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HORIZONTAL FISCAL EQUALISATION IN AUSTRALIA:

ECONOMIC, HISTORICAL AND POLITICAL PERSPECTIVES

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CONTENTS

PREFACE

SCOPE, PURPOSE AND THRUST OF THE STUDY

This collection of interconnected papers has been prepared in the context of the proposal that a number of reviews of Australia's horizontal fiscal equalisation arrangements should be considered at the 1994 Financial Premiers Conference in light of concerns expressed by some regarding the complexity and appropriateness of the Commonwealth Grants Commission's methodology, and the implications of it for economic efficiency. The papers are concerned less with the details of current procedures than with broader consideration of the economic, historical and political foundations of fiscal equalisation in Australia.

The study begins with an Introduction and Overview (Paper 1) of the detailed papers, which *inter alia* offers a broad-brushed assessment of the case for Australia's system of fiscal equalisation, and some background to the 'dispute' over current arrangements which has emerged over recent years, as well as an overview of the major issues raised in, and thrusts of, the individual contributions.

Paper 2 turns to the conceptual foundations for fiscal equalisation as they have been discussed in the economics literature. Reflecting the weight given to them in the literature, the paper pays substantial attention to the arguments based on the promotion of horizontal equity and efficiency in migration (or location) decisions, and suggests that, contrary to the impression often created by critics of equalisation, this literature not only offers support for fiscal equalisation transfers, but does so, in part, on grounds that it is efficiency enhancing. The paper also indicates, however, that there are a broader range of foundations for equalisation, more securely tied to the intrinsically federal features of Australia's fiscal and political system, which also need to be given due weight. These arguments particularly emphasise the role of fiscal equalisation both in underpinning the objectives and values of nationhood and common citizenship among members of a single, but federal, nation, and in promoting the benefits of diversity and (competitive) innovation and experimentation in policy development and service delivery that flow from providing balanced financial security and viability to autonomous State governments.

Paper 3 turns to consider the question of the comparative benchmarks against which fiscal equalisation is to be judged, and other fiscal issues pertinent to the present equalisation system. It points out that interregional transfers which are equalising in their effect occur in all fiscal systems in which central governments have a significant role in providing goods and services nationally (and even in the EC, despite its small "central" budget). Indeed, in highly centralised unitary systems, uniformly applied national tax systems are used to finance broadly equal access to public sector services irrespective of people's location, including those core social services that in federal systems are the province of State governments. Seen in appropriate context, fiscal equalisation in federal systems explicitly promotes what unitary systems undertake implicitly, but with the added advantage of allowing for greater diversity in outcomes and greater innovation and experimentation by sub-national governments.

The third paper also puts the role of fiscal equalisation in Australia into the context of other features of Australia's federal fiscal arrangements. In particular, it considers the implications of

the extreme degree of *vertical* fiscal imbalance, and the distribution of Commonwealth transfers to local government for the way fiscal equalisation arrangements are evaluated.

Paper 4 provides an overview of the history of interregional transfers in Australia, as perceived at the time of federation and as implemented and justified since then, It particularly emphasises that the common current conception that transfers to the less wealthy States had their foundations as compensation to them for the costs of protective national tariffs in the 1920s and 1930s is mistaken and misleading. Rudiments of what we would refer to, today, as the federal or nationhood principles are to be found in the convention debates, and in the special payments made to some States from the early years of federation; recognition of a common citizenship rationale can be found in the changes to State funding arrangements associated with the introduction of a national old age pension as early as 1909; and the fiscal needs of the financially weaker states, recognising that they faced higher tax and debt burdens to fund services and developmental expenditures, were acknowledged in special grants to them well before "costs of the tariff" became the central concern. The establishment of the CGC both formalised and, as societal values progressed, extended the concepts of need, fairness and common-citizenship that had had long historical foundations.

Paper 5 provides an even wider historical, political and political science perspective, encompassing the evolution of Australia's federal political structure from its colonial origins, and contrasting federal, confederal and unitary states in terms of the principles which organise them, and the outcomes they shape. Importantly, it suggests that the choice of a federal system for Australia, made by the colonies (later States) themselves, while underpinned by economic and financial considerations, represented an attempt by the colonies to create more effective regional economies through a constitution which guaranteed regional diversity. Moreover, the consequences of choosing a federal, rather than unitary, structure was that consensus, fairness and equity became principles to be applied by governments to themselves and their interrelationships with one another, rather than focussed primarily or exclusively on their treatment of individuals. And in Australia, the emphasis on liberty that characterised American debates about federal principles was replaced by an emphasis on the equitable distribution of powers and resources as fundamental to the political integration of the colonies.

Taken together, the papers serve to particularly emphasise two interrelated things:

- First, that it is narrow, misleading and mistaken to view fiscal equalisation as virtually exclusively about equity, and inherently in conflict with national efficiency objectives. In fact, it has the capacity to be efficiency enhancing, and particularly so by supporting the conditions necessary to enable the benefits of diversity and political competition to be fully captured.

- Second, political notions of equity, the strengthening of regional economies and provision for interstate transfers for equalisation purposes were recognised as a necessary part of the constitutional fabric, and the case for them, grounded in federal principles, has evolved as fiscal and political pressures and societal values have changed.

By the time this study was completed, brief summaries of papers prepared for New South Wales and Victoria, proffering qualitative and quantitative assessments of the effects of the Fiscal Equalisation system, had been released. A full discussion of these has not been attempted in the papers presented here on the grounds that we have not had access to sufficient detail to make full and balanced evaluations of them. This must await release of the full reports by New South Wales and Victoria.

The principal authors of the individual papers — variously, Christine Fletcher, Jeff Petchey, Julie Smith and myself — are identified at the beginning of them. All of the authors, myself included, in the recent past have held positions, *inter alia*, in the Federalism Research Centre at ANU though, with the exception of Christine Fletcher who is a Research Fellow in FRC, they and I have now moved on to other positions. Jeff Petchey currently is Principal Policy Officer, Ministry of Premier and Cabinet, (Western Australia), and Julie Smith is Visiting Fellow at the Centre for Public and International Law at ANU.

The scope of the study was established in consultation with officers of the SA Treasury, and earlier drafts were discussed with them, in particular Linda Hart, Ian Procter and Peter Emery. Comments also were received from officers of the Western Australian and Northern Territory Treasuries. Final editorial control, however, has remained with me.

Initial drafts of the papers also were reviewed by Professor Thomas J. Courchene, of Queens University, Canada, an eminent expert on fiscal federalism. He visited Adelaide during his tenure as a Visiting Fellow in the Federalism Research Centre, ANU, and his participation in seminars and discussions on the analysis of these issues helped sharpen our focus and our thinking significantly.

The papers were prepared in a context set, and according to a loose brief prepared, by me and in all cases have involved at least some light editing by me. Accordingly, I must accept final responsibility for them all.

Cliff Walsh
Executive Director
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PAPER 1

INTRODUCTION AND OVERVIEW

Cliff Walsh

1. INTRODUCTION

The purpose of this introductory paper is to provide a broad-brushed overview of the perspectives on fiscal equalisation — economic, historical and political — that are developed in the subsequent detailed studies. It also puts them into the broader context of recent developments in Australia's complex federal fiscal arrangements — developments which go some way to explaining why the questions of the adequacy and efficiency of current fiscal equalisation procedures have been put on the national agenda for discussion.

It begins, however, by offering a brief statement which attempts to encapsulate the overall thrust of the case for Australia's system of fiscal equalisation which can be derived from the later analysis. Its brevity necessarily involves high degree of simplification and generalisation of detailed and often complex arguments, but it may serve the purpose of providing a clear frame of reference for interpreting the later more extensive analysis.

This is followed by a series of sections which, respectively: draw attention to the confusions of meaning that surround discussions of fiscal equalisation; provide a brief overview of the history of both vertical and horizontal imbalance since Federation; undertake an examination of the context in which fiscal equalisation has come to be in dispute in the 1990s; offer an overview of the literature on motivations for equalisation transfers; and discuss the benchmarks, or alternatives, against which Australia's fiscal equalisation system appears to be being assessed.

2. AUSTRALIA'S SYSTEM OF FISCAL EQUALISATION: AN ENCAPSULATION

2.1 The Dynamic Efficiency, Individual Welfare and Common Citizenship Benefits of Equalisation

Australia's system of "fiscal equalisation", which seeks to ensure that all States and Territories have **the capacity** to provide similar standards of public sector services to their residents without having to impose significantly different tax burdens on them, is looked on with admiration and envy by other federations.

Based on a long-standing and highly respected mechanism for undertaking independent assessments of the States' relative fiscal capacities and needs, it has:

- underpinned the **stability** and **viability** of Australia's federal system of government, *and*
- sustained the **dynamic efficiency and welfare gains** associated with allowing and encouraging **diversity** and **competitive innovation** in State policy development and service delivery, *while also*
- supporting shared views and values concerning **common citizenship rights and aspirations** in Australia as a single, but federal, nation.

Recent claims that fiscal equalisation essentially is about 'equity', and that it is in conflict with 'national efficiency objectives', are misplaced and excessively static in perspective. Appropriately viewed, fiscal equalisation *simultaneously* sustains and encourages **dynamic efficiency,** enhances the **welfare** of citizens *and* meets shared national aspirations concerning the potential for **equality of access** to core public sector services for all Australians, irrespective of where they choose to live.

Neither the practical (but undesirable) alternative of a unitary system of government (which would achieve a similar degree of interregional equalisation but by **imposing an outcome of broadly uniform levels of all public services** across regions), nor the impractical alternative of having independent, autonomous member-states **linked only by agreement to have a limited range of "national" public goods and services jointly funded and supplied** (such as defence and foreign relations, and possibly cash welfare benefits to individuals) would provide all of these efficiency, welfare and common citizenship benefits.

2.2 The Equalisation System In Brief

In broad but simplified terms, **equalisation of fiscal capacity** among the States and Territories is achieved through the payment to them, by the Commonwealth, of (untied) general revenue grants which consist of:

- a notional starting point of an **equal per capita share** of the total pool of general revenue grants (and selected specific purpose payments);
- **plus or minus** an adjustment for differences between States and Territories in per capita revenue raising capacity [based on assessments of the relative size of the revenue bases to which the States have access (e.g., payrolls, land values, financial transactions etc.), and on the nationwide average State tax rates applied to those bases]; *and*
- **plus or minus** an adjustment for differences in per capita costs of providing services [based on a variety of specific factors which impact on expenditure — including the size

and dispersion of the population being serviced, the influence of urbanisation on costs, and additional demands arising from the social composition and age structure of the population being serviced: for each government service, these factors are applied to the nationwide average level of States' expenditures.].

The equal per capita component, in effect, is required to redress Australia's vertical fiscal imbalance, arising from the Commonwealth's dominance of major taxation bases (incomes and sales of goods) compared with the States' and Territories' principal role in delivering services to people and businesses.

The adjustments for differences in revenue raising capacities and expenditure needs (amounting, approximately, to a net $2 billion in 1992-93 in a total pool of $18 billion of general revenue and Hospital Funding Grants) are assessed by the independent *Commonwealth Grants Commission.*

The Commission's assessments are based on principles and methods designed to ensure that the States and Territories have broadly equal fiscal capacity to supply State-type services to their residents, without restricting their capacities or incentives to choose different levels and patterns of service delivery in accordance with the preferences of their citizen/voters, and without encouraging or subsidising operational inefficiency in revenue raising or service delivery.

2.3 The Benefits of The System

Following three decades of discontent and agitation among the governments and people of the less populous and less wealthy States after Federation in 1901 — discontent and agitation which ultimately threatened to put the stability and existence of the federation itself at risk — the present arrangements for achieving fiscal equalisation between the States (and more recently including the mainland Territories) had their foundations in the establishment of the independent Commonwealth Grants Commission in the 1930s to assess the fiscal needs of claimant States.

Even before the establishment of the CGC, however, and before the consequences of protective national tariffs, centralised wage fixation and the Navigation Act became sources of disadvantage and growing discontent for the less populous States, special assistance was made available to the economically weaker States through s96 of the Constitution in recognition of their fiscal needs. Moreover, the change to State funding arrangements which accompanied the introduction of a national pension scheme in 1909 recognised the lesser capacity of the less populous States to afford to support nationally agreed standards of social policy. From the outset, federal, nationhood and common citizenship principles permeated Commonwealth-State financial arrangements, albeit in ways more muted and more ad hoc than are evident today.

Over time, the system of fiscal equalisation has evolved to help to ensure that all Australians can be provided with the broadly equal access to core State-provided social services — education, housing, hospitals, law and order and so on — which has come to be regarded as their entitlement as citizens of one nation, irrespective of where they choose to live. At the same time, the system allows the States and Territories to respond to differences in the preferences of their residents for the levels and patterns of State taxation and spending on public services, and allows and encourages them to be innovative in the development of policies and in the way services are delivered.

In short, the fiscal equalisation arrangements have underpinned the **stability, viability and vitality** of Australia's federal political and fiscal system, while also ensuring that no Australian is denied the ability to gain access to commonly agreed standards of publicly provided services as a result of their choice of State of residence. Where differences do exist in access to services, they generally are the result of the decisions of democratically elected State governments responding to the preferences of their citizen/voters, not the result of fundamental differences in fiscal capacities among States leaving some Australians with second-class standards of citizenship.

2.4 Strains On The System

Not everything in Australia's federal fiscal system is working well, however.

Since around the mid-1970s, and more sharply so since the mid-1980s, the Commonwealth government has substantially and unilaterally reduced the total pool of grants available to the States and Territories as a share of the Commonwealth's total revenues and outlays, and in real terms.

In large measure — and certainly so far as their 'general revenue' (i.e. untied) component is concerned — those grants represent **a return to the States of a share of income tax revenues to which they are entitled** as a result of their agreement after World War II not to take back their constitutional right independently to levy income taxes on their residents and on businesses. As a consequence of this post-war arrangement, unlike in some other mature federations such as the United States and Switzerland, Australia has maintained a unified national system of assessment and collection of income taxes.

However, in Australia, the entitlement of the States to a share in national income tax revenues has not been given formal recognition through a constitutionally entrenched guarantee (as is the case in Germany, for example). Nor has the Commonwealth, alternatively, been willing to agree to have the States' entitlement reflected in an explicit (jointly agreed or independently set) State

component of national income tax collections (as is the case, in varying forms, in Canada and Belgium, for example).

In using its acquired monopoly over what, constitutionally, is a **shared** revenue source to shift a substantial part of the burden of its own budgetary adjustments onto the States in recent years, the Commonwealth has put the efficiency and stability of Australia's federal fiscal system at risk.

Whereas the Commonwealth's outlays primarily involve the provision of cash benefits and other transfer payments to individuals and businesses, the States are the suppliers of essential social and economic services, and of social and economic infrastructure. In the recent past, in particular, the States have made substantial improvements in the efficiency and effectiveness of their delivery of public services, and are continuing to seek to obtain further efficiency dividends. However, to maintain the adequacy and quality of their provision of core services and to fund essential infrastructure in the face of severe reductions in Commonwealth "tax sharing" grants, the States have been forced to rely more heavily on what universally are agreed to be narrow, inadequate, inefficient and inappropriate sources of revenue — including especially taxes which fall directly on business inputs (payrolls, fuel, financial transactions etc.).

