	0	1.9	10
Land Taxes and Rates	0.3	6	0.2	4	na	0	0.2	10	na	na	0.1	11	0.7	4
Other Taxes	0.2	4	0.0[a]	0	0.1	3	0.0[a]	0	0.0[a]	0	0.0[a]	0	0.5	3
Total[b]	4.8	100	5.2	100	3.0	100	2	100	2.4	100	0.9	100	18.1	100

Notes: a) Less than $50,000. b) Figures may not add to totals due to rounding. na = not applicable
Source: Mathews and Jay (1972), Table 5.

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 position and the attractions that would offer to the population of Australia generally (p. 812).

After lively but inconclusive debate, and against a backdrop of conflicting desires regarding future tariff and taxation policies of the Commonwealth, the 1891 National Australasian Convention eventually resolved the distributional issue through an uneasy compromise. It determined that until the federal tariff was in place, the federal surplus revenue should be returned in proportion to the amount of revenue raised in each State, with Commonwealth expenditures charged to the several States in proportion to their population. The 1891 Bill left the Commonwealth parliament to determine a 'fair' distribution of the federal surplus after the uniform tariff, albeit with the collections basis continuing 'until the parliament otherwise prescribes' (pp. 959-60) As McMillan noted this gave the parliament, *'when it has come together in its true constituted federal spirit, a chance of dealing with the thing on the only lines upon which it can be dealt with – the broad lines of federal union'*. (p. 823)

The Bill was 'put by' by Australian parliaments until a new impetus to federation arose from the 1891-93 financial crisis and the popular movement for federation. By 1897, the desired principles for resolving the federal finance problem were much clearer. The task of the Framers of the Constitution, as summarised by Garran during the Adelaide session of the 1897-98 Convention (Garran 1897b), was to allocate taxing powers and expenditure responsibilities and provide for intergovernmental financial arrangements which were 'coordinate', in the sense of minimising the dealings between Commonwealth and State governments to the narrowest and simplest possible basis, 'elastic' enough to cope with future

[14] Sir William John Downer (1843-1915), barrister, became a member of the South Australian Legislative Assembly in 1878. He was Attorney-General in the Bray Government of the early 1880s, and a progressive on women's suffrage. He was Premier from 1885-87 and again from 1892-93. He was elected to the Senate in 1901.

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, Mackay-Smith 1895, Black 1895). Reducing the interest burden of the colonies' debt through consolidation was the only financial benefit of federation that figured in public debate (Gilbert 1973). The promise of significant economies was one of the ways those favouring federation might convince a sceptical public that federation did not mean higher taxation (Norris 1975). Advice by a

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

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15 See Walker (1897). John Thomas Walker (1841-1923) financier and politician, had close personal, family and professional links with the Bank of New South Wales. Vice President of the Australian Economic Association, and a fellow of the Institute of Banking in London, he was also closely associated with the Bankers' Institute of New South Wales. He was deeply interested in the constitutional aspects of federation and attended the People's Convention at Bathurst in 1896. He proposed a detailed scheme for federal finance which was influential because of its proposal for a 'commercial' principle as an alternative to a per capita basis in charging Commonwealth expenditures to the various States. He was a New South Wales delegate to the 1897-98 Federal Convention but was ignored by the 1897 Finance Committee at the Adelaide Convention. Walker's proposals were later adopted at the Melbourne sitting. After Federation, Walker sat as a Senator for New South Wales in four federal parliaments between 1901 and 1913.

16 George Turner (1851-1916) was the leading proponent of the detailed scheme for federal finance 'wrecked' by New South Wales Premier Reid at the Adelaide Convention in 1897. Turner's practical and businesslike approach earned him considerable respect, and as a reluctant Premier and Treasurer he had been responsible for reconstructing Victoria's public finances after the disastrous banking and finance collapse of the early 1890s. Turner played a leading role in the 1898 Melbourne Conference and at the 1899 Conference of Premiers. A Protectionist member of the first Commonwealth Parliament, Turner presented the first Commonwealth Budget as Barton's Treasurer, and 'bore with Kingston the burden of the 1902 tariff legislation'. Regarded as a non-party man, Turner retired at the 1906 election after serving as Treasurer in the Watson Labor Ministry and in Reid's Free Trade Ministry.

17 In opposing the Braddon clause, Reid is said to have relied heavily upon the advice of Sir Timothy Coghlan (1855-1926), New South Wales government statistician from 1886 to 1905. Coghlan contributed substantially to the public debate on the financial aspects of federation, insisting on safeguards for New South Wales.

18 Less than one sixth of customs revenue in New South Wales came from tariffs on interstate trade, but Queensland relied on intercolonial duties for around one fifth of its customs revenues and Tasmania relied on them for around one half.

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 join the Federation immediately. The possibility of Western Australia joining the Federation was not really taken seriously until just before federation when, to encourage it into the union, a clause providing for a temporary special tariff for Western Australia (S.95) was inserted in the Constitution. This clause recognised the special difficulties that the State would have in adjusting its finances, given its very heavy reliance on customs duties. It allowed it to continue to impose duties on goods from other colonies on a diminishing scale for five years after the uniform tariff was introduced. The problem of supporting Tasmania was viewed as trivial because of its small size. Nevertheless, Alfred de Lissa (1897), a leading figure among Australia's pioneers of national accounting (Groenewegen and McFarlane 1990), argued from

[19] The 'derivations' basis was to operate for five years after the uniform tariff. 'Bookkeeping' permitted revenues to be attributed to where revenues were derived or goods consumed, rather than where they were collected. While it would be administratively difficult, it would allow revenues on interstate trade, a half of total customs collections for some States such as Tasmania, to be returned to such States.

a Tasmanian perspective that even a per capita distribution of revenues was likely to be insufficient for the solvency of all States. He showed that a fair distribution of national revenues in the new federation required adjusting for differences in the economic product of each colony, effectively to compensate for their varying fiscal capacity. Nevertheless, both these colonies were concerned at proposals for special treatment, and sought general financial arrangements rather than specific provisions to meet their needs (May 1971).

From late 1897, attention moved to providing for some 'guarantee' to the States that they would receive sufficient surplus revenues to protect their solvency. Eventually, the 'guarantee' found its form in the so-called 'Braddon clause' (section 87 of the Constitution) as well as in the requirement for any surplus of Commonwealth revenue to be returned to the States (sections 93 and 94). The Braddon clause, so named after Tasmanian Premier Sir Thomas Braddon[20], required that the Commonwealth restrict its spending to no more than 25 per cent of the customs and excise revenues; at least 75 per cent of the net surplus must be distributed to the States.[21]

Flexibility added by s. 94, s. 95, S87, and s. 105 was an important feature of the financial provisions addressing the smaller States' need for financial security. As Wise (1913)[22] commented:

> it being impossible to foresee the future and with secession not possible there had to be some remedial mechanism for States with a grievance.

Of equal significance for the long-term evolution of federal financial relations, and at the same session of the Convention, delegates debated Commonwealth powers to legislate for aged pensions. Despite reservations by many delegates, this was eventually agreed in order to generate popular support for federation.

However, the Braddon clause in its original form was objectionable to New South Wales representatives at the 1897-98 Convention because it appeared likely to create pressure for a protectionist Commonwealth tariff (Norris 1975). They argued that it would introduce an unprincipled and permanent rigidity into the financial clauses of the Constitution. In particular, New South Wales citizens were said to face higher taxes, in the form of either a protective tariff, or increased income and land taxes, effectively to make substantial transfers

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20 This clause originated with an earlier proposal by the South Australian F W Holder, but was initiated late in the Melbourne sitting of the 1897-98 Convention by Tasmania Premier Sir Edward Braddon. Braddon (1829-1904) civil servant and politician, had been Minister for Lands in P.O. Fysh's Tasmanian government from 1887. Braddon became Premier in 1894 and did much to restore Tasmania's finances between then and 1899. Braddon was a convinced federalist, and hosted the 1895 Premiers' Conference which resolved to re-launch the federal movement. He was particularly concerned with the likely effect of Federation on colonial finances. The overwhelming Tasmanian acceptance of federation at referendum is attributed in part to his personal conviction and effort. He was elected to the first Commonwealth parliament and served as deputy to Reid in opposition.

21 By this time the 'commercial principle' proposed at the Bathurst convention had been accepted as the basis for dealing with federal spending: new functions to be performed by the Commonwealth including defence spending would be attributed on a population basis, while federal expenditures due to transferred functions would be attributed to the State which benefited from those expenditures. At that stage around £1,200,000 was the anticipated cost of transferred functions such as posts and telegraphs, while around 300,000 pounds was the additional costs of federation. Negotiations now concentrated on the 'net surplus' and net losses to States.

22 Bernhard Wise was a Sydney lawyer whose political career encompassed being Attorney-General of the Parkes New South Wales Government before and after Federation, and election as one of the ten State representatives to the Federal Convention which drafted the Constitution. Wise had a keen interest in wage arbitration and conciliation, federation and trade issues, and was a longstanding supporter of the federal movement. He was an active participant in the Australian Economic Association and later wrote an account of the federal movement.

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 taxes to replace the customs was not yet possible or even desirable as a solution to the federal financial problem.

As a result of strong New South Wales opposition to the Braddon clause, led by Reid, a Premiers' Conference in 1899 eventually agreed to limit its effect to ten years after federation, *'and thereafter until the Commonwealth Parliament otherwise decides'*. However, the issue nearly broke up the Conference as the smaller States were concerned that this temporary provision did not adequately protect their financial situation and would force them into even higher taxation (May 1971). In the end, the Premiers agreed there should be a further protection for the financial viability of States: the Commonwealth was given the power to make grants to any State *'on such terms as it saw fit'* for the first ten years after federation, and thereafter as Parliament should decide (La Nauze 1972). This would become section 96 of the federal Constitution.

This provision was an acceptable compromise to New South Wales mainly because the needs of the financially weakest State could now be addressed directly through a grant to that State. By contrast, with an unlimited Braddon clause the Commonwealth might have been forced to raise tariff revenue to finance payments to all States at a level necessary only for the weakest; a situation characterised by New South Wales free traders and anti-federalists as requiring the Commonwealth to raise four times more revenue than it needed. It is noteworthy that even at this embryonic stage of the development of the federal financial system, there was strong resistance to a situation of vertical fiscal imbalance.

[23] By this time, a decision of the US Supreme Court ruling that the federal income tax was unconstitutional because of its uneven incidence in the various states had influenced thinking in Australia about Commonwealth direct tax powers. (See La Nauze 1972 and Quick and Garran 1901).

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 financial autonomy), as would the Senate. Furthermore, it was of the essence of federalism that voters were both citizens of the Commonwealth and of a State, and in this political reality lay the ultimate protection of the autonomy of the States (La Nauze 1972). Thus, as Harrison Moore reflected in 1910, *'the course adopted was to make temporary provision in the Constitution and to leave the ultimate adjustment to the Commonwealth parliament when the course of years had furnished the necessary experience'* (Harrison Moore 1910, p.531).

27 Sir John Forrest (1847-1918), explorer and politician, and Western Australian Premier during the 1890s, led the colony's delegation throughout the federation decade. While consistently supporting federation, Forrest wanted to ensure Western Australia would not suffer financially from joining. As Treasurer in the Deakin Government during the period 1905-07, Forrest managed competing States' claims arising under the 'bookkeeping arrangements' and initiated discussions leading to the *per capita* system of distributing federal revenues among States from 1910. As Treasurer in 1909, Forrest put in place the *Per Capita Agreement* with Premiers, which lasted until 1927. Forrest was again Treasurer under Cook (1913-1914), and Hughes (1917-18).

28 Lyndhurst Falkiner Giblin (1872-1951) was a distinguished scholar, statistician and soldier. Briefly a State Labor MLA, he served with distinction in the Australian Imperial Forces from 1914. He became Government Statistician in 1919, and had considerable influence on federal financial issues during the 1920s. Giblin was on many advisory bodies and influential on Depression economic policy, including the Premiers' Plan of 1931. Giblin was appointed a founding commissioner of the Commonwealth Grants Commission in 1933, and was influential as economic advisor to the Commonwealth Government from 1937.

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

In the first decade after federation, continued divergence in economic and fiscal capacity prevented any agreement between the States on a permanent solution to the problem of the federal surplus. Moreover, there was now a new party at the negotiating table – the Commonwealth – with its own objectives and electoral accountability.

By the end of the decade the Commonwealth's rising expenditures on age pensions began to eat into the 'surplus' revenues available to States, while the introduction of its progressive land tax encroached on potential State tax fields. The threat posed by this expansion of Commonwealth expenditures and the continued divergence of interest among the States over a debt takeover produced a gradual agreement by States on the objective of a permanent extension of the Braddon clause by late in the decade. But it was too late for the States to reverse a significant shift of fiscal power to the Commonwealth Parliament.

State Premiers began meeting regularly soon after federation (Bernie 1947) and at the Conference of Premiers in April 1903 turned their attention to Commonwealth-State financial matters (New South Wales 1903). Concerned at their financial positions once the Braddon clause expired in 1910, the smaller States and Victoria were eager to tackle outstanding issues of federal finance to forestall rising Commonwealth expenditures which were eating into revenues available to States. As Victorian Premier Irvine[29] said at that time,

> Even with the protection of the Braddon clause, several of the States have already been obliged to have recourse to heavy direct taxation. If that protection be allowed to lapse, the immediate result will be a steady depletion of the surplus customs revenue payable to the States, bringing with it and increasing further and more drastic increases in direct taxation (New South Wales 1903, p. 97).

Victoria put forward a detailed scheme for transferring State debts to the Commonwealth which was the initial basis for negotiations. However, New South Wales Premier Sir John See[30] viewed action to transfer States' debts as premature. New South Wales was suspicious of effectively subsidising other States through agreeing to a per capita redistribution of the Commonwealth revenue surplus. It also was more sceptical of financial benefits from debt consolidation. By virtue of its size, the State already had relatively favourable terms in the loan market. So New South Wales continued to urge other States to trust the Commonwealth government to resolve outstanding financial issues fairly in the fullness of time, with the view that 'if the Federal government do that which the people did not intend, Parliament will not tolerate it'.

Reports of discussions the following year show that the Commonwealth Treasurer Turner responded enthusiastically to debt takeover proposals as a means of providing financial security for the States and achieving the public debt interest savings sought from federation (Commonwealth Parliament 1904). However, in practice this entailed either introducing

[29] Sir William Hill Irvine (1858-1943) Premier and Chief Justice in Victoria, is recorded as a man of absolute probity, clear vision and firm resolution as attorney-general in the 1899-00 McLean ministry. As a Member of Federal Parliament from 1906 until 1918, he argued for increased Commonwealth powers especially in taxation, immigration and defence. Irvine was Chief Justice of Victoria from 1918 to 1935.

[30] Sir John See (1845-1907) merchant and politician, supported federation as a practical aid to progress. He sought vigorous public works policies. Narrowly defeated for the 1897 Australasian Federal Convention, he campaigned vigorously in New South Wales for the referenda on the Constitution in 1898 and 1899. See served in Lyne's ministry as colonial secretary, and succeeded Lyne as New South Wales Premier in March 1901.

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.

[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.

Various financing schemes for the aged pension had been considered since 1901, including a Commonwealth land tax (Kewley 1973). The Commonwealth now proposed earmarking revenues from a special duty on tea and kerosene, outside the Braddon clause. As this would not meet full costs, the Commonwealth proposed reducing the surplus customs and excise revenue payments to States on a per capita basis for the balance. However, the States were hostile to Reid's proposal. While some States would be relieved of existing or imminent age pension costs, national pensions were seen as an unnecessary and premature extravagance by others. Tasmania and South Australia, for instance, argued that their taxation was already too high to contemplate pensions for the near future. In their view, a national pension scheme had to be financed by new Commonwealth direct taxation. In addition, while agreeing a national scheme was fairer, States were concerned that its expanded eligibility made it more costly than leaving it to individual States.

From September 1905, a New South Wales proposal to substitute fixed grants for the Braddon clause was adopted by Commonwealth Treasurer Forrest (Forrest 1905). Following further proposals for an annual per capita payment as part of a debt transfer scheme developed by Tasmanian Statistician R.M Johnston[32] (Prest and Mathews 1980), the Commonwealth in 1908 proposed a fixed payment to the States equal to their debt interest obligations. This was rejected because the financially weaker States considered the fixed payment too low, while New South Wales and Queensland remained sensitive about being sole judges of their loan raising.

The States' interests were by now converging on making the Braddon clause into the permanent basis of federal finance. However, the Commonwealth's opposition to a permanent extension of the Braddon clause had hardened, as it became increasingly concerned from 1908 that financing growing Commonwealth expenditures would force it to introduce new, direct taxes. Under strong political pressure, the Deakin government had committed itself to introducing a Commonwealth old age pensions scheme. In 1908, the Commonwealth Parliament passed the *Surplus Revenue Act 1908,* providing for any surplus customs and excise revenue above the Braddon clause's 75 per cent minimum to be charged to Commonwealth trust funds rather than returned to States. The 1908 Commonwealth tariff introduced by Lyne[33] as Treasurer supposedly increased this surplus revenue to around two thirds the estimated cost of age pensions, and Labor supported the legislation conditional on the Commonwealth old age pension scheme having first charge on the revenues. Although the establishment of Commonwealth trust funds was contested, the Act was subsequently upheld by the High Court (Sawer 1956) so that States now received only the minimum grants guaranteed to them by the Constitution under the Braddon clause (section 87). The Braddon clause itself was to expire in 1910.

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32 Robert Mackenzie Johnston (1845-1918) was Tasmanian Statistician and 'man of science'. Johnston was appointed Tasmanian registrar general and was government statistician for thirty seven years from 1881. Between 1895 and 1910, Johnston did much work on the economic implications of federation, and strongly supported federation. He was a leading advocate of the principle of per capita grants as the fairest way to compensate the States for their loss of revenue at federation.

33 Sir William John Lyne (1844-1913) politician, was secretary for lands in Dibbs' 1889 ministry, and led the Opposition to Reid's Free Trade government in 1895. Lyne was a delegate to the 1897-98 Australasian Federal Convention and a member of its finance committee, but argued strongly that sections of the draft bill disadvantaged New South Wales. Although most Protectionists supported Federation, Lyne opposed the Constitution bill at the New South Wales referenda of June 1898 and June 1899. As Premier of New South Wales from 1899, Lyne was invited by the Governor-General to form the first Commonwealth government in 1900 but was unable to form a ministry. Lyne was later elected to the Federal Parliament and served as minister for trade and customs under Barton and Deakin in 1903-04. As treasurer in 1907-1908 he introduced Australia's first truly protectionist tariff and set the pattern for Australian financial arrangements for the second decade of the Commonwealth .

