

## **ISSUES IN COMMONWEALTH-STATE FUNDING**

Authors:

Ross Garnaut  
Professor of Economics  
The Australian National University

and

Vince FitzGerald  
Co-Chairman  
The Allen Consulting Group

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THIS ISSUES PAPER SHOULD BE READ ALONGSIDE THE BACKGROUND PAPER ISSUED BY THE COMMONWEALTH-STATE FUNDING REVIEW IN DECEMBER 2001. THE PAPER TAKES AS GIVEN THE DATA AND GENERAL DESCRIPTION OF THE AUSTRALIAN FEDERAL FUNDING ARRANGEMENTS IN THE BACKGROUND PAPER

## **1. CONTEXT OF THE REVIEW**

The two authors of this paper have been commissioned by the Governments of New South Wales, Victoria and Western Australia to review and to report on Federal-State financial arrangements. The terms of reference cover both the grants derived from Goods and Services Tax (GST) revenue and the Special Purpose Payments (SPPs) from the Commonwealth to the States.

It is no secret that the three States which have commissioned the Review are unhappy with the manner of distribution of the GST revenue within the framework of the Intergovernmental Agreement of 1999, which preceded the introduction of the New Tax System embodying the GST on July 1 2000. Neither is it a secret that the other States and Territories are in varying degrees for the time being satisfied with the arrangements for distributing the GST revenue. Some people from the non-commissioning States, for example the Leader of the Opposition and former Chief Minister of the Northern Territory in a submission to the Review, have indicated their views that the Review, so early in the life of the post-GST arrangements, is unwelcome.

The arrangements for distributing amongst the States a substantial part of the revenues collected by the Commonwealth are an important part of our national economy and Federation. The arrangements have grown organically over a long period of time, and changed in some significant ways at the time of introduction of the GST. The Constitution allocates to the States the responsibility for a number of services that are considered to be of high

importance by the Australian community, including health education, law and its enforcement, housing, and administration of land and mineral resources.

The scale of the transfers and the importance of the services funded by them warrant the arrangements being placed under close public scrutiny and periodic review by people who are not direct parties to the arrangements. It is now a long time since the arrangements have been independently reviewed and Commonwealth-State funding has changed a great deal over that time. There are no ready processes for review that have no connection with interested parties at this time. The Commonwealth Government in 1999 and 2000, and since, had and has the primary objective of settling down the new tax system, to which the allocation of GST revenues is incidental. The Commonwealth Treasury would once have felt itself in a position to put a “Treasury” view into the public arena, for example in the early 1990s when it indicated a long-term preference for equal per capita distribution of payments over horizontal fiscal equalisation. The Secretary of the Treasury has indicated that this is not now possible, as, at least since the 1999 amendments to the Public Service Act, the political leadership of the department, in the person of the Treasurer, would be held responsible for any statement by Treasury officers. The States, both those which are happy and those which are dissatisfied with present arrangements, are obviously interested parties. The Commonwealth Grants Commission recognises that it is in no position to review independently its own work, and has welcomed review by others. There is not now in Australia an independent academic Centre specifically funded to specialise in studies of Commonwealth-State relations. There is widespread agreement that it was a pity for the Commonwealth Government in the early 1990s to reject the recommendations of a review, supported by financial commitments from all State governments, and to end its funding over a quarter of a century of the Federalism Research Centre (FRC) at The Australian National University. Under the distinguished leadership of Professors Russell Mathews and later Cliff Walsh and Brian

Galligan, the FRC made a significant contribution to the evolution of Commonwealth-State funding arrangements at an earlier period in history.

The contemporary Commonwealth-State funding arrangements are so complex as to raise significant barriers to thorough and continuing review by independent academics or analysts from independent research institutes or the media. Several eminent scholars based at Australian universities are making substantial contributions to this work, and warrant additional support for the efforts that they are making in the national interest.

In these circumstances, we were asked by the Governments of three States, representing at a State level 68.5% of the Australian population, to undertake the Review. We sought and obtained undertakings on independence, which were repeated publicly by the three Treasurers at the launch of the Review in November 2001. On this basis, we were pleased to accept the commission. Perhaps the three States were confident that a genuinely independent review would be favourable to their interests. Be that as it may, we have been asked to deliver a Report based on our own independent judgement, and that is what will be made public in a few months time. It would have been ideal for all States and Territories, with or without the Commonwealth, to have commissioned the Review. Nevertheless, we have enjoyed functional cooperation from people in all States. People who are closely familiar with thinking on Federal finances in the non-commissioning States, and the Commonwealth Grants Commission, will make central contributions at this seminar. We are making large efforts to ensure that our recommendations are formed after consideration of all strands of Australian thought on the matters under consideration.

It may be helpful for us to explain what we understand to be the role of the Commonwealth Grants Commission (CGC) in the allocation of Commonwealth revenues amongst the State and Territories. The CGC, an old

Australian institution dating back to the 1930s, plays the central role in allocation of the GST revenue. It is required to apply the principle of “Horizontal Fiscal Equalisation” under the Intergovernment Agreement of 1999. “Horizontal Fiscal Equalisation” is not defined under the agreement. It is said by some States and Territories to require no more than some transfer from fiscally stronger to fiscally weaker States and Territories, as has been the case since the beginning of the Federation. It is said by others to embody in detail the approach to fiscal equalisation applied by the CGC at the time of the Intergovernmental Agreement. The CGC's role in allocating GST revenues is seen by some as that of an independent umpire, adjudicating the competing claims of the eight States and Territories on the whole range of issues affecting allocation amongst the States and Territories. The CGC does not see itself in that role on matters of policy, but rather as operating within and implementing broad policy established by the Commonwealth Government. There is room for useful discussion at this seminar on the boundaries between “policy” and implementation. The particular way the CGC currently allocates the GST revenue, by counting receipts within most SPPs as State revenue for equalisation purposes, incidentally makes it responsible for the final allocation of funds that are distributed within most Special Purpose Payments.