At a time when there is a national consensus supporting the need for microeconomic reforms and structural change in the Australian economy to improve our international competitiveness and to meet the challenges to our living standards arising from globalisation, the Commonwealth has been pursuing policies with respect to State financing which, in their overall consequences, are undermining that thrust.

Relatedly, and potentially even more directly threatening to the future dynamic efficiency and stability of Australia's federal system, the substantial reduction in the pool of grants available to the States resulting from unilateral Commonwealth decisions has contributed to a potentially divisive dispute about the system of equalising fiscal capacity. In circumstances where the total size of the cake is shrinking, friction over **shares** of the cake may become more intense.

Instead of being seen as a mutually (i.e. nationally) beneficial mechanism for promoting **both** the dynamic efficiency and stability benefits **and** the common citizenship and equity benefits which flow from our federal arrangements, it has become unfortunately common, especially within the more populous States, to refer to fiscal equalisation as involving a "trade-off" between efficiency and equity, and to suggest that the balance has been tilted too much in favour of equity.

With the benefit of hindsight, it perhaps was predictable, in the context of a federal fiscal system which makes the Australian States excessively dependent on the Commonwealth for their revenues, that general budgetary stress would create incentives for the more prosperous States to

question the distribution of a diminished shared revenue pool. However, the foundations on which the 'dispute' has been promoted are narrow, misleading and mistaken.

2.5 The Alternatives Considered

Had Australia's 19th Century colonies decided that the appropriate form of the national union which they sought to establish for the start of the 20th Century was that of a **unitary nation** — i.e. with a single sovereign level of government, able to form and/or re-form regional and/or local governments through its own legislative power — they would have committed the more prosperous regions to a degree of inter-regional redistribution to less prosperous regions akin to, but different in form from, that achieved in Australia today.

In unitary nations — like Britain, France, Sweden and Italy, for example — central governments make substantial transfers of resources from more prosperous to less prosperous regions. These transfers occur, in part, because uniformly applied (progressive) income taxes on the relatively well-off citizens, combined with the payment of common welfare benefits to those less well-off, result in transfers from regions with relatively large concentrations of the well-off to those with concentrations of the less well-off. But it goes beyond this. Inter-regional transfers also occur because **central** governments use uniformly applied national taxes to finance the provision of basic social services, such as education, health and hospitals, police and so on, for all citizens; and they do so in ways which ensure that there is broadly equal access to these services wherever people may live. So regions which pay less per head of population in national taxes because of lower incomes and/or in which provision of services cost more per head of population, **implicitly** receive transfers from higher income and/or lower cost regions.

Because these transfers occur implicitly through the central government budget (frequently with the involvement of local governments, which are under central government control), they often go unnoticed, and rarely are calculated, because they do not leave a "data trail". But they exist, and the greater the priority put on equalising opportunity, the greater will be this implicit equalisation in unitary nations.

In Australia, however, because the founders chose a federal system, many basic social services are funded and supplied by State and Territory governments. This allows us to increase the welfare of Australian citizens by allowing differences in preferences between States to be reflected in decisions about the level and pattern of taxes and expenditure, and to gain dynamic efficiency benefits for the nation by encouraging and facilitating competitive innovation in the development of policy and the delivery of services. But to ensure that we have a similar degree of equality of opportunity to that achieved centrally, but implicitly, in unitary systems, we make **explicit** fiscal

equalisation transfers between States to equalise their **capacity** to afford to provide services which meet the common aspirations of all Australian citizens.

So, what unitary systems do implicitly through uniform national taxation and expenditure systems, Australia, in part, does explicitly through procedures designed to equalise fiscal capacity among the States and Territories — and, in doing so, we gain the advantage of allowing more diversity and innovation in political decisions and service delivery arrangements where people want to express different preferences.

Human nature being what it is, it almost invariably is the case that these "equalisation transfers" in federal systems become the subject of societal debate and discussion — and often for good reason, because the magnitude of, and the incentives implicit in, these transfers incorporate the essence of the societal social contract. What is inappropriate, however, is to view these equalisation payments as the "cost" of a federal system. Were Australia a unitary state adhering to the same or similar "social contract", these same (or similar) transfers would occur within the tax/transfer/expenditure system run centrally and more-or-less uniformly through Canberra: but because they would occur automatically, and would not leave a statistical data trail, the likelihood is that they would not be seriously questioned.

2.6 Different Social Contracts, and Different Social Outcomes

For various historical, cultural and societal reasons, the extent to which different nations — whether federal or unitary — engage in equalisation in these implicit or explicit forms differs.

Australia, like some other federations such as Canada and Germany, has a social contract which puts more emphasis on equalising opportunities across regions (States) and maintaining societal cohesion than does a federation like the United States. Similarly, unitary nations like Sweden assign social cohesion a higher priority than, for example, does unitary Britain.

Our fiscal equalisation system, since its foundations in the 1930s, has provided us with substantial advantages compared with other countries, whether federal or unitary. In particular:

- We have avoided the disparities in incomes and well-being between regions, and in access to social services, that are evident in federal United States or unitary Britain, and avoided the social divisions that flow from them.

- At the same time, however, we have avoided the serious problems of "transfer dependency" that have been identified as applying, for example, to the Atlantic provinces of federal Canada, and the Southern regions of unitary Italy, where regionally

differentiated transfers have gone **beyond or taken forms different from** those required to equalise fiscal capacity and have underpinned other rigidities which sustain low productivity economic performances.

- And we have avoided the large-scale, inefficient, fiscally-induced migration to the richer cities or regions which, because of the lack of regional equalisation of fiscal capacity and the existence of gross disparities in services, has characterised the United States and parts of Europe.

2.7 In Support of The System

In the final analysis, Australia's system of fiscal equalisation not only underpins social cohesion and our shared views about common citizenship rights and aspirations, it also promotes and sustains the dynamic efficiency benefits associated with allowing and encouraging diversity and innovation in State policy development and service delivery. It is not a cost of Australia's federal system resulting from a supposed trade-off between equity and efficiency, but rather a source of dynamic efficiency gains and increased welfare for individuals, consistent with Australia's political culture and social aspirations.

Elimination, or even substantial dilution, of fiscal equalisation as it currently is practiced in Australia would undermine the benefits of the federal system for *all* States and Territories — the "contributors" to, as well as the "recipients" of, equalisation payments — by:

- reducing the attachment of the less populous and less wealthy States and Territories to sustaining fiscal independence and autonomy;
- threatening the creation of differences in the quantity or quality of services that are affordable by States and Territories, or in the levels of taxes they must impose on their residents;
- increasing the demands of the governments and residents of the less wealthy States for tied grants to them to ensure greater equality of access to services; and
- discouraging, or diminishing the capacity for, competitive innovation between all States and Territories, and between them and the federal government, in the development of policies and the delivery of services.

2.8 A Deficiency in the System: Commonwealth Grants for Local Government Purposes

There is, however, at least one dimension of the current system of grants to the States and Territories in which equalisation arrangements clearly are deficient. This involves the grants made to them for passing-on as general purpose funding for local governments.

Within the States and Territories, these grants are distributed between local governments through (State-based) Local Government Grants Commissions, which are required to distribute the bulk of the grants between local governments according to fiscal equalisation principles similar to those applied by the Commonwealth Grants Commission.

However, **the distribution between the States and Territories of general purpose grants for local government** is on an equal per capita basis, which fails to adjust for the differential needs for local government funding support between the States.

The Commonwealth Grants Commissions' most recent assessment of the implications of this inter-state distribution of local government funding indicated that it results in substantial relative over-funding for some States' local governments — especially New South Wales and Victoria — and under funding for the rest.

The persistence of this situation represents a defect in the performance, and partially offsets the otherwise substantial benefits, of Australia's system of fiscal equalisation.

3. FISCAL EQUALISATIONS TRANSFERS: SOME PRELIMINARIES

The issue of *horizontal* fiscal equalisation, which is the central focus of the present analysis, typically is used as a shorthand for a wide variety of reasons which justify or underpin *inter-regional* or inter-jurisdictional transfers (i.e. transfers of resources between States and Territories in a federation, and between regional sub-national jurisdictions in unitary nations).

Three points might be made immediately:

- First, reference to the transfers as "equalising" conveys an erroneous impression that their essential, or even exclusive, rationale is based on *equity* considerations. This terminology has its origins in a distinction in the academic literature between interjurisdictional spillovers associated with the provision of particular sub-national services (e.g. people educated in one region moving to another) and those designed to address a broader range of issues, of which interjurisdictional equity is only a part.

Efficiency as well as equity may be promoted by so-called equalising grants, both by reducing inefficient fiscally-induced migration and by facilitating innovation and experimentation by autonomous State Governments.

- Second, and somewhat relatedly, the interstate transfers which are made *explicitly* as so-called "fiscal equalisation payments" in federal systems have important parallels with inter-regional transfers which occur *implicitly* in unitary nations (such as the U.K. and France) as a result of the *tendency* of central governments in unitary countries to provide or finance roughly equal access nationally to public sector services (including many which, in federal systems, are provided "independently" by sub-national governments), from broad-based uniformly applied national taxes.

- Third, although the issues which give rise to the need for horizontal (interregional) transfers *conceptually* are distinct from those which arise from the need to correct *vertical* fiscal imbalances (i.e. an imbalance in the revenues available to the national and sub-national governments relative to their expenditure responsibilities), in practice the two typically are inter-twined. This is so *both* because the inter-regional (horizontal) transfers typically are achieved by the national government acting as a conduit for the transfers (rather than their being directly paid by the donor States to the recipients) *and* because, arguably, the causes and degree of vertical fiscal imbalance can have a bearing on the degree of (interstate) contention about the magnitude of horizontal transfers. (A reduction in VFI, however, would not necessarily reduce the need for or magnitude of fiscal equalisation payments).

In various ways, the force of these three points will be seen to be reflected in the analysis of "fiscal equalisation" contained in all of the studies which contribute to this report — and, in particular, they will be seen to have a strong bearing on the discussion both of relevant benchmarks for assessing the efficacy of Australia's system of interregional transfers, and of the consequences of other features of Australia's federal fiscal arrangements on the consideration of possible changes to fiscal equalisation arrangements as a piecemeal reform.

The discussion begins with a birds-eye view of the links between horizontal and vertical fiscal imbalance throughout Australia's federal history (drawing particularly on Paper 4 which in turn is given broader political context by Paper 5).

4. VERTICAL AND HORIZONTAL IMBALANCE SINCE FEDERATION

4.1 The Vertical Dimension

In Australia, at least since the possibility of federation between the former colonies (now States) first was discussed seriously, questions of both vertical and horizontal fiscal balance have been of continuing interest, and debate, and often sources of open conflict.

At the time of federation, the granting of exclusive power to the Commonwealth to collect customs (and excise) duties — at the time, overwhelmingly the dominant source of public sector revenues — created a huge degree of vertical fiscal imbalance (a surplus of revenues over projected expenditure needs at the Commonwealth level and vice versa at State level) and a consequent need to ensure an appropriate redistribution of revenues back to the States. At the same time, substantial differences between the States in their economic and fiscal strengths, in their levels of indebtedness, and in the consequences for them of federation and the subsequent development of "national" policies, also opened-up questions about how the Commonwealth's fiscal surplus should be distributed between the member States.

The constitutional settlement provided only "temporary" resolutions of the issues, and the first 30 years or so of federal Australia's history saw repeated outbreaks of discontent and attempted solutions. By the time of the outbreak of World War II, however, there had been reached a period in which — while acknowledging the inevitability of recurring tensions as national and State policies and strengths shift over time — some sort of resolution of both the vertical and the horizontal balance issues had been achieved.

The progressive development and growth of State own source revenue bases — especially the income tax base in which the States held the lions-share at that time — together with the Financial Agreement of 1927 through which *inter alia* the Commonwealth took over a large part of the responsibility for servicing then accumulated State debt, had resulted in the States in aggregate, on the one hand, and the Commonwealth, on the other, having reasonably balanced access to own-source revenues. Moreover, the establishment of the Commonwealth Grants Commission in 1933 to recommend 'special grants' to claimant (financially weaker) States, and the Commission's development of a framework for assessing financial need in place of the ad hoc and highly conflictual inquiry processes previously used seemed to provide an acceptable vehicle for developing principles which would help to institutionalise, and to an extent depoliticise, issues of horizontal balance.

World War II, however, and in particular the Commonwealth's acquisition and subsequent retention of 'monopoly' control over income taxation, returned vertical fiscal imbalance to centre

stage in Australia's federal fiscal arrangements — and from time-to-time to centre stage in the politics of intergovernmental relations.

The degree of imbalance has been reduced over time, partly by the Commonwealth vacating tax fields in favour of the States (notably land tax in the early 1950s, and payroll tax in 1971), but in recent times by the Commonwealth cutting its grants significantly and, in effect, forcing the States to work their own limited revenue sources harder. Nonetheless, VFI remains high by international standards, with the Commonwealth collecting 76 per cent of total taxation revenues, and its transfers representing 127 per cent of State own-source taxation revenues (in Canada and the USA, federal transfers to the States amount to around 25 per cent of State tax revenues). Moreover, a sharp increase in the share of Commonwealth transfers which are tied (specific purpose payments) has further reduced State budgetary flexibility and created considerable Commonwealth-State conflict.

4.2 Horizontal (Interstate) Transfers

Contrary to the impression frequently given in recent discussions, the beginnings of Australia's development of "equalising" interstate transfers were not exclusively, or even predominantly, to be found in arguments about the costs to some States of protective national tariffs which favoured the big States — arguments which gained particular (but, again, not exclusive) prominence in the 1920s and early 1930s prior to the establishment of the CGC.

While customs duties featured from the start of the debate about the federal financial settlement, they did so initially because the necessity to transfer the exclusive power over customs to the Commonwealth both posed the problem of deciding how to deal with the Commonwealth surplus revenues and involved issues of the relative shares of the states from these transfers, since some relied more heavily on customs duties than others.

In fact, the general questions of *fairness* and *sustainability* in the federal financial settlement had been major issues in the conventions, and were not merely problems that arose over time. They were, moreover, related to a much broader set of issues than merely the consequence of the establishment of a uniform national tariff. Differences in economic and fiscal strengths, and in particular the burden of state debts, were raised as vital concerns, with the small states concerned about the ramifications of the financial settlement, and especially the size and distribution of surplus revenues, for their viability. The rudiments of a "federal principle", articulated in terms of the distribution of surplus revenues, were set out during the debates, acknowledging that financially weaker States would need protection from the adverse effects of federation.

The original proposal (resulting in s105) to dispose of surplus revenues by having the new Commonwealth government take over state debts arguably would have resulted in an entirely different dynamic in fiscal relations. However, both during the debates and at several subsequent critical points in the evolution of post-federation fiscal arrangements, it met objections from some States as possibly giving rise to federal meddling in state expenditure decisions (especially on railways), and as possibly being too redistributive towards the smaller, more debt-ridden States.