By 1909, federal financial negotiations were primarily concerned with arrangements for a fixed Commonwealth payment distributed to States on a per capita basis. Gaining the acceptance of the smaller States to the consequent drop in revenue payments required special arrangements for Tasmania and Western Australia. Even at this stage — whether for reasons of genuine belief or for political expedience - the problems of the smaller States were still seen as temporary, and these arrangements were for a fixed term. This was even as fiscal difficulties were forcing the smaller States into heavy land and income tax increases, in competition with a new Commonwealth land tax. Furthermore, rising Commonwealth outlays (including on defence and age pensions) threatened the States for the first time with Commonwealth competition in the loans market (loans were needed to finance the resulting Commonwealth budget deficit). This potential competition for loan funds, and the prospect of a Labor government winning the forthcoming elections, caused the Premiers, at a secret conference in August 1909, to agree to proposals by Prime Minister Deakin and Commonwealth Treasurer Forrest for a set of arrangements to apply after the expiry of the Braddon clause.

In the 1909 *Per Capita Agreement* the Premiers agreed to replace revenue sharing arrangements based on a minimum percentage for the States with a fixed per capita payment to States. The *Agreement* involved a further substantial fall in revenues to the States, and reflected both the loss due to Deakin's *Surplus Revenue Act 1908,* and adjustments for the balance of the Commonwealth's costs for national old age pensions. Although a referendum in 1910 failed to embed the *Per Capita Agreement* in the Constitution, it was enacted by the Fisher Labor government as the *Surplus Revenue Act 1910*. Under the 1910 Act, which operated for ten years, revenue payments were distributed to the States on the per capita basis originally sought by the smaller States, at 25/- per head of population. In addition, the Act included an arrangement for temporary special grants to Western Australia for ten years from 1910-11 as compensation for that State's particularly large per capita contribution to customs revenue.[34]

The ink was barely dry on the Act when Tasmania succeeded in having its long-standing claim for compensation under the bookkeeping arrangements referred to a Royal Commission. The Commission's Report confirmed Tasmania's losses and recommended a payment of £1.8 million, to be made in equal instalments over ten years. The payment was not viewed as charity but merely as a payment which was due to the State under the general transitional financial provisions of the Constitution.

The special payments to Western Australia and Tasmania implicitly acknowledged that equal per capita grants at the levels set under the 1910 arrangement were insufficient for some States' budgetary needs. However, as Giblin observed of the 1910 arrangements, *'the dogma of equal financial strength in proportion to population was in full force with only very minor qualifications'* ([1926] 1980, p. 52).

Later that year, amidst great controversy, the Fisher Labor government also brought in a Commonwealth land tax, pointing to an election mandate and State legislatures' rejection of recent State land tax initiatives. Although State Treasurers did not relish increasing their direct taxation further, the Commonwealth's intrusion into what was viewed as their tax field was

[34] The cost of the grant was shared between the Commonwealth and the other States.

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 consumption levels of the States meant the direct taxes of the smaller States were especially burdensome on their electors.[35] The uniform, comprehensive and therefore more costly national age pension scheme implied heavier taxation than would have been the case with State-based schemes, and contributed to centralisation of revenues with the Commonwealth. While the Commonwealth received public favour for its expanded social programs – funded from customs revenues formerly due to States — State parliamentarians had to deal with strong public resentment of the upward creep in States' politically visible land and income taxes.

The per capita grants established under the *Surplus Revenue Act 1910* were severely eroded by inflation arising from the First World War, forcing the already heavy-taxing smaller States to further increase direct taxes. The introduction of a Commonwealth income tax in 1915 to help finance Australia's contribution to the conflict also set the Commonwealth government in tax competition with the States, creating acute problems of double taxation, particularly for less wealthy States. These two factors contributed to pressures for special assistance for Western Australia and Tasmania, and for the introduction of arrangements more clearly demarcating the scope of State and Commonwealth direct taxation. As was noted earlier, a common expectation at the time of the Federation Debates was that the Commonwealth would use its direct taxation powers only in a time of emergency. However, the Commonwealth's need to finance special assistance, combined with its new responsibilities due to the war, required its continued presence in the direct tax field.

2.4 Fiscal crisis of the States, 1920-1933

New negotiations on federal finance were necessitated by the imminent expiry of the *Per Capita Agreement* in 1920. At a 1919 Premiers' Conference the Commonwealth government cited its war-related spending commitments as justification for reducing per capita grants. Further, it offered to substantially withdraw from income taxation if States agreed to terminate

[35] The effect of the reducing level of Commonwealth payments is evident in the increasing relative severity of direct taxation in the smaller States, especially South Australia and Tasmania, and the substantial easing of taxation possible in New South Wales between 1901 and 1909. An index of Tasmania's direct taxes as a share of industrial production, and relative to its share of the national aggregate of such production (see May 1972), rose from 0.97 at federation, to 2.03 by 1910. Likewise, the relative tax burden in South Australia increased from 1.18 to 1.44, and in Western Australia from 0.39 to 0.86. In New South Wales it fell from 1.26 to 0.75 over the same period.

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

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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.

The Bruce-Page government nevertheless remained committed to more 'coordinate' fiscal arrangements. In early 1927, it passed legislation abolishing per capita grants. The *States Grants Act* replaced per capita grants with a fixed payment at the 1927 aggregate payment level. This forced the States to negotiate on the Commonwealth's proposal to take over States' debts and contribute to their debt servicing, in return for ending per capita payments, and the changes culminated in the *Financial Agreement* of 1927. In the short term, the States were better off under the new arrangements. The Commonwealth Government's payments would also be guaranteed by an amendment to S. 105 of the Constitution, unlike the per capita grants which had been at the Commonwealth Parliament's discretion. More particularly, the *Agreement* meant the Commonwealth took over part of States' debt servicing responsibilities. This was beneficial to the heavily burdened smaller States, as the formula for the Commonwealth government's contributions provided greatest relief to them. The smaller States' finances had been especially stretched by the 'men, money and markets' policies of high immigration and land settlement pursued by the Bruce-Page Government during the 1920s.

However, the basic problem of federal finance remained. While the *Agreement* took the Commonwealth down its preferred path to a diminished role in funding the States, it did little to address the unequal fiscal capacities of the smaller States. The national old age pension, and war-related responsibilities for debt and veterans' welfare had left the Commonwealth with insufficient revenues to relieve the States of all debt servicing commitments. The continuing need for the Commonwealth to fund special assistance for Tasmania and Western Australia also underpinned its continued presence in the income and land tax fields. According to R. Mills:

> The States find it increasingly more difficult to meet their political responsibilities from the fields of taxation which they now share with the Commonwealth, while the Commonwealth finds it necessary to explore new fields of expenditure in order to dispose of a superabundant revenue. [39]

Between 1925 and 1932, there were no fewer than seven separate official inquiries and three Royal Commissions, into the effects of federation on the State finances of Tasmania, Western Australia and South Australia. Recognising underlying economic development factors as the root cause, conditions attached to 'disabilities' grants aimed to encourage convergence in the States' economic capacity (May 1971). Special grants were also directed in some cases at eliminating the inducements for population movements between States that arose from differences in taxable capacity (Prest 1974).

Anti-federal sentiment had increased markedly by the mid 1920s. Much attention focussed on the economic and associated fiscal 'disabilities' imposed by federation. The Commonwealth wage arbitration system and industry protection policies were perceived as threatening the economies and State budgets of the smaller and predominantly primary producer States. Special assistance to Western Australia from 1925-26 emerged from a 1924 Tariff Board Report on the disadvantages to that State's Budget from Commonwealth protectionism. The Commonwealth government's Royal Commission on the 'Finances of Western Australia as Affected by Federation' recommended a grant of £450,000 per year to replace surplus revenue grants, as an alternative to the State levying its own tariff. However, in the event, the Commonwealth paid a smaller amount for a period of five years from 1925-26.

Tasmania had been seeking redress for some time for 'the financial disabilities of federation', associated mainly with its high indebtedness from unprofitable State railway operations. The Tasmanian Premier in 1925 argued for long-term development loans because its difficulties were due to its intermediate stage of economic development. However, a special investigation conducted by Sir Nicolas Lockyer[40] in 1926 into Tasmania's claims of disability from federation elicited a new approach. Giblin's submission on behalf of Tasmania argued for grants on the grounds of the general disabilities to which the weaker States are always liable in any federation. Giblin said that for a small, resource poor State, membership of a federation inevitably brought difficulties beyond those imposed directly by Commonwealth policy. A federated State found it more difficult to avoid raising standards of public services, and States no longer had the same liberty to cut costs to suit their cloth (Giblin 1930). This change of emphasis away from 'disadvantages of federation' to disabilities/needs was to prove a fundamental, if subtle, shift in the grounds of the debate.

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39 Mills (1928). A key figure in interwar federal financial developments was economist and educationalist R.C Mills (1886-1952). During the 1920s, as professor of economics and dean of faculty at the University of Sydney, Mills helped establish the Economic Society of Australia. Unusually for that time, he argued that taxation might have other purposes than earning revenue. He defended the general appropriateness of the Commonwealth levying business and individual income taxation, which was still seen as a temporary 'war tax' by many including Earle Page, Treasurer in the Nationalist-Country Party government during 1923-1929. In 1928 he argued that assigning income taxation to the States was not an appropriate solution to the federal finance problem. Mills's membership of the Royal Commission into Money and Banking in 1935 was influential, and led to his friendship with Ben Chifley. Later, in 1942, Mills chaired the Commonwealth Committee on Uniform Taxation which recommended replacing the eleven State income taxes and the Commonwealth income tax with a uniform federal income tax. This also included the scheme providing compensation to States. Mills oversaw the implementation of these recommendations as chairman of the Commonwealth Grants Commission from 1941-45.

40 Sir Nicholas Lockyer (1855-1933), public servant, had been a senior New South Wales Treasury official with responsibilities including implementing the 1895 New South Wales income and land tax. At federation he joined the Commonwealth Public Service, and together with Kingston and Wollaston was responsible for framing the first Federal tariff. Lockyer became Comptroller-General of Customs in 1911, and a member of the Interstate Commission from 1913-1920.

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 assistance and determine such grants on a better coordinated, more principled and objective basis.

During the election campaign the Opposition Leader, Scullin, promised to implement special grants to Western Australia and Tasmania without conditions attached. Shortly after his election to government, these conditions were removed. In early 1930 the Scullin Government responded to Tasmanian protests at grant conditions recommended by the Development and Migration Commission by establishing a review. The review, by the Commonwealth Parliamentary Joint Committee of Public Accounts (the Joint Committee), considered 'The General Question of Tasmania's Disabilities' and reported in August 1930. When controversy re-emerged later in the year over the South Australian grant, the government also asked the Joint Committee to investigate that grant. An approach by Western Australia for additional special assistance soon after prompted the Commonwealth to amend the terms of reference for the Joint Committee's investigation of South Australia.

Coordinating these claims was tricky. In March 1931, the Scullin Government asked the Joint Committee to review its recommendation on Tasmania and consider the Western Australian claim on the same basis. This Joint Committee review represented the first attempt to co-ordinate the claims for grants by South Australia, Western Australia and Tasmania (Prest and Mathews 1980). By that time there were three different processes and forums considering claims for special assistance.

Before it finished its work on Western Australia, the Joint Committee was abandoned. However, its 1930 report on Tasmania and 1931 report on South Australia pulled together a number of strands of thinking on the special grants issue. Most importantly, the Joint Committee refused to try to quantify the net disabilities of federation. Instead, in determining its recommended grant to South Australia, it followed the suggestion made by Giblin to its 1930 Tasmanian inquiry, that the most practical basis for determining a grant was to look at a State's public accounts, and calculate the grant needed to balance the budget where the State: was taxing with considerably greater severity than the Australian average; was not attempting social provision on a more generous scale than average; had below average costs of administration; and had shown moderation and caution in loan expenditure (Giblin 1930). The Joint Committee also called for the establishment of a permanent independent body to determine grants on a consistent and principled basis. South Australia and Tasmania took up the Joint Committee's call.

As a result, the Commonwealth decided in 1932 to establish the Commonwealth Grants Commission. Thus, the Grants Commission was the institutional response to the political instability and conflict engendered by State financial difficulties during the Depression. It was also a formal, institutional acknowledgment that economic and fiscal capacity in the States was not converging. Redistribution between States was now recognised formally as a necessary and permanent feature of the Federation.

Searching for the underlying cause of the States' financial distress, the 1935 Report of the Grants Commission highlighted that financial inequality between States resided in what it described as 'a conflict between political and economic forces' in Australia (Commonwealth Grants Commission 1935, p. 40). It observed that the evolution of self-governing colonies had resulted not from merely provincial jealousies, but from what it saw as the need for 'some effective principle of decentralisation' to ensure the healthy development of all parts of the Continent. Before federation, the provincial tariffs had checked the economic tendency for concentration of manufacturing in the south-east of Australia, but this barrier was abolished at federation. There were consequent pressures for concentration of management and financial control, and of population in the eastern States, along with the specialisation of other States in the appropriate area of primary industry. The Grants Commission said that the centralisation trend:

> has been that best fitted for Australia as a whole, and is in accord with the universal modern trend of economic integration which favours the large unit as against the small. But it tends to concentrate population and power, both political and economic, in the eastern centres (p.41).

That is, the economic tendency was centralisation of power, while the direction of change in democratic political institutions was decentralisation of power.

> One of the features of democracy is the demand to control economic conditions in the interest of certain ideas of justice and social welfare, to redistribute wealth and to secure other ends considered desirable. The traditions and common purposes of national groups affect the ends which are sought by this political control, and in a country of very large area the local interests of provincial groups have a similar influence. This leads to a demand for separation into small political units so as to secure the type of political control which each section desires. The tendency of hostility to the larger political unit grows because of the fear that one section should be able to impose its will by political means over the whole area. Federation is a device by which the economic trends towards a large unit can be compromised or reconciled with the political trend towards the small one (p. 43).

The Commission's first recommendations for grants were driven to a considerable extent by the need to accommodate the interests of the smaller States at a time when Western Australia was petitioning the UK Parliament to be allowed to secede from the Commonwealth. Reflecting the political realities of the time, the Commission needed to adopt principles and methodologies that generated a level of grants at least matching the generosity of grants under the previous arrangements. The political acceptance of the Commission's principles was due in considerable measure to its recommendations falling within the bounds of what the Commonwealth would meet and what the States would accept.

For the first few years the Commission focussed on reconciling the 'fiscal need' and 'compensation' bases for grants. It examined various factors that might produce a fiscal need for grants, such as less advanced economic development or higher development costs, lower fiscal capacity, and poverty of resources and the demonstration effect of federation. In considering its approach, the Commission was faced with the difficulty that the needs of the claimant States derived from substantially different factors. Several possible causes of difficulties for the smaller States in a federation had been identified in the 1920s. While these emphasised the effect of federal policies, they also extended in the Tasmanian case to poverty of natural resources, as well as underdevelopment, and included possible extravagance and irresponsibility by State governments.

The Commission needed to find a 'principle' which could be applied with consistency to the various circumstances of the different States. To prevent political conflict with the larger States, it was also necessary for the Commonwealth to find the correct balance of federal principle/generosity and conditionality/effort. The difficulties of measuring 'disabilities', and the differences between States in the nature of their claims for special assistance also underscored the need for the Commission to develop an approach which was flexible, seemed objective and was at the same time more practical than attempting to place a money value on the 'net disabilities from federation'. These characteristics were found in the principle of 'fiscal need', described by Head (1967), as *'an ingenious reconciliation of the diverse arguments in a principle of financial equality'*.

There was, by that time, an emerging view that accurate measurement and quantification of net economic 'disabilities' from federation or federal policy was impractical (May 1971, p. 24). Significantly, as early as its first report the Commission abandoned any attempt to account for the disabilities of federation. While it was not denied that federal policies disadvantaged some States more than others, federation itself gave all States advantages. In addition, more than thirty years after federation, it was not practicable to distinguish the net impact of federation or federal policy for each State. In fact, it was by no means clear that the disabilities approach would yield the politically necessary positive case for grants to States such as South Australia and Tasmania (Head 1967).

The Grants Commission concluded, as had the Royal Commission into South Australia in 1929, and the Joint Committee in the early 1930s, that distinguishing the causes of differences in States' prosperity was futile. In coming to this conclusion, it drew on the evidence of expert witnesses as well as the views of claimant States, although the Chairman of the Commission, the Hon F W Eggleston (later Sir Frederick), was most reluctant to move away from the compensation principle to a fiscal need principle (Commonwealth Grants Commission 1995).[44]

The principle of fiscal need, explained in the Commission's 1935 report (pp. 31-39), was that *'the Governments of States ... are in a different position from the people of a State. Governments cannot change their occupation or move to other States where conditions are better'*. In fact, *'the movement of their people to other States in accordance with economic*

44 See Commonwealth Grants Commission (1995) pp. 30-33. Eggleston favoured assessing grants on the basis of disabilities of federation, whatever the difficulties. He said of the States that they '…will spend what they can get and they are always in need. A distribution according to needs is, therefore, simply handing them another mug of the beer that intoxicated them.' (ibid. p.32) However, he canvassed a range of leading academic economists and was seemingly unable to find any support for his resistance to the fiscal need principle.

conditions worsened their problems, because the overhead burden of interest may become so heavy as to outweigh any possible economies in current expenditure'. As governments fixed by the Constitution must continue to function, and pay their way, it was fundamental that *'it must be made possible for every State Government to carry on'*. By the Financial Agreement the Commonwealth was responsible for their solvency. It was therefore *'a fundamental obligation for the Commonwealth (and indeed for other States) to make it possible for a State government in distress to function at some standard. 'The federation must preserve itself. It cannot allow any of its constituents members to fail'*. The only ground for this assistance was *'the inability of the State to carry on without it'*.

The basis thus adopted for ascertaining the level of assistance was to bring claimant States up to a minimum standard somewhat below that of the standard States, rather than to an average level of the standard States. In recognition of the federal principle of the grants, and no doubt reflecting public outrage at the conditionality of some previous payments, all grants were unconditional.

This principle of fiscal need, reflecting what might be termed the 'federal' principle, was to be refined over subsequent decades. However, fiscal equalisation, in the sense of bringing claimant States to a level of fiscal capacity equal to that of non-claimant States, was still some years away. This appears primarily to have been a reflection of concerns that fiscal equalisation might undermine the financial responsibility of the claimant States. It also had a political rationale, acknowledging the potential objections to equalisation at a time when even the wealthiest State was in severe financial difficulties. Reflecting this, there were penalties for claimancy until the Second World War, as well as deductions from grants based on judgements about the extent of a State's own responsibility for its difficulties.

2.5 Uniform Taxation and problems of federal surplus revenue revisited

In 1942, the Commonwealth government unilaterally established a monopoly of Australian income taxation. The proximate cause was the need to provide Commonwealth funding for the war effort in an equitable and efficient way (Laffer 1942).[45]

Paralleling the arrangements for distributing tariff revenues just after federation, the States were initially reimbursed Uniform Income Tax revenues according to the distribution of collections before the war, over the period 1939-41. Like the Constitution's financial provisions for customs collections, the arrangements also acknowledged the particular difficulties of the smaller States: any State that felt it received insufficient grants could apply for supplementary assistance. Such claims were to be assessed by the Commonwealth Grants Commission.