## **2. FINANCING THE FEDERATION**

Fiscal policy was the dominant subject of the debates that preceded Federation, including in the young Economic Society and the pages of its journal, the Australian Economist. The theory of public finance did not then exist in anything like its present form. However, as in the later discussions leading to the formation of the European Union, there was practical appreciation of the principle of subsidiarity (where it is possible for decisions to be taken at more than one level of Government, decisions should be taken at the most decentralised level practicable), and it was embodied in the States’ retention of responsibility for all of the main community services.

There was also practical understanding of the benefits of vertical fiscal balance — each level of Government being responsible for raising most of the revenue which it spent, thus ensuring a responsible linkage of taxation and public expenditure decisions. Here there was a deliberate erring towards the revenue requirements of the young Commonwealth. The main source of revenue, customs and excise, was allocated exclusively to the Commonwealth, although with part of the revenue for a number of years to be returned to the States. That this erring on the side of the Commonwealth was understood by at least some participants in the Constitution-making process is indicated by Deakin's celebrated comment that the States would be tied to the chariot wheels of the Commonwealth.

Over the past century, however, there has been a *de facto* shift in the main taxing powers towards the Commonwealth that would have surprised the makers of the Constitution. Most important in this process were a series of High Court interpretations of the Constitution culminating in two fateful decisions of the High Court. A 1959 (*New South Wales and Victoria v The Commonwealth of Australia*) decision allowed the Commonwealth to use its power to attach conditions to grants to block the States from re-entering the income tax field, 'temporarily' taken over by the Commonwealth in wartime. A 1997 (*Ha and Lim v New South Wales*) decision, going much further than previous ones on the same issue, defined 'excise' so broadly as to exclude the States altogether from levying taxes ('franchise fees') on the sale of goods. The effects of these decisions were compounded in 2000 by the replacement, for practical and good reasons, of a number of State taxes by a new Commonwealth tax, the GST, with the revenue from the latter distributed to the States as untied Commonwealth grants. The effect of each of these developments was to increase the 'vertical fiscal imbalance' in the Federation — the disparity between expenditure responsibilities and ability to raise revenues.

The result is vertical fiscal imbalance to an extent that has no parallel in other Federal systems in developed countries. This had two consequences of large dimension. First, it introduced the possibility of the Commonwealth attaching conditions to the use of funds that the States required to carry out their basic responsibilities. In a series of steps since the early 1970s, the conditional or 'specific purpose' grants (SPPs) have grown to about 40 per cent of Commonwealth grants and a high proportion of total State revenues. This effectively converted all State Constitutional responsibilities into powers shared with the Commonwealth. Second, in contrast with the United States, a Federation in which the States met their revenue requirements mainly from taxes raised within their own borders, this raised questions in a political context about how the revenue should be distributed amongst States.

There is no reason in principle why a similar degree of Federal fiscal equalisation could not be achieved within a Federation of mainly fiscally self-sufficient States, through the fiscal actions of the Federal Government. But the exceptional vertical fiscal imbalance provided a favourable environment for the advancement of horizontal fiscal equalisation. Although Australia, at the time of Federation and now, had and has less inter-state variation in average incomes than any other Federation at least amongst high-income countries, it took horizontal fiscal equalisation further than any other Federation.

The dominance of transfers from the Commonwealth in State finances, the conditions placed on their provision, and the elaborate framework of horizontal fiscal equalisation had the *de facto* effect of shifting enjoyment of the proceeds from the main surviving State sources of revenue from the State in which they were collected, to the States as a whole. Take the examples of the revenues generated by a new mining project in any State but most commonly in Queensland or Western Australia, or from higher property transfer taxes in a period of strong economic growth in any of the States but most powerfully in

New South Wales and Victoria. With a lag, there would be a reduction in grants to the State which had been the immediate recipient of the revenue, and an increase in grants to others. The State in which the new development occurred would receive a share of the total on average roughly equal to its population share.

The accumulated effects of these changes had the potential to negate much of the rationale of a Federal, as distinct from a unitary, Constitution. The CGC in its administration of Horizontal Fiscal Equalisation has sought to avoid distorting State Government decisions on taxation and expenditure, and more generally decisions affecting economic development. The extent to which it has succeeded in doing so is critical to assessment of the implications of the evolution of the fiscal arrangements for the Federal Constitution.

The system of Commonwealth-State finances changed again at the time of the introduction of the GST. This was not widely discussed at the time, being less contentious and of less immediate public interest than the introduction of the GST itself. In Constitutional terms, the GST is a Commonwealth tax, the parameters of which can be changed at any time by the Commonwealth Parliament. However, the political statements by the Commonwealth at the time of its introduction, and the Intergovernmental Agreement signed by the Commonwealth and all States and Territories, raise the political costs of unilateral change by the Commonwealth, at least in the near term.

This introduces a considerable degree of confidence that the GST at its current rates and in something like its present form will continue except in the event of agreement between the Commonwealth and States and Territories representing a large majority of the Australian electorate; and that the GST proceeds (subject to lengthy transitional arrangements that are favourable to the States and Territories as a whole), will be passed to the States and Territories taken together. It does not introduce certainty about how much GST will pass to each

State or Territory. That is a matter for the CGC, and its interpretation of “Horizontal Fiscal Equalisation” from time to time. It is therefore subject in the manner of the past 70 years to the composition of the membership of the Commission, to the intellectual influences on the Commissioners from time to time, and to the political influences on a Commonwealth Government that might cause it at some time to provide guidance on the meaning of Horizontal Fiscal Equalisation.

