

7 Australia's federal experience

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Introduction

In 1901, the former colonies of New South Wales, Victoria, Queensland, Tasmania, Western Australia and South Australia federated to create the nation of Australia under the auspices of a new constitution. Within the federation, the colonies became States and a democratic national parliament with an upper house (the Senate) and a lower house (the House of Representatives) was created.¹ The party that achieves a majority of seats in the lower house forms the national government, generally referred to as the Commonwealth.

Since then Australia has remained a relatively prosperous democratic federation with two features that distinguish its fiscal arrangements from other federal countries: highly centralized tax powers and a strong emphasis on inter-State equity. Centralization of taxes has its origins in decisions made in the course of framing the Constitution, as well as transfers of taxing powers made during the Second World War. The cornerstone of the emphasis on equity is a federal institution known as the Commonwealth Grants Commission. Created in 1933 following a period of instability in the federal union, the Commission implements the most comprehensive system of inter-State transfers of any federal country. The goal of these transfers is to achieve equity across States in the provision of public services.

The next two sections of the chapter are organized around two important distinguishing features of Australian federalism – centralization and the emphasis on equity. The conclusion highlights implications of this experience for the European Union.

Centralization

In common with the European Union, an important economic motive behind Australian federation was the desire to create a customs union with a uniform system of external tariffs.² For this reason, the power to levy tariffs was given exclusively to the Commonwealth in Section 90 of the Constitution. The right to levy excise taxes was also ceded to the Commonwealth within the same Section. Various explanations for this have been offered. One is that the founders were concerned that States might use excise taxes to interfere with

the intended effects of federal tariff policy.³ Another is that they were worried over the potential for excise tax competition between States to distort free internal trade. There is also evidence of a general fear of the negative effects of inter-colonial rivalry, its impact on federal stability and the need for the States to pursue common interests through co-operation.

The effect of the State tariff and excise tax exclusion embodied in Section 90 was to leave the States financially weak. In the now famous words of Alfred Deakin, one of the key instigators of Australian union, Section 90 left the States 'financially bound to the Chariot wheels of the central Government'.⁴ However, though the Commonwealth gained considerable tax powers at federation, it had few expenditure responsibilities (these were restricted mainly to defence and foreign affairs). The Commonwealth's tax revenues far exceeded its spending. States, however, retained responsibility for the major public expenditures.

The mismatch between expenditure and revenue for the two levels of government is illustrated in Table 7.1. In 1901 the Commonwealth was the dominant collector of taxes, although this disparity is reversed if revenue from land sales and business operations is taken into account. The States, on the other hand, were responsible for more than 90 per cent of expenditures. These imbalances have changed during the twentieth century. The increasing importance of the Commonwealth's taxing powers in the overall financing of government spending reflects, in part, the increasing share of total taxes raised by the Commonwealth, rising from 66 to 77 per cent of tax collections. But also, non-tax elements of State revenues have declined as the pace of land sales slackened off and privatization has cut the importance of State-owned business operations. Centralization of expenditure has been even more pronounced. In 1901 the Commonwealth's share of expenditure was less than 10 per cent, with the States providing the bulk of public services. By the end of the century, the share of Commonwealth spending had risen to 53 per cent.

Table 7.1 Changes in revenue and spending powers: Australia (%)

	1901–02		1998–99		
	<i>Commonwealth</i>	<i>State</i>	<i>Commonwealth</i>	<i>State</i>	<i>Local</i>
Tax revenue ¹	76.2	23.8	77.1	19.4	3.5
Total revenue ²	41.5	58.5	68.4	26.2	5.3
Total expenditure ³	9.4	90.6	52.7	47.3	

Notes

1 For 1901–02, Barnard (1986); for 1998–99, Australian Bureau of Statistics, *Taxation Revenue 1998–99* (catalogue no. 5506.0), Table 2.

2 Includes revenue from land sales, net revenues from business operations and taxation, but excludes intergovernment transfers. For 1901–02, source as for 1; for 1998–99, Australian Bureau of Statistics, *Government Financial Estimates 1999–2000* (catalogue no. 5501.0), Tables 2, 5 and 11.

3 Excludes intergovernment transfers. For 1901–02, Barnard (1986); for 1998–99, Australian Bureau of Statistics, *Government Financial Estimates 1999–2000* (catalogue no. 5501.0), Tables 1 and 10.

Comparing the 1901 figures with those for 1998, two points emerge: the Commonwealth has greatly increased its share of total tax revenue collected and it has expanded its share of total public sector expenditure.⁵ These changes are due mainly to the further loss of tax powers by the States in the period between federation and the current era. They are also influenced by the fact that there was a general expansion of the role of government during the twentieth century and much of this expansion occurred at the national level (principally, development of the welfare state and income redistribution).