The substitution of other arrangements for dealing with surplus revenues at the time of federation — notably the Braddon Clause, but also the bookkeeping arrangements and s96 — apparently was supported, in part, by appeal to the unrealistic (and possibly fictional) expectation that convergence of economic and fiscal strengths between states would follow from federation, and resolve the distributional problem painlessly. Nonetheless, it was made clear that the financial settlement had to support all States' finances sufficiently to enable them to join the federation, had to be fair, and had to provide sufficient flexibility to meet specific needs. This was provided for in a wide range of provisions, not least s96, which, unlike provisions with respect to taxation, enabled the Commonwealth to give preference to particular States with respect to grants.

In a variety of ways, over the whole of the first three decades leading up to the establishment of the CGC as a permanent mechanism to assess the case for special assistance to the financially weaker states, what now would be termed federation, nationhood and common citizenship principles, among others, permented discussion and decisions. For example:

- The 1905 Premiers' Conference considered the need for special assistance to the financially weaker States arising from their relatively heavy burden of direct taxation they had to impose to maintain State services because they previously had relied especially heavily on customs revenues.

- The 1909 introduction of nationally funded Old Age Pensions involved smaller per capita contributions to the cost for South Australia, Western Australia and Tasmania, in recognition of their inability to contribute as much as the other financially stronger states to a nationally imposed standard of social services;

- The 1910 replacement of the Braddon Clause with per capita grants, while a modest redistributive standard by comparison with current procedures, in practice involved significant redistribution. Moreover, it was accompanied by special (s96) grants to Western Australia and Tasmania over the ensuing 10 year period which, at least in part, were rationalised by the Commonwealth on grounds of their budgetary needs, including because of high debts accumulated since Federation to meet their development needs.

- The introduction of a highly progressive income tax by the Commonwealth during World War I increased the extent of redistribution implicit in the combination of per capita and special grants funded from national, "uniformly" imposed, taxes.

- The Road Grants, introduced in 1923, were distributed on the basis of a formula which particularly benefited the more sparsely populated States (Western Australia, South Australia and Queensland) on grounds that their needs and development responsibilities exceeded the capacity of their people and their finances.

- The 1927 Financial Agreement, which saw the Commonwealth take over State debts and contribute to State debt servicing under s105 (in return for ending the per capita grants), resulted in the States with the highest debts per head (Western Australia, South Australia, Queensland and Tasmania) benefiting most.

This, only partial, listing clearly illustrates the way the struggle for stability in financial arrangements incorporated an emphasis on need, fairness, and national expectations, often articulated in terms we would recognise today as involving recognition of federal principles. By the early to mid 1920s, the vain expectation that convergence would resolve the problem of different economic and fiscal capacities among the States had given way to recognition in academic literature and official thinking that more-or-less permanent assistance would be required for weaker, smaller states.

While the protective tariffs introduced after World War I, combined with national wage setting and the Navigation Act, clearly were perceived to be particular threats to the economies and budgets of the smaller (predominantly primary producing) States and were used as part of their case for special assistance in the 1920s and early 1930s, fiscal need was accepted by the Commonwealth as a substantial part of their case, and consistently used as part of the assessments of the States' cases undertaken by Royal Commissions and other review procedures. So, when the CGC was established to replace the ad hoc, arbitrary and controversial system of assessments characteristic of the 1920s, its adoption of fiscal need as the basis for its assessments was essentially a formalisation and extension of what had become standard practice, rather than merely an 'ad hoc' way of dealing with the impossibility of calculating the "disabilities of federation".

The evolution of 'equalisation' arrangements after World War II reflected *both* the transfer of income taxation exclusively to the Commonwealth, and the development of national initiatives and expectations for the delivery of welfare benefits and social services (the welfare state). Virtually from the outset, and certainly over time, the notion of tax reimbursement gave way to financial assistance grants with substantial, if somewhat ad hoc, redistributive components, paralleling the

growth of ideas about appropriate national objectives, standards and expectations in the provision of core State services, notably education and health.

The CGC's own procedures broadened with the removal of penalties for claimancy, removal of budget deficit standards, and acceptance of a four state standard, arguably involving increasing acceptance of the notion of common citizenship. While later supported, and extended by modified reference to the literature on "horizontal equity" which began to emerge in the 1950s, the procedural changes reflected evolution of social values in federal context. The 'final' transition to "full" equalisation, through a six-State standard for assessing relativities for distributing general revenue grants introduced in the early 1980s, was a logical progression to redress the consequences of political ad hocery in the distribution of general revenue grants for equalisation purposes.

5. FISCAL EQUALISATION IN DISPUTE IN THE 90S: THE CONTEXT

Australia's system of horizontal fiscal equalisation (HFE), which is implemented, in effect, through decisions about the shares of the roughly $18 billion of General Revenue and Hospital Funding Grants that will be given to each State and Territory, in recent years has been subject to strengthening dispute — not for the first time in recent memory, but with an unusual degree of vigour.

The most populous States — Victoria and New South Wales — at times with some support from the Commonwealth Treasury and other Commonwealth agencies, increasingly have argued that the fact that more than $2 billion of Commonwealth tax revenues are collected from their residents and distributed, in effect, as equalisation grants to the other State and Territories not only involves an excessive burden on them which reduces their capacity to provide services to their residents, but also is source of inefficiency.

At different times, the specific claims of the most populous (donor) States have varied. At times, the discontent seemed to be strongly focussed on the fact that Queensland — endowed with the natural advantages of a strong minerals and agricultural base and the climatic and physical features to give it a growing tourism industry and to attract strong population growth through internal migration — was receiving large and increasing shares of "equalisation transfers". More recently, the focus has shifted (possibly for strategic reasons) to claims about the implications of the equalisation methodology for efficiency and competitiveness for Australia as a whole.

A continuing claim has been that because the equalisation methodology includes allowances for locational factors (i.e. higher costs associated with providing services to small and/or remote

communities), it promotes inefficient location decisions; and, further, that the way in which these locational factors are included gives insufficient weight to the costs of providing services in the big cities. Claims frequently have been made that the formulae used to calculate revenue needs and expenditure disabilities encourage inefficient strategic behaviour by the States and Territories. More recently, New South Wales and Victoria have argued that *any* redistribution to the less populous states (or, at least, any beyond that implicit in an equal per capita distribution of Commonwealth general revenue payments), involves unwarranted and inefficient support for the less populous (recipient) States and creates a dependency mentality.

Some of the more consistently stated and seemingly fundamental aspects of these shifting claims are assessed in the detailed papers which follow. It might be noted, however, that the claims have been countered not only by the less populous States but also by the Commonwealth (though its position seems to have been somewhat variable). In particular, in its final submission to the CGC's Methodology Inquiry in 1990, the Commonwealth Treasury, in principle, accepted equalisation of revenue capacities and individual-specific expenditure disabilities as consistent with allocative efficiency. Moreover, in agreeing to refer to a Heads of Treasury Working Party the question of "the adequacy of the current fiscal equalisation scope and methodology and the principles upon which it is based", all Heads of Government endorsed "the central principles of and need for horizontal fiscal equalisation".

The increased vigour with which the more populous States have pressed their claims in the last few years has coincided with two major trends in relation to intergovernmental grants in Australia.

- First, and most obviously, since the mid 1980s, there have been significant cuts, in real terms, in the pool of general revenue grants available for distributing between the States and Territories, making the issue of the distribution of the pool even more than usually important and contentious. Between 1987-88 and 1991-92 there was a cut in general purpose grants of almost $2 billion (about 12.5 per cent) in real terms.

- Second, at about the same time that the cuts in the pool of grants began to bite, there began to be a reversal in the trend established over the previous decade or so towards the more populous states receiving increasing per capita shares in the general revenue grants. In 1974-75, the four less populous states received per capita grants equal to about 165 per cent of those received by New South Wales and Victoria; but between then and 1986-87, the differential in favour of the less populous states fell progressively to reach a "trough" in 1986-87 of about 135 per cent of the New South Wales/Victoria per capita grants. Since 1986-87 the differential has grown again to be about 155 per cent prior to the latest CGC review. In short, New South Wales and Victoria have been receiving smaller *shares* of the diminishing pool, further heightening the potential for conflict.

This second fact, to some extent, is a consequence of the strong growth in State revenues, of disproportionately large benefit to New South Wales or Victoria, which occurred in late 1980s as a result of a boom (or "bubble") in asset prices and land prices. At the time that this occurred, it made it politically easier for the Commonwealth to impose its cuts in grants to the States. The subsequent bursting of the asset price bubble has left the States substantially more fiscally stressed. Moreover, because they are donor States, not recipient, New South Wales and Victoria have the greatest dependence on own source revenues, and hence are worst affected by the revenue decline. But because (at the behest of the States) the CGC's procedures use 5 years averages, New South Wales and Victoria have continued to have revenue capacity assessments partially reflecting the earlier boom (though, in general terms, 5 year averaging apparently has been more favourable to New South Wales and Victoria than 3 year averaging would have been).

Other, more general, issues have played a part, too, in creating anxiety and agitation about the whole structure of current federal fiscal arrangements. For example, at the same time as it has made unilateral cuts in State grants, the Commonwealth also has increased substantially the share of its grants that are tied, to the point where they now represent substantially and consistently more than half of its assistance to the States. The consequent reduction in the States' budgetary flexibility, moreover, has come at a time when the forces and imperatives of international competitiveness are threatening some of the States' already narrow and limited sources of revenue, with New South Wales and Victoria particularly exposed to these problems because they rely more heavily than average on own-sources of revenue.

In short, considerably aided and abetted by the Commonwealth's treatment of State grants, and compounded by prolonged recession, there has been a substantial destabilisation of the States' fiscal flexibility and viability.[1] Confronted by intransigence on the Commonwealth's part in relation to both VFI and the role of tied grants, it perhaps was inevitable that fiscal equalisation transfers became an alternative target for "reform" in the eyes of the more populous States which, in effect, fund the transfers.

6. MOTIVATIONS FOR EXPLICIT INTER-REGIONAL TRANSFERS IN FEDERAL COUNTRIES

In the analysis of conceptual foundations for fiscal equalisation transfers in federal countries offered in Paper 2, a wider range of arguments are considered than has commonly been the case, especially in the Australian discussion and debate.

1 Further compounded, in some cases, of course, by financial and other policy disasters at State level.

First, a range of arguments in which the political, social, economic and fiscal features of the choice of a federal form of governance are particularly critical are analysed, covering:

- compensation for the effects of federation;
- federation, nationhood and citizenship rationales;
- promotion of regional economic convergence and social cohesion; *and*
- preservation of regional autonomy and the stability of political competition.

Then, consideration is given, in substantial detail, to the conventional arguments in the literature for fiscal equalisation but which, in fact, represent a somewhat uneasy interface between issues of concern to federal systems, on the one hand, and to unitary systems with fiscal decentralisation, on the other — namely:

- horizontal equity between individuals in different regions; *and*
- efficiency in migration (location-choice) decisions.

About the horizontal equity and efficiency in migration cases for equalisation transfers, three particularly important points need to be made:

- First, the claim sometimes made that they establish only a case for interpersonal, and not intergovernmental transfers, is not universally true, and fails to take account of the recognition in the literature that interpersonal transfers would create perverse disincentive effects to the use by States of own-source revenues and would face constitutional restrictions. Equalising fiscal capacities (but *not* actual revenue or fiscal outcomes) as practised in Australia avoids creating incentives for States to try to exploit the transfer system by policy changes.

- Second, it is not only horizontal equity arguments that underpin arguments fiscal capacity equalisation, as often seems to be implied or asserted, even in discussions by the CGC. Indeed, contrary to the misconception involved in frequently-made assertions that equalisation transfers either encourage or retard migration and hence must be "inefficient", they actually can be efficiency-enhancing. That is, they are required to avoid inefficient fiscally-induced migration arising from differences in fiscal capacities among States.

- Third, the claims that inclusion of allowance for the differential cost of providing State-type services to remote and/or sparsely populated regions must cause inefficient location decisions is, at best, overstated and, at worst, misleading. What actually is 'equalised' is the capacity of States to provide State-type services in their high cost regions *relative to*

the average costs of providing these services in similar high cost regions elsewhere (not relative to the average cost of services everywhere). Since, moreover, it is likely that governments provide a lower standard or range of services to remote areas, it hardly seems plausible to suggest that the system strongly subsidises location in remote areas.

From the part of the analysis in which the essential features of **federal systems** are particularly considered, what emerges is a strong emphasis on the role of interjurisdictional equalisation transfers (among other things) for the **formation** of federal unions in the first place, for securing the requirements which flow from notions of **common citizenship and nationhood** that are a vital component of the evolution of the federal solution, and for securing maximum benefits from **political autonomy and political competition** within and between spheres of government in a federal system by reducing the risk that instability in political competition might lead to destructive competition and wasteful beggar-thy-neighbour policies.

In short, the analysis points to fiscal equalisation transfers between jurisdictions as a mutually beneficial source of support for the dynamic efficiencies, and the broader social benefits, that can flow from genuinely federal systems of government. By comparison, the traditional arguments rely on relatively narrow comparative-static aspects of efficiency in resource allocation, and limited concepts of interpersonal equity.

Equally importantly, what the arguments based on the characteristics of truly federal arrangements lead to, taken together, is a case for comprehensive fiscal capacity equalisation — a case which, in principle, should be regarded as mutually beneficial by all member States, given the risks to them all from instability in political competition in federal systems. That is, even knowing their actual or likely future positions in the resource endowment spectrum, rich States have an incentive to support a system of transfers to poorer States to help ensure that all States remain equally committed to maximal "autonomy" in State decision-making, including over revenue-raising, during the post-constitutional period, provided the central government maintains a stable framework of intergovernmental grants.

7. THE QUESTION OF BENCHMARKS

Many of the claims made to date that suggest Australia's system of fiscal equalisation creates inefficiency, at least implicitly, adopt a presumption that the alternative to the present arrangements, in effect, is a system of independent "sub-nations", benefiting from a customs and economic union and from certain commonly provided public goods (defence, social security etc), but without other explicit or implicit interjurisdictional interaction and transfers.

As Paper 3 especially points out, such a benchmark model cannot be rejected, conceptually, as entirely irrelevant. But it stands at odds with the bulk of reality - even for the EC, where substantial explicitly redistributive 'Structural Fund' transfers are made to less wealthy regions. On some recent estimates, these structural fund transfers, predominantly to Spain, Greece, Ireland and Portugal, achieve as much as half of the redistributive effect of the explicit fiscal equalisation transfers between States (Länder) within federal Germany.

However, there seems to be a strong case for arguing that the relevant benchmark, in fact, is the alternative of a unitary state. What seems especially pertinent to this benchmark view is, that, in unitary systems, there is a great deal of interjurisdictional redistribution achieved through a *tendency* towards uniformity in the delivery of public services - or at least reasonable access to core services - *either* directly through their funding from uniformly applied taxes through the central fisc *or* (supplemented) by equalisation grants (frequently with performance requirements) to local authorities, to whom responsibility is delegated for provision of some services. Equally pertinent is the observation that unitary systems typically also have explicit centrally-funded "regional development" policies, often intentionally designed to reduce mobility from "poorer" to "richer" regions. In fact, although now somewhat dated, the McDougall Report (1977), prepared for the EC, estimated that the redistributive effect (i.e. the degree of reduction in initial inter-regional per capita income differences) of central government implicit and explicit inter-regional transfers averaged around 45 per cent for *unitary* France, Italy and U.K., compared with about 35 per cent in *federal* Germany, Australia, Canada and USA where fiscal equalisation (sometimes) replaces some of the implicit transfers found in unitary countries.