That said, there is greater certainty than there has been in the past about the quantum of untied Commonwealth revenue available to the States. That in itself does not provide certainty about the total amount of revenue passing to the States: that depends on the Commonwealth's discretionary decisions on the amount of SPPs. The current Commonwealth Government has said that it has no intention to reduce the aggregate level of SPPs. Intentions can change. It is also not clear if this commitment is maintenance in dollar terms, real terms, or real per capita terms. If the commitment is only maintained in dollar terms, even with the low rates of inflation that have ruled over the past decade and which we have reason to hope have been entrenched by independence and low inflation targets of the Reserve Bank of Australia, maintenance of the nominal value of SPPs is consistent with substantial real decline, at a rate that offsets roughly all of the real per capita growth in receipts of the GST. That outcome may not emerge from Commonwealth policy decisions in any particular year, but it is an outcome that is open to the Commonwealth without breaching commitments or even general statements of intent.

It is the current practice of the CGC to count receipts of SPPs as revenues in its calculation of needs for purposes of distribution of the GST, unless the Commonwealth explicitly directs that certain SPPs be isolated from the equalisation process. It is open to the Commonwealth, without breach of current commitments or general statements of intent, to isolate a larger proportion of the SPPs from the process of equalisation.

The Commonwealth's general statements of intent at the time of introduction of the GST therefore place a floor under total real payments to the States at something like the current level in per capita terms except in times of low economic growth or high inflation. They do not place a floor under the total amount of payment to a particular State or Territory.

In 1993, a new set of words was used by the CGC for the first time (so far as we can ascertain from the documentary record) to define Horizontal Fiscal Equalisation. From the early days of the CGC in the 1930s, the provision of assistance to raise recipient States' capacities to provide services was explicitly qualified by statements that complete equalisation was not the goal, and that levels in the claimant States would remain below others. A new objective of more complete equalisation, first accepted by the Commonwealth in 1983, was couched in terms of recipient States being able to provide services of a standard not appreciably below those in the "donor" States. In 1993, through a process of which we know little at this time, the qualification was removed. The objective was restated as allowing the recipient States to provide services equal to those in the donor States.

### **3. THE THEORETICAL CASE FOR FISCAL EQUALISATION**

Horizontal Fiscal Equalisation in Australia had its origins in pragmatic response to the reality that the poorer States, at first Tasmania and Western Australia, from time to time had difficulty in financing the normal operations of Government from revenue raised from within their own territories using their own taxation powers under the Constitution. The pragmatic case was strengthened by recognition that policies of the Commonwealth that were driven by political interests centred in the large industrial states (notably tariff protection, centralised wage determination and cabotage in coastal shipping) systematically worked against the interests of the smaller and poorer States.

The virulent secessionist movement in Western Australia in the 1930s, itself spurred by perceptions that the Scullin Government's large increases in protection exacerbated the effects of the Great Depression in Western Australia, added weight to the pragmatic case.

After the establishment of the CGC in 1933, the case for a measure of equalisation on equity grounds began to be articulated. Transfers between States on grounds of equity were generally seen as imposing some cost to economic efficiency.

A new element entered the discussion with the publication in *The American Economic Review* in 1950 of a paper by James Buchanan, "Federalism and Fiscal Equity". (Buchanan, 1950). Buchanan's paper has since then been cited intensively by Australian supporters of fiscal equalisation. It is seen as providing a theoretical argument for equalisation on grounds of economic efficiency. (See, for example, the recent paper by Hancock and Smith (2001)).

The presence within a Federation of States with different mixes (for whatever reason) of people with different income levels can cause the 'fiscal residuum' (personal benefits from public goods less taxation) to be different for similarly situated individuals. The presence in a State of a higher proportion of rich people, who are prepared to pay more per capita in taxation for public goods that all citizens can enjoy, increases the fiscal residuum for others resident in the State. In certain circumstances, this can induce interstate migration of people whose circumstances allow them to benefit from the high fiscal residuum to the State that has a high proportion of high-income people, whether or not the marginal economic product of the migrants is higher in the new location. The emigration of high-income citizens may further reduce the fiscal residuum for people, and perhaps especially for high-income people, in the State with an initially lower proportion of high-income people.

Buchanan sets out the case on economic grounds for making the fiscal residuum for the individual similar for similarly situated individuals whatever their State of residence. He notes that the relevant conception of equality in this context is equality of individuals in similar circumstances. “Equality between States”, he observes, “is difficult to comprehend, and it carries with it little ethical force for its policy implementation.” He notes that interstate transfers become more defensible if they have the effect of establishing equal treatment among individuals in similar circumstances. Transfers among States can assist in this objective only if their use is tied to specific activities for the benefit of specific individuals. “A specific type or method of intergovernmental fiscal adjustment is suggested from the above analysis. This is geographically discriminatory central government personal taxation”. He notes that this method of transfer “does not conflict with either the revered principle of fiscal responsibility or that of State fiscal independence”.

Buchanan notes that while intergovernmental transfers of funds could allow states to treat citizens “in the same manner fiscal wise as their equals in all other states”, they “would not necessarily, or probably, choose to do so”. Untied grants to the poorer States would be distinctly second best.

Most Australian citation of the original Buchanan article has been oblivious to the analysis which led to the recommendation of regionally differentiated rates of Federal taxation. The original principal author of the 1980s Australian form of Horizontal Fiscal Equalisation, Professor Russell Mathews, was, however, aware of the authority that Buchanan provided for a distinctly different approach. In an important exchange with Professor Cliff Walsh at a conference to discuss the CGC’s 1988 relativities report, (Walsh, 1989) he rejected the Buchanan approach, in favour of his preferred system for Australia, explicitly based on a view of equity that gave a central place to equality in the *capacity* of the States to provide services for their citizens. (Mathews, 1989, Walsh, 1989) The model of Horizontal Fiscal Equalisation now prevailing in Australia, based

on equalising capacity of States (on a rationale of ‘policy neutrality’), rather than on equalising outcomes for individual citizens differs fundamentally from Buchanan's ideal concept.

Buchanan's 1950 article in the AER was criticised by contemporary North American economists on the established grounds, that equalisation transfers inhibited output-enhancing movement of people to where their incomes and output would be higher (for example, Scott 1950). In his reply, Buchanan noted that the applicability of the case that he had made for fiscal equalisation and of the criticism depended on the empirical detail. In addition, he noted a strong case for conditional grants to activities that increase the productivity of resources and in some circumstances their mobility, such as education and transport (Buchanan, 1952).