Taxes

The shift of taxation powers to the Commonwealth since federation has been a result of two factors. First, in 1942 the Commonwealth took control of the income tax base as a temporary wartime measure, albeit not without an unsuccessful High Court challenge by the States as to the constitutional validity of the legislation. Prior to 1942, both the States and the Commonwealth levied income taxes, with a wide variety of bases and rates. In the previous two decades there had been some movement towards uniformity of tax arrangements by the various States, but in 1942 there were still 26 separate Commonwealth and State income taxes.⁶ In the longer term, Commonwealth control of the income tax simplified and unified that part of the tax system; in the short term a more important motivation was to constrain spending by the States, releasing resources for military purposes. The latter objective was achieved by returning to the States a sum less than the State taxes collected immediately prior to the transfer of tax responsibility. In terms of tax centralization, the effect of these measures was dramatic – in 1945, 94 per cent of all taxes were collected by the Commonwealth.⁷

Temporary tax measures quickly acquire a degree of permanence, and in 1946 this proved to be the case with the transfer of income tax powers. Post-war legislation enacted by the Commonwealth entrenched wartime arrangements. Provided States vacated the income tax field, they received grants from the Commonwealth, the size of which was indexed for growth in population and nominal wages. With various changes to the basis on which the grants are determined, this system has persisted to the present day.

The second major force towards centralization involves the meaning of the term 'excise' used in Section 90 of the Constitution. To an economist, an excise at the State level is a tax on the quantity or value of particular goods produced within the State. As noted earlier, such a tax, if levied by a State, has the potential to discriminate between imported and locally produced goods and may interfere with the intended effects of federal tariff policy.

Given the lack of clarity in the Constitutional debates and the Constitution itself about the definition of excise, the High Court was soon asked to interpret its meaning. The first case to be considered⁸ saw the Court adopt an economist's view of an excise. This left the States free, in principle, to impose other consumption-type taxes, including general sales or value added taxes.

The early stance by the Court was soon abandoned in favour of a more expansive view of the meaning of excise, the implication of which is that the States can only levy a tax on consumption (e.g. a general sales tax) as long as they levied the tax on consumers directly. However, adoption of such a broad view of excise meant that the States could not use retailers as tax collection agents, effectively excluding the States from adopting consumption taxes. Section 90 cases have seen the adoption of this wide definition of an excise as any tax on the production, distribution or sale of goods. In other words, an excise has been interpreted by the High Court more as a general sales tax or value added tax.

Thus, the excise tax exclusion within Section 90 of the Constitution, together with the High Court's broad interpretation of excise, has excluded the States from the consumption tax base.⁹ As with the income tax, this is in contrast to other federations where sub national governments levy consumption taxes. The result is that, as detailed in Table 7.2, the States have been restricted to a relatively narrow tax base, relying mainly for their own-source revenues on payroll taxes, land taxes, franchise fees, and a range of other minor tax instruments.

Spending

While tax powers have been ceded to the Commonwealth the States have retained responsibility for major areas of spending, including education, health and the provision of important public infrastructure such as utility services, roads, rail networks and ports. However, as noted, the major expansion of public expenditure – a feature of most economies during the twentieth century – has taken place at the national level, principally in the area of income redistribution. Thus, as indicated in Table 7.1, the Commonwealth's share of expenditure has increased considerably since 1901 while the States' share has decreased. Unlike taxes, this is due to the expansion in expenditure at the national level rather than to any loss of expenditure responsibilities by the States.

Fiscal imbalance

We have argued that in Australia the disparity between revenue means and expenditure needs at the two levels of government – vertical fiscal imbalance – has increased substantially as a result of the centralization of tax powers. Though similar trends can be identified for other major federations, it is commonly recognized that the level and rate of increase of central dominance over taxation has been relatively more marked in Australia. This is recognized, for example, by Shah (1994). He shows, using an index of sub-national autonomy derived from measures of vertical fiscal imbalance such as those presented in Table 7.1, that of ten major federations (including the United States and Germany), Australian States have the second lowest degree of fiscal autonomy.

Table 7.2 Sources of tax revenue 1998–99 (\$Abn)

Commonwealth		State and local	
Income	101.9	Payroll	8.0
Payroll	3.2	Gambling and insurance	6.2
Sales, customs and excise	31.7	Motor vehicles	3.9
Other	0.5	Franchises	9.9
		Property	16.7
Total	137.3	Total	40.8

Source: Australian Bureau of Statistics, *Taxation Revenue 1998–99* (catalogue no. 5506.0), Tables 3 and 4.