[45] The varying income tax burdens and structures in the different States made it difficult for the Commonwealth to maximize its war revenues without unacceptable equity implications for taxpayers in different States or on different incomes. In particular, poorer States such as South Australia had found it necessary to levy substantial tax on low income groups, which were relatively lightly taxed in some other States. Other States taxed high income earners relatively harshly. Different fiscal capacities and policies also resulted in variations in the extent of reliance on income tax revenues. This meant that without imposing unconstitutional differential income tax burdens on the different States, the Commonwealth could not fairly and effectively levy a heavy national income tax.

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 States would derive from a restoration of the taxing powers I have never been able to ascertain. Long before the introduction of uniform income tax, when the three claimant States had complete taxing power, they were not able to finance themselves. I have said before, and I repeat now, that the three less populous States must be assisted by the larger and more affluent States and the Commonwealth, if we are to have a national outlook on the development of Australia. Previous governments, irrespective of their political beliefs, took the same view.… I strongly suspect that if the Commonwealth were to return to the three claimant States their taxing power and tell them to finance themselves, they would be in great difficulty and would not know what to do (Stargardt 1952, p. 229).

Intrinsic to Chifley's argument is a recognition that collection of progressive taxes by the Commonwealth and distribution of the proceeds to the States on an equal per capita basis is tantamount to a redistribution from richer States to poorer States.

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46 New South Wales had introduced payroll tax in 1925 to fund child endowment.

47 Wartime restrictions on State expenditures combined with the uniform tax arrangements made it less meaningful to assume a State could exercise financial autonomy and responsibility in its taxation and expenditure policies.

48 When the larger States were running budget surpluses and accumulating reserves during the war, the claimant States argued that they would be disadvantaged in the reconstruction period because of the Commission's practice of bringing them up only to a balanced budget standard. It was argued that this procedure distorted the fiscal policies of claimant States. However, it was not until 1967 that the Commission decided to allow equalisation to a surplus budget standard (Head 1967).

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 criteria of fiscal need, and political factors that were reflected in the 1958-59 grants base. As a result, over the next decade or so there was increasing arbitrariness and ad hocery in the relativities of general revenue grants and in the division between claimant States and non-claimant States. As Prest had commented in 1959, *'if such a differential per capita is to be used, there is a strong case for basing it on some objective formula …'* (p. 482).

In the late 1960s, Australia's endemic vertical fiscal imbalance was further increased when the High Court ruled invalid the receipts duties that were becoming increasingly important to State governments. The High Court ruling precipitated the negotiation of a new *Financial Agreement,* agreed to in 1970, involving a transfer of State debts to the Commonwealth, a new capital grants program for housing and public works, and a hand-over of the Federal payroll tax to the States as a 'growth' tax in 1971.

Thus between 1942 and 1970 federal financial arrangements began adapting to the unification of income taxation and to improved economic conditions, and expansion of the progressive tax-transfer system added a further redistributive element to Australian federal finance. Through this period, the Commonwealth took advantage of its superior taxing powers to exert a growing influence over the pattern of State governments' expenditures. The Grant Commission's special grants procedures increasingly acknowledged States' reduced independent powers to tax after 1942, and while the Commonwealth was politically malleable on grant distributions between the States, there was no evidence of it adopting another fundamental distribution principle. In the late 1960s, the Commonwealth experienced tensions with politically aligned States over grant allocation issues; having shown itself willing to be politically accommodating with grants it now found an expectation that it would do so. With the later move to full equalisation of such grants to States, this latter problem would be largely addressed.

2.6 Summing up

If delegates to the Australian Constitutional Convention had studied modern theories of federal finance, which assign the redistribution function to the central government for several very good reasons, the financial clauses of the Constitution of 1901 would be rather different. As it was, the federal Constitution gave few redistributive functions to the central government,

49 After adopting a two State standard in 1961, the Commission eventually announced its intention to adopt a four State standard from 1967. However, the four-State standard was unstable. In the early 1970s, both Queensland and South Australia again became claimant States, and attention again focussed on the appropriate basis for determining relativities for the distribution of general revenue (FAGs plus special grants).

50 See Commonwealth Grants Commission (1995) pp. 62-66.

with even labour representatives sceptical of relinquishing States' powers to provide age pensions (Norris 1975). The Constitution's guarantees of revenues for States proved ineffective. Over subsequent decades, therefore, as governments took on a more active redistributional role, intergovernmental financial arrangements had to be adapted and improvised.

The changing fiscal relationship between the Commonwealth and the States from federation has been examined here from a new perspective, emphasising the central role of redistribution (including fiscal equalisation) in shaping the broader federal/state financial relationship. While some view the CGC as an outgrowth of protectionism, it has been shown that the origins are deeper and more complex. Similarly, by mapping out the unnoticed connections between different aspects of Commonwealth-State financial relations, this paper has questioned the view that the centralisation of taxation (and associated expansion of social security) over this century reflects just a Commonwealth grab for power or a 'cop-out' by 'taxation-shy' State governments. It is suggested that the changing financial relations between governments were moulded by broad social and economic forces, but particularly by the different taxable capacities of States, and by their citizens' shared values of national unity and equality. As was evident to the framers of the Constitution, the problem of the federal revenue surplus (or 'vertical fiscal imbalance'), and its distribution (horizontal balance) are inseparable.

The financial clauses of the Constitution, and more broadly the decentralised democratic political institutions set down by the Constitution, provided the institutional framework within which the respective roles of Australian governments, and Commonwealth-State financial arrangements, evolved in the decades after federation. This chapter has shown in particular how the diverse taxable capacities and fiscal situations of the States led to a relatively flexible set of financial clauses in the Constitution (the apparent prohibition on virtually any State sales taxes being the key exception).The flexibility that does exist is in no small measure a product of the fiscal politics of the late 19th century, and the need to leave open a possibility of adopting alternative policy agendas favoured in different parts of the polity. The ensuing compromises appear to have been instrumental in fixing the course of Australian federal finance, through limiting the term of the Braddon clause (section 87), and generating the Commonwealth's (section 96) grants power.

The paper has shown how differences in the fiscal capacity of States worked as a centralising force after federation because the weaker States benefited from a greater redistributive role for the Commonwealth in three ways; through progressive taxation, via economic risk sharing such as through unemployment benefits and similar cash transfers, and via special or specific purpose grants. This process was assisted by accelerating economic integration after federation which made progressive taxation and provision of social services by States increasingly difficult, and by the financial difficulties of smaller States from the mid 1920s which forced the creation of institutions to formalise redistribution between States through the Commonwealth government, and to centralise progressive income tax and social security.

Fiscal equalisation is shown here to be one reflection of the changing redistributional role of government; centralisation of the progressive tax-transfer system is another. According to Mathews, horizontal equalisation is a practical manifestation of Australians' dominating concern for equity.

> It has been one of the most important unifying influences in bringing together people scattered over vast geographical areas in regions with different industrial structures, different degrees of development and different rates of growth and affected in different ways by Commonwealth policies. … it has been one of the principle means of achieving equity for all Australians …[and is] a major factor in achieving political stability across the different regions, of reconciling the different interests and concerns of city and country, and of protecting the less populous States against NSW and Victoria. At the same time, it has protected NSW and Victoria against inequalities associated with back-room deals and arbitrary Commonwealth action (1994).

Although achieving the greater harmony sought in areas where more unified markets made national laws and policies more necessary, such as in tariff, banking and defence policy, the framers of the Constitution would, if they were able, probably judge themselves unsuccessful in protecting the fiscal powers and fiscal autonomy of State parliaments. As a consequence, State governments were left unable to respond effectively to political demands for a more redistributive role for government in the 20th century.

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Chapter Three

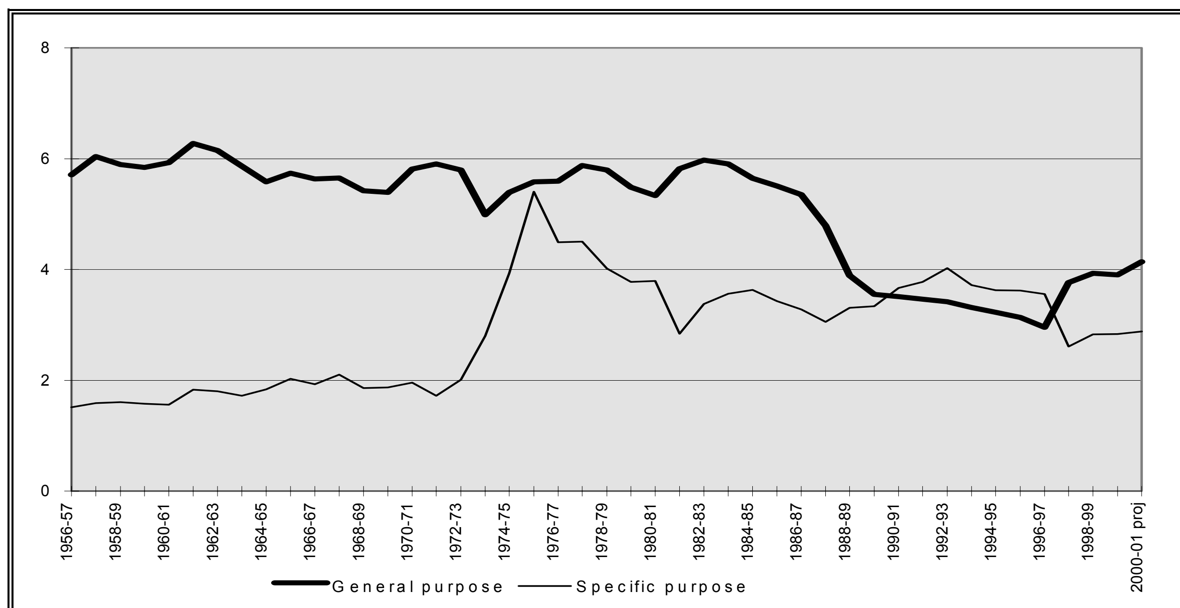
1970 to the Present

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 purpose and specific purpose — from the Commonwealth to the combined State/local sector since the early 1960s.

Figure 3.1
Commonwealth payments to the combined State/local sector as a percentage of GDP



Source: See Data Appendix.

3.2 The Situation in the Early 1970s

By 1970 there had been in place for ten years a system of financial assistance grants (FAGs) ostensibly with an objective calculation basis, but supplemented with additional FAGs payments and special grants to claimant States on an ad hoc basis. Although in principle FAGs for each State were indexed in line with population growth, wages growth and a 'betterment factor', some additional payments were made at times. And there were in addition special assistance grants, assessed by the Commonwealth Grants Commission. Consequently the distribution of combined FAGs and special assistance could still follow a significantly different pattern than that embodied in the fundamental FAGs formula. Table 3.1 illustrates this for 1974-75 — in that year South Australia, for instance, had a 12.4 per cent share of FAGs plus special grants, compared with an 11.0 per cent share under the FAGs

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.* Commonwealth Budget Paper No.7. SACES calculations.

Certainly there was a recognition by the States that the main game was the total amount of assistance. In its history the Grants Commission (1995) notes that:

> By 1976, the changes in the method of payment of Commonwealth grants to the States, combined with ad hoc changes in the level of payments themselves, had resulted in a marked shift from the distribution of reimbursed income tax revenue in 1942. However, as this redistribution was carried out in an ad hoc manner, with no real assessment of the extent to which it reflected relative needs, the less populous States were thought to have had a continuing need for special financial assistance … in the knowledge that the Commission would assess special grants after all other adjustments had been taken into account, the claimant States did not press as hard as the other States for increases in their tax reimbursement and financial assistance grants …[51]

The guiding principle employed by the Commonwealth Grants Commission in making its assessments for special grants had been unchanged since its adoption in 1936. A special grant should be awarded to a claimant State to *'make it possible for that State by reasonable effort to function at a standard not appreciably below that of other States'.*[52] The grants based on these recommendations thus equalised recipient States' capacities with the capacities of the two 'standard' States, New South Wales and Victoria. However, the States had discretion in how funds were spent, so capacity equalisation did not imply outcome equalisation. The benefits of a federal system in terms of decentralised choice were still allowed to occur.

While a type of equalisation calculation was performed, it applied only to claimant States. Some of the potential claimants at various times cut special deals with the Commonwealth which effectively over-equalised them. Academics such as Mathews objected to the highly politicised nature of the distributions between States, and called for a more thorough implementation of equalisation. Mathews proposed a general revenue grant distribution which would achieve fiscal equalisation among all the States by application to the FAGs pool, rather than the existing arrangement whereby 'claimant States' could seek additional special

[51] Commonwealth Grants Commission (1995), p.67.
[52] Commonwealth Grants Commission (1972), p.44.

grants determined on a type of equalisation principle. At a 1971 conference on Australia's federal arrangements, he argued:

> Given the existence of large general-revenue grants to all States, such as the financial assistance grants in Australia, the case for separate equalisation grants becomes even weaker. The financial assistance grants themselves should be adjusted to reflect differences in relative need, that is to say they should have a built in equalisation component in order that the allocation is equitable and efficient from the point of view of all States in the Federation, and not merely some of them.[53]

There was also a widely held view that the degree of vertical imbalance in the Commonwealth-State financial relations was problematic. This imbalance had been increased and entrenched by High Court decisions which had restricted the range of tax bases with which the States could raise revenues. Some modest relief was provided when the Commonwealth transferred payroll tax to the States in 1971. However, a relatively large degree of vertical imbalance remained.

3.3 1973 to 1975

The election of the Whitlam Government in December 1972 brought with it a significant change in approach to inter-governmental financial arrangements. The quantum of grants was increased significantly, with the Commonwealth commencing spending in areas previously regarded as States' responsibilities. This was achieved through an increased range of specific purpose grants to the States. These grants are in substance Commonwealth own expenditures although they have the legal form of grants to the States. One aspect of the Commonwealth's expanded field of activity was the commencement of Commonwealth grants to approved 'regional organisations of local government'. Decisions about local government had previously been the exclusive purview of the States. In aggregate, Commonwealth payments to or through the States and local government rose from 7.5 per cent of GDP in 1973-74 to 10.7 per cent in 1975-76.

Whitlam had long held the view that urban planning and infrastructure provision in Australia were inadequate, and that this was partly a result of the States starving local government of funds. He saw local government having an important, broader role to fulfil. For instance, in 1968 he had said:

> … A Labor Government would not deny State governments and local government finance adequate for the functions that they are incomparably best able to perform, or by default impose on them functions better performed at a national level.
>
> … Local government must be accepted as a partner with the States and the Commonwealth in future financial arrangements. Residents of the newer suburbs suffer from the squeeze on local government and semi-government authorities more than they suffer from the squeeze on the States. The financial agreement under a Labor Federal Government would become a tripartite agreement including the 3 tiers of government in Australia.[54]

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53 Mathews (1974), p.228.

54 Whitlam, E. G. (1968), *Responsibilities for Urban and Regional Development.* Walter Burley Griffin Memorial Lecture, Canberra.

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 outcomes within their jurisdictions. On the other hand, they overrode the States' abilities to determine the allocation of resources between local governments and to limit the scale of activities of local government.

As an adjunct to the Commonwealth's move into local government funding, the legislation under which the Commonwealth Grants Commission operated was replaced with the *Grants Commission Act 1973.*[55] In addition to its traditional role advising on special assistance to the States, the new Act gave the Commission a role advising on the funding of regional organisations of local government. The new Act also incorporated the Commission's equalisation principle into statute. Sec 5 says that in considering grants for a State the Commission shall be guided by the principle of:

> making it possible for the State, by reasonable effort, to function at a standard not appreciably below the standards of other States.

And under Section 6 the same principle was to be used in assessment of funding for local government through 'regional organisations of local government'.

However, the special assistance assessed by the Commission continued to be available on a claimancy basis only. The smaller States had to make claims to the Commonwealth for special assistance. Similar claim processes also applied in respect of approved regional organisations of local government.

In fact from time to time the Commonwealth entered into deals with the smaller States to take them out of 'claimancy'. Rationality would dictate that the smaller States accepted these deals when they promised to be more favourable than the alternative of special assistance assessed by the Commission. Because equalisation was applied to grants only under the 'claims'

[55] The prefix 'Commonwealth' was dropped from its name but was reinstated by the Fraser Government a few years later.

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 authoritarian control, the Liberal and National Country Parties said that they viewed federalism as a philosophical rather than a structural concept, which would prevent undue concentration of powers and thus help to guarantee political and individual freedom.[56]

It was as a consequence of these philosophical views that some of the Whitlam reforms in local government were wound back. However, it would be mistaken to characterise *New Federalism* as rejecting the Whitlam reforms in their entirety. In fact the increased resources provided to State and local government were maintained for a time, and to this day explicit allowance is made for local government in Commonwealth funding decisions. However, the Coalition moved towards a system where funding levels were explicitly related to Commonwealth tax collections, and where the States' role in decisions about local government resourcing was enhanced.

In 1976, in its first Budget, the new Government introduced a new system of tax sharing entitlements to replace FAGs. The new system was intended to give States greater control over their own revenues and at the same time make them less reliant on the Commonwealth.

The central feature of the first stage was the replacement of the States' FAGs and local government assistance with set shares of personal income taxes[57]. The second stage continued the reforms of the first stage, but also introduced a mechanism allowing the States to levy their own income tax surcharges (or reduce income taxes); the States had of course been removed from the income tax field with the Uniform Tax arrangements of the War. However, the new arrangements were quite different to what had occurred pre-War. Although the package effectively allowed the States to levy their own income taxes it did not let them vary the definition of the base or the progressivity of the tax structure. In addition, they were to operate only in the personal income tax field. These structural constraints were then, and are today, consistent with the predominant view of good tax design in the public finance literature.

In fact no State ever made use of the provisions to set their own income taxes. It is sometimes argued, and persuasively, that the Commonwealth did not do enough to create 'tax room' for the States — i.e., cut its own income taxes to allow the States simultaneously to introduce their surcharges in a manner that was in gross terms neutral to the taxpayer. In 1989 the

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56 Mathews and Grewal (1997) p. 245.

57 The Commonwealth also provided guarantees to each State that the amounts would not be less than the scheduled FAGs payments and would not be allowed to fall from one year to the next.