The ideas from the 1950s, much cited in Canada as well as Australia, have been the subject of recent observations by now Nobel-Laureate Buchanan. He notes in an address in October 2001, to the Montreal Economic Institute, that developments in public choice theory since the publication of his seminal paper require any modern proposal to do more than lay down idealised structures that embody either equity or efficiency criteria. Taking the real world of public choice into account, the “central government, which must, in any case, put any equalisation scheme in place, cannot simply walk away from its follow-on responsibilities...The central government must, in effect, adopt a hands-on policy with respect to the ultimate distribution of the equalising funds within the poorer regions.” He notes that he does not see any general case for or against fiscal equalisation: it depends on many dimensions of the circumstances. “The case for some sort of equalisation is directly related to the size of the predicted disparities among the fiscal capacities of the separate provinces”. Finally, he notes that the case for equalisation based, “at least in part, at reducing the incentives for migration from the relatively poor to the relatively rich regions of the economy, may be thwarted or even overwhelmed

in effect by national policies towards migration”.

The use in Australia of Buchanan's theoretical case for fiscal equalisation of a particular kind under particular circumstances, to support an approach of a different kind in different circumstances, is reminiscent of the use of the Stolper-Samuelson theorem (1941) to support a pre-existing “Australian case for protection”. In the Buchanan case, however, we can learn a great deal from examination of the detail of the argument, which seems to have been somewhat misunderstood or cited in support of arrangements not meeting his criteria. Arrangements which more closely conform to his ideas are worth examining. For example, is the Buchanan first best approach to fiscal equalisation, through the use of differential taxation, worth a closer look?

#### **4. WHAT AUSTRALIA DOES: EFFICIENCY AND ECONOMIC GROWTH**

As Buchanan has observed, a component of a system of public finance has to be judged not on some ideal of how it might work, but on how it works in practice, and how its strengths and weaknesses compare with those of alternatives as they could be expected to work in practice.

The Review's terms of reference require us to assess the efficiency, equity and simplicity and transparency of the established Australian system of transfers from the Commonwealth to State Governments. The remainder of this paper outlines what we have identified as important factors in assessment of these matters in relation to the Australian system of Commonwealth-State payments as it is described in the December 2001 Background Paper.

We seek guidance from the seminar in ensuring that our list of relevant considerations is comprehensive, in assessing the importance of the various possible effects on efficiency, equity and simplicity within the established Australian system, and in beginning to compare the established system with

some alternative ways of delivering the transfers and defining Horizontal Fiscal Equalisation. We take the level of vertical fiscal imbalance as being determined by a century of Constitutional politics and High Court interpretation, so that transfers on something like the current scale are going to continue. The variables to be considered are the forms of transfer (extent and nature of conditionality) and the distribution of the grants among the States.

We have identified the following nine types of effect on economic efficiency and growth:

(i) *The tendency for equalising transfers to shift resources from higher to lower productivity locations.* This is the conventionally dominant economic efficiency consideration in assessing Horizontal Fiscal Equalisation. (There is an equity as well as an efficiency consideration here, as it is sometimes argued that early adjustment of population flow to and from a slower growing region is the most effective means of raising employment rates and incomes of the less well off, both those in the region and those elsewhere. This equity effect is more commonly discussed in countries which have, or have had, much larger and more deeply entrenched regional disparities in living standards than Australia, such as China, the United States and Canada.) This effect is discussed in the paper to be presented at this forum by Monash University's Centre of Policy Studies (CoPS).

(ii) *Relatively faster population growth in regions where marginal productivity is higher,* as in (i), may be more productive for the national society as well as the individual if it is preceded by transfers to the slower growing region that allow adequate provision of services affecting labour market value. The obvious candidate is education, but health, and in places where there are social stresses a range of community services may also be relevant. This is recognisable as Buchanan's secondary case for Horizontal Fiscal Equalisation,

emphasised in the recent Montreal paper, requiring the tying of transfers to productivity-raising applications. To the extent that such growth-enhancing effects of Horizontal Fiscal Equalisation are considered to be important, the CGC approach of assessing the quantum of transfers by reference to cost disabilities in delivery of such services as education, but not to require expenditure to be undertaken on the activities to which the transfers were targeted, would appear to be a source of inefficiency.

(iii) The converse to the effects in (i), *where a lower “fiscal residuum” or other cause of divergence between private and public benefits of emigration causes some people to move out of slower growing regions when their marginal social product is higher than in the higher-income region to which they are moving*. This is, of course, the basis of the primary Buchanan case for Horizontal Fiscal Equalisation. A version of this effect is also incorporated into the CoPS modelling presented at this seminar, in the form of “congestion” costs of emigration to larger centres of population.

Buchanan's recent comment that international migration policy needs to be taken into account in assessing this efficiency effect is highly relevant in Australia. We are in the early stages of working through the implications of international migration, and would welcome comment at the forum.

(iv) *The overhead and transactions costs of managing the system itself*. In the case of the GST-based untied transfers, these include the costs of the CGC, and the State (and to a much smaller extent Federal) bureaucracies that serve and seek to persuade the CGC. On the latter, of greatest importance may be the opportunity cost of the time of many of the most talented officers of the State and Territory public services engaged in what is an extraordinarily detailed and administratively cumbersome process. The task of these officials is to seek to maximise CGC assessments of their own jurisdictions' expenditure disabilities, and minimise assessments of their revenue-raising abilities — and to critique

other jurisdictions' assessments. Less transparent, and probably larger, are the transactions costs of the SPPs, with continuous negotiation over conditions and guidelines, boundaries, administration, performance, reporting and accountabilities.