Scholarly debate over the economic costs and benefits of vertical fiscal imbalance and State fiscal dependence has not been particularly intense. Research results that do exist have been almost entirely against centralization. Specifically, commentators have argued that centralization reduces accountability and creates fiscal illusion among voters. They also argue that policy competition between States which, as Breton (1984) has proposed, may curtail the taxing power of wayward governments acting in their own self-interest, is diminished by centralization. While this may result in a lower overall level of taxation than otherwise would have been the case, other writers observe that the States have been forced to rely on relatively inefficient taxes because of the central dominance of the major bases. Useful discussions of all of these arguments can be found in Walsh (1990, 1993, 1996).

Finding Australian scholars who support the *status quo* is much more difficult – indeed, we know of no well-reasoned defence of Australian centralization. Politicians and policy-makers claim that centralization of tax powers is necessary in order to allow the Commonwealth to conduct macroeconomic policy, income redistribution and pursue the national interest in matters of joint concern to the States. As noted earlier, pursuit of common interests was a motivating factor behind federation in 1901 and the Commonwealth frequently uses this justification for central intervention in its dealings with the States.

The detractors from centralization have called for a reallocation of tax powers to the States. These calls were particularly strong during the 1980s and early 1990s when the States were going through a period of budgetary stress, but have tapered off in recent years. Two options were proposed. The first, allowing the States into the consumption tax base, required a Constitutional amendment to delete the words ‘. . . and of excise’ from Section 90. The second, that the States be given access to the income tax base – in conjunction with the Commonwealth – was the proposal that seemed to be taken most seriously, at least among the few scholars taking an interest in federalism. The economic costs and benefits of each approach are discussed in Collins (1993). In practice, neither of these proposals received widespread support at the policy or political level. Federal politicians and bureaucrats

continue to use national interest and macroeconomic arguments in support of the *status quo*.

Specific purpose payments

Petchey and Shapiro (1997b) provide another perspective. They observe that, because of a High Court decision in 1926, the Commonwealth has unfettered power to attach conditions to the tax reimbursement transfers that it must make to the States each year as a result of vertical fiscal imbalance. Successive Commonwealth administrations have taken advantage of this decision and an increasing proportion of total Commonwealth transfers to the States since 1926 have been conditional. The conditions include matching requirements and clauses specifying that the States must adopt policy guidelines set down by the Commonwealth in order to qualify for funding. Greatest use of these transfers, known as specific purpose payments, has been made in education and health. In the year 2000–01, specific purpose payments will account for 69 per cent of all Commonwealth transfers to the States.

Bureaucracies have grown at the Commonwealth and State levels of government charged with the sole task of administering and negotiating agreements related to specific purpose payments. In recent years both levels of government have expressed support for a reduction in these conditional grants, without effect. The States in 2000 remain highly dependent on specific purpose payments, particularly in health and education.

According to the thesis put forward by Petchey and Shapiro, specific purpose payments have allowed the Commonwealth to have a considerable influence on State policy-making in areas intended by the spirit of the Constitution to be State responsibilities. Indirectly, tax centralization and vertical fiscal imbalance have facilitated the diminution of State autonomy over their expenditure policies. States have increasingly become spending agents of the Commonwealth with little discretionary power over taxes or expenditure policy. The implication is that centralization is even more severe in Australia than measures of fiscal autonomy, for example, those of Shah, or simple vertical fiscal imbalance ratios, suggest.

The 2000 tax reforms

Recently, a rare opportunity arose to decentralise tax powers, a chance that was not taken. During 2000, the Commonwealth introduced a value added tax known locally as a Goods and Services Tax (GST). In 2000–01, the new tax is expected to raise about \$24 billion.¹⁰ There have been compensating cuts in income and other taxes so that the policy change is approximately revenue neutral from the Commonwealth's perspective. The principal motivation for the changes to tax policy is economic efficiency, with the choice of consumption tax based on the belief that a value added tax is less inefficient than a simple consumption tax.¹¹

Prior to its introduction, limited debate took place on whether the tax should be levied independently by the States – an option that would require amendment of Section 90 of the Constitution. Supporters of a more competitive federation favoured the introduction of a State based sales tax similar to the one levied by the United States.¹² However, for policy-makers and politicians the constitutional obstacles to this option seemed insurmountable. In Australia, there is a history of electoral suspicion and rejection of constitutional amendments, and given the practical difficulties with operating a value added tax at the sub-national level in a federation (see Boadway (1997)), a State level consumption tax was ruled out.