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 Mathews, Australia's leading academic in the field of fiscal federalism, had said a few years earlier that:

> The broad aim of grants machinery in a federal system should be to achieve an equitable and efficient allocation of resources within the framework of national social and economic policy objectives … The financial assistance grants themselves should be adjusted to reflect differences in relative need, that is to say they should have a built in equalisation component in order that the allocation is equitable and efficient from the point of view of all States in the Federation, and not merely some of them …[there is] an obvious failure, in the present distributional arrangements, to bring all States into the equalisation process … The major purpose of this paper has been to suggest a logical method of distributing Commonwealth grants among the States, based on systematic analysis instead of the arbitrary and inequitable decisions that have characterised recent Commonwealth policies in this field.[61]

As well as being justified from an economic management viewpoint, the decision to move to a more arms length principle for dividing funds between the States had political attractions for the Commonwealth. The issue of State grants had been difficult for Commonwealth Government politicians. Governments from both sides of politics had found themselves providing favourable treatment to friendly State governments, and although the power to use grants in that discretionary way might at face value seem attractive to a Commonwealth Government, the reality was that such a system created expectations on the part of politically aligned State Premiers that were difficult to meet. Disputes with Premiers could then feed into internal instability. Both McMahon and Gorton, for instance, fell foul of State Premiers whose demands they refused to meet, and paid a price for it in terms of eroded support within

[61] Mathews (1974), pp. 225, 228, 229, 237.

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' relativities	Change in grants implied in CGC 1981 Report		Change in grants following June 1981 Premiers' Conference	
	$m	$m	Per cent of State & local receipts	$m	Per cent of State & local receipts
New South Wales	2,028	+116	+1.5	+25	+0.3
Victoria	1,507	+55	+1.0	+15	+0.3
Queensland	1,192	+128	+3.6	+30	+0.8
South Australia	761	-77	-3.8	-	-
Western Australia	806	-160	-7.3	-	-
Tasmania	328	-64	-8.3	-	-
Total	6,621	-	-	+69	+0.3

Source: *Payments to or for the States, the Northern Territory and Local Government Authorities 1983-84,* SACES calculations.

In the case of South Australia, for instance, $77 million less would be provided than under the old arrangements — this amounting to about 4 per cent of State and local government sector total receipts. In Western Australia, the reduction in grants was equal to over 7 per cent of total receipts. The gains to the larger States, although smaller in relative terms, were also significant.

Not surprisingly, the larger States enthusiastically endorsed the findings of the review, and the smaller States resisted it to varying degrees.

62 Reid (1971) gives a fascinating account of the politics of the late 1960s and early 1970s, for instance regarding the way in which the New South Wales Premier Sir Robert Askin shifted support for leaders at the Federal level according to what they could deliver to him.

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 can make up the shortfall in one year … I believe we have a very strong case for the recommendations of this report to be phased in …[65]

The Western Australian Premier, Sir Charles Court, was more strident in his criticisms and raised the spectre of West Australian secession:

> I believe that the Prime Minister and his government could not in all conscience accept this report … They could not expect a State like Western Australia with so many problems of distance and dispersion and with development taking place, to absorb this even over a period of three to five years'[66] [and] 'While I am not a secessionist, you can't blame people for feeling strongly about this … Resentment is already running high and will get higher … Western Australia as a separate unit would be better off economically with faster growth rates, cheaper goods and many benefits it doesn't have now.[67]

The upshot was that at a special Premiers' Conference convened soon after the release of the Commission's 1981 Report, it was agreed to have the Commission conduct a further review of the relativities. For 1981-82, the old set of relativities would apply but the Commonwealth would provide some top up funds to the larger States which took them some way toward the financial outcome they would have got under the Commission's recommendation. Columns 4 and 5 of Table 5 show the actual amount and proportions of total revenues.

The events of this period are particularly significant because the Commission's 1981 Report proposed for the first time a grant sharing arrangement which was based on the principle of full fiscal equalisation. Gone was the arrangement under which only claimant States could seek top up funds. Instead, the new process generated recommendations on the grants to go to all States as part of one simultaneous equalisation process. And in its approach the

63 Kelton, Greg (1981a), 'Keeping SA on the fiscal rails', *The Advertiser,* 12 June 1981.
64 Ibid.
65 Kelton, Greg (1981b), 'A body-blow, says Premier', *The Advertiser,* 11 June 1981.
66 'Big test for PM, says Sir Charles', *The West Australian,* 11 June 1981.
67 Gilmour, Trevor (1981), 'Premier warns of anger in WA', *The West Australian,* 19 June 1981.

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 did not flow fully into the actual general revenue assistance arrangements that were implemented. However, the relativities did provide a benchmark which guided the allocation of general revenue assistance even if it did not ultimately determine it.

At a Premiers' Conference held in June 1982, the Commonwealth and the States discussed the findings of the Grants Commission's new Review. The Review confirmed the directions of change indicated in the 1981 Report, albeit with generally smaller magnitudes. However, the Commission's recommendations still were not adopted, and again a compromise solution was chosen which was considerably more favourable to the smaller States. This compromise was continued at the 1983 and 1984 Premiers' Conferences. The compromise included a real terms guarantee, which the Commonwealth Treasury said:

> … will have the effect, in the case of most States, of slowing or reversing progress toward the distribution of per capita grants based on the relativities in the Grants Commission's 1982 report (as modified) and which, except for the guarantee, would come into effect in 1984-85, the final year of the phasing-in period.[68]

3.6 1985 to 1990

3.6.1 The Adoption of Full Fiscal Equalisation

In 1983 the Fraser Government had been replaced by a Government led by Bob Hawke.

In April 1985 the Commission released a new set of relativities, and at the 1985 Premiers' Conference the Commonwealth declared its intention to accept them. Mathews and Grewal (1997) note that the 1985 assessments produced results that were much closer to the 1984-85 distribution of FAGs than the 1982 assessments would have been, and acceptance of the Commission's relativities was therefore much less traumatic than three years earlier. They also argue that while the Fraser Government paved the way for fiscal equalisation by having the Commission form its recommendations on that basis, the 1985 decision was the first time that the Commonwealth really bit the bullet and adopted the Commission's recommendations largely intact.

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68 *Payments to or for the States ... 1983-84,* p.18.

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 Australia, Tasmania and Queensland[69]. All were winners — except the Commonwealth. Worse still, 2 per cent real increases were guaranteed for each of the next two years. Despite the emergence in the meantime of the banana republic, this was honoured in 1986. Consequently in that year when wages, which comprise about two-thirds of State spending were actually falling in real terms, FAGs payments to the States increased by 2 per cent real. Apart from the additional stress on the 1986 Federal Budget, this windfall gain encouraged the States to continue travelling on their wayward fiscal paths.[70]

Clearly attitudes like this were important in determining the Commonwealth's subsequent course of unilateral cuts to State funding.

3.6.2 Fiscal Stringency

In 1985 the general revenue grant arrangements were restructured. The tax sharing entitlements were replaced with a system of FAGs which were unrelated to tax collections. In addition, the States were to receive additional general purpose payments in the form of the 'identified health grants' which had been in existence since 1981-82. The arrangements were specified for the triennium 1985-86 to 1987-88, and included real terms escalation factors — zero in 1985-86 and 2 per cent in 1986-87 and 1987-88, although in the event, the Commonwealth cancelled the escalation for 1987-88 on grounds of its national saving policies.

In 1988 and 1989, and incurring the extreme displeasure of the Premiers, the Commonwealth unilaterally reduced general revenue assistance to the States. To some extent this was offset by the establishment of a new specific purpose payment in respect of Hospital Funding Grants (replacing the previously untied Identified Health Grants). However, there were reductions of $650 million (approximately 5 per cent) in 1988-89 and $550 million (4 per cent) in 1989-90 in general revenue assistance against the forward estimates. Although FAGs in both years were allocated according to the CGC relativities, in 1988-89 there were minor modifications to this result in the form of special revenue assistance to Western Australia, South Australia and Tasmania and Northern Territory (which was now included with the States in the equalisation process) so that no State, after application of new relativities, population estimates and the downsized grant pool, would face a nominal decline in general revenue assistance. The NT received further special assistance in 1989-90.

In fact, between 1986-87 and 1989-90 Commonwealth general purpose payments to the States fell from 5.4 to 3.6 per cent of GDP. Had the States taken up 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.

[69] Queensland received special revenue assistance on the basis of a Commission recommendation relating to Medicare impacts.
[70] Walsh (1995), p. 137.

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]

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 extreme as the adoption of a flat equal per capita standard. One member of the Committee, Peter Emery (who was at the time Deputy Under-Treasurer of South Australia), noted his general agreement on the approach to interstate allocations, but suggested an alternative approach. Emery dissented on the need for tied funds to local government, arguing instead that local funding needs could be accommodated in an untied State grant. Consistent with this model, equalisation should be applied by the Commission on a 'whole of State' basis — i.e. to a combined State and local entity. See National Inquiry into Local Government Finance (1985).

3.6.4 The Grants Commission's Review of Efficiency Aspects of Fiscal Equalisation

In the Terms of Reference for its 1988 Review, the Commission was asked to consider:

> … whether, in its view, application of the fiscal equalisation principle has any significant consequences for the efficient allocation of resources across Australia.[73]

The Commission conducted extensive consultations with the States and the Northern Territory, and responded in its 1988 *Report on General Revenue Grant Relativities.* Its findings in respect of efficiency were as follows:

- The submissions received from New South Wales and Victoria argued that in important respects the fiscal equalisation principle undermined the achievement of allocative efficiency. In particular, while individual-specific equalisation might in principle be consistent with allocative efficiency, location-specific equalisation certainly was not. Victoria equated individual-specific equalisation with assessment of units of use, social composition and age-sex composition factors. Location-specific factors were equated with scale, dispersion, isolation, urbanisation, economic environment and physical environment factors.
- Submissions from the other States and the NT generally opposed the strongly held view of New South Wales and Victoria that fiscal equalisation was significantly detrimental to the achievement of allocative efficiency. They argued that although there might be some allocative efficiency implications, it was not clear what they were. Certainly they did not accept the presumption of New South Wales and Victoria that an equal per capita assessment of location-specific factors would be more efficient than a fiscal equalisation assessment.
- Commonwealth Treasury believed that some elements of fiscal equalisation — particularly some of the components which Victoria described as location-specific factors — were at odds with allocative efficiency.
- The Commission itself concluded that:

> … while some of the efficiency effects have been stated incorrectly or exaggerated, the principle of fiscal equalisation does have some consequences for the efficient allocation of resources across Australia. But these consequences are not significant enough to warrant any changes in the manner in which the fiscal equalisation process is carried out.[74]

3.6.5 The Grants Commission's Review of Local Government

In 1989 the Grants Commission was asked to report on the distribution of local government assistance between the States and Territories. It developed a set of relativities which were complementary to its State assessments — 'complementary' in the sense of avoiding any issues of double coverage arising from differences in the fields of operation of State and local government from State to State. According to the Commission's official history, these relativities would have led to significant redistributions away from New South Wales and Victoria to Queensland. However, the Commission did not recommend use of the relativities

73 Commonwealth Grants Commission (1988), p. 32.
74 Ibid. p. 147.

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 on. I have spoken to my colleague the Attorney General about re-examining all the legal options that may be available, including a constitutional challenge to the Grants Commission situation. New South Wales and Victoria are cooperating in the preparation of an economic and social argument about the issue. It is fundamental that the two largest States address a situation that has been deteriorating for the best part of half a century and that is now presenting an absolutely unacceptable and unfair distribution of funding in relation to the people of New South Wales and Victoria.[76]

The Victorian Premier, Joan Kirner, also criticised the situation, suggesting that fiscal equalisation be subjected to the same sort of microeconomic reform scrutiny as had a range of other Commonwealth policies, such as manufacturing protection.[77]

In spite of these difficulties, the Premiers' Conference endorsed the central principles of and need for fiscal equalisation. However, it was recognised that there were concerns about the implementation of equalisation, and Heads of Treasuries were asked to examine the adequacy of the scope and methodology for fiscal equalisation, and the principles on which it was based. New South Wales and Victoria also engaged consultants to conduct reviews for them.

The Heads of Treasuries Review was asked to focus on the complexity and transparency of the existing fiscal equalisation processes, its possible efficiency cost, and the possible implications for facilitating structural change throughout Australia.

The Review's report is a curious document, presumably reflecting the highly charged political environment in which it was prepared. It was circumspect in its findings It had only very limited conclusions in respect of the efficiency consequences of equalisation, apparently because there were sharply diverging views put on this issue by New South Wales and Victoria (on the one hand) and the smaller States (on the other).

The smaller States argued that fiscal equalisation was justified on both equity and efficiency grounds. They pointed to arguments well established in the public finance literature regarding the role of a system of equalisation payments in promoting equity and efficient location decisions[78].

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[76] Greiner, N. (1992), Response to Question Without Notice: 'State Funding', *New South Wales parliamentary debates.* New South Wales Parliament. pp. 3004-5

[77] Kirner, J. (1992), Response to Question Without Notice: 'Commonwealth Grants Commission', *Parliamentary debates (Hansard),* Vol. 406. Victoria Parliament, Legislative Assembly. pp. 787-9.

[78] These arguments are elaborated in the next Chapter.

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

In April 1995 the Commonwealth and the States reached agreement to implement a set of competition policy reforms. As compensation for any adverse revenue consequences of these agreements, the Commonwealth agreed to provide the States with extra general purpose payments in the form of Competition Payments[81]. These funds were available on a per capita basis, although States had to demonstrate compliance with their obligations under the Agreements to be entitled to funds.

The Competition Payments were a notable development in that they gave the Commonwealth leverage over the States' behaviour in areas where the Commonwealth could not itself act. In State spending areas, the Commonwealth could typically achieve its own objectives, if it so chose, by providing specific purpose payments. However, the Competition Payments gave the Commonwealth influence over the States' own policy choices in non-spending areas. Although they are provided as general purpose payments, there is a significant element of conditionality involved.

Because the Competition Payments were an extra layer of general purpose funds on top of FAGs, and because equalisation could be achieved by accepting the Commonwealth Grants Commission's relativities, the equal per capita distribution of competition payments was consistent with the principle of equalisation.

3.7.4 The *Local Government (Financial Assistance) Act 1995*

The *Local Government (Financial Assistance) Act 1995,* still in operation today, provides a legislated formula for general purpose funding for local government via the States. The intrastate allocation is required to be on a full fiscal equalisation basis subject to the proviso that no council should receive less than the amount they would receive if 30 per cent of the State's financial assistance payment in respect of local government were allocated per capita.

However, general purpose payments continue to be allocated between States on an equal per capita basis, and this is enshrined in the Act. This approach is anomalous, given that the Act requires the States allocate funds, as far as practicable, on a full horizontal equalisation basis.

> The distribution of grants between States on a per capita basis, rather than horizontal equalisation, evolved as a result of difficulties in determining the latter. This difficulty stems mainly from variations in local government between States: in different States councils provide different services, operate under different legislation and use different accounting practices.

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80 Commonwealth Treasurer (1994)

81 No less significant was the Commonwealth's provision of a rolling three year guarantee to maintain the FAGs pool in real per capita terms. However, this arguably was the de facto policy at the time.

> 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 allocated between States on the basis of a set of historical relativities.

3.7.5 The National Commission of Audit

In 1996 a new Liberal Government was elected with John Howard as Prime Minister. Howard had been Treasurer and a key player in the implementation of the New Federalism policies under the Fraser Government in the late 1970s and early 1980s.

One of the first things that the new Government did was to establish a National Commission of Audit to enquire into the management and financial activities of the Commonwealth Government. The Commission of Audit recommended significant reductions in government spending, and the Commonwealth required the States to contribute to these reductions. The States made State Fiscal Contributions to the Commonwealth for the triennium 1996-97 to 1998-99. These Contributions are best understood as reductions in general purpose payments to the States in that period, and they amounted to a little over 3 per cent of the States' general revenue assistance. In addition, specific purpose payments were reduced across a range of programs.

The Commission of Audit accepted the need for a fiscal equalisation mechanism, but raised the question of whether this could be achieved with less effort:

> Accepting that in the context of financial arrangements for the Australian federation there is a need for a mechanism to impose fiscal equalisation, the question arises whether this can be achieved by a simpler and less costly means than a full time permanently staffed Commission.
>
> An alternative to the current approach may be to develop a set of simpler indicators which can be agreed by the States and applied without the need for dedicating the current level of resources.[83]

These concerns about the costs of the Commonwealth Grants Commission's processes had of course been raised before, for instance in submissions to the Heads of Treasuries' Review. And from the point of view of the Commonwealth, the opportunity to save some costs — Heads of Treasuries estimated the cost of the CGC processes for the Commonwealth and States at about $6m per annum — would of course be attractive. However, what was missing was an identification of just what those indicators were that could achieve fiscal equalisation at lower cost. In their absence, it is perhaps unsurprising that the Commission of Audit's recommendation was never taken further.

[82] National Office of Local Government (2000) p.17.
[83] National Commission of Audit (1996) Ch.4.

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 revenue to fund important community services. The States have committed to abolish nine inefficient taxes, removing their reliance on these distortionary and growth-reducing taxes and charges. The Agreement will also remove the States and Territories' current reliance on Financial Assistance Grants.[85]

Key features of the revised *Agreement* were that (with implementation date of July 2000 unless otherwise indicated):

- the Commonwealth would enact legislation to establish a GST at a 10 per cent rate, with the funds raised, net of collection costs, to be paid to the States;
- the Commonwealth's wholesale sales tax would be abolished;
- the arrangement under which the Commonwealth, on behalf of the States, levied taxes on petrol, liquor and tobacco and on-passed the funds to the States would cease;

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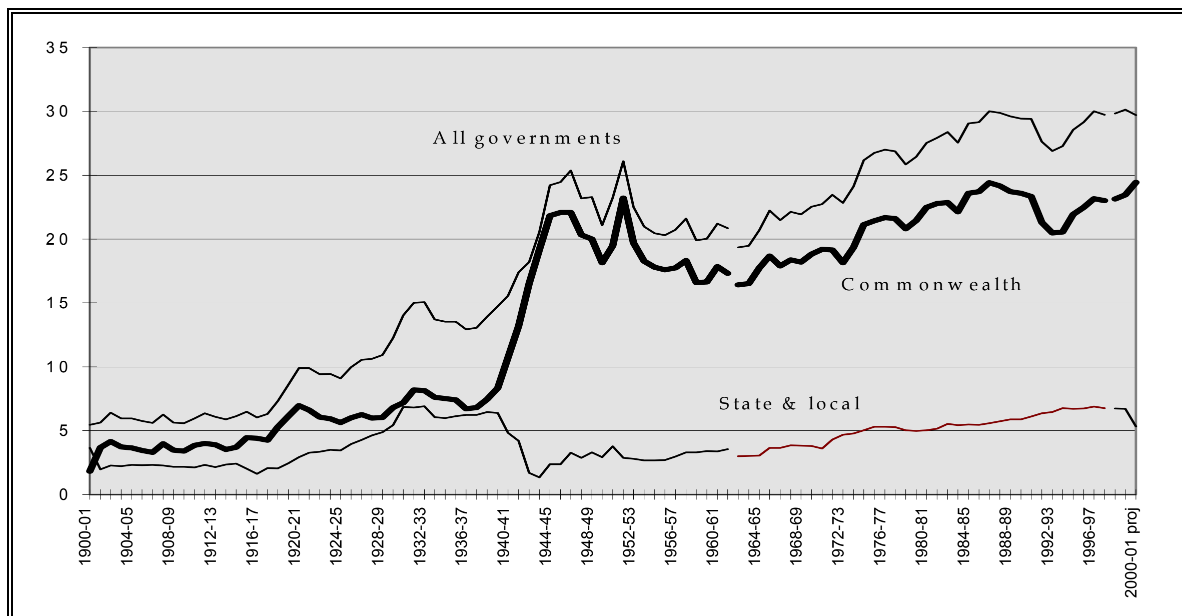
84 The modifications were made to secure the support of the Australian Democrats for the legislation necessary to implement ANTS in the Commonwealth Parliament.