(v) Separately from the overhead and transactions costs of administering the SPP system, *the duplication, imperfect coordination and game-playing to assert control by both Commonwealth and State officials* engaged in funding closely related services in areas where the States have responsibility under the Constitution, through SPPs and directly through State budgets, is a source of potentially large inefficiencies. These may involve cost shifting and re-labelling, exploitation of weaknesses in criteria, matching requirements and reporting arrangements, and so on. Apart from inefficiency per se, accountability is diminished. There are also potential costs of distortion of priorities at the State government level, through matching funding requirements and specific conditions in SPPs. The same issues arise in aboriginal affairs, where the Commonwealth has had an over-riding responsibility since the 1966 Constitutional Amendment.

(vi) The tendency for Horizontal Fiscal Equalisation to lead to *the public sector playing a relatively enlarged role in recipient States than in donor States, independently of citizens' own preferences for public relative to private goods*. This distortion appears in the CoPS paper as the "sticky paper" effect. Here we are not considering the effect of a disproportionately large public sector on the political economy of growth policies, which are discussed in (ix) below.

(vii) *The opportunity provided by the "averaging" methodology in the CGC calculation of revenue and expenditure disabilities, in assessment of each State's share of the GST revenue, for a State to influence outcomes by increasing taxation or expenditure effort in areas where its own disabilities are large*. Such "grant-seeking" fiscal policy is a matter with which the CGC has

been concerned over a long period. It is generally thought to be present but not to be a large effect.

(viii) *The emphasis on “disabilities” in costs of delivering services in assessment of a State’s share in the GST revenues, and the need for a State continuously to demonstrate that its costs are higher than those of other States, can be expected to reduce emphasis on cost-reducing reform.* Any such tendency may be strengthened by the CGC's consistent use of delivery costs compared with State average practice rather than costs under best practice in assessment of disabilities — even though there is now a good deal of information available for identifying best practice costs. The latter approach is at odds with the general focus on best practice through the public sector over the past two decades of cost-reducing reform in Australia.

(ix) The dominance of transfers from the Commonwealth in a framework of Horizontal Fiscal Equalisation could be expected to have *a significant effect on the political economy of policy and development strategy affecting growth*, in both recipient and donor States. This has not been much discussed in Australia, although in the international literature it has been seen as making a case against Horizontal Fiscal Equalisation (see Buchanan, 2001). The direction of this influence is clear, but has it been material to the political economy of development strategy at a State level in Australia?

Sir Charles Court, Minister in development portfolios and then Premier of Western Australia over most of the two decades in which Western Australia moved from being a “mendicant” to a donor State provides eloquent testimony to the discouraging effect of equalisation in a submission to the Review. In Sir Charles' view, the development of Western Australia's large mineral resources involved much more than collecting windfall gains from accidents of geological history. Revenues from mineral developments are not simply rents, although an element of good fortune is necessary for a State to have large

opportunities in this area. Development of this kind and on this scale is not possible without huge political effort and acceptance of some political costs, including in Sir Charles' case the costs of confronting unhelpful Commonwealth Governments. For a State to have the revenue benefits of development largely equalised away from it (90 per cent equalised away in Western Australia's case) by the CGC discourages such efforts.

Chambers of Commerce in several and not only in donor States have in conversation with us pointed to a different corner of the same issue. Decentralised development often requires large State Government investment in services and infrastructure of many kinds. States are discouraged from capital investment in provision of such services by the absence of full compensation for such expenditures in the CGC's calculation of disabilities. This can be seen as being generally discouraging to rapidly growing States. This would not be of concern, except that it is accompanied by the equalisation away of future revenue gains, which therefore are not available to service debt incurred in funding investment in new infrastructure. Other interlocutors from recipient States have argued that the political benefits of expanded employment in new developments mean that State Governments do everything they can to promote them, independently of fiscal consequences.

Similar points could be made about incentives for mainstream development in the donor States. In the CGC's report on relativities, (Commonwealth Grants Commission, 2002) the CGC explained the reasons behind NSW's grant share falling in 2002-03, namely the buoyancy of its real estate and share markets resulted in an increased capacity to raise revenue. In Victoria's case, its grant share fell because its strong wages and salary growth increased its capacity to raise payroll tax. The resulting reduction in GST revenue grants on account of buoyant revenue from the real estate sector in Sydney and strong wages growth in Melbourne, might be some as some as an economically costless transfer of a windfall, a rent, from those States. But is it a rent, or is the prosperity of

Sydney and Melbourne related to the economic policies of past and present State Governments? Does the equalising away of revenue consequences of State Government decisions affect incentives to maintain growth-promoting policies?

It has been suggested that grant-dependence and the ethos of equalisation has reduced the emphasis on economic development relative to other objectives in the recipient States. The relatively large role of the public sector in the economies and therefore the political economy of the most grant-dependent States might reinforce this effect. This is suggested in the recent ACIL Report for the New Zealand Round Table, which attributes Tasmania's economic under-performance over a long period to a long history of development-discouraging policies and attitudes (ACIL, 2002). Some mainland commentators point to particular cases of Tasmanian Governments failing to take political risks in support of development projects that would have been accepted in other jurisdictions. Tasmanian commentaries on these same projects have emphasised unhelpful interventions by the Commonwealth Government.

From early in the life of Horizontal Fiscal Equalisation under the aegis of the CGC, the Commission has been aware of the dangers of compensating States for growth-inhibiting policy. The CGC has explicitly rejected compensation for policy mistakes. But to the extent that it has been effective in avoiding such compensation, the success seems to be related only to first round effects. The CGC may have been able to exclude the direct effects of a policy mistake from its calculations of disabilities. But where a large mistake has caused a State to incur debt or has contributed to a business environment that is unfavourable to investment, the resulting deceleration of general economic growth, and the lower general revenue expansion, with which it is associated, are taken fully into the disabilities calculation.

It is common to see the efficiency costs of Horizontal Fiscal Equalisation as arising principally from compensation for disabilities on the expenditure side. The consideration of political economy effects of equalisation on efficiency focuses attention on the costs of revenue equalisation.