The outcome of the tax reforms imply that lip service was paid to the notion of improving the States' autonomy, but in practice nothing changed. The Commonwealth levies the GST, with all the revenue returned to the States. The States also have some indirect say in levying the tax rate (currently a uniform 10 per cent) and administrative matters. The Commonwealth has eliminated its existing unconditional grants to the States (though not the specific purposes payments) by an amount equal to the revenue raised from the GST.¹³ Therefore, the reforms still leave the Commonwealth with substantial control of State expenditure at the margin, at least in the immediate term.

This amounts to a revenue sharing mechanism in which the States share one hundred per cent of the federal GST base. The arrangements do not give the States independent tax powers and do not increase State fiscal autonomy. Rather, the untied grants that States used to receive, and which were determined largely at the discretion of the Commonwealth, have been replaced by a revenue sharing system.

Of course, one can argue that this gives the States more certainty since they are less dependent on Commonwealth discretion over the size of untied transfers and instead have access to a tax that will likely grow in real terms. However, in another sense they are just as dependent on the Commonwealth which still has discretionary power over the tax rate, the tax base, and whether the States continue to receive one hundred per cent of the revenue raised.

The 'fiscal cartel' thesis

Explanations of why Australia has become so centralized are few. One of the more prominent ideas is that the Australian federation is a fiscal cartel in which States and the Commonwealth collude to minimize tax competition. The benefit to the Commonwealth and the States is that they exploit the monopoly power of the central government and raise more revenue than under a competitive tax regime in which tax powers are decentralized and States engage in tax competition. The monopoly tax revenues are passed back to the States through the intergovernmental transfer system. Shapiro and Petchey (1994), in a theoretical analysis of the economic effects of the excise tax exclusion within Section 90, model Australian federalism in this fashion.

Is this good or bad for citizens? The answer depends on how one views

government behaviour. If it is believed that governments are benevolent and pursue the interests of the citizenry, then a fiscal cartel may be desirable. In this world, it is well known that fiscal competition leads to inefficient outcomes.¹⁴ By eliminating the inefficiency, a cartel raises social welfare (tax harmonization, as distinct from centralized tax collection, can achieve the same welfare improving outcomes if governments are benevolent). The presence of scale economies associated with tax collection enhances the welfare gains from a fiscal cartel (scale economies are not a benefit of harmonization, however, since tax raising remains at the state level). In Australia, the economies of scale argument is frequently used by the Commonwealth to justify central collection of taxes.

Alternatively, if governments pursue their own interests, including revenue maximization or furthering the prospects of powerful lobby groups, a tax cartel is not in citizens' interests. In this world, fiscal competition helps protect citizens against the abuse of power by governments. By removing competition the cartel takes away this protection and makes it easier for governments to pursue their own interests.

Anecdotal evidence of political and official support for the tax cartel is readily found. Kelly (1978) notes that the system is one of the 'sacred cows' of Australian politics. The discussion of this issue in Kelly ends with a poem, supposedly a State tax official's response to a Commonwealth offer of more tax powers:¹⁵

We thank you for the offer of the cow,
But we can't milk so we answer now,
We answer with a loud emphatic chorus,
You keep the cow and do the milking for us.

Regretfully, there is no rigorous empirical analysis of whether State governments and the Commonwealth have colluded in a tax cartel arrangement to maximize tax revenue. But the idea remains a popular one in Australia. It also appeals to economists who worry about the power of government, public choice issues and whether governments act in the best interests of citizens or pursue their own agendas.

Borrowing

At the time of federation, the States and Commonwealth each retained the right to issue sovereign debt. No rules-based constraints on borrowing, such as the balanced budget requirements or specified debt ratios that characterize other federal systems, were contemplated. None have been implemented subsequently. Rather, the twentieth century has seen increasing centralism in terms of the Commonwealth's control over global borrowing limits for the federation as a whole. It is only in recent times that this control has been relaxed, with increasing reliance placed on market-based monitoring of State indebtedness.

The Commonwealth's first substantive entry into the market was occasioned

by the need for military spending after 1914. After the war, the early 1920s was a time of intense competition between State governments in domestic and international financial markets, and non-co-operative borrowing policy was thought to create negative externalities. The Premiers' Conference of 1923¹⁶ delivered a cooperative mechanism by creating a new institution, the Loan Council, with the aim of co-ordinating borrowings by the States and the Commonwealth. The Council did this by securing voluntary agreement on the timing of loan issues and the equalization of loan conditions and interest rates to be paid.