85 Howard (1999).

- 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



Source: See Data Appendix.

A side effect of the reforms is to increase the degree of vertical fiscal imbalance in Australia's Commonwealth-State financial relations. In 2000-01, the first year of the *ANTS* arrangements, Commonwealth taxation is expected to account for a historically high 24.4 per cent of GDP (0.9 percentage points more than in 1999-2000). State and local taxation is expected to fall

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 think Bob Carr is running advertisements which frankly are a waste of his taxpayers' money. He's basically saying that we're not all meant to sort of look after each other…[86]

The changes to Commonwealth-State financial relations involve some fundamental structural changes to State Budgets, and in recognition of this the Commonwealth Grants Commission was asked to calculate a new set of GST relativities which take into account these changes. Table 3.3 shows how the per capita distributions under the GST relativities differ from the amounts under the FAGs relativities. The first column shows the per capita distributions that would have occurred under the FAGs arrangements. The second column shows the distribution of the change in the size of the pool, which is on a close to per capita basis[87]. The third column shows changes in assessments of revenue needs, and the fourth column shows changes in assessments of expenditure needs. The fifth column shows the GST distribution.

The change in the size of the pool is distributed on an approximately per capita basis. This is important because it means that the reforms do not automatically, by increasing the size of the pool, proportionally increase the differences in per capita amounts between States. In fact the method chosen preserves the absolute differences in per capita amounts in spite of the increased pool.

However, the structural impacts on State Budgets are not confined to the size of the pool. The States also cease to receive Commonwealth revenue replacement payments (in respect of tobacco, petroleum and alcohol), and must make some adjustments to their gambling taxation, abolish bed taxes, etc. Because capacities in these tax fields vary, their abolition needs to be

[86] Howard, John (1998), 'Transcript of the Prime Minister the Hon John Howard MP radio interview with Alan Jones Radio 4BC', http://www.pm.gov.au/news/interviews/1998/4bc0611.htm. Premier Carr had launched a media campaign seeking a grant distribution basis which would be more favourable to his State, New South Wales.

[87] The deviations from per capita in the table apparently relate to application of historical data in relativity calculations and the treatment of 'interaction' terms in this decomposition. However, it is apparent that the amounts are very close to equal per capita for all jurisdictions except the Northern Territory, and even in that case the difference is not large.

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
FAGs and GST Distributions and Causes of Differences — Per Capita ($)

	FAGs distribution	Change in size of pool	Change in revenue assessments	Change in expenditure assessments	GST distribution
New South Wales	1,108	+327	-6	-8	1,421
Victoria	1,060	+327	-26	0	1,361
Queensland	1,250	+327	+16	-1	1,592
Western Australia	1,142	+327	+37	+31	1,538
South Australia	1,527	+328	-5	-1	1,849
Tasmania	2,010	+331	+35	-13	2,362
Australian Capital Territory	1,416	+328	-12	+8	1,740
Northern Territory	6,005	+348	+157	+1	6,510
Total	1,236	+327	-	-	1,563

Source: CGC (2000a, 2000b), SACES calculations.

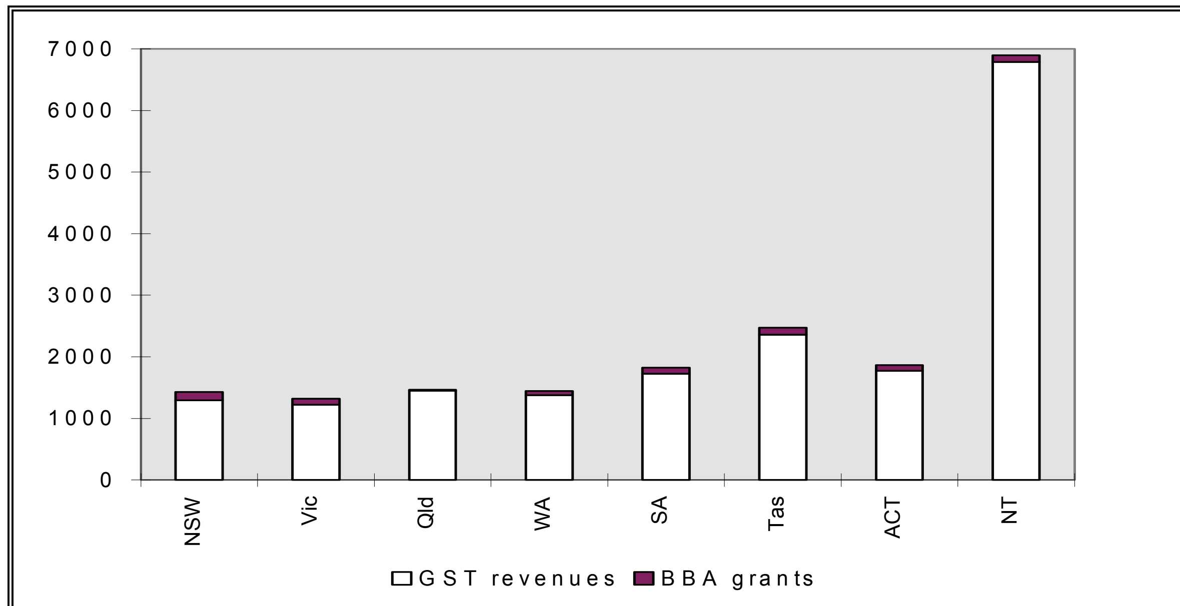
In fact, the GST relativities will not be the fundamental determinant of the grant distribution during a lengthy transition phase. The Commonwealth has provided guarantees that the States and Territories will not suffer any real diminution of revenues as a result of the new arrangements — the guarantee being expressed as a 'Guaranteed Minimum Amount'. Consequently some 'Budget Balancing Assistance' payments (BBAs) will be made to bridge the gap between the amounts which would have been payable under the old system and the amounts that are payable under the new GST distribution. It is estimated that BBAs will be required at least until 2007-08 (which is as far as the officially released forward estimates go). However, they do not dramatically change the distribution from that implied in the GST relativities.

The Guaranteed Minimum Amounts are based on estimates of what FAGs payments the States would have received under the old system, with various adjustments to take account of tax reforms. Because the FAGs payments are also determined on a fiscal equalisation basis, there is a strong element of fiscal equalisation present in the Guaranteed Minimum Amounts.

Estimates provided to the 2001 Ministerial Council were that GST revenues for 2001-02 would be $28,029.2 million, while the Guaranteed Minimum Amount would be $29,805.0 million.

Figure 3.3 shows, for 2001-02, the per capita distribution of GST revenues, BBAs and the Guaranteed Minimum Amounts (which in 2001-02 are the sum of the two). It is apparent that although the BBAs do have some impact on final general revenue assistance outcomes, the fiscal equalisation distribution which is intrinsic to the GST revenue distribution is broadly preserved.

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



Source: Commonwealth Treasurer (2001).

3.8.2 Fiscal equalisation

The central element of Commonwealth-State relations at present is the *Inter-governmental Agreement on the Reform of Commonwealth-State Financial Relations,* which commits the Commonwealth to distribute GST revenues between the States according to fiscal equalisation principles, subject to transitional guarantees. In its *State Revenue Sharing Relativities 2001 Update* the Commission has prepared grant relativities on this basis.

The Commonwealth Grants Commission implements the fiscal equalisation principle by the so-called direct method. It collects data from the States and Territories about their actual revenues and expenditures to derive nationwide averages. In then assesses relative abilities and needs against these national averages on the basis of statistical evidence and judgement. Most specific purpose payments are treated by inclusion, and are thus netted out. Capital expenditures are out of scope in a direct sense, but are accounted for de facto by interest charges and depreciation assessments. It follows from this method that the Commission does not consider the State's actual budget results; the implication is that, after equalisation of revenue and expenditure capacities, any differences in budget outcomes reflect policy choices.

Recently New South Wales and Victoria have collaborated to criticise fiscal equalisation arrangements. The focus of the campaign has been on Queensland, which has attracted particular attention because it is assessed as having a need over and above its per capita share, in spite of its relatively fast economic and population growth.

In spite of these views, the meeting of the 2001 Ministerial Council for Commonwealth-State Financial Relations left the existing arrangements in place. The Commonwealth Treasurer, Peter Costello, commented shortly before the meeting that:

> 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 a full equalisation basis as far as possible.

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88 Costello, Peter (2001).

89 Macdonald, the Hon Ian (2000), in letter to President of the Local Government Association of the Northern Territory. Cited by Warren Snowdon MP, House of Representatives, Hansard, 1 June 2000.

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Chapter Four

The Future of Federal Financial Arrangements in Australia

4.1 Introduction

The previous two Chapters have documented the changes since Federation to Australia's grant sharing arrangements, and the intellectual and political forces behind those changes. Now, at the Centenary of Federation, Australia can reasonably be characterised as a mature federation, in the sense that the rules of the Federation are fairly well established through the emergence of conventions, case law and political balances. However, the wide degree of latitude that the founders of the Federation left to subsequent generations still allows a significant degree of political choice in the detailed implementation of federal arrangements.

The purpose of this chapter is to consider how Australia's federal financial relations might evolve in the future.

Section 4.2 considers issues in the vertical structure of Australia's federal financial arrangements. A particular issue is the dominance of the Commonwealth Government in the taxation field, and associated with that large funding grants to the States to enable the States to fulfil their substantial spending obligations. The reliance of the States on untied Commonwealth grants has been said, in recent Australian debate, to constitute a major structural flaw in the federal financial arrangements. In fact, economic analysis provides little support for that view. A more significant problem is the States' inability *at the margin* to access, and vary effort levels on, broad based taxes. This could be addressed by allowing States access to the personal income tax field.

Section 4.3 reviews the horizontal structure of Australia's fiscal arrangements, and in particular Australia's practice of a fairly comprehensive system of fiscal capacity equalisation. It is found that the economics literature of the past five decades provides a strong case for equalisation. This then raises a question as to whether Australia's system of fiscal capacity equalisation corresponds with the type of equalisation that is supported in the literature, and the answer given is that broadly speaking it does.

4.2 Vertical issues: the allocation of fiscal roles between the Commonwealth and State tiers of government

4.2.1 Introduction

Establishment of a federal system requires some allocation of spending and revenue powers between federal and state governments. There is therefore a debate to be had about where should lie those powers. There is no reason to believe that the outcome reached will be one in which revenue capacities at each level of government will meet the spending needs of each level of government, and in that case a system of intergovernmental grants may be a central feature of the federal financial system. To the extent that grants from one level of government to another are required to offset imbalances in the allocation of spending responsibilities and revenue powers, a situation of 'vertical fiscal imbalance' is said to exist.

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 debt charges) since Federation. It is apparent that, with the introduction of the GST, the level of general revenue grants is at a relatively high historic level, while the High Court's interpretations of the Constitutional preclusion on state excises, and the abolition of some State taxes under the *ANTS* reforms, leave the States with the most limited tax powers since Federation. It seems reasonable to conclude that vertical fiscal imbalance is near to, if not at, an all-time high.

New South Wales Treasury (1997) says of Australia's vertical fiscal imbalance:

> Most commentators see VFI as the root cause of the problems in Commonwealth-State financial relations including duplication/overlap, ineffective service delivery, confused accountability, the growth in specific purpose payments and the dysfunctional interaction between Commonwealth and State Governments.

The next sub-section considers, in conceptual terms, the consequences of an imbalance between spending and revenue powers. It finds that there is little conceptual support and dubious empirical support for the view that vertical fiscal imbalance is a problem. However, problems may arise when states are forced to rely on inefficient tax bases. The sub-section after that considers the implications for Australia's federal system.

4.2.2 Theory

4.2.2.1 Devolution and efficiency

A key feature of a federal system is that there are at least two levels of government. Thus there is a lower tier of governments, with each lower tier government having essentially the same range of powers and responsibilities, but each operating in a distinct geographic area. There is of course some risk of duplication and overlap, both between the lower tier governments themselves and between the lower and higher tier of government. So why not simply have one centralised government and avoid costs of overlap, duplication, etc? Oates (1999) describes the rationale for fiscal devolution in the following terms:

> Decentralised levels of government have their raison d'etre in the provision of goods and services whose consumption is limited to their own jurisdictions. By tailoring outputs of such goods and services to the particular preferences and circumstances of their constituencies, decentralised provision increases economic welfare above that which results from the more uniform levels of such services that are likely under national provision. The basic point here is simply that the efficient level of output of a 'local' public good (i.e. that for which the sum of residents' marginal benefits equals marginal cost) is likely to vary across jurisdictions as a result of both differences in

> 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 tier of government. However, decisions about management of a river catchment are unlikely to be very efficient if made by a number of separate governments with coverage 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.

migrations between states could be checked by non-fiscal factors (e.g., barriers to migration), but that *'as such restrictions are introduced we leave the spirit of the unitary model and move to the other extreme of non-cooperating sovereign jurisdictions'*. (p. 455)

Pauly (1973) constructs a case for devolution of distributive decisions on the basis that individuals have different preferences for giving via redistributive processes, and that individuals with like redistributive preferences may group together in jurisdictions which best match their distributive preferences.[91] To the extent that redistribution is a 'local' public good – i.e. people care only about the pattern of redistribution in their own jurisdictions – decentralised distributive decisions allow differentiation of distributive schemes in accordance with those local preferences. However, devolved distributive decisions still involve inefficient migrations by recipients of distributive transfers. And, to the extent that the geographic coverage of a jurisdiction varies from the geographic area over which an individual has distributive preferences, another source of inefficient migrations arises.

4.2.2.2 The 'flypaper' effect

Federal systems often involve transfers of funds from one level of government to another, typically from higher to lower levels of government. When funds are transferred on an unconditional basis, they have little or no influence on the price of public and private goods, but have the effect of boosting incomes in the recipient jurisdiction. Theory would suggest that, in the absence of any fiscal illusion or other systemic failure, residents should treat the rise in income via higher grants in the same way as any other increase in income.[92] In fact, there are empirical studies which find the contrary. Rosen (1999) says that:

> A considerable amount of econometric work has been done on the determinants of local public spending … Contrary to what one might expect, virtually all studies conclude that a dollar received by the community in the form of a grant results in *greater* public spending than a dollar increase in community income. Roughly speaking, the estimates suggest that a dollar received as a grant generates 40 cents of public spending while an additional dollar of private income increases public spending by only 10 cents. (p. 502)

This phenomenon is known as the 'flypaper effect'. A possible explanation is that there is fiscal illusion, in the sense that taxpayers demand less for grant moneys than they do for taxes imposed on them directly. To the extent that this fiscal illusion drives the outcome, a 'flypaper effect' is said to exist. However, there are other explanations for the empirical data.

First, there is a tendency to regard grants from central to regional governments as exogenous, and to consider changes in government spending as a direct consequence. However, given that these grants are (at least if aggregated across regions) funded by corresponding taxes, it may be more realistic to regard them as a product of decisions through the political process

[91] Pauly's work is in the vein of Hochman and Rodgers (1969) who, by introducing the incomes of other individuals to an individual's preference function ('utility interdependence'), introduce the possibility of 'pareto optimal redistribution'. This redistribution could be carried out voluntarily, but because it is a public good (non-rival, non-excludable) under-provision will result. Therefore a case exists for governmental redistribution as a 'public good'. In the absence of distributive elements in the preference function, no redistributive scheme can be pareto superior to another because changed redistributions leave at least one party worse off.

[92] Formally, theory would suggest that the income elasticities of private and public goods would be the same regardless of the way in which the rise in income occurs.

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 out that corporate investment activity has also been linked to internally generated earnings, which is akin to a flypaper effect in the corporate sector – the phenomenon is not unique to the public sector.

In fact the strongest objections to the fiscal illusion, or failed public choice, explanations of a flypaper effect are at a conceptual level. Brennan and Pincus (1998) raise two powerful criticisms.

First, if a deficiency of revenue raising responsibility creates profligacy at the state level, should not the excess of revenue raising responsibility at the federal level have the opposite effect? Large funding transfers from federal to state government can only be explained if voters are free of the sorts of fiscal illusion which are said to lie behind the flypaper effect – otherwise a federal political party could enhance its electoral prospects by reducing transfers.

Secondly, vertical fiscal imbalance means that *on average* states do not raise the full amount of every dollar that they spend. But *at the margin* they must raise their own revenues to fund spending programmes, and as such face a situation in which they must raise every additional dollar that they choose to spend. That is to say, the marginal cost of a dollar of spending is a dollar of revenue effort. So long as states raise some revenues of their own, the incentives facing State decision makers are not obviously distorted by the existence of vertical fiscal imbalance.

In summary, even when flypaper effects can be empirically identified, there are difficulties in determining whether or not their causes are malign (in the sense of a failed public choice mechanism) or not. However, there are strong arguments against their existence, including that the political dimension of marginal funding decisions is that a dollar must be raised for a dollar spent. Therefore the view that a high level of unconditional grants – 'vertical fiscal imbalance' – necessarily causes a failure of public choice mechanisms is difficult to support as a general proposition.

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. They also include less visible deadweight losses associated with distortions to patterns of economic activity, these deadweight losses arising from tax-induced distortions to relative prices.[93]

In fact there is often a reluctance to have simultaneous occupancy of a tax base by different levels of government. As a consequence, one or other level of government may be forced to raise revenue by means of an inferior tax base. The end result will be a sub-optimal set of taxes within a federation.

The problem can be addressed by means of inter-governmental grants, or by simultaneous occupation of efficient tax bases. Dual occupancy of efficient tax bases, with coordinated tax arrangements, is potentially more efficient than having one or both levels of government rely on inefficient tax bases. This is especially so when one allows for the fact that tax bases which at face value are distinct may in fact have a high degree of overlap in reality. Tax bases employed by different levels of government may differ in terms of initial incidence and legal definition, but the differences in terms of ultimate incidence are generally smaller. A tax on financial transactions, for instance, is like a value added tax applied at a differential rate to financial services providers. A payroll tax is like a tax on incomes of employees (but applied in a discriminatory way in the case where a payroll threshold is in place).

4.2.3 Analysis of Australian issues

The level of Commonwealth grants to State governments in Australia is high in comparison to the practice in other federations. This is sometimes interpreted as meaning that Australia has a centralist system, but it is arguable that other factors, such as the allocation of spending powers between national and sub-national governments, are more meaningful. A unitary state, for instance, has no vertical fiscal imbalance but is highly centralised. Australia has a greater degree of fiscal centralisation than some other federations, but is less centralist than unitary states. The degree of fiscal centralisation in Australia, far from being extreme, lies somewhere in the middle of the continuum of possible governmental arrangements.