These are potentially important effects, but we are at this stage uncertain of their quantitative importance. This could be a particularly valuable area for discussion at the forum. As we will discuss later, there are also equity issues on the revenue side, which have also tended to be under-emphasised relative to those arising on the expenditure side.

## **5. WHAT WE DO IN AUSTRALIA: EQUITY**

What do we mean by equity?

In common Australian parlance, a policy is regarded as equitable if it transfers income or purchasing power or access to services amongst Australians, and in doing so redistributes from richer to poorer individuals or households. This common understanding of equity is the primary test.

In public finance there are two common concepts of equity, both of which have relevance to the matters under discussion. One is vertical equity, the concept introduced in the immediately preceding paragraph.

The second is horizontal equity, requiring the similar fiscal treatment of people in similar circumstances. A policy is inequitable by this criterion if it increases the burdens or the benefits to some individuals or households relative to others in similar circumstances.

Both concepts of equity can be applied to arrangements altering relative taxes, transfers and access to public services across States.

There is sometimes discussion of equity amongst regions. Concern for a “poor region” mostly amounts to concern about low average living standards of individuals and households living in the region. It is possible that the incidence of poverty amongst individuals and households might sometimes be addressed most effectively by programs to assist development generally in a region with many poor people (by contrast with programs dealing directly with individuals or households).

Can States or Territories be treated as “regions” in this sense? If we were defining especially poor regions that need help and rich regions that should help them, none of the regional boundaries we would identify would coincide with those of a State or Territory. Canberra has by far the highest per capita income of the States and Territories, but there are particular local government areas in New South Wales and Victoria that have higher per capita income than the ACT. At smaller scales again, there are pockets of people who are very well off indeed - and vice versa. There are poor communities in the Northern Territory, e.g. remote aboriginal communities, but most communities in Australia have far lower per capita incomes than Darwin. There are poor suburbs, badly supplied with community services by the standards of Adelaide, in the mostly well-off cities of Sydney and Melbourne. There are poor and declining rural communities in all Australian States. Residents of large parts of rural Australia have access to services that is greatly inferior to Hobart residents.

Sometimes the discussion of equity amongst States suggests that something quite different is being considered — an idea that all member jurisdictions of the Federation should always continue as viable members, and that a State should be assisted if its fiscal circumstances do not allow it to function as a normal member of the Federation, essentially independently of the circumstances of its individual citizens. This was undoubtedly the spirit in

which the Commonwealth responded to fiscal distress in the small States early in the Federation, and in the discussions leading to the formation of the CGC.

There is also a conception of equitable distribution in which income and wealth should, in the absence of good reason to the contrary, be left in the hands of the people whose efforts have led to their formation. (Within limits, most people would consider greater vertical equity to be good reason at least to ameliorate differences in income and wealth, although not to attempt to eliminate them.) Support for this concept can be found in all ethical traditions. The Marxist ideal in the socialist stage of development of "distribution according to work" was mentioned frequently in China in the first decade of market-oriented reform. When redistribution is proposed on grounds of vertical equity, in all contexts except that of intergovernmental transfers in Australia, the case is always for less than full equalisation. The top marginal income tax rate is less than 100% because of the incentive effects of complete confiscation of above-average incomes, but also because most people would not see confiscation as equitable.

Two different concepts of equity are applied in current distribution of Commonwealth grants amongst the States.

SPPs, for example for education and health (and there are many in each of these important sectors), are mostly distributed on the basis of need for the particular service being assisted, wherever, and to what degree, it exists in the community. The starting point for applying this in practice to allocating SPP funds among States is typically equal per capita payments, with adjustments for demographic and other factors affecting need for the particular service. There are some departures from this approach. Several such departures with historical causes have led to relatively low overall SPP payments per capita to Queensland, for example.

The GST revenue is distributed amongst the States according to the CGC's

conception of Horizontal Fiscal Equalisation. The goal is to provide each State with the capacity to provide the same level of services as others if it performs its functions with average efficiency and uses its opportunities to raise revenue to an average extent. A State receives larger grants if the average cost of delivering services is higher than in other States, or if its revenue-raising potential is lower than in other States. The focus is on equality of capacity amongst States, and not at all on equality in access to services amongst "regions" (other than States as regions) or households or individuals. It is accepted that the level of services provided to provincial, rural and remote regions, whether in South Australia or New South Wales, is much lower than in Sydney, Adelaide or Hobart. The objective is to ensure that each State is able to provide services in the cities at the average levels for cities, and services elsewhere at the average level of deprivation relative to the cities.

The CGC decisions on distribution amongst the States ultimately determine the whole allocation of all Commonwealth funding to the States. SPPs, unless explicitly 'quarantined' by the Commonwealth (which is not done for most of the major SPPs, road funding being an exception — for fairly obvious reasons), are treated as State general revenue by the CGC. Higher SPPs based on Commonwealth assessment of needs leads to lower shares of the untied grants pool based on the GST revenue. The CGC effectively over-rides the assessments of needs that underlie many SPPs.

The GST revenue, and in effect the funding of SPPs, is allocated so as to allow each State to provide services at a standard equal to the average, but there is no requirement for a State to provide the “average” services for which it was funded.

At least on the expenditure side, there is a plausible rationale to a fairly standard pattern of ‘bread-and-butter’ services such as education and health care services across Australia, especially those related to equality of

opportunity for young people . But it is not so obvious that there is any solid rationale for taking that approach on the revenue side. Mineral royalties are not relevant to the ACT for example, and some States prefer to avoid some kinds of gambling revenue, but despite Commonwealth control of most of the major taxes, there are many alternative ways open to a State or Territory to raise a given proportion of economic income generated within its borders. Is it equitable to compensate a State or Territory that may have some gaps vis-a-vis the 'standard' tax pattern, but does not take up the option of using other bases open to it relatively more — when the compensation comes from taxes levied on lower income people in other jurisdictions?