Seen in this light, what federal systems with fiscal capacity equalisation achieve is what is implicitly (and sometimes explicitly) accepted as appropriate in unitary system: that is, the use of uniform national standards (or systems) of taxation to fund *broadly* equal access to core social services nationwide. They do so, moreover, with the added advantages, in the federal case, of:

— higher well-being for citizens arising from allowing for greater diversity in outcomes where preferences differ for levels and patterns of services between States; and

— providing the capacity for (competitive) experimentation and innovation in policy development and service delivery that comes from a combination of *both* autonomy *and* a guarantee of balance in the underlying financial viability of the States.

This is not to imply that all federal nations (or all unitary nations) attach the same value to eliminating the possibility that different policy outcomes reflect differences in the fiscal capacities of different sub-national jurisdictions, rather than differences in policy preferences. Clearly, societal values differ significantly between nations, with the United States apparently being willing

to tolerate much greater differences in outcomes (and the associated potential for their to be substantial fiscally-induced migration) than are Australia, Canada and Germany. These apparent value differences are not unchanging or unchangeable, but they are etched into political and constitutional fabric of societies and cannot be ignored just because their origins and evolution are not easily identified or fully understood.

8. CONCLUDING REMARKS

In this introductory overview, it has been possible to cover only some of the many issues addressed in the detailed papers which follow. It should serve, however, to provide an overall context, and to indicate both the major issues discussed in them and their principal thrusts.

What should clearly come through is a more positive interpretation of the significance of Australia's system of fiscal equalisation than typically has been offered, particularly by the more populous "contributing" States, in recent times, even when restricted to considering narrow 'economic' conceptions of the role of equalisation: historical and political perspectives enrich the case by helping us to better understand the evolution of the system and the forces which have shaped that evolution.

PAPER 2

CONCEPTUAL FOUNDATIONS OF FISCAL EQUALISATION: A SURVEY

Jeff Petchey
and
Cliff Walsh

1. INTRODUCTION AND OVERVIEW

Federations are characterised by an extensive and usually complex system of grants from their central (federal) governments to otherwise autonomous sub-national governments. Although sometimes implemented as a component part of grant programs also designed to achieve other purposes, in many federations, particular importance is attached to transfers designed to achieve **horizontal fiscal equalisation**.

1.1 Fiscal Equalisation: Federal versus Unitary Contexts

Whether administered as "stand alone" interjurisdictional grant programs (through the auspices of the federal government as in Canada, or directly between "States" as occurs, in part, in Germany, for example), or as adjustments to States' shares of grants within revenue sharing arrangements between federal and State governments designed to facilitate nationally uniform assessment, administration and collection arrangements for major taxes (as is explicitly the case in Germany, and implicitly so in Australia, for example), **fiscal equalisation payments** are intended to transfer resources between sub-national jurisdictions ("States") to ensure that they all have **the capacity to provide similar standards of services to their residents without having to impose significantly different tax burdens on them.**

The degree to which "fiscal equalisation" is achieved or attempted in practice in different federal systems (and, by the same token, but in different ways, in unitary systems) varies, reflecting differences in **societal values.** These, in turn, are reflected in different **practices and procedures** for assessing and implementing equalisation transfers. In particular, the degree of attachment to the **independence and autonomy** of sub-national governments and (relatedly) the degree of tolerance of **differences in outcomes** between regions, and between individuals in different regions, varies significantly.

The standard economics literature on federalism and fiscal equalisation, however, pays little or no attention to these differences in values. The case for **decentralisation** of fiscal decision-making and equalisation of fiscal capacities which emerges in that literature reflects a recognition of

potential differences in preferences **for service levels or qualities**, not of preferences for differences in political **structures** or administrative **procedures**, or of preferences over differences in **outcomes** of different structures or procedures. From this perspective, some of the literature which is surveyed in what follows sets aside a number of issues which, in practical and political terms, influence decisions about fiscal equalisation procedures in different federal systems and, to that extent, should be regarded as limited in its perspective.

Even within its own "economics-oriented" perspective, however, the extant literature should be regarded with caution. Much of the economics literature on fiscal equalisation, like other aspects of the fiscal federalism literature, is based on a presumption that federalism, on the one hand, and fiscal decentralisation in otherwise unitary systems, on the other, can be treated as analytically equivalent. On this view, the central issue is to identify what intervention (e.g. through central government taxes or grants) might be required to correct for efficiency distortions that arise from the behaviour of *individuals*, and in the equity with which individuals are treated, when decentralisation of some fiscal decisions is allowed in what otherwise are unitary systems.

In our view, this perspective potentially is dangerously misleading. The essence of true federal systems is that they are the result of a compact between a collection of autonomous ("sovereign") political units — States — to create a central (national or federal) sphere of government, to which certain powers are ceded in the interests of securing the benefits which flow from forming an economic, fiscal, social and political union. Principal among these benefits usually are argued to be the creation of a common system of defence and foreign relations, the creation of a customs union and single economic market, and the building of a common sense of nationhood and of shared (but dual) citizenship, while allowing independent and potentially diverse decisions over policy development and the levels and patterns of service delivery in a range of functional spending areas at the sub-national level. Although it is subject to potential misinterpretation, the slogan "unity in diversity" captures something of the flavour of the proclaimed benefits of a federal system.

Even where the initial formation of the federal compact itself was subject to the will of the people (as also may be subsequent changes to it, e.g. through referendums), the federal system exists and operates as a set of dealings and relationships **between governments**, each "autonomous" in their own agreed sphere. Correspondingly, political and procedural phenomena such as the provision for interjurisdictional "equalisation" transfers need to be seen and understood to be inherently associated with the conditions necessary for the existence and stability of the federal compact, and for securing the benefits to the nation from its existence, as much as about interpersonal equity and individual efficiency effects.

This does not mean that comparisons with unitary systems, and analysis of the consequences of fiscal decentralisation within them, are totally irrelevant. Federal systems represent an alternative way of achieving the efficiencies (economic, fiscal and political) perceived to attach to the formation of unitary nation-states from formerly "independent" political units while, however, in the federal alternative also preserving the advantages of sub-national autonomy over a wide range of policy areas. This makes the benefits and efficiencies achieved through the unitary alternative an appropriate **benchmark** for assessing the value and virtues of federal arrangements. But in the end, it is the value and the virtue of **the differences** between federal and unitary systems that really are at issue and, to evaluate them, federal systems have to be seen as being much more than just "unitary systems with fiscal decentralisation".

In this connection, it is important to observe that, in unitary systems (as is discussed later in this Paper and again in Paper 3), a great deal of inter-regional fiscal "equalisation" occurs — indeed, on some estimates, on average, more than occurs in the major federations. But, typically, much of it occurs in a way which is practically and conceptually different from the formula-based (and more-or-less explicit) inter-jurisdictional transfers designed to achieve equalisation of fiscal capacity that are discussed in the fiscal equalisation literature. That is, in highly centralised unitary systems, central governments use uniformly applied national taxation systems (e.g. income tax) to fund *not only* uniform provision of national public goods and services — such as defence and foreign relations, and welfare benefits — that usually also are provided by central governments in federal systems, *but also* to fund broadly uniform access to many of the public services such as education, health and hospitals, law and order and so on which, typically (and often exclusively), are the province of autonomous sub-national governments in federal systems.

Centralised provision of these services in unitary systems in a way which ensures broadly equal access to them for residents of all 'regions', financed from uniformly applied national taxes, involves potentially significant **but implicit** transfers between areas (regions) which have different average per capita taxable capacity (e.g. because average per capita incomes differ) and/or different costs of service provision (e.g. because of a different socio-economic compositions of population, or different population densities which affect unit costs of provision).

In practice, of course, even unitary systems decentralise at least administrative provision of services, and often (and increasingly) give a degree of "autonomy" in decision-making to local and/or regional governments in decisions about the delivery of services. In some cases, the funding of local governments from a mixture of local taxes and central government grants involves a degree of limitation on local discretion which ensures that the system as a whole remains essentially "centralised unitary". In this event, an explicit (comprehensive) equalisation component usually will be contained in central government grants, often combined with strict guidelines about service delivery standards. Here, the concerns about horizontal equity between

individuals in terms of outcomes between regions (and relatedly about fiscally-induced migration which otherwise might occur), which are the central concerns of the conventional fiscal equalisation literature, have obvious and direct application in the interests of preserving the broadly uniform outcomes that are more-or-less *intended* to prevail.

Even where a greater degree of regional or local discretion in the levels or patterns of service delivery is permitted, unitary systems with fiscal decentralisation can be expected to put considerably more emphasis, in principle, on equalisation grant arrangements — and related guidelines for securing uniform national standards — which are explicitly designed with a view to equalising *outcomes* than is the case, in principle, in federal systems. This, again, makes the conventional horizontal equity and locational efficiency arguments more directly and immediately relevant to them.

In federal systems, by comparison, the autonomy of sub-national governments over functional areas within their agreed spheres, the capacity for diversity of outcomes in their autonomous political choices which can enhance the welfare of their citizens (residents), and the innovation and competition in policy development and service delivery which is facilitated by their fiscal independence, all are essential and highly valued features of political and fiscal arrangements. Correspondingly, the central concern in the design of fiscal equalisation arrangements is to preserve autonomy and the capacity for diversity and incentives for productive policy innovation, while ensuring that differences in outcomes are the consequence of political choices which reflect differences in preferences, not the consequence of unacceptable differences in fiscal capacities among sub-national jurisdictions.

1.2 The Essentially Federal Dimension

In the analysis which follows, the essential features of **federal systems** are particularly emphasised. While the conventional arguments about inefficiencies in interjurisdictional migration incentives and "horizontal" inequities between individuals in different jurisdictions that can arise from decentralisation of fiscal decision-making are set-out and analysed, we present them against the background of an understanding and assessment of arguments which go to the very heart of questions about the conditions necessary for the existence, stability and vitality of federal systems.

What emerges is a strong emphasis on the role of interjurisdictional equalisation transfers (among other things) for the **formation** of federal unions in the first place, for securing the requirements which flow from notions of **common citizenship and nationhood** that are a vital component of the federal solution, and for securing maximum benefits from **political autonomy and political competition** within and between spheres of government in a federal system by reducing the risk

that instability in political competition might lead to destructive competition and wasteful beggar-thy-neighbour policies.

In short, the analysis points to (fiscal equalisation) transfers between jurisdictions as a mutually beneficial source of support for the dynamic efficiencies, and the broader social benefits, that can flow from **genuinely federal** systems of government. By comparison, the traditional arguments which — as we have already emphasised, in effect, flow from consideration of fiscal decentralisation in otherwise unitary systems — rely on relatively narrow comparative-static aspects of efficiency in resource allocation, and equally narrow concepts of interpersonal equity. However, they do provide *some* guidance to the variables which appropriately might be included in capacity equalisation assessments and, when practical (as well as philosophical) considerations are taken into account, they support arguments for **interjurisdictional** transfers as the feasible-best way of addressing the fiscally induced inefficiencies and inequities that are their central objects of analysis.

Equally importantly, what the arguments based on the characteristics of truly federal arrangements lead to, taken together, is a case for **comprehensive** fiscal capacity equalisation. That is, expenditure needs as well as revenue raising disabilities need to be included if equalisation transfers are to meet all of the essential purposes we identify for them — in particular, both to ensure stability in political competition in federal systems and to fulfil the requirements of a common sense of citizenship. We also note that, given the risks to all member States from instability in political competition in federal systems, **the case for comprehensive fiscal capacity equalisation is one which, in principle, should be regarded as mutually beneficial by all member States.**

Clearly, a case can be argued convincingly that, put behind a "veil of ignorance" which denies them knowledge of whether they will be a "rich" or a "poor" State in ensuing periods, representatives of all States at a constitution-forming constituent assembly would support a comprehensive equalisation procedure. **But** our arguments suggest that, even knowing their actual or likely future positions in the resource endowment spectrum, rich States have an incentive to support a system of transfers to poorer States to help ensure that all States remain equally committed to maximal "autonomy" in State decision-making, including over revenue-raising, during the post-constitutional period. This point, that contributing and recipient states are better-off with equalisation and that it is in the interests of both to support it, is emphasised and demonstrated in Petchey (1992) in an analysis of the efficiency case for equalisation.

It seems equally clear, however, that what potentially would undermine consensual support for "equalisation transfers" at post-constitutional level would be a situation in which the dependence of all States on central government transfers became "excessive", leaving their autonomy

threatened by the capacity of the central government to reduce the generosity of grants which represent their major revenue source. In this case — essentially the situation in Australia today — the **shares** of intergovernmental transfers take on the role of being **the sole** significant variable over which the States, "rich" and "poor", can hope to influence their fiscal positions, and the mutuality of support for equalisation transfers is put at risk.

1.3 The Conceptual Foundations in Summary

In accordance with our emphasis on the importance of recognising and analysing the implications of the intrinsically **federal** features of Australia's political and fiscal arrangements, we order and subdivide our presentation and assessment of conceptual foundations for fiscal equalisation transfers into two distinct subgroups.

First, in Section 2, we analyse a range of arguments in which the political, social, economic and fiscal features of the choice of a federal form of governance are particularly critical. Specifically, we analyse arguments based on:

- compensation for the effects of federation;
- federation, nationhood and citizenship rationales;
- promotion of regional economic convergence and social cohesion; *and*
- preservation of regional autonomy and the stability of political competition.

Then, in Section 3, we consider what have been the conventional arguments in the literature for fiscal equalisation but which, in our perspective, represent a somewhat uneasy interface between issues of concern to federal systems, on the one hand, and to unitary systems with fiscal decentralisation, on the other — namely:

- horizontal equity between individuals in different regions; *and*
- efficiency in migration (locational-choice) decisions.

As we have made clear already, these latter "conventional" arguments — often presented as suggesting, at best, a somewhat uneasy case for transfers between regions — while not irrelevant to federal systems, downplay essential features of federal systems as based on compacts and inter-relationships between governments. We nonetheless include them in our discussion *both* because they have played a substantial role in debates about fiscal equalisation *and* because, in our assessment, their implications for the practice of making transfers between regions are less uneasy than often has been suggested.

2. INTRINSICALLY FEDERAL FOUNDATIONS FOR FISCAL EQUALISATION

Our detailed analysis starts with arguments which rest essentially on the nature of the classic federations as compacts between member-States to form a "unifying" federal sphere of government to which certain powers are ceded. At the same time, however, responsibility for a wide range of functional policy areas is reserved (either as a residual, or explicitly) to the member-States, whose powers in these regards remain fully autonomous, protected by a constitution and a constitutional court. Usually this involves a (somewhat) clearer division of powers over expenditure and regulatory functions than over taxation and other forms of revenue raising, which must be "shared" in order to sustain the autonomy of both the federal and State spheres.

We begin with the compact itself, and the possibility that a **compensation case** for interjurisdictional transfers may exist, both to secure federation in the first place and to maintain it in effective operation where the net benefits of federation to member States are not perceived to be shared "fairly" by them all.

The collection of arguments which make up the **federation/nationhood/citizenship case** which we consider next, focus on suggestions that equalisation is required to ensure the financial independence of States, which they require to fulfil their constitutional obligations, and also to meet the expectations of common citizenship rights associated with national, but federal, unity.

