

ISSUES IN COMMONWEALTH-STATE FUNDING

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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 (Review of Commonwealth-State Funding, 2002a). The Fiscal financial system has grown organically over a long period of time, and changed in some significant ways at the time of introduction of the GST. This paper raises issues relevant to the assessment of the efficiency, equity, transparency, and simplicity of the current arrangements.

FINANCING THE FEDERATION

Fiscal policy was the dominant subject of the debates that preceded Federation. The theory of public finance did not then exist in anything like its present form. However, 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). This 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 at the time of Federation, 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.

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 two fateful decisions of the High Court. The 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, this raised questions in a political context about how the revenue should be distributed amongst States.

There has been a tendency over the past century for “horizontal fiscal equalisation” (redistribution from apparently fiscally strong to apparently weak States) to become more comprehensive. Since the 1930s, the Commonwealth Grants Commission (CGC) has played an advisory role in relation to horizontal

fiscal equalisation. In the 1990s, the CGC initiated a hardening of the equalisation objective, to the equalisation of *capacity* to provide services at the *same* level in all states. The 1999 Intergovernmental Agreement on distribution of the GST provides for allocation of GST revenues amongst states by the CGC consistently with the “principle” of Horizontal Fiscal Equalisation. Some State governments interpret this as requiring distribution according to Horizontal Fiscal Equalisation as it had come to be defined in the late 1990s. Others dispute this interpretation.

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 levels and rates of growth of output and incomes than any other Federation, it now takes horizontal fiscal equalisation further than any other Federation.

The dominance of transfers from the Commonwealth in State finances, and an elaborate framework of horizontal fiscal equalisation has 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.

The political statements by the Commonwealth at the time of the introduction of the GST, and the Intergovernmental Agreement signed by the Commonwealth and all States and Territories, introduce a high 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.

There is now greater certainty than there has been in the past about the quantum of untied Commonwealth revenue available to the States. However, there is no 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 minimal commitment is to maintain SPPs in dollar terms, the Intergovernmental Agreement effectively places 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.

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. Thus the CGC effectively controls the allocation of all Commonwealth payments across the States, including Special Purpose payments, according to its definition of horizontal fiscal equalisation.

THE THEORETICAL CASE FOR HORIZONTAL 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. 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 other States.

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 has since then been cited intensively by Australian supporters of fiscal equalisation. He 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.

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”.

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 late twentieth century Australian form of Horizontal Fiscal Equalisation, Russell Mathews, was, however, aware of the authority that Buchanan provided for a distinctly different approach. In an important exchange with 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 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 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”.

WHAT AUSTRALIA DOES: EFFICIENCY AND ECONOMIC GROWTH

We take the level of vertical fiscal imbalance as being determined by a century of Constitutional politics and High Court interpretation, so that transfers from the Commonwealth to the States 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 of Federal financial arrangements 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 in 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 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.)

(ii) *Relatively fast 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 other community services may also be relevant. 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 poorer growing regions when their marginal social product is higher than in the higher-income region to which they are moving. This is, of course, Buchanan case for Horizontal Fiscal Equalisation.

Buchanan's recent comment that international migration policy needs to be taken into account in assessing this efficiency effect is highly relevant in Australia. Sydney, Melbourne and Perth have much higher proportions of overseas-born to total population than the rest of Australia. This generates many challenges of adjustment, the meeting of which makes demands on public services. The growth in total and per capita Australia output and incomes depends on the scale and composition of immigration. Growth outside the “migrant cities” also depends on the rate of immigration to Sydney, Melbourne and Perth (Garnaut, 2002). Measures to provide more and better public goods outside New South Wales, Victoria and Western Australia, at the cost of higher taxation or poorer services in the “migrant cities” can have large effects on growth in other regions as well as on the national economy, through their effects on levels and composition of migrants.

(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 criticise other jurisdictions' assessments. Less transparent, and probably larger, are the transactions associated with 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 include cost shifting and re-labelling, exploitation of weaknesses in criteria, matching requirements and reporting arrangements. 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.

(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.*

(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 it has not been demonstrated that this is 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.

(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.

If a State makes major and successful efforts to promote economic development, most of the associated gains to its own revenues are equalised away. The deterrent effects of this on incentives for growth-promoting policies are the greater, because growth often requires substantial State capital expenditure on economic and social infrastructure, that is not considered in the CGC's assessment of expenditure disabilities. On the other hand, major errors in economic management that lead to sustained slow growth are substantially compensated by the CGC's assessment that this increases "revenue disabilities" (See the submission by Court and Stone to the Review of Commonwealth-State Funding (<http://www.reviewcommstatefunding.com.au>))

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. 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 suggests that this is an important effect (ACIL, 2002).

WHAT WE DO IN AUSTRALIA: EQUITY

In public finance there are two common concepts of equity, both of which have relevance to the matters under discussion. One is vertical equity, which relates to the treatment of poorer relative to richer people in the national community.

The second is horizontal equity, requiring the similar fiscal treatment of people 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 horizontal 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 in the national community 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.

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.

These two different concepts of equity are both 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 usually equal per capita payments, with adjustments for demographic and other factors affecting need for the particular service.

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 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 or Adelaide.

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, in the absence of differences in average levels of output and income much greater than is typical across the Australian States. 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 collect 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?

The following eight issues arise in assessment of the equity of current Commonwealth-State funding.

(i) How vertically equitable are Commonwealth-State transfers, that is, what are 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?

(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?

(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?

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 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.

Complexity creates large compliance costs for users of the systems. It makes evaluation of performance and efficiency-raising reform difficult. And it creates problems of accountability in a democratic polity.

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. 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. 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. Similarly, States are required to provide services only at an average level of efficiency, notwithstanding that there is now a wealth of data regularly collected from which costs under *best practice* efficiency could be assessed.

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 produces 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.

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.

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 input from officials from the State being assessed and with the right of other States 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 is likely to be one in which transparency is difficult to achieve. 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, in relation to both levels of Government

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.

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?

An alternative 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.

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.

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. 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.

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.

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