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93 These distortions relate to 'allocative inefficiencies' which are induced by the tax system. 'Allocative inefficiencies' are inefficiencies which arise when patterns of consumption (and thus production), and choices of input mixes for production, are changed in response to prices which are not reflective of underlying resource costs. Inefficiency arises because the failure of price signals to reflect costs means that consumers' and producers' choices are not based on opportunity costs, and consequently sub-optimal consumption bundles will be chosen by consumers and sub-optimal input mixes will be chosen by producers. For this to happen there must be 'substitutability' between some commodities in the optimal consumption or input bundles, and the greater the degree of substitutability the greater the extent of substitution that occurs and consequently the greater the efficiency loss. Narrow based taxes may induce greater allocative inefficiencies per dollar of revenue because they discriminate between substitutes to a greater extent than broad based taxes. Higher wholesale tax rates for utilities than station wagons, for instance, would cause some substitution of utilities for station wagons, a distortion that does not arise when the two are subject to equal tax rates as under a goods and services tax. (In fact, in the absence of complete coverage of all 'commodities' – including leisure and household non-market production, Ramsay principles would suggest the use of differentiated tax rates according to demand elasticities for different commodities, but this then requires that those elasticities be known. Given the inevitable uncertainties, such an approach would create incentives for rent-seeking behaviour, and this is probably why it is generally avoided in practice.)

Furthermore, the degree of devolution which is implicit in the Australian structure needs to be understood in terms of two different types of grants: specific purpose payments, which involve national level spending decisions financed by national taxes, and general purpose payments which involve state level spending decisions financed by national taxes. General purpose payments clearly have a more decentralist character than do specific purpose payments. Vertical fiscal imbalance may in fact be symptomatic of the devolution of spending decisions to sub-national governments, with the devolution supported by unconditional grants. A policy to reduce vertical fiscal imbalance by centralising spending decisions would have a centralist character, even though it would diminish the imbalance.

Recent reforms to Australia's federal financial structure as a result of the *A New Tax System (ANTS)* package are best understood as incidental outcomes of a reform process which was primarily motivated by the desire to replace a range of 'bad' taxes with a 'good' tax. The reforms were driven primarily by the twin objectives of linking government revenues to a tax base growing in proportion with the economy (rather than shrinking as with the wholesale sales tax) and improving the Australian tax mix (viewed collectively, across governments) in line with 'optimal taxation' considerations. Aside from reductions in income taxes, the goods and services tax (GST) allows for the abolition of wholesale sales tax and reductions in a range of transaction based State taxes, these taxes being arguably more costly than GST in terms of the allocative inefficiencies that they induce. The optimal taxation literature tends to de-emphasise the issue of which level of government imposes taxes, and focuses instead on the relative merits of alternative tax mechanisms. Those taxes which involve least costs in terms of distorted allocative outcomes and compliance costs are then, prima facie, to be preferred. It is thinking along these lines that has led recent fiscal reforms in Australia.[94] Replacement of narrow based taxes with broad based taxes had been recommended by the Asprey Committee as long ago as the 1970s (see Taxation Review Committee 1975).

The *ANTS* reforms increase the degree of vertical fiscal imbalance in Australia. This is because the GST is a Commonwealth tax, notwithstanding attempts by the Commonwealth to represent it as a State tax.[95] A part of its proceeds is used to make grants which replace State taxes, and as such the degree of vertical fiscal imbalance is increased. There is thus an apparent acceptance of a move towards a federation based on centralised tax collections and substantial devolution of spending choices to the States.

Although vertical fiscal imbalance has often been criticised, it has not been demonstrated from a national interest point of view that a pressing problem exists. The States do conduct substantial revenue raising in their own right. This means that although *on average* the States do not raise the full amount of every dollar that they spend, *at the margin* they must raise their own revenues to fund their own discretionary spending programmes. That is to say, the marginal cost of a dollar of spending is a dollar of revenue effort. The incentives facing State

[94] Changes to the federal financial arrangements have been given emphasis in ANTS but its arguable that these aspects are more in the nature of 'window dressing', which enabled the Government to sell GST, than a primary objective. Hypothecating the GST to the States, and the Commonwealth's declared policy of requiring unanimous agreement of the Commonwealth and the States for any changes in the GST rate, helped to reassure the electorate that the GST rate would not easily be changed.

[95] For instance the decision to exclude it from revenue tables in its 2000-01 Budget – see Covick (2000).

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 lent support by casual observation: the most vocal critics have been State Governments, while those with the power to rectify the situation – Commonwealth Governments – have elected not to do so.

This is not to say that a lower level of vertical fiscal imbalance is undesirable, only that there is not a compelling case for it.

A more evident problem is the States' continued lack of access to broad tax bases of their own. At present there is a constitutional preclusion to the States imposing consumption taxes, which is unfortunate because consumption taxes are probably at least as good as income taxes for the States to access. But a feasible alternative is to allow States access to income taxes — presumably access to the personal income tax base without capacity to vary the progressivity of the structure. As described in Chapter 3, an initiative along these lines was introduced by the Fraser Government, but in a rather half-hearted way, and it was subsequently repealed by the Hawke Government. Subsequently, upon unanimous representations from the States, Hawke considered reintroducing such an arrangement in the 1991, but was forced to abandon the idea when it became apparent he did not have support for it.

Even with a change of government in 1996, a return of income tax powers to the States has not re-gained impetus. The focus of the Howard Government's reform efforts has been on diminishing the States' reliance on tax bases that arguably are narrow and distorting, with the shortfall made up by Commonwealth grants. However, this process has not been taken as far as it might; if the States were allowed to have some presence in the income tax field – constrained to a common base definition and prevented from interfering with the progressivity of the income tax[97] – they would then be able to substitute income taxes for narrow based taxes and improve the tax mix at a national level. The presence need only be at the margin, and might not involve any large change in the existing statistical indicators of vertical fiscal imbalance.

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96 A possible qualification is that the narrow based nature of State tax bases makes it difficult for the States to reach the same groups of taxpayers as could be reached with changes in broad based taxes such as income tax or GST. However, payroll taxes and motor vehicle taxes still have significant breadth, and might achieve the desired result to a reasonable approximation. To the extent that the qualification does hold, it could be remedied by a State presence *at the margin* in a broad based tax or taxes – it does not require elimination of vertical fiscal imbalance.

97 How this would be done is unresolved. Consideration would need to be given to the potential distributive consequences of State actions in the personal income tax field. Variations in the income tax rate affect high income owners much more than low income earners, while associated variations in spending are probably distributed per capita or even in inverse relation to income. If these impacts were significant, there would be a case for structuring the States' involvement in such a way as to have smaller distributive consequences.

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.

[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 buyers and producers, who may in turn pass it on to their customers and suppliers.

Secondly, some attribution of the costs associated with public goods needs to made. The desirable attribution scheme is to use the individuals' own valuations, which would need to be measured.

Thirdly, a decision needs to be made in respect of some government services about whether to attribute costs on the basis of the notional cost of fair value insurance premiums or the cost of actual services used. For instance, it would probably be more realistic to allocate costs of a fire service as a fair value premium rather than the costs of actual services rendered in any one year. The fair value stipulation would imply, however, that likely variations in costs relating to 'high risk' and 'low risk' areas would be reflected in the premia entered into the net fiscal benefit calculation.

In fact, the discussion that follows is not primarily concerned with how to quantify net fiscal benefits. Instead, the net fiscal benefit is introduced because it allows an assessment of the redistributive impact of government activity. This in turn allows the use of conceptual models

[99] For example, taxi plate arrangements enforce transfers from users of taxi services to taxi plate owners.

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 distributive justice. For instance:

- Gambling taxes vary according to how much one spends on gambling. Individuals who gamble more pay higher amounts of tax than individuals who gamble less, and there is no reason to believe that they receive commensurately higher benefits in the form of government expenditures; accordingly the net fiscal benefit amounts of gamblers are potentially lower than the net fiscal benefit amounts of non-gamblers.
- Governments provide schooling services to households with children, but spread the costs across the community: households with children gain a net fiscal benefit while households without children have a negative net fiscal benefit.

The aggregate distributive impact of the fiscal system is thus the cumulative result of a large number of separate revenue and spending policies. Each of these policies has a net fiscal benefit associated with it (which will be zero in the case of the non-affected individual), and in concept these can be summed to produce an aggregate net fiscal benefit for the individual.

[100] The terms of the trade-off (the 'relative prices') may – and frequently will – be changed by government policies. For services provided from general revenue, there may be no capacity for an individual to vary consumption. The alteration to the trade-off in this case is of an extreme form, with the price asymmetric around the actual consumption level (zero in one direction, positive or even infinite in the other).

Distributive outcomes in a federation

In an important but often neglected 1952 paper – 'Federalism and Fiscal Equity' – James Buchanan[101] explored the distribution of net fiscal benefits in a federation. Buchanan noted that in a federation there are at least two levels of government, so that the net fiscal benefit[102] to a mobile resource owner comprises a net fiscal benefit from the national government and a net fiscal benefit from the state government of the region that the resource locates in. Where state governments pursue essentially similar distributive policies but have different population structures, then net fiscal benefits will differ from state to state.

A range of other papers produced since then examine the causes and consequences of interstate differences in net fiscal benefits. Flatters, Henderson and Mieszkowski (1974) consider the issue in a Ricardian diminishing marginal returns framework, and a prominent paper by Boadway and Flatters (1982) applies a similar model to a broader range of fiscal effects in a federation. More recent extensions are in Petchey (1995 and 2000) and Bucovetsky (1997). The issue is also summarised in an accessible way in Courchene (1984) and Petchey and Walsh (1993).

A consequence of interstate differences in net fiscal benefits is that even if the national government applies the same national-level net fiscal benefit to a resource owner regardless of where the resource locates, differences in the state-level net fiscal benefit from one jurisdiction to another will have the effect of making net fiscal benefits vary from state to state. (Because jurisdictions tend to have a geographic basis, the net fiscal benefit variations will have a locational basis too.) Although some of these differences might reflect different policy choices at the state level, it also turns out that differences will almost certainly arise even when states pursue essentially the same distributive policies. These accidental differences in net fiscal benefits from state to state may arise for a variety of reasons. The commonly acknowledged possibilities in the literature are:

- differences in demographic structure coupled with state redistributive policies;
- differences in sub-national governments' claims on rents from natural resources and endowments; and
- differences in the cost of public good[103] provision.

Box 4.1 provides an example of each.

A potential conflict arises in a federal system because national and sub-national governments might pursue different distributive policies, and might even expend efforts in counteracting each other's policies. Such a situation, should it arise, would appear to be highly undesirable – especially to the extent that there are costs of operating the distributive systems. However, when different levels of government operate their own redistributive policies in a mutually compatible or even reinforcing way, this conflict need not arise.

[101] Buchanan was awarded the Nobel Prize in Economics in 1986 for his pioneering work in the field of public choice.

[102] Buchanan emphasised the deficiencies of an analysis which considered only tax impacts without addressing benefits via government expenditure. He used the term 'fiscal residua' but I shall stick with the contemporary usage which is 'net fiscal benefit'.

[103] A public good is a good or service which provides to a group of individuals benefits that are non-rival (i.e. consumption of the public good by one individual does not decrease the amount available for another individual to consume) and non-excludable (i.e. once the public good is in existence it is not possible to prevent an individual enjoying the benefits of it).

Box 4.1
Causes of interjurisdictional variations in net fiscal benefits

Differences in demographic structure under redistributive policies

Suppose there are two States, A and B. State A has 1 retiree and 2 workers. State B has 2 retirees and 1 worker. Each worker earns $10, which equals the marginal product of labour — marginal products are equalised across the States. Each State provides residents with $2 in transfer payments. Transfer payments are financed from taxes on workers.

That being so, State A must raise $6 in taxes from 2 workers, implying a tax of $3 per capita, a net fiscal benefit of -$1 and comprehensive income of $9 each. State B must raise $6 in tax from 1 worker, implying a tax of $6 per worker, a net fiscal benefit of -$4 and comprehensive income of $6.

In this scenario there clearly is an incentive for the worker to migrate from State B to State A. However, this arises not because of higher productivity in State A, but from an attempt to avoid the higher fiscal burden in State B. Indeed the worker from State B would accept lower wages and a less productive use in State A. Note that this result does not require that State B pursue more generous social policies than State A.

Differences in State government claims on natural resources and endowments

Consider again a simple model with two States A and B. Assume as well that each State has mineral resources yielding $6 per annum in government revenues which is distributed to citizens on a per capita basis; there is no redistribution between citizens. State A has 2 workers earning $10. So, too, does State B. The per capita net fiscal benefit in each State is $3 and per capita comprehensive income is $13. The fiscal system is neutral on location decisions.

Now there is a major oil discovery in State A worth $6 per annum in resource rent payments to the government of A, which is developed on a fly-in fly-out basis so that there is no change in the locations of residence of workers. Workers in State A now have a net fiscal benefit of $6, which is $3 higher than the net fiscal benefit in State B.

Consequently there is an incentive to migrate from State B to State A even if, in doing so, the productivity of the migrating worker falls.

Differences in the cost of public good provision

Continue again with a two State world. At the outset State A has 4 workers and State B has just 2. Workers earn $10 each so that marginal products of labour are equalised.

Now, due to a technological innovation, it becomes justifiable for government to produce a public good in both States. Suppose that governments in A and B each provide a pure local public good — a weather forecasting service, for instance — which costs $2 to provide. To finance this, taxes are set at $0.50 in State A and at $1 in State B, while benefits are the same per capita at $2 in each State. Then workers in State A enjoy a net fiscal benefit of $1.50, while workers in State B enjoy a net fiscal benefit of $1.

Again, there is an incentive to migrate from State B to State A. But even if a worker leaves State B for State A to accept a lower productivity deployment, there is no offsetting saving in the costs of public good provision. The migration decision is inefficient.

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, via a system of per capita national-level taxes and transfer payments operated at the personal level on a discriminatory basis from state to state. However, there often will be practical, political, legal and constitutional issues which render impracticable this approach.

An alternative is to have equalising payments to state governments, which receive or pay funds on behalf of their residents. In terms of its distributive impact, this alternative can produce an identical result to interpersonal equalisation, so long as the state governments distribute receipts and the burdens of payment accordingly. If they do not distribute receipts and imposts accordingly, the interpersonal equalisation objective will not be achieved.

Where a national level government makes grants to states, the national level government might actually embed the equalisation payments in its grants to state governments, avoiding the need for explicit transfers from one state to another.

As a practical matter, it should be noted that inter-governmental equalisation by itself might require payments to or by states. There would be payments to those states with below average fiscal capacity and payments from those states with above average fiscal capacity. However, if the national government provides operating grants to all governments quite apart from any equalisation adjustments, then any required payments from states can be netted off those grant amounts and payments to states added on to grants. So long as the intended grant amount for a state is at least as large as the equalisation payment required from it, there is no requirement for actual payments from one state to another; the equalisation scheme is embedded in the grants from the national government.

In addition, it is quite feasible that a set of equalisation transfers would include transfers to a jurisdiction with high private incomes — for instance if it had low levels of natural resources or had a relatively small population base across which to spread the costs of public goods. It is also quite feasible that equalisation payments would be required to a state with a strong growth rate. In fact the direction of necessary equalising payments cannot reliably be inferred from broad indicators such as average private income or growth rates, as other factors matter too.

Equalisation of this type is of a neutralising character. It makes it possible for like individuals to enjoy like fiscal treatment in the different states of a federation.

4.3.2.3 Equity

Horizontal and vertical equity

Before considering the equity implications of a federal structure it is worth reviewing a useful analytical framework. Economists tend to think of two types of equity — horizontal equity and vertical equity. 'Horizontal equity' pertains to the equal treatment of like individuals. 'Vertical equity' pertains to differential treatment of identifiably different individuals.

There is a major and long established body of work in the economics and philosophy literatures based on the comparison of and aggregation of individual utilities – the so-called ‘utilitarian’ view. This work is the product of a search for, inter alia, empirical foundations to guide distributive questions. If it could be implemented, the utilitarian calculus would allow an empirical determination of distributive equity. However, the utilitarian approach is in fact impossible to implement in any rigorous way because of the impossibility of objectively measuring and comparing individual utilities.

A more tractable approach is to regard matters of distributive equity as subject to individuals’ preferences, rather than amenable to scientific measurement. It is then a matter for individual judgement just what constitutes an equitable fiscal system, and it is certainly the case that different individuals will have different views. There is, therefore, no fiscal system which can meet every citizen’s view of equity. However, by means of the political process, some or other system of equity principles – horizontal and vertical – will be embodied in the fiscal system.

In practical operation, the application of equity concepts in fiscal systems relies largely on the use of observable information regarding people’s circumstances, and equity adjustments are typically applied in a layer by layer process. Liability for income tax is determined according to a measure of income, and horizontal equity is achieved by even application of the tax to individuals with like income circumstances. Liability for consumption taxes depends upon consumption patterns, and people with like consumption patterns are subject to the same tax burdens. Eligibility for social security transfers is determined according to factors such as income and numbers of dependents. Treatment in the public health system is provided on a non-charged basis, and this implies that the fair value insurance premia for those services are met from the fiscal system; as a consequence, the notional fiscal contribution to payments varies according to people’s risk characteristics. All of these elements of the fiscal system combine to implement a complex set of equity criteria.

If the fiscal system is constrained to balance, in the sense that the sum of net fiscal benefits across all individuals and fiscal instruments is constrained to be zero (or something else) then it follows that one net fiscal benefit amount cannot be set independently, in that it needs to perform the balancing role. If there is a requirement of horizontal equity, which requires that fiscal instruments treat like individuals equally, then one fiscal instrument is constrained, in the sense that it needs to be set in such a way as to meet the fiscal balance requirement.

As was illustrated previously (see Box 4.1), there is no reason to believe that like individuals who reside in different jurisdictions in a federation will, in the absence of equalisation, receive like distributive outcomes from the fiscal system. Consequently, there is no reason to believe that horizontal equity will prevail across jurisdictions in a federation.

Narrow-based and broad-based horizontal equity

Application of the concept of fiscal equity in a federation requires that individuals who are alike in every relevant respect should be treated equally by the tax/transfer system — i.e., that they should receive the same quanta of net fiscal benefits (positive or negative). To do this, it is necessary to identify the set of factors to be used to determine who are or are not ‘equals’. To the extent that there is a debate about which factors are admissible, then there will be a divergence of views as to what constitutes horizontal equity.

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, full fiscal equalisation could only ensure that the average horizontal inequity from State to State was zero, and at the individual level, some horizontal inequities would remain. The national level government would need to override those State distributive policies to achieve strict interpersonal equalisation (but it might not be able to do so).