At the time the concern was with minimizing borrowing-policy competition between governments, rather than with the magnitude of borrowings and the prospect that governments might be 'under' or 'over' borrowing. States were left to determine how much they borrowed. Further, if agreement was not reached over timing, interest rates and conditions, States could opt out of the voluntary compact. The Commonwealth's role was limited to one of facilitating co-operation and monitoring the voluntary Council's operations based on information reported by the States on their borrowings.

These voluntary arrangements were soon replaced by a permanent Loan Council as part of the Financial Agreement of 1927, an objective of which was for the Commonwealth to acquire freehold title to properties transferred to it at the time of federation, in return for the assumption of Commonwealth liability for State debt.¹⁷ The seeds of Commonwealth domination of the Council were sown from the start because, although the States each had one vote in Council decisions, the Commonwealth had two votes plus a casting vote. By the 1930s concerns about the need to eliminate competition from government borrowing policies, the prime purpose for setting up the Loan Council, gave way to worries over excessive state borrowing and high spending on infrastructure during the Depression. The Commonwealth responded by exercising its control over the Loan Council and imposed binding limits on new state borrowings. From this point onward, the Commonwealth's stranglehold on the Loan Council expanded and it was increasingly used as a credit rationing scheme applied to the States and local governments to achieve macroeconomic goals.

This system broke down in the 1980s, for a number of reasons. At the time the Commonwealth had large budget deficits and used the Loan Council to reduce the state allocations in real terms. States responded by using innovative financing arrangements, made possible by general deregulation of financial markets, through both local governments and public enterprises. The proportion of State and local government borrowing under the control of the Loan Council fell from 95 per cent in 1979–80 to 25 per cent in 1983–84.

The financial market deregulation of the early 1980s also helped foster the idea that financial markets could become effective monitors and regulators of sub-national borrowing policies. By this time concerns over inefficiencies arising from competition between States in financial markets had also evaporated because of the increasing sophistication and size of domestic markets, and growing access by the public sector to international financial markets.

The so-called global approach, introduced in 1985, was an attempt to continue regulation in the form of a voluntary agreement between the Commonwealth and the States, monitored by the Commonwealth through the Commonwealth Treasury. The Commonwealth had no legal sanctions to enforce compliance as it did under the earlier arrangements but it did use financial sanctions quite effectively, for a time, after 1985. The role of the Loan Council as sole borrower on behalf of the States was scrapped. It was given the new task of setting an overall global borrowing limit for new (gross) borrowings for the sub-national sector. Given the federal dominance of the Loan Council this was in reality nominated by the Commonwealth and agreed to by the States following 'negotiation' with the threat of financial sanctions through general revenue grants being used to ensure compliance.

This period marked a radical shift in the distribution of borrowing policy powers in the sense that states were now allowed to borrow directly from financial markets in their own right, and negotiate directly over terms and conditions. Further, the explicit Commonwealth guarantee had gone. For the first time since 1927, investors were lending directly to states as sovereign entities and being exposed to state risk, although there was still an implicit Commonwealth guarantee. In practice, the Commonwealth's financial sanctions have proved impossible to enforce with any precision. Because a major activity of the States is the provision of public services through institutions with a variety of ownership structures, monitoring State liabilities is extremely difficult.

A feature of the new arrangements is that while the Loan Council has a less direct role in sub-national borrowing regulation, and the states have more independence, moves have been taken to improve monitoring and regulation of sub-national borrowing by financial markets. Adoption of a common accrual accounting standard across all national and sub-national jurisdictions is an important part of this process. However, financial markets alone are still seen in Australia as inadequate monitors and regulators of the States. Two reasons are given for this. First, in a federation where the central government implicitly guarantees state debts there may be a moral hazard problem leading states to over-borrow. Second, there is a public choice question of whether governments react efficiently to financial market signals. Both have been advanced as reasons for continued regulation of sub-national borrowings in Australia.

There has been no recent analysis of the efficiency of these arrangements. However, it is of note that in 1999 general government debt, aggregated over all jurisdictions, was just 15.7 per cent of GDP, which is low by contemporary OECD standards.¹⁸

Constitutional and political constraints

Clearly, the Australian Constitution has not protected State interests from the encroachment of Commonwealth fiscal dominance. Rather, through its lack of

specificity, and the actions of the High Court, the Constitution has aided the loss of State autonomy.

The other way that State interests might have been protected is through the political process itself. In this respect, a two-house Parliamentary system was established at the federal level in 1901: the House of Representatives and the Senate. The intended role of the Senate was to protect State interests, and in particular, the interests of the less populous States. To achieve this, these States were given more than their per-capita share of Senate representatives (vote weighting). However, most political commentators recognize that the Senate has never been an effective 'States house' mainly because of the party system, which has seen voting on party, not State, lines.