We welcome contributions of others in thinking through the following eight issues, and others, that arise in assessment of the equity of current Commonwealth-State funding.

(i) How equitable are Commonwealth-State transfers by the primary test, of their effects on the distribution of income amongst individuals and households? How does the equity of the established system by this test compare with other Commonwealth fiscal interventions, including through the social security system and the income tax? How does it compare with alternative systems of distributing Commonwealth funding amongst the States, for example according to state of origin of the revenue, or on an equal per capita basis? These central equity issues are addressed in the paper to this seminar by the University of Canberra's National Centre for Social and Economic Modelling (NATSEM).

(ii) Is there a case in equity for considering distribution among States and Territories beyond the effect that it has on the distribution of income amongst Australian individuals and households?

(iii) In particular, what in equity is to be made of the large transfers from Australians as a whole, to Australians in the Capital and Northern Territories

with average incomes well above Australia as a whole? If the problem in each case is inadequacy of the tax base when the latter is determined by capacity in the “average” ways in which States raise revenue, is there a case for the relatively rich territories raising revenue in different ways? For example from an income tax surcharge on the first \$X of taxable income, or a higher than average rate of some other taxes (e.g. conveyancing duties, whose level appears quite discretionary among the jurisdictions)?

(iv) Is it equitable for the amount of payments to a State to be determined by the State's excess costs of providing a service to a certain standard, without any requirement for the State to provide that service to that standard or at all in order to receive the funds?

(v) Is it equitable for a recipient State to be compensated for higher costs of delivering services in its capital than in the average of State capitals, when the standard of non-metropolitan services in all States is well below that level?

(vii) What is the effect in equity of over-riding the interstate distribution effects of Commonwealth SPPs the allocation of which has been based on needs within particular programs?

(viii) Is it equitable to aim at equal capacity to provide services in all States and Territories, absolute equality between States in this sense, rather than to allow some superiority of services capacity in States, which through some combination of skill, effort and good fortune have contributed more revenue to the common weal?

## **6. WHAT AUSTRALIA DOES: SIMPLICITY AND TRANSPARENCY**

Whatever its merits on grounds of equity and efficiency, the established system of Commonwealth payments to the States has a major problem of complexity,

to an extent that the processes are incomprehensible to almost all Australians. This applies in different ways to both aspects of Commonwealth payments: the SPPs; and the distribution of the GST revenue by the CGC. Inaccessibility creates a problem of accountability, not only for the transfer system itself, but for the activities, including the performance of State Governments, funded by them.

In the case of the GST grants, the problem of transparency and accountability does not arise out of any concealment of the general principles it seeks to apply. However, the CGC often does not provide reasons behind the many judgments that are made in the application of these principles. The problem arises from the complexity of the principles and their divergence from common understandings of equity, and of the calculations that are made to ensure that the principles are applied fairly. We are reminded of similarly complex arrangements that have emerged in other areas of public administration where officials have been given an element of autonomy in implementing policy, which is seen as having implications for equity, and is the centre of intense political interest. Australia's genius for almost infinite bureaucratic elaboration of less or more soundly based principles in the interests of equity is demonstrated by the old system of protection (the "tailor made" and "scientific" tariff), the arbitration system with its elaboration of numerous legal minimum conditions for employment for many different skills and occupations; the Income Tax Act, which breaks new records for length with each new simplification; the legendary complexity of the superannuation rules; the social security system with its concern to handle special cases fairly; the old systems of rural industry regulation, on which no-one outside the rural industries was well enough informed to pass comment; and our rules for migration. It is our special talent, and it would be unfair to make a special critical point about its application to Commonwealth-State financial relations. But complexity does create large compliance costs for users of the systems, it does make evaluation of performance and efficiency-raising reform difficult, and it does create

problems of accountability in a democratic polity. That is why, one by one, these manifestations of a special Australian talent are being reviewed and changed. Some of the initiatives for reforms have come to a considerable extent from within the administrative bodies with responsibilities in the area (for example the Tariff Board) and some mainly from external pressures.

In the case of the CGC and the distribution of the GST revenue, the complexity emerges partly from the character of the principles being applied and partly from the manner of their administration. The CGC describes what it does in implementing Horizontal Fiscal Equalisation in quite simple terms. The CGC's current description of its equalisation principle is as follows: "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 level." (Commonwealth Grants Commission (2002)).

That description is indeed simple, yet what it means even in broad terms is understood by relatively few people. Many do not understand that it sets out to equalise *capacity* to provide a standard range of State government provided services, and that recipient governments are free to spend the proceeds on anything they wish, or not to spend (some of) it at all. Many do not understand that it covers State government 'services' comprehensively, i.e. all activities they spend money on, and not only those that directly provide services to their citizens and are directly relevant to equity outcomes. Equally, it is not well understood that capital expenditures required for service delivery, e.g. to provide social infrastructure in areas of population growth, are not directly factored in.

Nor is it widely understood that the range and standard of services is taken as the average of what is provided, and that if there are inequalities within States

in the range and standard of services provided, the average reflects that. For example, if services in rural and regional areas are on average more limited and of a lower standard than in urban areas, the prevailing average level of *inequality* becomes the benchmark for equalisation of States' fiscal capacity. The 'same level of efficiency' is similarly defined as the average, notwithstanding that there is now a wealth of data regularly collected from which costs under *best practice* efficiency could be assessed. So what is being equalised is actually the average level of *inefficiency*.

On the revenue side, few would understand that 'the same level of effort to raise revenue' is again defined by the average range of taxes levied at the average rates. No account is taken of the fact that individual States (which term we are using to include the Territories) may inherently be 'light on' in some of the tax bases but be well placed to raise above average revenues from others; they may even have potential revenue sources that are not in the benchmark at all. This can produce the strange result that lower income jurisdictions are assessed as having considerably greater ability to raise revenue than ones with much higher levels of economic activity and incomes per capita.