We then turn to consider a case which provides a rationale based on the need for a degree of **economic convergence and social cohesion** in federal systems, and on the need for interjurisdictional transfers to ensure these requirements are met.

Finally, we analyse the important case based on sustaining and encouraging **regional political autonomy and political competition**. This case especially emphasises the dynamic efficiency benefits associated with creative competition in policy making and service delivery in federal systems, but also identifies equalisation transfers as a necessary condition for avoiding the potentially destructive effects of instability in political competition.

2.1 Compensation for the Effects of Federation

One of the more important branches of the fiscal federalism literature has examined the question of why we might wish to have federal-type structures. This issue usually has been addressed by asking why decentralisation of functions should take place within a mature centralised nation-state. That is, the analysis typically starts with an implicit assumption that there already exists a unitary system and the issue is whether a system of sub-national governments should or should not be created: the choice is seen as one of decentralisation versus sustained centralisation.

Important contributions to this literature have been made by Stigler (1957), with his 'menu approach', and Oates (1972), who developed the notion of 'perfect correspondence' and the related 'decentralisation theorem'. In addition, the theory of club goods has something to tell us about optimal jurisdiction formation (Cornes and Sandler, 1986); and there also are arguments in favour of decentralisation which rely on appeals to imperfect information on the part of the central government over local preferences: the idea that local governments are closer to the people and know their preferences better (Oates, 1972 and Tresch, 1988). Yet another case, put forward by Brennan and Buchanan (1980), is that decentralisation limits the power of governments in the interests of citizen-voters by introducing inter-governmental competition. For an overview and discussion of all these arguments see Tresch (1981) and Walsh and Petchey (1992).

While a detailed discussion of this extensive literature would take us too far afield for present purposes, it should be noted that, although considerable effort has been put into justifying decentralisation within an existing unitary-state or federation, comparatively little attention has been given to what is perhaps the more interesting question of why politically independent 'states' choose to cooperate through explicit contractual arrangements (constitutions) and federate. Since many examples of federations were formed, at some point in their histories, from previously independent member-States (or colonies), rather than through decentralisation within a given single nation, in a sense, the literature has overlooked some of the more interesting and more relevant questions.

What analysis has been undertaken on this latter question has tended to argue that federation can yield the benefits to potential member-States of (i) "gains from trade" as internal trade becomes free; (ii) tax-price and scale-economy benefits in the provision of "national" public goods; (iii) the pooling of risk between heterogeneous member-states; and (iv) increased bargaining power with other nations. On the other hand, federation can bring with it costs for any particular member-state. One of these might be the fact that the functions which are centralised will be provided uniformly to all member-states regardless of possible differences in preferences. This uniformity of provision might lead to a loss of well-being for some States' residents, depending upon the diversity of preferences. For example, every resident of the federation will have to contribute to, and consume, uniform levels of provision of, defence (a centralised function in all federations) even though, within different member-States, they may have different preferences for levels and quality of common defence. Of course, it is possible that the functions centralised in federations will be those for which there is little diversity of preferences, in order to minimise this cost. Moreover, this "uniformity cost" will not be present for those functions which remain decentralised.

Federation can yield an excess of benefits over these uniformity (or other) costs (a distributable social surplus), but not all of the parties to federation will necessarily benefit, or obtain what is

perceived to be a "fair" share of the benefits. Thus, in order for federation to be attractive — that is, for it to make at least one member-state better-off while leaving the others at least as well-off as they were in autarky — it may have to be accompanied by lump-sum transfers (from the distributable surplus) between member-states. These transfers will need to be from the 'winning' to the 'losing' states to facilitate the formation of the federal system itself.

This is the basis of the compensatory argument for lump-sum transfers of income from states which gain from federation to states which "lose". They can be thought of as **equalisation payments** in the sense that they either partially or fully 'equalise' the net social benefit from federation and are necessary in the interests of obtaining **and sustaining** federal unity. [For further discussion see Maxwell and Pestieau (1980)]. Indeed, although arguments for equalising grants among the States were many and varied and predated the 'tariff compensation' issue, it can be argued that the compensatory motive, and in particular the need to compensate the smaller primary producing states such as Western Australia for the costs imposed on them by the operation of uniform national policies, including the external tariff (which benefited New South Wales and Victoria), centralised wage fixation, the navigation acts and so on, played a significant part in the system of special payments to the less wealthy states in Australia in the 1920s and 1930s and in the eventual formalisation of these payments in the 1930s through the creation of the Commonwealth Grants Commission and the system of equalisation. The principle of 'needs' actually adopted by the Commission as the basis for equalisation payments to the states, on this view, may have been, in part, a 'feasible-best' way of sustaining some compensatory equalisation [for further discussion of this point see May (1971)], although it clearly had other foundations, too, to be found in much earlier inquiries into the economically weaker States' arguments for compensatory payments (see Paper 4).

Equalisation based on the compensation principle implies that the degree and incidence of equalisation should be sensitive to changes in the distribution of losses and gains from federation over time. This has been argued potentially to be particularly important in the present policy environment where the level of external tariffs have fallen considerably and are continuing to do so. Indeed, Swan and Garvey (1992) suggest that

> "Whatever the underlying rationale for the lowering of tariffs, the idea of inter-state payments under Section 96 as compensation for the burden of tariff protection placed on states such as Western Australia and Queensland, implies that state transfers should fall over time. As tariff protection is phased out, under the compensation rule, 'fiscal equalisation' and inter-state transfers more generally should also be phased out."[1]

1 Swan and Garvey (1992), p12.

This is the case, however, only if States do not suffer costs from any other aspect of federation, so that compensation is not justified on other grounds. There are, in reality, other costs associated with federation which can persist independently of the external tariff, such as the differential effects of uniformity of provision of centralised public goods (where preferences differ) and of welfare benefits (where regional wage rates need to adjust to reflect falling regional employment). Centralised wage fixation or national minimum standards for enterprise bargains also can involve costs to regions which need to adjust to falling relative demand for their outputs. There might still be a case for compensatory transfers for these other costs, even in the absence of any costs from external tariffs. Moreover, there are other valid reasons for equalisation which are unrelated to the compensatory motive and the level of external tariffs, some of which are explored in the following sub-sections.

2.2. The Federation, Nationhood and Citizenship Rationales

As indicated in the analysis offered by Courchene (1984), for example, there exist a variety of arguments for interjurisdictional transfers in federations associated with the fundamental requirements for State autonomy, and with the common (shared) aspects of national as well as State citizenship rights and aspirations which go along with the formation of a single, but federal, nation.

Although these arguments sometimes are suggested to be "non-economic", they do have strong connections with economic arguments, in particular those presented later concerning the potential instability of political competition, on the one hand, and the more conventional horizontal equity case, on the other.

The principal focus of the 'federation' motive is that the autonomy of States in the policy and regulatory fields assigned to them under the Constitution requires they have **financial security**. Even if their access to revenue is not as severely constrained as it is in Australia, because the basic economic and financial positions of the States can be expected to differ and, indeed, to vary over time, ensuring the required degree of financial security for all States requires the existence of a mechanism for providing unconditional transfers between the States according to their varying fiscal needs. Otherwise, differences in their access to resources would lead to excessive (relative) tax burdens and/or levels of indebtedness for some States, in meeting their Constitutional obligations.

The 'nationhood' and 'citizenship' rationales shift the focus more directly onto the implications **for States' residents** that would arise from variations in the financial security and capacity of the different States. Federation, it is argued, brings with it **shared** expectations and aspirations concerning access to public sector services. This is most immediately and obviously seen in the

centralisation of some spending and taxing decisions through their being put into the hands of the federal government, with associated uniformity not only in their financing but also in access to them across all member-States.

Over time, however, there also may be a growing expectation that core State-type services should be available on similar terms across States: or, more specifically (in accordance with the importance attached to State autonomy), that differences in levels or patterns of State-type services be the result of democratic political decisions reflecting differences in preferences across States, not differences in capacities to fund similar service levels. To assure this, a case again emerges for unconditional transfers to equalise fiscal **capacities** *(but not outcomes)* across member-States.

At the time many of the major federations were formed, a lesser role existed for governments in the delivery of social services and welfare benefits than is expected of them today. Over time, although to different degrees in different federations, the interpretation of the nature of the social union embodied in the federal contract has expanded to incorporate a wider meaning and deeper attachment to "equality of opportunity". There seems little doubt that — even in those federations which embody values that tolerate a much higher variation in **outcomes** than is the case in Australia, Canada or Germany, for example — common citizenship expectations and aspirations have expanded in federations (and in unitary systems). In some part, this probably is a consequence of the expansion of the notion of the welfare state supported by central (federal) government. It probably also reflects "learning" (by governments, bureaucrats, and informed and/or mobile residents) from the diverse experiences and experiments of the different member States.

In his analysis of these motives, Courchene (1984) also adds a cautionary note, based on his earlier (1971) analysis of the consequences for regional economic adjustment of interjurisdictional transfers combined with other features of federal policies which apply in Canada. In particular, he points out that, in the context of the economic and monetary union which is an integral part of overall federal arrangements, the member-States do not have access to an explicit exchange rate mechanism to assist in the process of adjusting to 'shocks' affecting their relative competitiveness. Regional economic adjustment could occur, however, alternatively through changes to relative wages and prices between regions, if this were allowed to happen. However, if "national" wage-setting arrangements and regulations prevent wages falling in adversely affected regions, and the State facing adjustment problems is receiving substantial equalisation payments completely justified by their initial intended purposes, then these transfer will, in effect, at least offset the affected States "current account deficit" and minimise required adjustments in other ways. This, he suggests, might be referred to as a situation of "transfer dependency" — a disease he associates

with the Atlantic provinces in Canada (where unemployment insurance arrangements further compound the dependency problem).

It is clear, however, that the **source** of the problem lies in obstacles to the ability of wages and prices to adjust appropriately (possibly compounded by welfare payments which also may be uniform nationally, or, as in Canada's unemployment insurance case, perverse in effect). The appropriate response is not to attack equalisation payments, which may meet their objectives appropriately and effectively, but to remove other blockages to regional adjustment.

In Australia's case there has not, to our knowledge, been any evidence of the extreme form of transfer dependency that afflicts Canada's Atlantic Provinces (or the depressed regions of southern (unitary) Italy, which receive transfers through the EC "Structural Funds"), although current changes to the competitive positions of the States, given our degree of wage uniformity, conceivably could result in similar problems. However, the solution, we repeat, would lie with freeing up relative wages between States, rather than with adjusting equalisation arrangements for the wrong reasons. Indeed, during a period of transition of new economic policy regimes, provided adjustment mechanisms are allowed to work effectively, fiscal equalisation transfers may help to maintain financial security for States coping with difficult economic adjustments.

If "transfer dependency" is a risk, it is so in a sense which is at best "incidental", and in general not logically connected, to the fact that equalisation transfers are made to meet the requirements of federation, nationhood and citizenship (or to satisfy any other motive for that matter). And it is a risk which is even bigger in unitary systems, where regional relative wage and other adjustments may be even less likely, and where large inter-regional transfers are virtually automatically generated through central government fiscal operations.

2.3 Regional Economic Convergence and Social Cohesion

Even in federations which do not appear to attach much weight to redistributive transfers for explicit "equalisation of fiscal capacity" among regions (and more so in all unitary countries), a substantial volume of interregional transfers occur.

Estimates prepared for the MacDougall Report (1977), concerned with public finances in the EC, suggested that, even among advanced countries in which transfers play a modest role (e.g. USA as a federal country and UK as a unitary state), the effect of implicit and explicit interregional transfers achieved through the central government budget was to reduce initial disparities in regional per capita incomes by 28 per cent (USA) to 36 per cent (UK). Some of this reflects the central government's provision of national public goods like defence *and* interpersonal transfer payments funded from central government taxation systems. Some, however, reflects either the

direct provision of services, such as regional roads and infrastructure, education and training and so on, by central governments or the provision of intergovernmental grants to fund similar expenditure programs at sub-national level.

Because they were focussing on a group of European countries which had not yet reached full economic and monetary union, the MacDougall Committee was more-than-usually aware of the need to focus on how the loss of the exchange rate mechanism and independent monetary policy adjustment, and the prospect of other common economic policies, would affect the prospects for the existence, stability and cohesion of emerging federal-type arrangements. In this respect, they put particular emphasis on the importance of securing and maintaining some degree of convergence in the economic performance of member-states of 'federal' systems to ensure a sustainable degree of economic integration. For these purposes, they indicated that **explicit** interregional transfers were desirable, and that they should be targeted at reducing interregional differences in capital endowments and in productivity, through support for economic infrastructure and education and training.

These objectives in the EC have been given explicit recognition in the development of the so-called Structural Funds, which make substantial transfers to lagging regions in the Community, amounting to the equivalent of between 2 and 3 per cent of **national** GDP's in several recipient countries (EC, 1993). The Maastricht Treaty proposes establishment of a new "Cohesion Fund" to provide additional interregional transfers to secure greater political and social stability, as well as economic convergence, under the conditions of macroeconomic and microeconomic reforms that will underpin a 'single' market and a common currency.

The parallels between mature federations like Australia, on the one hand, and the EC as an emerging confederation yet to complete monetary union, on the other, clearly should not be overstretched. However, it is worth observing a couple of things.

First, while at the time of federation Australia already was a monetary union, it faced the stresses of establishing a customs union and free trade area as well as other changes brought about by Commonwealth national policies. The founders evidently expected that **economic convergence** between the States would occur under the customs union and with internal free trade, and the fact that it did not may help to explain a number of developments, including the provision of special grants to the weaker states based on fiscal needs, and the later development of road (infrastructure) grants, for example, well before the formal establishment of the CGC (see Paper 4).

Second, but relatedly there is a risk of inhibiting economic convergence, or possibly exacerbating differentials, unless States have the capacity to maintain at least average levels of expenditure on

social and physical infrastructure. Using education as an example (but this would apply equally well to health, law and order, roads, etc.), without fiscal equalisation, the problems of "poorer" States would be compounded — reduced expenditure and therefore standards of services would lead to a less educated workforce, reducing the skills base and economic capacity of the State (and nation) thus leading to further reductions in revenue-raising capacity and therefore capacity to provide services. Furthermore, the better educated and more skilled residents may be the ones more likely to respond to the differentials in available fiscal benefits and migrate.

Third, at a more general level, the issues raised here go to the heart of cohesion and stability in federal systems — issues of on-going concern. At times of significant economic change which favour some 'regions' over others, concerns very similar to those in the pre-federal stage in Australia (and Europe) arise — arguably such as those now facing Australia as microeconomic reform and globalisation impose renewed, and regionally differentiated, adjustment pressures on the economy. While the arguments for (unconditional) transfers based on 'cohesion' in an EC context represent modest pre-federal alternatives to the formula-based equalisation transfers in mature federations, their proposed establishment for the EC serves as a strong reminder of the role of "equalisation" as a stabiliser in times of significant change and stress in relative inter-State economic performances.