The implication is that the institutions and legal processes established at federation left the way open for Australia to become highly centralized if the public choice process at the national and State levels decided that this should happen.

Equity

High centralization and vertical fiscal imbalance imply that the Commonwealth makes comparatively large transfers to the States each year. These transfers now comprise specific purpose payments (conditional transfers) and all of the revenue from the GST, which is unconditional.

We have noted that the specific purpose payments have promoted Commonwealth influence in State policy decisions – back door centralization. What we now suggest is that, through the model used to distribute unconditional transfers, centralization also facilitates inter State uniformity in the provision of public services. The emphasis on uniformity, we argue, is a result of an overriding concern in Australia for egalitarianism and equity. As noted, this is a key feature that separates Australia's system of federalism from other countries.

The distribution of unconditional transfers to the States is determined by a horizontal fiscal equalization formula developed by the Commonwealth Grants Commission. The formula, the most comprehensive adopted anywhere in the world, is complex. A full explanation is unwarranted here but we can give some basic insights using a simple example. Consider revenue base j . The formula estimates the average tax rate applied by all States to base j . Suppose this to be 10 per cent. The formula then calculates the (per capita) value of tax base j in State i , which we suppose for our example to be \$40, and the (per-capita) value of tax base j averaged across all States, which we suppose to be \$50.

Two calculations then follow. First, the average tax rate for base j is applied to the average tax base j . In the example, this yields \$5. The average tax rate is then applied to tax base j in State i – in our example this yields \$4. The implication is that if State i were to apply the average tax rate to its own tax base j , it would raise \$4 in revenue, but when the average tax rate is applied to

the average tax base, the yield is \$5. The difference is due to the fact that State *i*, in our example, is assumed to have a relatively low valued tax base *j* (on a per-capita basis). This might be because it is a relatively poor State.

The formula treats the difference between the two, here an amount of \$1, as a revenue need. State *i* would be entitled to receive a \$1 (per-capita) grant from the pool of funds available. This means that if the State chooses to make an average tax effort with respect to base *j* it will receive \$5 in revenue – \$4 from its own efforts and \$1 in grant which is derived from the tax base of all other States included in the formula.

In this respect, the formula is no different from tax base sharing schemes used around the world, both at the national level, and at the city or regional level. Essentially, the formula allows each State to share the total tax base of all States and to raise a given amount of revenue from its own base without having to tax its citizens more heavily (or lightly) than the average tax rate. Of course, the total revenue need for State *i* will be the sum of its needs on each tax base. This sum could be negative or positive, depending on whether State *i* is rich or poor in terms of income and endowments of resources.

What distinguishes the Australian approach is the other component of the model which assesses expenditure needs. This is calculated by first assessing, for each expenditure category, the average (across all States) cost of providing the service. The formula then estimates the extent to which the cost of providing each service in State *i* deviates from the average for that service due to factors such as population size, the geographic dispersion of the population, economies of scale, ethnic background and age distribution. These factors are known as 'cost disabilities' and can be compensated under the Commission's methodology. In estimating cost disabilities, an attempt is made to isolate the influence of policy induced inefficiencies.

The Grants Commission estimates two types of cost disability, one for recurrent expenditures and another for spending on capital. However, the Commission's capital cost disabilities are estimated from the recurrent disabilities. This procedure, along with other aspects of the estimation of capital disabilities, has attracted criticism from the States and the Commission is currently undertaking a review of its capital equalization methodology.¹⁹

The deviation between a State's cost of providing a particular service and the average cost is then used to create an estimate of the expenditure need for that service in State *i*. Positive expenditure needs arise for a service when a State faces relatively high costs of providing it. The sum of expenditure needs across all services determines a State's total expenditure need, which may be positive or negative.

The equalization formula combines the revenue and expenditures needs estimates in such a way that yields, for each State, a ratio that determines the State's share of the pool of funds available for distribution. The share of a State in the revenue pool is determined by the strength of its revenue base relative to the average and the costs it faces in providing services relative to the average.

A major impact of the formula is to redistribute income from the high

income low cost States to the lower income high cost States. The extent of this redistribution can be seen by comparing what the States actually receive from the pool under the equalization model with what they would receive if the revenue were given back to the States on the basis of where it is raised. Alternatively, one can examine what the States would receive if there were an equal per-capita distribution. This last comparison is made in Table 7.3. Clearly, New South Wales and Victoria (high income and low cost States) and Western Australia (high income but high cost State) would gain from an equal per-capita distribution while all other States would lose, relative to the distribution using the Commission's formula.