Capitalisation

It is possible that some types of variations in fiscal capacities will have been capitalised into asset values for sufficiently long that they will have been reflected in the purchase prices paid by the current generation of asset owners. Where capitalisation of that type exists, horizontal equity precepts might be interpreted as supporting a maintenance of the status quo. Feldstein (1976) puts this view:

> In practice, tax **changes** are a source of horizontal inequity because individuals make commitments based on the existing tax law. Commitments involving human capital may be irreversible (e.g. education level) or reversible either very slowly or at a substantial loss (e.g. occupation or location). Commitments involving property may be easily reversed but the sale of assets will involve a capital loss. In both cases, individuals who were equally well off before the tax change are not equally well off after the change. (pp.95-96, emphasis added)

The Feldstein view is open to the criticism that it takes as a given that having differential impacts of tax reforms on like individuals is horizontally inequitable. It is a matter of fact that tax reforms may have unequal impacts, but the existence or otherwise of inequity requires an ethical judgement. There is a very wide array of governmental policy positions which are not guaranteed in perpetuity, and individuals can (and do) make their investment decisions (human capital or transferable property) according to their assessments of the prospects of policy changes. When the eventual policy outcomes differentially impact on individuals by virtue of their different portfolio choices, it is not clear that the result is inequitable. It could be argued that they are simply a result of voluntary positions taken in respect to an uncertain future environment. But fundamentally the Feldstein argument seems to rely on the presumption that individuals are entitled to assume that the tax system will remain unchanged in perpetuity. It also raises a question as to whether, if this is true for tax reform, it applies to all other government policy changes with unequal impacts. In fact it is hard to mount the case that there is even an implicit guarantee of no changes to the tax system.

However, leaving aside these concerns, the practical implication of an equity concept along these lines would be that a federation without fiscal equalisation should continue without it. The implication for a federation with fiscal equalisation would be that it should be continued.

Is there a unique set of equalising transfers?

One of the potential causes of interstate horizontal inequity is the operation of within-state redistributive schemes by state governments, and equalising transfers can redress these horizontal inequities. It follows that the set of required equalising transfers depends upon the shape of the within-state redistributive schemes (along with population structures). In the extreme, and ignoring any transfers required on other grounds, if the state governments abandoned any redistribution, the need for equalising grants would fall to zero.

Mieszkowski and Musgrave (1996) present a worked example in which two different sets of equalising payments are implemented. Each set of payments achieves fiscal equalisation, but they have different consequences for within-state redistributive outcomes.

However, it is unsatisfactory to regard the nature of within-state redistributive schemes as a matter of indifference for state governments and simply an accidental outcome – in reality they are politically sensitive. The Mieszkowski and Musgrave result, which achieves equalisation at alternative levels of within-state redistribution, is arithmetically valid but analytically inadequate in that it fails to take into account any subsequent response from state governments to reach an optimal redistributive scheme. It is more satisfactory to conceive of state governments as active in the setting of redistributive outcomes and, to the extent that the structure of equalisation payments interferes with the operation of state redistributive schemes, willing to respond to restore optimal redistributive outcomes.

Inter-government grants and equity

These distributive equity concepts are grounded in comparisons of the circumstances of individuals. The idea of the State in its own right being a candidate for equity is not the focus of argument. And indeed Buchanan (1950) explicitly rejects that approach:

> Equality in terms of States is difficult to comprehend, and it carries with it little ethical force for its policy implementation …

Instead he develops a concept of fiscal equity in a federal system, formulating the concept in the following terms:

> Any discussion of the operations of a fiscal system or systems upon different individuals or families must be centred around some concept of fiscal justice. And although fiscal justice in its all-inclusive sense is illusory and almost purely relevant to the particular social environment considered, there has been contained in all formulations the central tenet of equity in the sense of 'equal treatment for equals' or equal treatment for persons different in no relevant respect. This principle has been so widely recognised that it has not been expressly stated at all times, but rather implicitly assumed. Whether or not this principle is consistent with maximising 'social utility', it is essential as a guide to the operations of a liberal democratic state, stemming from the same base as the principle of the equality of individuals before the law.

4.3.2.4 Efficiency and the allocation of resources between states

Fiscal distortions and the case for equalisation

Fiscal equalisation is the practice of allocating financial resources to sub-national jurisdictions in such a way as to equalise their fiscal capacities. Several contemporary criticisms of fiscal equalisation characterise it as introducing an arbitrary distortion to location decisions, albeit possibly justified on equity grounds. However, this is a gross, and in fact quite mistaken, depiction of the effects of equalisation. A richer, more realistic model is required.

In the absence of fiscal equalisation, there will be differences from state to state in the net fiscal benefits to be received by a mobile resource owner, with these differences being quite separate from the private returns that the resource owner would receive from locating in one state or another. Yet a market based system relies on resource allocation decisions being guided by these market based 'signals'. Unless the invalid signal in the net fiscal benefits is neutralised, choices about which jurisdiction to locate in will be distorted. Fiscal equalisation performs this neutralising role.

Therefore for a federal government seeking to promote efficiency, the appropriate policy will be to offset inter-jurisdiction differences in net fiscal benefits. This will bring about a situation where any particular resource owner faces the same net fiscal benefit regardless of the jurisdiction that they choose to locate in (although different individuals may still receive different net fiscal benefits according to the redistributive objectives of state governments).

There is a line of argument — rather unconvincing — that fiscal distortions from one jurisdiction to another do not matter because they are capitalised into land values. Of course, if one accepted this view it would not rule out an allocation of grants determined by fiscal equalisation principles, but rather would lead to the conclusion that every interstate pattern of grants produced the same efficiency outcome and that it did not matter what allocation was

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] If the answer to this question is 'no' — as seems likely in most real world contexts — fiscal distortions do have efficiency consequences (see Appendix 4A for further discussion of distortions to location decisions and capitalisation.)

A solution to distortions induced by redistributive decisions?

It is sometimes argued that equalisation supports jurisdictions with relatively dependent population structures, and therefore (by assumption) encourages individuals to choose dependent status.[105] Fiscal equalisation, so the argument goes, is efficiency enhancing in terms of spreading the burden of dependent groups in a horizontally equitable and efficiency maximising way, but it may be inefficient in terms of creating a climate in which that dependency can grow.

Buchanan (1999) acknowledges this possibility in the Canadian context:

> It seems to me that there is an argument, and there might be an argument in Europe that will be forthcoming that you may want to have a set of equalizing grants in order to accomplish roughly some sort of equalization in fiscal capacities as among regions. Of course, many of my libertarian friends would object very strongly to that, but I think there is an argument against it and an argument for it. One argument against it can be illustrated with the example with Canada. Canada has had a set of these kind of equalizing grants for quite a long time, but the main beneficiaries of those grants have been the maritime provinces. The maritime provinces in Canada have come to be in a dependency status with vis-a-vis the rest of Canada. In a sense, over time that is a major objection to any sort of equalizing grant. Whether or not you want to put the full burden of adjustment on the mobility of your factors in this fiscal arrangement or federal arrangements is, I think, the critical question. (p. 179)[106]

So should governments eschew fiscal equalisation because, by so doing, they attack fiscal dependency? For one to answer in the affirmative, it would seem necessary to be satisfied that:

- states' distributive policies are in fact inefficient, which may be the case to the extent that they cause incidental changes in behaviour; and
- that the trade-off between inefficiency and equity objectives that the states make is inappropriate; but
- for some reason the problem cannot be remedied at source — i.e. by causing the states to abstain from excessive redistributive behaviour (e.g. by conditional grants); and
- that abolishing fiscal equalisation will act as an effective surrogate for direct action to diminish the extent of state government redistributive activity.

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[104] Where mobile populations are highly responsive to fiscal signals, then changes in fiscal signals may indeed have a large impact on land rents — i.e., capitalisation may occur to a substantial degree — while still causing significant distortions to jurisdiction choices.

[105] This is a persistent theme of submissions from New South Wales and Victoria to various inquiries into fiscal equalisation in Australia.

[106] The quote is from a transcript.

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 not to raise. It could also occur in a system based on assessments of revenue capacity and expenditure needs if a State could influence the assessments by varying its own policies. This might be the case if assessments were based on an average of states' spending policies, and a state had a large weight in the average.

To the extent that states engage in grant seeking behaviour by adjusting policies to maximise grants, 'grant design inefficiency' is said to exist. The scope for behaviour of this type is likely to be greatest for large states (they have more influence on the population weighted benchmarks) and for states whose populations are indifferent to tax and spending decisions by their state government, leaving it free to implement a fiscal structure which is grant maximising.

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 federation, such as inferior policy responses by States under severe fiscal stress (e.g., recourse to inefficient tax bases and beggar thy neighbour policy choices, or a recourse to excessive centralisation of governmental power when it becomes apparent that stressed member States are unable to deliver some minimum services to their populations).[108]

A 'federal' rationale can be contrasted to a 'nationhood' rationale which relates to a concept of some uniform minimum rights across a federation. Courchene (1984) describes it as the idea that:

> [citizens], wherever they live, ought to have access to certain basic economic and social rights — rights that ought to attend … citizenship. (p.89)

He goes on to make the point that the nationhood rationale lends support to a system of tied grants (as the fiscal transfers are meant to ensure provision of some fundamental services which are regarded as rights of citizens in the federation), whereas the federal rationale leads to provision of untied resources. He notes the presence of this idea in Canada's federalist thought at least as far back as the 1930s, when the Rowell Sirois Commission observed that:

> … no logical relationship exists between the local income of any province and the constitutional powers and responsibilities of the government of that province. (quoted in Courchene 1984 p. 87)

There are parallels between notions of minimum citizen rights and objectives of interpersonal equity. However, the proponents of federal solidarity argue for something more. Musgrave (1999) says that:

> Proponents of this approach [i.e. an interpersonal foundation as the only legitimate basis for equalisation] also overstate their case by claiming that it offers the only acceptable rationale for grants. Fiscal capacity equalization is rejected as based on an organic view of the state and therefore unacceptable on 'first principle.' Only individuals can have needs, as they argue, and not jurisdictions. This misinterprets fiscal capacity equalization. Needs, to be sure, are experienced by individuals, but — and this is the essence of the federalism problem — they are experienced by individuals in groups, that is, as citizens of particular member jurisdictions. As such, they represent the interests of their group, while as members of the federation they may seek to balance these interests in a federally equitable fashion. Failure to recognize this and the dual role of individuals misses what federalism is about. (Buchanan and Musgrave 1999 p. 169)

[108] Such an outcome is tantamount to fiscal equalisation with centralised control over spending decisions — in effect equalisation transfers still take place, but without the advantages of decentralised choices about the types of goods and services to provide and associated Tiebout-type competition.

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, support an arrangement which offers some right to continued existence for their jurisdiction under a large range of circumstances.[109] Of course, the participants in the contemporary debate do not start from a position of ignorance about what they will receive under alternative institutional arrangements. It is relatively clear (at least in the medium term) whether a particular State will be a net contributor or recipient from a system of fiscal transfers intended to preserve state viability. This must be an important consideration in any attempt to understand their views on equalisation.

The federal compact has a possible further implication for the choice between 'narrow based' and 'broad based' horizontal equity. If the terms of the federal compact provided for a well-off jurisdiction to reserve some net fiscal benefits for its constituents, then a 'narrow based' equity concept might be accepted. Certainly it is possible to conceive of states agreeing to federate on this basis.

4.3.3 Implications for Australia

4.3.3.1 Description of Australia's fiscal equalisation arrangements

Australia's interstate fiscal equalisation arrangements are conducted on principles of state government capacity equalisation for non-policy differences. The Commonwealth Grants Commission, which recommends equalisation relativities, produces equalisation factors on the basis of detailed assessments of expenditure needs and revenue capacity.[110] For instance, in its *2001 Update* report the Commission describes 'the principle of fiscal equalisation' as:

> State governments should receive funding from the Commonwealth such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard. (p.3)

And the assessments reject any equalisation of differences that arise from State Government choices — so-called 'policy' factors:

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[109] The case of local government gives an interesting counter example. Most individuals probably have little sense of tribal loyalty along local government boundaries. Indeed a central issue in many amalgamation debates has been the relative fiscal positions of amalgamating councils — i.e., an argument about the distribution of net fiscal benefits.

[110] There is debate at a detailed level about how the assessments are calculated, but the discussion here is confined to the broad design principles of grant arrangements.

> To the extent possible, the assessments are policy neutral — a State's policy decisions do not influence its grant. A common or average State policy on each function is derived from States' actual practices. Policies of an individual State are within the control of its government and are therefore not taken into account in determining its grant. (ibid. pp. 4-5)

Furthermore, the holistic approach to assessments of needs and resources ensures that the equalisation payments encompass virtually the whole range of each State's fiscal needs and resources. When a specific purpose payment diminishes the need for a particular State expenditure, the Grants Commission processes can accommodate this by allowing for the specific purpose payment, and in fact the overwhelming majority of specific purpose payments are treated by 'inclusion'. Thus, although equalisation is delivered by means of general purpose funding, it equalises across the State budget more broadly.

4.3.3.2 Do the Grants Commission's assessments correspond with the type of equalisation supported in the literature?

An important question is whether or not the type of equalisation practised by the Grants Commission is the same as the type of equalisation described in the literature. The answer to this question is 'yes', with one important qualification.

But before turning to that qualification, some clarification is desirable. The two types of equalisation sound rather different. The Grants Commission equalises State governments' fiscal capacities based on assessments of actual State Government revenue and spending policies. The Buchanan-type arguments in the literature, on the other hand, are concerned with equalisation, via State Governments, of net fiscal benefits for like individuals from one jurisdiction to another — a process that would seem to require assessments of individuals. In fact, this distinction is misleading, as the two assessments are different paths to the same end point. Arithmetically they are equivalent. The interested reader is referred to Appendix 4C for further consideration of this.

One important feature of the Australian arrangements is that the comprehensive nature of the budget assessments captures a net fiscal benefit concept in a way that partial equalisation — e.g. revenue only, or limited spending categories — never could. Shah (1994) argues strongly that fiscal equalisation needs to encompass the expenditure side of the budget as well as the revenue side. He says that *'... economic theory suggests that an equalization program should attempt to equalize net fiscal benefits across provinces. A pure revenue equalization system alone is not likely to accomplish such an objective ...'* (p.7). In this sense the Australian system is closer to the theoretic ideal for horizontal funding allocations than any other federation, although presumably no closer than many unitary states which conduct equalisation automatically through the operation of common spending and revenue policies by national government.

The really important distinction between the Grants Commission's equalisation principle and that in the literature is that the Grants Commission effectively excludes net fiscal benefit variations which arise from 'policy' choices by State Governments. This is most important in respect of major past policy choices, whether deliberate or not, with accumulated consequences (e.g. losses made by State financial institutions); to the extent that these vary

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.

The exclusion of local government budgets from interstate fiscal equalisation arrangements is a clear anomaly in the application of the fiscal equalisation principle. However, the local government budget is small relative to the States' budgets.[112]

4.3.3.6 Are the Grants Commission's recommendations aimed purely at horizontal equity?

In the main, the Grants Commission's equalisation recommendations do not have a vertically redistributive intent. They involve the Commission inferring an average of the States' vertical distributive policies by observation of those policies, and then implementing a horizontally equitable allocation of funds given that average redistributive policy.

The main qualification — in the scheme of things a minor qualification — to this characterisation arises in the context of the Northern Territory. It is difficult to find sub-populations which are 'like' those in the Northern Territory in the other States. Hence the Commission implicitly has to make assumptions about what the States' policies would be if they did have such sub-populations — for instance in the hypothetical case that the Territory were merged with another State. The option of asking the States directly is not feasible, as their answers would be strategically tainted. In effect the Commission is left guessing at a distributive policy to encompass this outlier. It is only in this sense that the Commission enters into the field of judgements about what fiscal treatment particular sub-groups of the community should receive.

It follows that intervention in what the Commission does can only in a very narrow sense affect the degree of distributive activity that the States engage in. The Commonwealth could direct the Commission to change its approach to assessing the Northern Territory, and lower grants to the Territory might induce some movement from the universally high cost Territory locations to lower cost interstate locations. However, for some communities — e.g. remote area Aboriginal communities — the notion that changes to fiscal equalisation would induce people to change from a fiscally dependent remote area lifestyle to a high private income, fiscally self-sufficient, urban lifestyle is clearly far-fetched.

None of the other States is an outlier in the way that the Territory is, and consequently the Grants Commission is able to infer distributive policies by observation of revenue and spending policies; it does not determine the States' own choices about what distributive policies to implement. If the Commonwealth is concerned that the States' redistributive policies entail excessive sacrifices of efficiency, the well-targeted policy response is to override those State distributive decisions — not to curtail fiscal equalisation. To attack the alleged problem by removing or constraining the equalisation arrangements involves the introduction of new inefficiencies which need to be set against any reduction in existing inefficiencies. Similarly, if the States' own redistributive decisions are deemed in some respect to be inadequate — for instance in terms of providing support to rural and regional Australia — intervention in the Commission's capacity/needs assessments is not an effective corrective mechanism. Those vertical distributive decisions are a matter for governments — whether Commonwealth, State or local — and are implemented by tax/transfer decisions within their own jurisdictions, not by fiddling with the interstate allocation of grants.

[112] In 1999-2000 net expenses (excluding grants) of the combined State total public sectors totalled $109.2 billion, compared with $14.8 billion for local government (see Australian Bureau of Statistics 2000).

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 capacity to an 'ability to pay' measure such as income tax. For instance Collins (2000) says:

> [The Commission's] concept of fiscal equalisation is more concerned with the revenue-raising capacities of State governments than with the ability of State taxpayers to pay tax. This raises fundamental questions about what should be an objective of fiscal equalisation — inter-state equity among taxpayers or the revenue raising convenience of State governments.
>
> It can surely be strongly argued that inter-State equity between individuals (or at least provision of the ability to achieve such equity) is the fundamental purpose of equalisation. (p.49)

And it is suggested that, instead, global measures may be more appropriate.

Collins's final sentiments actually emphasise the goal of interstate equity between individuals. However, the reform that he proposes — adoption of a 'global measure' is at odds with the equity goal.

To illustrate, consider the hypothetical case of two states with identical 'global' measures of tax capacity (e.g. gross state product or household income). Assume they are also identical in their expenditure needs and set taxes accordingly. Then assume that one state has extensive mineral endowments, and hence access to mining royalties, while the other has small mineral endowments and access to royalties, and both states set royalties at the same rate. If national grants to the two states were made according to global measures then each would receive the same grants, but the mineral rich state could reduce other taxes to lower levels than the mineral poor state. Any given individual would face a lower tax rate in the mineral rich state than in the mineral poor state. This would contradict the principle of interstate equity between individuals, although the global measure would be employed.