2.4 Decentralisation, Regional Political Autonomy and Political Competition

In an important pathbreaking economic analysis of the nature of federal (as opposed to merely decentralised unitary) political and fiscal systems, Albert Breton (1985, in his 'Supplementary Statement' as a member of a Canadian Royal Commission), explicitly emphasised the fact that intergovernmental relations in federal systems are highly competitive. This competition, in the form of creative policy competition between governments (federal vs state, as well as state vs state), while it produces so-called 'overlap' in policies and programs, is potentially highly beneficial, he argues, because it builds-in more effective 'constraints' on the potentially exploitative power of governments than the limited (but nonetheless important) basic electoral constraints involved in Westminster-style responsible government.

To an extent, Breton was simply formalising and extending what often has been claimed of federal systems — i.e. that they permit diversity within a basic unity. However, his argument goes beyond merely acknowledging that federal systems **permit** diversity, and beyond even the familiar "Tiebout hypothesis" that, with diversity, "voting with one's feet" (mobility) could result in a better matching of people's preference for expenditure/tax policy packages. It emphasises, rather, that by competing for votes through innovative policy development in response to voter/citizen preferences and pressures, federal systems can be dynamically, creatively, competitive in a sense

similar to that envisaged by Schumpeter in relation to private product markets, promoting new products, technological progress, and new forms of organisation.

There is a downside to this form of competition, however, as Breton recognises, especially in his subsequent further analysis of the issue (1991). While political competition in federal systems has a potentially creative, welfare-enhancing side, which produces policy innovation and restrains overall taxation and expenditure levels, it also may lead to forms of competition — for example, through special tax/subsidy packages to attract industry and so forth — which end-up producing wasteful beggar-thy-neighbour policy competition of a sort often described as "cut-throat competition" or a "race for the bottom". In short, competition may be (locally or globally) unstable. [The broader public finance literature on interregional tax competition also emphasises wasteful versus beneficial competition: see, for example, Oates and Schwab, 1988.].

As with competition in private markets, obtaining the beneficial effects of federal political competition while avoiding its potential wasteful consequences, depends critically on institutional design.

More so than in the case of competition in private markets, Breton argues, the promotion of stability, in general, cannot be achieved, or ensured, through co-operation between States alone, especially where "horizontal" competition (between States) is concerned. It requires involvement of a "third party" — the central or federal government — because self-enforcing agreements, trust and other potential means of solving instability problems in oligopolistic private markets are likely to break down **where oligopolistic competition between political jurisdictions is concerned** under the pressures of periodic electoral competition within and between 'co-operating' jurisdictions.

Short of centralising power, which would eliminate or reduce competition by destroying federalism, central/federal governments have available a number of instruments they can utilise to deal with different sources of competitive instability, ranging from introducing minimum or maximum standards, providing general revenue transfers, providing grants for "regional" development, and seeking to minimise tax exporting.

Both in relation to reducing instability in competitive diffusion of policies and programs, and in relation to price (tax) competition, Breton argues, it is important that regions (States) be "competitively viable" so that they are not systematically liable to be losers from interstate competition. For this, **there need to be transfers to the jurisdictions which suffer competitive disadvantages because of smaller size, lesser wealth, lesser fiscal capacity and so on.** And, in most circumstances, he suggests, such transfers will be "acceptable" to the contributing

jurisdictions, as well as the recipients, because they underpin the sustainability of political autonomy and political and policy competition at the sub-national level.

In other words, in genuinely federal systems, inter-jurisdictional ("equalisation") transfers provide the basis for viability, stability and cohesion which, in turn, make genuine political autonomy and political competition sustainable and creative: they promote **dynamic efficiency** in federations. And, in this respect, **all** factors which bear on relative competitive capacities of governments in sub-national jurisdictions are pertinent, whether they affect underlying relative revenue raising capacities, or policy and program costs.

Such transfers are not the only tools relevant to securing competitive stability, but they are important — and the more so, it might be added, the more centralised is revenue raising, because otherwise this is likely to promote the use by the States of more wastefully creative competitive strategies to increase budgetary flexibility, attract industry and so on.

3. The Interface Between Equalisation Issues Relevant to Federal Systems and Those Pertinent to Unitary Systems With Fiscal Decentralisation

The discussion of conceptual foundations for fiscal equalisation, to this point, has emphasised those features of federal political systems and associated fiscal arrangements which, to a substantial extent, make them intrinsically distinct from unitary systems, even where otherwise unitary political systems permit or promote decentralisation of fiscal decision-making by sub-national governments. In a truly federal context, where sub-national governments (states) retain genuine autonomy over a range of functions, compensatory motives, rationales based on notions of federal nationhood and common citizenship, and those concerned with the dynamic efficiencies and stability of political competition associated with the political autonomy of sub-national governments have been argued to play a central role. Between them, these arguments also have established a strong case for *comprehensive* fiscal capacity equalisation between member-States of a federal polity.

Against this background, we turn now to consider and incorporate the more conventional arguments for, and about, fiscal equalisation in federal systems which are based on treating fiscally decentralised unitary systems of government as equivalent to federal systems.

What is distinctive about these "conventional arguments" is that they focus their attention on the consequences *for individuals* of the decentralisation of fiscal decision-making in what, alternatively, would be centralised unitary political and fiscal systems. In particular, they focus,

first, on the **horizontal equity of treatment of individuals** who are equal in economic terms *before* sub-national taxation and expenditure policy decision, but (potentially) differentially affected by those decisions. Second, they examine how the **locational decisions of individuals** may be affected by fiscal decisions of sub-national governments in ways at variance with those which would maximise national efficiency and well-being.

As we have indicated previously, in both cases, the issues raised are relevant to the design of fiscal equalisation transfers in truly federal systems, but in our view less directly so than the extant literature might seem to indicate when appropriate allowance is made for the essential features of federal systems. What they **do** provide, however, is some guide to the variables for which equalisation is required, and ultimately, even in their own terms, it is clear that **interjurisdictional** transfers may be the feasible-best way of achieving objectives which, in this literature, are directed at modifying outcomes for, or the behaviour of, individuals.

We begin with the horizontal equity case, then turn to the efficiency in migration/location decisions case, and finally bring these closely related literatures together.

3.1 The Horizontal Equity Case

It commonly is argued that horizontal inequities may be created in federal economies, or in unitary nations with decentralised fiscal decision-making, for at least two reasons. The first is that the taxing and expenditure decisions of state (or sub-national) governments create net fiscal benefits (NFBs) for citizens which can vary between states for otherwise identical individuals. The second is that the tax and expenditure decisions of the central government *also* may create NFBs which differ between states. Consequently, the tax/expenditure mechanisms of the states and central government combined may lead to horizontal inequities between individuals in different states who, before the effects of state and central government decisions, would be regarded as "economic equals". It is argued in the fiscal federalism literature that these inequities should be corrected, in principle, using a system of *interpersonal* equalisation transfers, although it usually is conceded that inter-jurisdictional transfers may be the feasible-best available option in practice.

The horizontal equity case has been the dominant argument in favour of equalisation in the conventional literature on federal economies, assuming greater importance even than the efficiency case. For this reason, we devote considerable attention to it. However, we emphasise, again, our earlier observation that great care is needed in utilising this literature in a truly federal context.

In the following discussion, we first identify the potential sources of horizontal inequities, and then turn to consider various policy options for correcting them.

3.1.1 Sources of Horizontal Inequity

It is useful to differentiate between horizontal inequities that originate from state government redistributive policies, state taxes on natural resources, other state government activities and those that come directly from the activities of the central government.

State Redistributive Policies

The way in which the redistributive policies of sub-national or state governments can create inequities between states was highlighted by Buchanan (1950). His argument can be appreciated by analysing a simplified version of the arithmetic example he used in his paper [see Buchanan (1950) pp. 591-595]. In particular, consider a federation of two states, i = 1, 2. In state 1, it is assumed that there are three individuals; two rich and one poor in terms of their wealth endowment. In state 2, there are also three residents; one rich and two poor. It is assumed that everyone in the federation has the same preferences, that the rich in state 1 are identical to the rich in state 2, and that the poor in state 1 are the same as the poor in state 2.

Assume also, for now, that there is no migration between states. Suppose, moreover, that states provide goods and services with no spillover of benefits or costs to other regions, that each state government funds its provision of goods and services with a residence-based proportional (flat) state income tax and that the income tax rates are the same across states.[2] Although Buchanan chose an income tax here, presumably because states in the USA (and Canada) do impose significant income taxes, other residence-based taxes alternatively could be assumed (for example, payroll taxes, sales and excise duties), as long as they are taxes which are approximately related to income (or wealth) and hence the absolute amount of taxes paid varies according to the presence of high income (or high wealth) residents.

In comparing the welfare of individuals located in the two different states, Buchanan notes that

> "The object of comparison should be the aggregate fiscal pressure upon the individual or family, not tax treatment alone. The balance between the contributions made and the value of public services returned to the individual should be the relevant figure. This 'fiscal residuum' can be negative or positive".[3]

2 A residence-based tax is a tax for which liability is determined according to region or state of residence. These taxes are usually assumed to include state imposed income taxes, payroll taxes, sales taxes and excise duties. While the Australian states do not impose income taxes, and are constitutionally prohibited from the sales and excise tax bases by Section 90 of the Australian Constitution (see Shapiro and Petchey (1992b) for an analysis of the economic effects of Section 90), in most cases they rely for upwards of 40 percent of their own taxation revenues on payroll tax and franchise fees. Note also that the goods and services provided by State governments could be pure and impure local public goods or publicly provided private goods.

3 Buchanan (1950), p 588.

The fiscal residuum is, therefore, the difference between what individuals (directly or indirectly) contribute in taxes to the state in which they live and what they receive in state-provided goods and services. This residuum is, from now on, referred to as a net fiscal benefit, or NFB_i, where the i subscript refers to the state. It is added to a resident's wage income, w_i, (assuming for convenience — without making any qualitative difference to the results — that individuals receive only wage income through the market, implying that income from dividends and profits is not considered) to make up what is known as comprehensive income (CI_i). Hence, we have for state i = 1:

$$CI_1 = w_1 + NFB_1 \qquad (1)$$

As we shall see later, it is comprehensive income, rather than just wage income, which determines peoples' welfare and influences their decisions on where to live (that is, migration decisions).

Buchanan further proposes that this simplified federal system should be judged on the 'horizontal equity principle' that individuals who are equal in terms of income and preferences, but live in different states, should be treated equally by the fiscal system. Using this criterion he notes that

> "The fiscal structure is equitable....only if the fiscal residua of similarly situated individuals are equivalent".[4]

In the example constructed, Buchanan shows that NFBs, in general, will differ between identical individuals living in different states. To see this, assume that the rich in states 1 and 2 have a zero NFB, in the sense that the higher absolute amount of tax they pay (relative to the poor) is exactly matched by the benefits they derive from the level of public good provision. On the other hand, the (sole) poor resident of state 1 receives a positive NFB in the sense that this person's absolute tax contribution is lower (than each of the two rich persons), but they receive the benefit of the greater level of public good provision due to the presence of the two rich residents. The two poor individuals in state 2 also receive a positive NFB because of the presence of the rich resident in state 2, but their NFB is lower than for the poor in state 1 because there is only one rich resident in their state. Hence, the NFB for the poor in state 1 is higher than for the poor in state 2 because of the presence of more high income residents in state 1. The horizontal equity principle is violated because individuals who are identical in terms of preferences and incomes are not treated equally by the two state governments simply because of the presence of a greater number of high income people in state 1.

What is driving the Buchanan result is the fact that (i) taxes paid by individuals are progressive in the sense that those with above average incomes contribute more in absolute taxes than residents

4 Buchanan (1950), p 588.

with below average incomes; and (ii) expenditure by the state is distributed among residents on a uniform per capita basis. These two assumptions, combined, imply that state budgets are progressive: that is, they redistribute income from the rich to the poor. Progressivity has two general implications for NFBs. First, in general, residents with above average incomes will have negative NFBs because their tax contribution is greater than what they receive in services (although in the discussion above we have assumed for convenience that they simply have zero NFBs). Second, those with below average incomes will receive positive NFBs since what they receive in services exceeds their tax contribution.

Thus, the residence-based state income tax used by Buchanan (or other state taxes such as payroll taxes), combined with state expenditure which is distributed on a per capita basis, can cause horizontal inequity in a federal system due to variations in the location of high and low income residents across states. Of course, if all state budgets were distributionally neutral then the amount of residence-based taxes paid by individuals would be equal to the benefits they receive. This might be so also if all state services were provided on a user-pays basis, that is, all state fiscal activities correspond to the **benefit taxation principle** where residents are taxed according to the benefit received (as we will see later, in this case there is no need to equalise on horizontal equity grounds). Of course, in practice only a small proportion of government services are provided on this basis.

Buchanan saw horizontal inequity as a fundamental problem in federal systems. His view was that, to achieve equal treatment of equals in such a federation, the best policy option would be for

> "....geographically discriminatory central government personal income taxation. Central government income tax rates could be made to vary from state to state so as to offset differences in state fiscal capacities. This method of adjustment, by varying personal income tax rates among equals, could come closest to achieving the equity goal. In effect, it would limit the transfers to those among 'equals'."[5]

Using the above example, Buchanan's proposal was for the central government to impose a higher personal income tax on the rich in state 1 (relative to the rich in state 2) and redistribute the additional revenue to the rich in state 2. This lowers the NFB received by the poor in state 1 and raises the NFB for the poor in state 2. Effectively, the transfer equalises per-capita residence based income taxes paid by the rich in states 1 and 2. Note that this option operates through the central government budget and requires the central government to treat identical rich individuals differently in order to completely 'undo' the differential effects of the state budgets. The transfer also is between identical individuals in different states; not between different income individuals across states, nor between state governments.

5 Buchanan (1950), p 595.

However, Buchanan recognised that geographically discriminatory central government income taxation would face constitutional barriers in the USA, as it would in Australia (see Section 99 of the Australian Constitution which effectively bars discriminatory Commonwealth policies across states and also Section 51 (ii) which gives the Commonwealth power with respect to taxation but not so as to discriminate between states or parts of states), as well as probably also facing political barriers. He, therefore, proposed **transfers between state governments as the feasible-best alternative.** This form of **inter-governmental** fiscal equalisation is discussed further below.

What we have here essentially is an externality argument for fiscal equalisation, where the externality is generated in one state by the presence of the rich (and is of benefit to the poor in each state). It is also worth remembering that Buchanan was writing about the American federal system in which there were very large discrepancies in wealth between states — particularly between the southern states such as Mississippi and the north-eastern states like New York — and large observed differences in the provision of public goods and services (education in particular). However, the question arises: how relevant to Australia is this horizontal equity case for equalising residence-based taxes across states?

To consider this, note that the force of the Buchanan argument for equalising residence-based taxes depends crucially upon **state budgets** being progressive and redistributing from high income to low income residents (that is, taxation is not based on the benefit principle). In Buchanan's model, and the analysis here, progressivity is ensured by the assumptions of uniform per capita spending and a proportional income tax.

In Australia the assumption of equal per capita spending might not be a bad approximation to reality when one considers that most state expenditure is on functions such as education, health, and police services (which account for in excess of 50 percent of governmental expenditure in most states). These services tend to be provided on the basis of equal access to all residents regardless of their level of contribution through taxes. That is, they are not provided on the benefit principle.