Criticism of the equalization system has been directed at its efficiency costs. For example, Gramlich (1984) has been highly critical of the equalization model on efficiency grounds, claiming that it encourages people and capital to migrate to remote areas that are costly to supply. Dixon *et al.* (1993) use a general equilibrium model to argue that equalization leads to inefficient inter-State migration of capital and labour. Albon (1990) makes similar criticisms.

The system can also be defended on efficiency grounds. An obvious way to do this is to draw on the well known notion that inter-State transfers may be required to establish an efficient allocation of mobile factors of production between States. This argument, developed by Boadway and Flatters (1982), and refined by others including Myers (1990), Mansoorian and Myers (1993) and Burbidge and Myers (1994), is that if States have access to taxes on resource rents, or create fiscal externalities from the operation of their tax and expenditure systems, a free migration equilibrium in which factors allocate themselves between States to satisfy some sort of 'equating at the margin rule'

Table 7.3 The impact of horizontal fiscal equalization, Australia, 2000–01

	Distribution using CGC relativities (1)		Distribution on equal per-capita basis (2)		Difference (1) – (2)
	\$million	%	\$million	%	
New South Wales	9,229.2	30.7	10,149.0	33.8	–920.0
Victoria	6,499.3	21.6	7,464.0	24.8	–965.0
Queensland	5,703.3	19.0	5,599.0	18.6	104.0
Western Australia	2,920.1	9.7	2,968.0	9.9	–48.0
South Australia	2,768.0	9.2	2,340.0	7.8	428.0
Tasmania	1,104.0	3.7	730.0	2.4	373.0
Australian Capital Territory	544.7	1.8	489.0	1.6	55.0
Northern Territory	1,279.0	4.3	307.0	1.0	972.0
Total	30,048.0	100.0	30,048.0	100.0	0.0

Source: Commonwealth Budget Paper No. 3, 'Federal Financial Relations, 2000–01'.

Notes

Total is equal to \$23,955.6 million from the Goods and Services Tax in 2000–01 and \$6,092.1 in Health Care Grants which are also subject to the equalization formula.

may be inefficient. For example resource-rich States may use rents to provide location-specific factor subsidies. Inter-State transfers then have the potential to move factors in such a way that creates efficiency in their geographic distribution and maximizes national welfare.

Dixon *et al.* (1993) obtain the result that transfers shift factors inefficiently because they do not allow for the possibility that State taxes on resource rents and fiscal externalities can lead to inefficient free migration of mobile factors. Rather, in their model, factors always allocate themselves efficiently across States in the absence of transfers. Therefore, any inter State transfer induces inefficiency. This feature of the Dixon *et al.* (1993) model was emphasized by Petchey (1995) who, using a model more in the spirit of Boadway and Flatters, showed that transfers can be efficiency enhancing, and more specifically, that Australian equalization – even with its inclusion of expenditure needs – may be efficiency enhancing.

The efficiency effects of Australian equalization, when assessed against factor mobility arguments, are not yet settled. But one can say that the previously dominant opinion, that equalization creates inefficiency in the geographic distribution of resources, has been countered by other arguments. In our view, the two sides to the debate have probably neutralized one another, and interest in the issue has now waned to some extent.

Inter-State transfers may also be the glue that holds a federation together, ensuring federal stability. Briefly, the idea is that some States are winners from the process of federation while others are losers. The distribution of winners and losers, and the size of the gains and losses, is dependent upon the degree of diversity between the States forming a union. Diversity may be expressed in terms of economic factors such as incomes, preferences, production technologies or endowments of natural resources, as well as in terms of cultural, ethnic and political differences. If the economic surplus from union is sufficiently large to compensate the losing States, leaving them no worse off than they were in autarky (and hopefully better off), while at the same time making the winning States better off, then the union may be stable in the sense that no participating State will wish to secede. However, stability may depend on the existence of inter-State transfers. Moreover, the larger is the diversity between members of the union, the greater is the need for inter-State transfers to maintain stability. These conclusions result from the application of co-operative game theory concepts (where side payments are allowed) to the theory of federal union.

In Australia's case, there is some evidence that federal stability was a significant motivating force behind the creation of the Commonwealth Grants Commission in 1933.²⁰ However, since then federal stability has become less of an issue in Australia – especially since there is now such a high degree of homogeneity between the States. It would be difficult to defend equalization in Australia, at least in modern times, on federal stability arguments. The factor mobility–efficiency case has also, with the exception of Petchey (1995), not generally been used to justify Australian equalization. Rather, the

prominent view is that equalization is designed to support uniformity in the provision of access to public services across States – an equity goal.