In similar vein, and again assuming two states with identical 'global' measures of tax capacity (e.g. gross state product or household income)and expenditure needs, assume that one state has a higher proportion of smokers, and both states set tobacco taxes at the same rate. If national grants to the two states were made according to global measures then each would receive the same grants, but the state with the higher proportion of smokers could reduce other taxes (levied on both smokers and non-smokers) to lower levels than the state with a low proportion of smokers. Any given individual would face a lower tax rate in the 'high smoking' state than in the 'low smoking' state. Again, this would contradict the principle of interstate equity between individuals, although the global measure would be employed.

To the extent that smoking or not smoking is uncorrelated with capacity to pay, then it is the state tax systems which deviate from the capacity to pay principle – not the fiscal equalisation process.

And in fact the examples highlight a more fundamental issue. If one argues that a global measure — such as gross product or household income — is an appropriate measure of capacity to pay at the whole of State level, then should it also not be appropriate at the individual level? Yet State legislatures, by their actions, appear to reject such a simplistic assessment of capacity to pay and choose other benchmarks. A true measure of capacity to pay would need to take into account the implied capacities to pay that lie behind the States' actual revenue policies. Yet this is exactly what the Commission prepares — by considering all the States' revenue policies and underlying bases, it comes up with a measure of capacity to pay which relates to the tax policies actually used by the States. Use of this approach actually improves the degree of, or at least the potential for, interpersonal equity over what could be achieved with a less realistic indicator such as a global measure.

4.3.3.8 The organic rationale in Australian political debate

Organic arguments for equalisation are commonly heard in the Australian debate. The Heads of Treasuries' Working Party (1994) was unable to reach agreement on the efficiency consequences of fiscal equalisation, with the division occurring along State interests lines. In considering the hypothetical case in which fiscal equalisation was *presumed* to be inefficient, it still found organic arguments supportive of equalisation:

> if it is thought that there are efficiency costs associated with fiscal equalisation, there is nevertheless a case for above per capita payments to be continued for South Australia, Tasmania and the Northern Territory, but not for Queensland and Western Australia. This is because the budgetary positions and longer term economic growth prospects of South Australia, Tasmania and the Northern Territory would make it difficult for them to maintain an adequate level of services in the absence of grants of the magnitude currently provided. In addition, the protection of the fiscal interests of the less populous States has always been a feature of the Australian federal system. In contrast, Western Australia and in particular Queensland have been growing strongly in recent years and, given reasonably strong fiscal positions, have reached a level of maturity that does not require assistance beyond an equal per capita distribution of general revenue grants. (p. 33)[113]

[113] It is worth noting in this context that, as Table 1.1 shows, the passage of time has now brought this about for Western Australia and has brought Queensland very close to a per capita share. This reflects a narrowing of the differences between them, on the one hand, and New South Wales and Victoria, on the other, over recent years.

The comment is interesting for two messages that it contains — that equalisation is desirable to maintain viability of the States in the Federation, but might be dispensed with once viability is established. This is quite different from the conclusions which arise from considerations of efficiency and equity. However, as was seen in earlier chapters, the goal of viability for all the States has been a fundamental objective of Commonwealth State financial arrangements over the last century.

It is difficult to know what weight to attach to the federation and nationhood principles. They are very much a feature of Australia's federal arrangements, but they are also vague concepts which, it can be argued, are met across a range of grant arrangements. At the end of the day the States matter because of the people that live in them, and if policy keeps them in mind as the ultimate objective, then the federal rights issue resolves to a matter of providing suitable policy instruments to enable States to meet individuals' needs.

It should be noted as well that the federal rationale — financial viability of a State Government — might be achieved under quite adverse circumstances by means of expenditure restraint and revenue effort, with the burden falling on the populace, leading to migration of people and activity from the State.[114] In fact the history of Australia's grant arrangements suggests that there is a common view that outcomes like this should be avoided.

For instance, the Victorian Treasurer, John Brumby, a critic of Australia's current equalisation arrangements, has noted that:

> The Bracks Government is not fundamentally opposed to the principle of the bigger States with deeper economies helping out the smaller States … it is reasonable to help out jurisdictions such as Tasmania and the Northern Territory with subsidies.[115]

Critics of equalisation have also at times focussed on growth rates from State to State, and have interpreted strong growth as ruling out a need for equalisation. This view appears to reflect, at least partly, the view that each State's role is to try to win a competition with other States to have strongest growth rates. In this view, it matters not how the competition for growth is won.

Yet some differences in regional population growth rates are probably a reflection of population relocations that are driven by patterns of relative advantage in economic and lifestyle opportunities, and shifts like this are generally desirable. Fiscal equalisation removes fiscal distortions from the economic signals that indicate these relative economic and lifestyle opportunities. To argue that fiscal equalisation should be abandoned because it will advantage one State over another in the race for growth is to elevate the growth objective above an objective of population decisions based on underlying economic and lifestyle merits of locations. Growth is important as an indicator of the success of jurisdictions in creating those opportunities, but it is not the ultimate objective itself.

So to take funds away from fast growing States, with negative efficiency and equity consequences, has little to commend it. There is nothing intrinsically desirable about the equalisation of growth rates per se, or about reining back fast growing States. A longer term policy view, which recognises the mobility of most resources in the Australian federation will

[114] Arguably this is the approach taken in the United States for instance.

[115] Brumby (2001)

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 based view of horizontal equity. This finding is strongly supported in the peer reviewed public finance literature. For instance Boadway and Flatters (1982) conclude their technical analysis of grant distribution in the following terms:

> First, one cannot expect in general that migration decisions taken by individuals in a decentralised federal economy will lead to an efficient allocation of labour over provinces. Not only can the migration process be locally inefficient … it may also be globally inefficient. Second, self-interested provincial governments acting on behalf of their residents have an incentive to take budgetary actions that, from a national point of view, lead to inefficiencies and inequities. Finally, the federal government faced with the inefficiencies and inequities arising out of individual and provincial government behaviour will be justified in using a system of equalisation payments as a policy instrument in the pursuit of nationwide equity and efficiency. (p. 630)

This case has nothing to do with the 'disadvantages of federation' arguments which were around until World War Two; they are now essentially irrelevant to the Australian debate. Although one sometimes sees the suggestion that, because tariff protection has been reduced, the case for transfers to non-manufacturing States is also reduced, the reality is that the Grants Commission set aside that rationale for equalisation at its inception sixty-five years ago; since that time the purpose of equalisation payments has been to equalise fiscal capacities.

And in any case a convincing argument can be put that no State suffers a net disadvantage from federation. While a State might gain some advantages from secession, it is unlikely that those advantages would be sufficient to compensate for the surrender of rights and benefits which are central to the Federation. Clearly, the Commonwealth would act to discourage a secession, but that is not in prospect at present. Instead, some rationale for the determination of funding arrangements other than 'disadvantages of federation' is needed.

The need to distribute funds between the States with a degree of objectivity, and at the same time to maintain the viability of the States, was the impetus for the establishment of the Commonwealth Grants Commission. Although other guiding principles in efficiency and equity have since emerged, concerns about the viability of State governments in their own right are likely to remain important in grant decisions. All the States are here to stay, and the challenge is to make the Federation work as well as possible.

Nowadays, the weight given to efficiency and equity in grant decisions is probably at an all time high. Equalisation can be seen to have an important and positive role on both counts. This is not to say that equalisation can necessarily be applied with a high degree of precision. There will continue to be debate about how the Commonwealth Grants Commission assesses equalisation payments, and the Commission from time to time will modify its methods when convinced that better alternatives exist.

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.

If these ideas are persuasive, then fiscal equalisation will remain a central feature of Australia's Commonwealth-State financial relations into the future. The Commonwealth Grants Commission's assessments will vary as new data and methodologies become available, but an equalisation principle will remain in place. The alternatives — 'contributions', 'equal per capita', various forms of 'partial equalisation', etc. — are unattractive, as they are unlikely to be either efficient or equitable. The physical manifestation of uncorrected fiscal distortions would be a congealing of population in jurisdictions with high fiscal capacities, and at the margin there would be an excessive tendency to situate in those jurisdictions. The outcome would not be efficient in an underlying sense — efficiency, and the benefits that it brings, would have been sacrificed to a misguided view of what the welfare maximising policy is and/or narrow interests which were able to assert themselves through the political process.

Such a result would be particularly anomalous in light of the increasing weight given to efficiency considerations in the development of economic and social policy over recent years. Efficiency arguments have been motivators of at times painful policy reforms in the areas of tariffs, taxation, the labour market, the public sector and competition policy, to name a few, and it seems likely that this emphasis will continue. Fiscal equalisation is a part of the suite of policies in place to promote efficiency.

Equity considerations also remain important, even though there is often a divergence of opinion as to what constitutes equity. Some type of shared equity goals arguably are intrinsic to people's perceptions of the Federation and indeed are one reason for federation. Furthermore, Petchey and Walsh (1993) argue that:

> Clearly, a case can be argued convincingly that, put behind a 'veil of ignorance' which denies them knowledge of whether they will be a 'rich or 'poor' State in ensuing periods, representatives of all States at a constitution-forming assembly would support a comprehensive equalisation procedure. (p. 5)

For the Commonwealth to move away from fiscal equalisation, it would be necessary to accept that equity no longer required like treatment of like individuals in different States. While this is not guaranteed at present it seems to be approximately observed. Although

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.

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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] And the supply curve for residence is likely to be upward sloping (or at least not vertical), reflecting that a location can accommodate more people, for instance by introducing higher density living. Representing these demand and supply schedules with D_0 and S_0 in Figure 4.1, the equilibrium number of residents in Location A is Pop_0.

If the government now introduces a subsidy of $x to residents of Location A, then the demand curve shifts up by $x from D_0 to D_1. Under the assumption of an upward sloping supply curve, the equilibrium population increases from Pop_0 to Pop_1, and part of the subsidy flows into a higher cost of living (cost of living rises from CoL_0 to CoL_1).

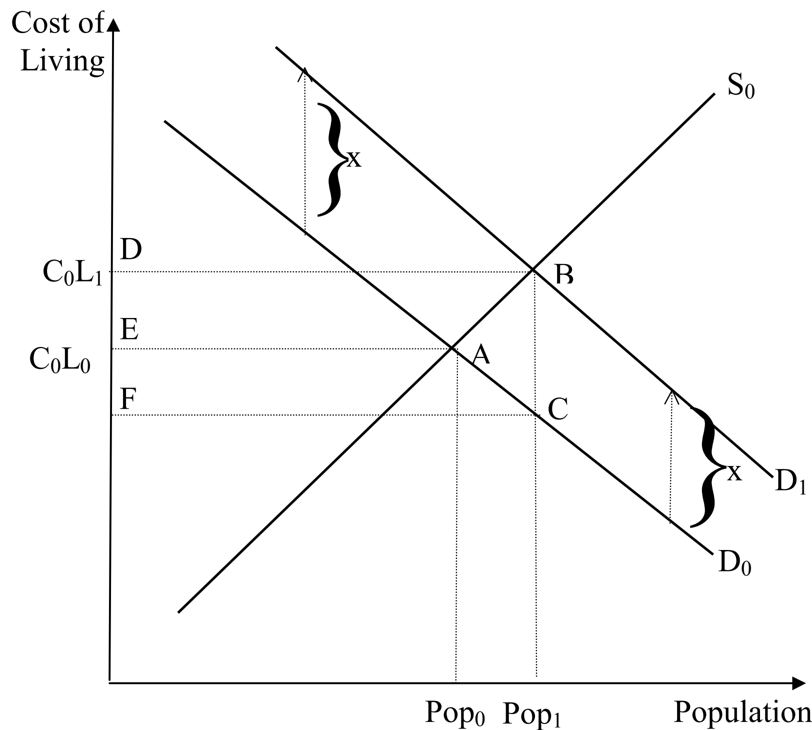
For the present purposes the key result from the diagram is that the fiscal subsidy increases the population in Location A. The capitalisation argument in its strong form holds that this does not occur. How would the diagram need to be revised to produce such a result? There are two possibilities: that the demand schedule is actually a vertical line (implying that a set number of people intend to remain in Location A, and that nobody is interested in moving into location A, regardless of cost of living) or that the supply of residence is vertical (implying that it is impossible for an extra person to live in Location A). Clearly neither of these is plausible. This is so notwithstanding that resources such as land are in fixed supply. Although land is in fixed supply, population densities can increase to accommodate more people. Hence the supply of residence is elastic.

This analytical framework also enables one to illustrate the distributive consequences of locationally differentiated fiscal signals, and to speculate about the welfare consequences of them. Rents to suppliers in Location A are represented by the triangular area between the supply curve, the horizontal cost of living line, and the vertical axis. Introduction of the fiscal transfer x has the effect of increasing supplier rents by an amount illustrated by the trapezium ABDE. Rents to people who locate in Location A are represented by the triangular area between the demand curves, the horizontal cost of living line, and the vertical axis. It can be shown that the introduction of the fiscal transfer increases rents of residents (leaving aside any land ownership benefits) by an amount equal to ACFE. The aggregate amount of the fiscal transfer is given by the rectangle BCFD.

116 I am grateful to Kym Anderson for comments on a suitable presentation framework for this point.

117 The downward sloping nature of the demand curve is reinforced if one allows for a diminishing marginal product of labour.

Figure 4.1
The market for residence in Location A



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

An essential feature of this analysis is that receipt of the fiscal transfer for a particular location is contingent on the person residing in that location. This should be contrasted with a fiscal transfer to an immobile resource such as land. If government introduced differential land tax rates by location, there would be no impact upon the location decisions of mobile resources. The incidence of the land tax would be on the owners of land, and would be the same regardless of where they live. Consequently there would be no impact on location of residence.

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.

It is of course entirely possible that the states' redistributive choices are acceptable to the national government, either because it agrees with the trade-off between efficiency and redistributive goals, or because it regards the matter as being appropriately determined by the states under the federal arrangements. If the national government does accept the states' behaviour, then it would not make sense to rationalise any particular national policy on the grounds that it overrides the states. In such a case fiscal equalisation would be supported on grounds that it maximises inter-jurisdictional efficiency.

If a national government decided that state policies were inappropriate, and that it wished to alter them, the question would then arise as to what was the best policy instrument to do so. The 'first best' response would be to change the offending policies. If, for instance, the national government believed the states engaged in excessive redistribution to residents of remote areas, it could override the states' policy by reducing the degree of remote area concessions in the national tax/transfer system or indeed by introducing concessions for urban settlements. Or it could convince the states themselves to modify their policies.

There is, however, no reason to believe that abolishing or attenuating the extent of fiscal equalisation would modify the states' distributive policies in the desired direction.

If one did believe that cuts to unconditional grants would cause a state to engage in less redistribution (and as discussed subsequently it is difficult to find a foundation for such a belief) it still would not follow that stopping fiscal equalisation would reduce the extent of redistribution. In a two state model, the ending of fiscal equalisation would reduce grants to one state and increase them in the other. By assumption, the state with lower grants reduces its redistributive activity. But does the state with higher grants not increase its redistributive activity? (Any argument to the contrary must rely on a quite asymmetric linkage between grants and redistributive activity – one in which states reduce redistributive activity when grants go down but leave redistributive activity unchanged when grants go up.) Yet if the state with higher grants increases its redistributive activity, this result is at odds with the original intention of the national policymaker.

In fact a more plausible response is that, in response to the abolition of fiscal equalisation, states would spread the changes in per capita grants approximately evenly across their populations (which, by virtue of the construction of the 'net fiscal benefit', would amount to a dollar for dollar change in each individual's net fiscal benefit). In this case all individuals in the fiscally disadvantaged state would be worse off and all individuals in the fiscally advantaged state would be better off, and at the margin individuals would migrate from the fiscally disadvantaged state to the fiscally advantaged state. But those migrations would not be confined to 'dependent' individuals in the fiscally disadvantaged state migrating to 'contributing' status in the fiscally advantaged state. They would also involve 'contributing' individuals in the needy state moving to 'contributing' status in the fiscally advantaged state, and possibly even moves by 'contributing' individuals in the fiscally advantaged state to 'dependent' status in the fiscally advantaged state. In fact the net impact on the degree to which individuals are in 'contributing' rather than 'dependent' status is an empirical question.

If one assumed that the pattern of departures from the disadvantaged state followed the (higher than national average) propensity to be in a 'dependent' status, and that the arrivals in the advantaged state followed the (lower than national average) propensity to be 'dependent' in that state, there would be some reduction in the propensity to be 'dependent'. Only if the population of the fiscally disadvantaged state were entirely 'dependent' and the population of the fiscally advantaged state were entirely 'contributing' would the direction of movement be exclusively out of 'dependent' status into 'contributing' status. Otherwise, the abolition of fiscal equalisation would reduce the degree of dependency, but introduce efficiency losses in the form of distorted jurisdiction choices. The degree of dependency could of course be reduced by direct action to change states' distributive policies, and without distortions to jurisdiction choices, by directly modifying the states policies. The abolition of fiscal equalisation would be an inferior mechanism to achieve the policy objective.

Appendix 4C

The equivalence of Grants Commission equalisation and equalisation in the literature

The equivalence of the two approaches can be seen by considering the nature of the individual's net fiscal benefit and then aggregating across individuals in a state. The NFB for an individual is composed of a State expenditure component delivered to them in cash or in kind less a State revenue component levied from them. A State's expenditure will depend on the amount of expenditure made on each type of individual (which is standard across States for each type of individual) multiplied by the number of individuals of each type in the State (this amount varying across States). Consequently the aggregate cost to States of providing the expenditure component of the standard NFB policy will vary. The amount required by each State will be equal to the cost to it of providing the standard expenditure policy — which in concept is what the Grants Commission assesses. A corresponding argument on the revenue side shows that the revenue obtained by States as a result of common revenue burdens imposed on like individuals is also conceptually equivalent to the Grants Commission's revenue capacity assessment. However, there is no guarantee that the expenditure need and the revenue capacity will be the same — in which case States will be unable to implement like policies. An equalisation payment from States with revenue capacity in excess of expenditure needs to States with expenditure needs in excess of revenue capacity is required to make standard policies feasible. In concept, this is what the Grants Commission's method does.

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 public entities and an increased degree of consolidation and netting out. Consolidated revenue and expenditure estimates in the period leading up to 1962-63 are distorted by imperfect removal of intergovernment payments. In addition, according to Barnard, the old estimates relate only to transactions authorised by parliaments or local governing bodies. The sharp fall in the ratio of gross revenues to GDP from 29.2 per cent as measured on the old basis in 1961-62 to 22.6 per cent on the new basis in 1962-63 clearly is largely if not entirely due to these conceptual changes.

Barnard also notes quality problems in the pre 1962-63 estimates with local government data (in some years it is non-existent) and provides some alternative estimates without local government — Barnard (1986). However, the estimates used are those which, at least in concept, include local government.

A second series break occurs in 1998-99, resulting from the replacement of the cash accounting framework with an accrual accounting framework in ABS collections.

Payments to States data from 1956-57 to 2000-01 are from Commonwealth Budget Papers and unpublished data from South Australian Treasury.

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