A second important feature which yields progressivity is the assumption is that states use taxes which have an incidence related to income (or wealth). This means that revenue collected is sensitive to the presence of wealthier residents in the state and that such residents will contribute proportionally more to the financing of each unit of service provided than will less wealthy residents. Buchanan used a proportional state income tax in his example, which clearly generates such an effect. This, obviously, is relevant to the USA and Canada where states impose such taxes. However, in Australia, there are no state income taxes. The main taxes used by the states are (i) payroll tax; (ii) financial transactions taxes; (iii) gambling taxes; (iv) stamp duties, especially on conveyances; (v) vehicle registration fees and drivers licences; and (vi) business

franchise fees. One can argue that these taxes may cause differential NFBs, but this is less immediately obvious than in the context of state income taxes. Consider the payroll tax as an example. If payroll tax (i) has its economic incidence on consumers; (ii) acts like a consumption tax; and (iii) is proportional to income, then it is equivalent to a proportional income tax. Moreover, if the revenue is used to finance equal per capita expenditures, then the payroll tax will generate differential NFBs. If, alternatively, the incidence is on producers, it is effectively a source-based tax (defined below), and as will be seen later, such taxes can create differential NFBs. If finally, the incidence is borne by workers, then the tax clearly will be like an income tax.

Similarly, property based taxes can be categorised according to their economic incidence. If residential property taxes are shifted forward to consumers of housing services, they are like residence-based taxes, and will create differential NFBs. Similarly, if non-residential property taxes are borne by firms they are like source-based taxes (again-defined below), and if shifted forward to residents/consumers of business products, they behave like a residence-based tax.

Therefore, in general terms, the major taxes upon which Australian states rely are probably income-related, create differential NFBs, and hence, as will be seen later, require equalisation on the basis of horizontal equity argument. Thus, there are grounds for supposing that state taxes in Australia might be **broadly related to income, and that expenditures are on something like a uniform per capita basis**. In turn, it is clear that the Buchanan equity case, based on the progressivity of state budgets, is applicable in Australia, despite the absence of a state income tax. Of course, if the States ever were given back access to income taxes, progressivity would be greater still. While equal per capita spending and proportional (flat) income taxes are convenient devices to obtain progressivity, and indeed may be highly relevant in the Australian case, the argument also applies more broadly to other taxes which are not based on the benefit principle as long as they yield progressivity.

State Taxes on Natural Resources

Apart from residence-based taxes [and the Buchanan (1950) arguments], the fiscal federalism literature has argued that **source-based taxation of rents on natural resources** (undertaken by states) can create differences in NFBs.[6] Boadway (1985), in relation to the Canadian provinces, notes:

> "If provinces finance some of their expenditures by source-based taxes, the federal personal income tax will understate personal incomes by an amount

6 A source-based tax is a tax for which liability is determined regardless of state of residence. These include taxes on rents from natural resources. In Australia, many of the so-called resource states (e.g. Western Australia and Queensland) do derive significant revenue from exploitation of natural resources, the proceeds from which go into general recurrent revenues (although Western Australia recently proposed putting its mineral royalties into a separate fund similar to the Alberta Heritage Fund) and are disbursed to state residents through the provision of State services.

> equal to the benefits accruing to provincial residents from the per-capita expenditures financed by source-based taxes. That is, taxable income equals net income plus provincial expenditures financed by personal taxes; it does not include those financed by source-based taxes. To the extent that source-based tax collections per-capita vary across provinces, the federal income tax system will be horizontally inequitable in the sense that identical persons residing in different provinces will be treated differently. In particular, persons in provinces with higher source-based taxes will be favoured."[7]

Thus if (i) some states in a federation have within their boundaries substantial natural resources over which they have sovereignty; (ii) rents from these resources accrue largely to non-residents; and (iii) the rents are taxed by the state and the benefits of these taxes are distributed to residents on the basis of residency alone, then these resources will contribute to NFBs. Moreover, the rents, and the NFBs created by them, will vary across states according to differences in resource endowments. Therefore, they also contribute to horizontal inequity.

One might expect this to be an important potential source of horizontal inequity in Australia, where a number of states are relatively resource-rich and do derive substantial revenues from the taxation of these resources. In Canada, inter-provincial differences in resource endowments, and how to equalise for their effects on NFBs, has been a major component of the debate on fiscal equalisation.

Other State Activities

There are other sources of NFB differentials between states. First, **cross subsidies from higher income groups to lower income groups through the use of non-marginal cost pricing policies in the provision of services such as water, electricity and transport services** (i.e. Community Service Obligations or CSOs) can contribute to NFBs, and create differential NFBs between states. Second, **state-provided infrastructure** also can give rise to differential NFBs. For example, suppose that state expenditure on infrastructure (such as roads) enables firms in that state to produce goods at lower prices (a benefit which may well vary from state to state). This effectively leads to higher real incomes (because of lower prices) which are not taken into account by central government income taxation, and hence, may contribute to different NFBs between states. To the extent, however, that state spending on infrastructure benefits non-residents through higher profits (rather than lower prices to domestic consumers), NFBs are not created.

Third, **economic rents earned by State Trading Enterprises** (or GTEs) may be reflected in the profits of these enterprises and give rise to NFBs if these profits benefit state residents. On the other hand, if these rents are not captured as profits, but instead are manifested as lower prices to residents for state-provided services, then NFBs will again be created, and differentially so across

7 Boadway (1985), pp 11-12.

states because resource endowments differ. As previously, these rents are not captured in the central government's income taxation base.

Fourth, **differences across states in the structure and capacities of the tax bases** themselves could lead to differential NFBs and hence horizontal inequity.

Finally, **differences in the marginal cost of producing public sector services between states will give rise to NFBs that differ across states.** Cost differences could mean that individuals who are identical in terms of incomes and preferences, although facing the same tax burden, could receive different amounts of public good. Such cost differences should be equalised on equity grounds.

In summary, the progressivity of state budgets, taxation by states of rents on endowments such as natural resources, CSOs, economic rents earned by GTEs and differences in the marginal cost of producing public services, all may contribute to differential NFBs across states. As will be seen later, it can be shown that NFBs created from **all** these sources require equalising on horizontal equity grounds.

Central Government Activities

It was noted above that the central government also can contribute to differential NFBs across states, and hence horizontal inequities, by not including NFBs created by state budgetary activities in its own tax base. However, **the central government may contribute to NFBs directly** through its taxation and expenditure decisions, and possibly in a way which counteracts the effects of state budgets (that is, central government activities may be at least partially equalising even without taking into account explicit equalisation grants.).

It is possible to envisage at least three ways in which the central government's budget conceivably might work — though with varying degrees of plausibility. The first is to assume that in each of the two states analysed above [in discussing the Buchanan model], we now have a central government tax which, like the state income tax, is proportional to income. If the proceeds of this tax are spent **only in the state in which they originate, and on a uniform within-state per-capita basis**, the central budget acts like a state budget. It is progressive (i.e. redistributes income from the rich to the poor) within each state, and generates different NFBs across states because of the higher per-capita incomes in state 1 relative to state 2. In this case, the central budget contributes to NFBs, and to differences in them across states, in a fashion identical to state government tax and expenditure policies. Also, central government expenditure per-capita will be higher in state 1 which has the higher per-capita income (because of the presence of twice as many rich residents) and relatively lower in state 2: its budget creates a higher NFB for the poor in state 1 than it does for the poor in state 2 (just as the state budgets do).

Therefore, if the central government spent in each state only what it raised there, there would be higher central expenditure in wealthier states, contributing to higher degrees of horizontal inequity, and, as will be seen later, higher economic inefficiency because of migration distortions. Therefore, on equity (and efficiency) grounds, the central government acting like a state would be difficult to justify since it would reinforce the inequities created by state budgets. However, it is hard to envisage any central government expenditure in Australia being of this type.

A second, and somewhat more plausible, way to think of the central government's budget is to assume that its expenditure is on an equal per-capita basis across the two states, while its taxes are, in effect, progressive within each state as assumed above. Expenditures such as national defence may be on this basis, but it is difficult to think of many others that would be. Equal per capita expenditures by a central government will be equalising in the sense that some of the NFB created by the rich in state 1 will be redistributed, via the equal per capita expenditure, to all the residents of state 2. Thus, if the central government allocated expenditure on an equal per capita basis across the whole federation its budget will tend to have an equalising effect because it will run counter to the inequities established by state budgets.

Finally, if the central government's expenditure per capita is higher in state 2 (the lower per capita income state) then its combined tax and expenditure policy will be yet more equalising than in the previous example, since more of the NFB in state 1 will be redistributed to state 2. Thus, under either equal per capita expenditure or higher per capita expenditure in state 2, the central government's expenditure and tax policy will be equalising without taking any account of explicit equalising grants. This is highly likely given the availability of uniform welfare benefits and other expenditures (such as for labour market programs), which are likely to be accessed more by low-income States' residents. Even though the interstate equalisation is *incidental* to the central government providing benefits to specific individuals or groups, its causes (and effects) are precisely parallel to those which underlie the case for explicit interstate equalisation on horizontal equity grounds — i.e. differences between States in per capita incomes and expenditure needs.

Brosio (1992) has shown that the Commonwealth budget in Australia does create NFBs which differ across states and in a way which correlates with the third example discussed above. He finds that Victoria, New South Wales and Western Australia (from highest to lowest in order of magnitude of income) make the highest per-capita tax payments to the Commonwealth, while Queensland, South Australia and Tasmania (again, from highest to lowest) make the lowest per-capita tax payments to the Commonwealth (we could think of state 1 in our example as being one of the higher income states, for example, Victoria, and state 2 as being one of the low income states, for example, South Australia). This divergence is apparently due to a greater presence of high income residents (or other sources) in the states of Victoria, New South Wales and Western Australia and a greater presence of lower income residents in the other states. Brosio's second

finding is that Commonwealth expenditure is not on a uniform per-capita basis across states, but is higher in those states with lower per-capita incomes (largely because of social security payments).

Considered together, these findings imply that the Commonwealth budget creates higher NFBs in the lower income states than in the higher income states. Brosio calculates that the states of Victoria, New South Wales and Western Australia have negative NFBs from the operation of the Commonwealth budget, while Queensland, South Australia and Tasmania have positive (and relatively large) NFBs.

This result is not entirely surprising — it corresponds to a priori expectations, and to experience and evidence of what occurs even more strongly in unitary nations because their central governments also typically have a bigger role in providing and/or funding what are State-type services in federal systems, and they do so in ways which provide broadly equal access to those services across all regions.

While this analysis of the impact of central government activities in federal systems certainly draws attention to the fact that horizontal inequities (differential NFBs) may be less than would appear from examining and comparing State budgets alone, the fact remains that State financing of their own-purpose programs does potentially generate significant residual horizontal inequities. The Buchanan approach argues that explicit equalisation transfers are required, to correct for these inequities.

Overall

NFBs can differ between states in a federation, and horizontal inequities persist, because of (i) the possible progressivity of state budgets and the other fiscal activities of state governments; (ii) the fact that central government taxation policy may not include all of the real income accruing to state residents in its income tax base; and (iii) the effects of the central government's own taxation (particularly income tax) and expenditure policies. Moreover, in Australia, preliminary evidence suggests that the NFBs created by the Commonwealth's budget tend to run counter to those that one would expect to be created by state activities. Explicit equalisation nonetheless is required to remove residual inequities arising from State own-purpose, and own-financed outlays.

We now turn to a discussion of how fiscal equalisation can be used to 'correct' for horizontal inequity in this hypothetical federation.

3.1.2 Correcting Horizontal Inequities

Accepting that inter-state differentials in NFBs exist, what should be done to correct for them depends upon the **normative view of horizontal equity** this is considered to be appropriate to federal systems.

It is argued that there are two notions of horizontal equity in federations. The first is known as **'broad-based horizontal equity'** and the second as **'narrow-based horizontal equity'.** The broad-based view is that individuals who are equals in the absence of central and state government budget activities, should also be equals after the tax and expenditure actions of both the state and the central government are in place. If the central government takes this broad-based view of horizontal equity, then all NFBs should be equalised so as to completely 'undo' residual horizontal inequities arising from both state and central government policies.

The narrow view of horizontal equity, on the other hand, suggests that persons otherwise equal in the presence of state government policies should also be equal after central government policies are in place. This view means that the central government should only correct for differentials in NFBs caused by central government actions. NFB differentials created by state policies would remain.

If the broad-based view is adopted, to the extent that they are approximately proportional to income (and expenditures are on a uniform per capita basis), all residence-based taxes should be equalised — in principle, through inter-personal transfers, although as we have noted (and discuss further later) *interjurisdictional* transfers probably are the feasible best available option. If states rely on source-based taxes which are generally incident on non-residents, including foreigners (perhaps this is the case in Australia with respect to resource revenues), these too should be equalised, as should the effects of: (i) explicit state redistribution policies through CSOs etc; (ii) income differentials caused by infrastructure spending; (iii) rents earned by state business undertakings; (iv) income differences caused by the pricing policies of state business undertakings; and (v) differences in expenditures required to provide public goods across states. **This approach would essentially mean that the federal system will behave as if it was a unitary system — differences arising from state policies which have a "distributional" content to them especially as a result of differences in average per capita incomes and expenditure needs would, in effect, be offset by central government "equalising" taxes or transfers.** Note, however, that this conclusion applies only if the transfers are, in fact, paid to individuals: the payment of the transfers (on grounds of feasibility) as capacity-equalising grants to State governments would not suffer this objection, since it would give the states equal capacities but would allow diversity to remain.

Alternatively, if the narrow-based view is adopted, then the central government should only be concerned to ensure that its *own* policies are neutral with respect to their effect on horizontal equity. Under this view, for ethical, constitutional or moral reasons, states are assumed to have the **'property rights'** to the NFBs generated by their own fiscal and expenditure activities and differences across states should not be equalised, at least on equity grounds. In the case where one state is resource-rich and derives considerable fiscal benefit from taxing resource rents relative to other states, under the narrow-based view of horizontal equity, these rents would be taken to belong to the people of that state and not be equalised. Indeed, in Canada the narrow-based view is partially adopted with respect to source-based taxation of resource rents where only a proportion of state taxes from minerals is equalised. The states' residents are deemed to have the property rights to the remainder. In the words of Boadway (1985):

> "The only concern of the federal government in this case is to ensure that its income base treats as equals persons residing in the different provinces who have the same real income, where the real incomes could include differing amounts of provincial public services."[8]

Thus, the degree of equalisation undertaken will depend upon one's view about issues of sovereignty and property rights in federal systems (and this remains a normative question) and the particular economic conditions in the federation being considered (here issues of the types of state taxes used and their incidence as well as the publicness of expenditures will be important).

Again, however, how these questions are viewed will depend on whether equalisation is, in practical terms, to be pursued among individuals, or among States. **The seemingly more "federalist" nature of the narrow view of horizontal equity disappears when States, rather than their residents, are to be the recipients of (unconditional) equalising transfers** — as would be supported both by the practical infeasibility of interpersonal equalising taxes or transfers, by the broader arguments about the nature of **federal** systems and the compacts which underlie them, and by the fact that, in effect, the horizontal inequities are caused by the existence of the sub-national governments in the first place (i.e., transfers *between governments* would wash-out the effects of political *structure* and any residual NFB's would be the result, of political *choices*). Moreover, as we point out later, the narrow based view fails to address adequately the problem of inefficient, fiscally-induced migration.