Conclusion

Regional unions of States are susceptible to centralization and the sustained loss of autonomy by member States. A benefit is that the union gains from scale economies associated with tax collection, and also the provision of public goods. Central action also allows a union of States to pursue common interests. But there are costs including a loss of policy diversity. This cost is considerable if preferences, resource endowments and technologies of the member states are very different. Also, if one is seduced by the notion that governments pursue their own agendas, the concentration of tax powers may not be in the best interests of citizens. Achieving the most desirable degree of central versus decentralized responsibilities is a matter of balancing the costs and benefits.

The aim of a regional union, such as the European Union, should be to develop a distribution of tax and spending powers that minimizes the costs of central action and maximizes the benefits. This will entail the development of mechanisms to protect member state interests as the power of the centre grows, as it must in order to deal with matters of common interest to the Union. The Australian experience suggests that explicit political and constitutional constraints on central power are difficult to design and may not work in practice.

If the European Union expands to accept more States from the eastern borders of the Union (e.g. States from the former Soviet Bloc) then the Union will also become much more disparate in terms of incomes and preferences over public policy outcomes. As a result, there will be greater migration of mobile factors of production, including capital and certain types of labour, from poorer eastern States to richer western States as the borders are opened. Fears of such migration are causing resistance to further integration. They have led to recent calls, by countries such as Germany, for policies designed to curtail the expected influx of labour. One proposal is that labour in the currently excluded States be made to wait for seven years (after integration) before being able to acquire a job in one of the existing member states.

An alternative, and perhaps more effective response, would be for the Union to consider a system of inter-State equalization transfers. We know from the discussion here that inter-State equalization transfers, in this case from the richer to the poorer States, have the potential to reduce any inefficient migration that may follow from an expansion of membership. Thus, the further planned expansion of the Union may need to be accompanied by the introduction of a formal system of Union wide equalization. This may mean considering, at the very least, a system of tax base equalization, which estimates revenue needs of member states. The Australian experience also suggests that there are benefits to having a formal and transparent system of inter-State redistribution, implemented by a separate institution that is responsible directly to the central parliament.

Notes

- 1 Two territories (the Northern Territory and the Australian Capital Territory) have been created since federation. These operate like States for most purposes and in what follows references to States can also be taken to refer to the territories. The third tier of government – local government – includes urban municipal authorities and rural authorities. These are not sovereign entities and have no status in the Australian constitution, although they do have status in State constitutions.
- 2 All the colonies were on the gold standard prior to federation, so monetary union preceded formation of a customs union, reversing the European sequence.
- 3 For discussion of this argument, see Coper (1988).
- 4 Deakin 1901, p. 17.
- 5 Examination of time series data (not displayed) on revenue and expenditure shares confirms that these observations are long run trends. We have presented observations for two years only for presentational convenience.
- 6 See Laffer (1942).
- 7 *Yearbook of the Commonwealth of Australia*, No.36 1944–45, p. 730.
- 8 *Peterswald v Bartley* (1904).
- 9 There were, until recently, three exceptions: the States were allowed to levy franchise fees on tobacco, alcohol and petroleum products. The Court justified this by arguing that franchise fees are taxes on the right to conduct business rather than consumption itself (this interpretation relied on the use of the previous year's sales as the fee base). Recently, however, even these loopholes have been closed and the Commonwealth on behalf of the States now collects franchise fees, with the revenue being returned to the States using a distribution formula.
- 10 Commonwealth Budget Paper No. 3, 2000–01.
- 11 The efficiency arguments are discussed in Freebairn (1998).
- 12 See the arguments in Petchey and Shapiro (1997a).
- 13 As is discussed later, the distribution of the GST revenue is determined by a fiscal equalization formula (as were the old Financial Assistance Grants which are replaced by the GST revenue).
- 14 See Wildasin (1988).
- 15 We do not know whether the poem is imagined (by Kelly) or real, and assume the 'cow' to be a representative taxpayer.
- 16 The Premiers' Conference is an annual meeting between state premiers and the Prime Minister to coordinate intergovernmental financial issues.
- 17 The Financial Agreement was a formal contract between the States and the Commonwealth, in the sense that the Loan Council was established by an amendment to the Constitution.
- 18 Commonwealth of Australia (2000) Table B4.
- 19 The only empirical estimates of capital cost disabilities for the Australian States are to be found in Petchey, Shapiro, MacDonald and Koshy (2000).
- 20 See May (1971).

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