One of the least well understood aspects is one mentioned earlier — that the CGC treats the SPPs received by a State as if these were general revenue, in effect overriding the distribution to recipient beneficiaries identified for these purposes by the Commonwealth Parliament, and substituting its own pattern of distribution of the funds.

These remarks abstract from the transitional arrangements that accompany the adoption of the net proceeds of the Commonwealth's GST as the pool for untied grants. These arrangements involve also calculating relative shares on the pre-GST ('financial assistance grants' or FAGs) basis, and 'budget balancing amounts' (BBAs) to bring State budgets up to levels that would have been enjoyed on all of the pre-GST taxation, grant and expenditure

responsibility arrangements. What form of equalisation is actually effected is to say the least, somewhat blurred.

Thus even at the general level, the seeming simplicity of the equalisation principle is much more complex than is generally perceived, differs considerably from commonly held notions of equalisation and equity, and is hardly transparent to the Australian community at large.

Simplicity and transparency are also hard to find at the level of detailed implementation. The CGC has endeavoured to make its assessments more and more objective, but the reality is that there is wide area in which subjective judgements are unavoidable. These are made by the CGC's staff under its oversight, with the input of State officials from the jurisdiction being assessed and with the right of other jurisdictions to have observers when on-the-ground assessments are being made. While there are thus offsetting influences, the situation in which each State is largely in control of what is presented and knows most about what its costs and delivery mode opportunities really are is likely to be one in which transparency is difficult to achieve. Moreover, the fine detail of the assessments is far beyond any layperson and difficult enough for expert officials to master. It is accordingly not a system in which it is easy for those who make the assessments, and the subjective judgements that go into them (along with much objectively verifiable information, of course) to be accountable in a practical way to political representatives and the electorate. In short, the system is, as far as those not involved in it are concerned, a black box.

In the case of the SPPs, complexity has different origins and characteristics. Different degrees of conditionality are applied to different sectors and to different programs within sectors. There are 120 different SPPs, most with their own rules and processes of administration. Most are based on some conception of "needs", but the methods used to assess needs vary widely.

The most important of all sources of complexity in the SPPs is the blurring of responsibilities between Commonwealth and State Governments. The Commonwealth purports to place conditions on the funds that it provides; the States utilise the fungibility of money to retain a high degree of de facto control. The public has difficulty in allocating responsibility for good and poor performance alike. Federal Government election campaigns are run to a significant extent on issues within the responsibility of the States, without means being available to assess the extent of real Federal influence in these areas.

One consequence of the overlap of responsibilities is high compliance costs for people and organisations seeking to utilise services funded by Government in areas of shared responsibility. This has been a theme of representations to the Review, from both business and community welfare groups.

There is a great deal of consistency in suggestions for reforming and simplifying the SPPs. There is wide support for the consolidation of the SPPs in areas of exclusive State Constitutional responsibility into a small number of sectoral programs, with Commonwealth conditions taking the form of jointly developed and agreed broad objectives. Performance against objectives would be monitored, without Commonwealth involvement in management of the programs. There may be an area of shared Constitutional responsibility, in which it would be appropriate for the Commonwealth to accept administrative responsibility and for the States to agree and monitor performance against objectives.

The remedies are not so readily agreed for the complexity and associated lack of transparency and accountability in the distribution of GST revenues. There are many anomalies in the current detail of calculation of GST shares, but their

remedy would add to complexity. Simplification would have to be based on simpler principles, which would need to pass tests of efficiency and fairness.

One simplification would involve returning revenue to the States in which it was generated. This would approximate arrangements in Federations, including the United States, which have a low degree of vertical fiscal imbalance. This would involve radical reallocation of grants amongst the States.

At many times over the past century when leaders or officials have sought a simple rule for allocation, they have fixed upon equal per capita grants. This was the basis of distribution of the surplus of Commonwealth revenue over expenditure in the early years of the Federation. It was the basis that the Commonwealth Treasury opined was the way of the future in its last public expression of a Treasury view on these matters. It is the benchmark against which the CGC explains its recommendations for actual allocations. When the CGC itself was asked in the late 1970's to recommend a basis for the distribution of Commonwealth payments to local government councils amongst States, it outlined an equal per capita distribution on the basis of its "simplicity and predictability" (Commonwealth Grants Commission, 1979).

One simple variation on the equal per capita theme would be the addition of a lump sum to each jurisdiction to cover the fixed costs associated with maintenance of Government. This would cover the concern for "interstate equity" that derives from recognition that a fiscally weak State should be assisted to the extent necessary for participation as a State in the Federation.

Per capita allocation, perhaps with a fixed lump sum to cover overheads, would be simple and transparent, and would make State public finances more transparent. But would it be equitable; and what would be its effects on efficiency?

## **7. CONCLUDING REMARKS**

This paper has raised some large questions about the efficiency, equity and simplicity of the established arrangements for Commonwealth payments to the States. We look forward to assistance in answering the questions from discussion at the forum.

The answers will contribute to assessments about whether there are superior alternatives.

Judgements will need to be made between different conceptions of equity, and of the relative importance of equity, efficiency and other objectives.

Judgements will need to be made about the efficiency, equity and simplicity of realistic possible alternatives in practice, which may differ from ideal schemes drawn up without regard to the political compromises that typically accompany the introduction of new arrangements among governments. We are aware that whatever the imperfections of current arrangements, the allocation of Commonwealth funding amongst the States through the unmediated political process could lead to worse outcomes.

These issues are important in the affairs of Australia. The total of the community's resources allocated via Commonwealth-State transfers (around \$50 billion annually) is a large factor in the national economy, and the transfers are crucial to provision of many of the bread-and-butter services that are most important to Australians in their everyday lives.

Whatever the difficulties of the issues themselves, or of securing reform if superior alternatives can be identified, the importance of the issues certainly warrants considerable effort in analysis and identification of alternatives — and

indeed in taking them up subsequently. This forum can potentially make a valuable contribution to that effort.

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