There is one further important point to note. If the central government decides on the broad view of horizontal equity, recall from the earlier discussion of Brosio (1992) that, it need only use explicit equalising grants to equalise the **residual NFBs** created by the operation of both state and federal government policies. What this implies is that the degree of explicit equalising which needs to be done through grants is smaller than it would otherwise be (than if, say, the NFBs

8 Boadway (1985), p 16.

created by the federal budget tended to reinforce those created by state budgets). Indeed, Brosio finds that the degree of implicit equalisation undertaken in Australia through the Commonwealth's expenditure and taxation exceeds explicit equalisation through grants. He notes:

> "... redistribution is performed both by the Commonwealth's own-purpose expenditure and by grants to the states. Their pattern is surprisingly similar, but since the Commonwealth's own-purpose expenditures are of a much bigger size, their impact turns out to be more substantial than that of grants, which are generally supposed to be the main instrument for regional redistribution. Here the explanation stems from the relevance of social security expenditure and from the implicit redistributive role played by final consumption expenditure. Since the latter is distributed on an equal per capita basis its relationship with income becomes progressive."[9]

3.1.3 Summary

The equity case for equalisation can be summarised as follows. Progressivity of state budgets, rents earned from endowments such as natural resources, intrastate redistribution, and the central government's budget, all can create differential NFBs between states. This means that residents of different States who are equal (in terms of incomes and preferences) before the operation of state and central government budgets may not be equal after the expenditure and taxation efforts of both governments are in place. On horizontal equity grounds, therefore, some form of interpersonal transfers that equalise NFBs can be justified. In practice, however, such equalisation would have to be achieved by inter-governmental grants, both because calculation of required interpersonal transfers would be horrendously complex and because central governments in federal systems typically are precluded from discrimination between States at least in their taxation policies. Moreover, although the inter-State nature of the federal compact does not, in itself, convert the equity argument directly into one between States rather than individuals, it points to another reason why inter-State equalisation transfers might be the preferred option.

The degree of equalisation seen as being desirable on these grounds will depend upon whether one takes a broad or narrow view of horizontal equity and this in turn hinges on who is perceived to have the property rights to natural resources in federal systems and on how one views the role of interpersonal versus intergovernmental grants. Equalisation, moreover, only should be concerned with the horizontal inequity which remains after the combined effects of central and state budgets are taken into account.

9 Brosio (1992), p 11: Note that "the latter" in the final sentence refers to Commonwealth final consumption expenditure, not social security outlays, of course.

3.2 The Efficiency in Migration Case

The efficiency case for equalising transfers can be thought of as an extension of the horizontal equity case. This can be seen by assuming that, in the two-state model considered above, residents are now free to migrate between states in order to maximise their well-being which, in this model, implies that they maximise comprehensive incomes. It is argued in the 'fiscal externality' literature [see Buchanan and Goetz (1972), Flatters, Henderson and Mieszkowski (1974), Hartwick (1980), Boadway and Flatters (1982a, 1982b), Myers (1990) and Hercowitz and Pines (1991)] that, **in the absence of appropriate equalising transfers,** this will lead to residents migrating to capture a share of NFBs and that this, in turn, creates economic efficiency costs making all residents of the federation worse-off. Once we allow free migration, the NFBs, which in reality are forms of externality, have the potential to introduce an economic distortion (inefficiency).

3.2.1 The Source of Inefficiency

The argument can be seen by noting that individuals who maximise comprehensive incomes (defined previously) will migrate to equate comprehensive incomes across states, so that in equilibrium (a situation where no individual will wish to move) the following condition is met:

$$CI_1 = w_1 + NFB_1 = CI_2 = w_2 + NFB_2 \qquad (2)$$

If NFBs are higher in state 1 than in state 2 as our previous example supposed (because of the presence of more rich people in state 1 and/or a greater endowment of mineral resources), then an individual will be willing to migrate to state 1, even if it means accepting a lower wage than in state 2, as long as comprehensive income is higher. The higher NFB in state 1 makes up for the lower wage. Thus, we could have a migration equilibrium, given by equation (2), in which comprehensive incomes are equated (and no resident can do better by migrating), but where wages, or NFBs, need not be equated. Since wages are assumed to be equal to marginal product (MP), this also means that MPs may not be equated in equilibrium (except, perhaps, by chance). Any equilibrium where MPs are not equal is inefficient because it implies that we can reallocate people between states and obtain higher total output (labour can be reallocated so as to shift the economy on to its Production Possibilities Frontier). Thus, in our example, 'too many' residents will migrate to state 1, attracted there by the relatively higher NFBs. As they migrate to state 1, they drive the wage rate and MP in state 1 below the wage and MP in state 2, and generate an efficiency loss, making **all residents** of the federation worse-off.

Note that, if $NFB_1 = NFB_2$, then equating comprehensive incomes would also lead to an equality of wages and hence marginal products in equilibrium (this would be an efficient migration

equilibrium). However, in general, NFBs will not be equal and hence (2) will not lead to an equality of wages and marginal products. Finally, observe that it is the presence of *differential* NFBs, not NFBs per se, which leads to inefficient migration equilibria.[10]

3.2.2 Correcting for the Inefficiency Through Equalisation

Boadway and Flatters (1982b) develop a model capturing the efficiency consequences of free migration in the presence of NFBs and characterise an inefficient free migration equilibrium distorted by the NFBs discussed above. They show that fiscal equalisation transfers can be made between regions to correct for these inefficiencies and increase per-capita well-being for residents in both the recipient and contributing states. The optimal 'equalising transfer' is derived analytically. It effectively equalises per capita NFBs between states, or per-capita residence and source-based taxes, **and is the same transfer as is required in the broad-based equity case.** As noted above, equalising the NFBs implies that wages and marginal products will also be equal at a free-migration equilibrium.

Hence, there is a formal equivalence between the equalising transfer designed to establish broad-based horizontal equity and the transfer aimed at ensuring that there is no inefficient migration in a federal system. The transfer that establishes broad-based horizontal equity also establishes an efficient free-migration equilibrium — a conclusion which highlights the misconception involved in frequently-made assertions that equalisation transfers either encourage or retard migration and thus, it is incorrectly claimed, must be inefficient, by definition. What follows, in fact, is that they can be **efficiency enhancing**. This result is demonstrated, within the context of a federation with different resource endowments across States, in Petchey (1992).

The equivalence between equity and efficiency results is summarised neatly by Boadway (1985):

> "Since the NFB differentials (which lead to inefficient migration) are the same as those that give rise to horizontal inequities, the remedy for fiscal inefficiencies is the same as that for horizontal inequities of the broad-based sort. Of course, if one opts for the narrow-based view of horizontal equity, there will be a conflict between the degree of equalisation called for on efficiency grounds and that called for on equity grounds. The former will be greater."[11]

This very important point can be appreciated by reference to Boadway and Flatters (1982b), pp 619-622. Here, the authors' capture both inefficiency and horizontal inequity by modelling a federal economy with free migration between regions where residents maximise per-capita utility. They characterise a free migration equilibrium in which per capita utilities (comprehensive

10 Note that, by a similar line of reasoning, business location decisions also can be affected by fiscal factors.
11 Boadway (1985), pp 18-19.

incomes) are equalised, but which is distorted by the presence of different NFBs. Hence, the equilibrium is both inefficient, in the sense that marginal products of labour are not equalised, and horizontally inequitable, in the sense that NFBs between states differ as well. They also show that an optimal equalising transfer can correct both the inefficiency and the inequity.

Thus, NFBs are not equalised by the free migration process (only per-capita utilities and comprehensive incomes are) and it is the role of equalisation to equalise NFBs and, in so doing, equalise wages and marginal products across regions. **This must necessarily lead to some migration in response to equalisation but it will be efficient migration.** Again, note the contrast to the popular misconception that migration in response to transfers is inefficient.

One interesting point to note at this stage is that Swan and Garvey (1992) seem to argue that free migration itself will establish an equality of NFBs across regions, thus eliminating any need for equalisation on equity (or efficiency) grounds. In mounting an argument against equalisation, and especially the analysis of Buchanan (1950), they suggest that

> "What Buchanan leaves out is that in the absence of fiscal equalisation migration flows from one state to another will entirely solve the alleged problem. Moderate income individuals will move from state two to state 1 until the fiscal residuum is equalised in the two states. All individuals will now be treated equally in the fiscal area."[12]

By proposing that free migration establishes an equality of NFBs (and hence efficiency), and that there is accordingly no efficiency case for equalisation, Swan and Garvey (1992) are effectively arguing that free migration equilibria are efficient. Yet it is the whole purpose of the fiscal externality literature, since at least Buchanan and Goetz (1972), to show under what conditions free migration leads to inefficient equilibria (where NFBs are not equalised) and that there is at least a theoretical case for policy intervention, through equalising transfers, to establish efficient equilibria. Indeed, the simple message from this literature is that **differential NFBs (which are really externalities) create inefficient migration equilibria.**

Another point of interest is that, if the narrow view of horizontal equity is taken, so that on equity grounds NFB differentials created by state government activities would not be equalised, it is still the case that such NFB differentials would need to be equalised on efficiency grounds. If the narrow-based view and the equity case dominate the efficiency case from a policy perspective, and less than full equalisation is undertaken, then there will remain efficiency losses following the equalisation transfer.

12 Swan and Garvey (1992), p 19.

Hence, in granting state sovereignty (or property rights) over NFBs created by state activities (for example, if states were allowed to fully keep the revenues from taxation of resource rents), there is an efficiency trade-off because equalisation will not go far enough from an efficiency point of view. The migration equilibrium established post-equalisation would still be inefficient in the sense that marginal products would not be equalised and nor would NFBs, although the equilibrium would be horizontally equitable from the narrow-based perspective. This is effectively what has occurred in Canada by not fully equalising for resource rents.

3.2.3 Summary

In summary, the argument for **equalisation on efficiency grounds** hinges on the idea that the NFB differentials created by state and central government budgetary activities, while creating horizontal inequities, can also stimulate inefficient migration between states. Fiscal equalisation which seeks to equalise NFBs on horizontal equity grounds also, therefore, will discourage inefficient migration and remove the efficiency costs associated with it. Equalisation has the potential to establish an allocation of resources which is efficient, as well as to promote horizontal equity, in a federal fiscal system.

3.3 Issues Raised by the Equity and Efficiency Cases

In the following discussion, we examine a number of issues often raised with regard to the equity and efficiency arguments. The aim is to assess whether these issues weaken or strengthen the case for equalisation. The issues relate to the possibility of capitalisation, questions of the assignment of property rights, theory versus practice in Australia, inter-governmental versus inter-personal transfers, state migration taxes, voluntary inter-state transfers and other matters.

3.3.1 Capitalisation of NFBs

It should be noted that the property market has been suppressed in the analysis of NFBs above. In a model with a property market, it is possible that NFBs might be 'capitalised' into the price of fixed factors such as land. To the extent that such capitalisation occurs, the significance of differential NFBs as a source of continuing economic inefficiency and inequity declines. This is because, although migrants share in the NFBs generated by a state when migrating, they also incur a cost of residing there in terms of higher land prices. Effectively, therefore, capitalisation of NFBs into the price of land means that residents are charged a price for the NFB they receive (and migrants do not receive them without any cost).

In this regard, Oates (1984) notes:

> "....existing fiscal differentials ....across jurisdictions will tend, to some extent at least, to be capitalised into property values so that those who choose to live in fiscally disadvantaged areas are compensated by having to pay lower land rents; from this perspective, horizontal equity under a federal system is, to some degree, self-policing. The need for equalising grants in a federation is thus questionable. Perhaps it is best to regard their role as a matter of 'taste'."[13]

As we already have noted, the "taste" variables (i.e. societal values) referred to by Oates are an important matter often left out of economic analysis. Nonetheless, the question of whether capitalisation is an empirically significant self-policing mechanism is unresolved. Unfortunately, there appears to be no empirical analysis of capitalisation of "rents" and the extent to which this diminishes the case for equalisation. Nevertheless, on a priori grounds, one would expect some degree of capitalisation to occur and more so the more fixed (or inelastic) is the supply of land. It is only differential NFBs, to the extent that they are not capitalised, which further distort migration decisions and create horizontal inequities.

It also might be noted, of course, that if a fiscal equalisation system is in operation which, broadly speaking, achieves equal NFB's for like individuals between different States, then there are no differences in NFB's to be capitalised, and no inducements to (inefficient) migration on this account. Then other variables — such as better employment prospects and/or climatic decisions — would explain observed migration, such as that currently observed to be happening from the south to the north and west in Australia.

3.3.2 Property Rights over Rents

The models used in the analysis of equity and efficiency cases for equalisation assume that states have property rights over the fixed factors generating rents and hence the source-based taxation revenues flowing from these rents. As noted, the narrow-based view of horizontal equity dictates that source-based revenues from fixed factors belong to the states and should not be equalised on equity grounds (although this will involve some efficiency cost because equalisation will not go far enough).

If the property rights were reassigned to the central government (so that all residents of the federation own the rents), the link between an individual's share in the rents and location choices would be broken, thus removing rents as a source of migration distortion and inefficiency. They also would no longer cause an equity problem since the proceeds from central government taxation of the rents presumably would be distributed in a fashion which is independent of state of residence. Therefore, one can see the problem of source-based taxation of mineral rents, location inefficiency and horizontal inequity as being caused by the particular assignment of property rights

13 Oates (1972), p .

assumed in the model. It *might* be argued that, rather than have a system of equalising transfers to get around this problem, property rights should be reassigned to the central government. Rents also would disappear as a source of distortion if they were 'privatised'; that is, not collected publicly and disbursed to residents of a state, but rather, accrued entirely to private individuals. It is only when rents accrue publicly that they are a source of distortion.

However, assignment of property rights to state governments is what one finds in federations. State sovereignty over natural resources is guaranteed constitutionally in many federations, including in Australia, as well as in Canada (where the narrow-based view of horizontal equity is adopted to some extent with respect to mineral revenues). While reassignment of property rights may be, in principle, appear to be an option, it probably is not feasible where the states existed at some point in time as autonomous entities with full sovereignty, nor would it be desirable, in any case, if one believes in retaining the federal system with decentralisation of powers.

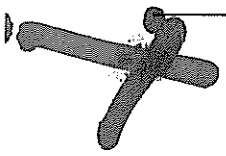
The 'problem' of the need for fiscal equalisation therefore cannot, and should not, be seen simply as a question of inappropriate assignment of property rights.

3.3.3 Theory Versus Practice in Australia

Most of the theoretical contributions to the horizontal equity and efficiency case for fiscal equalisation have suggested that, in principle, the equalisation adjustments should be interpersonal, although some (e.g. Buchanan and Wagner, 1971) have constructed cases for them to be intergovernmental. In practice, of course, federations have adopted intergovernmental transfers as the means of implementing equalisation principles.

One *possible* justification and explanation for this is that, while equity and efficiency arguments do underpin equalisation transfers in federal systems, intergovernmental transfers have been adopted as the only practical (feasible-best) way of implementing the transfers. This is explained by Boadway (1985) who notes that equalisation

> "In principle, ... could be done by a system of interpersonal transfers. However, there are two reasons why this might not be the desirable method. First, if the federal government tried to equalise all interpersonal differences in per capita source-based taxes, there would be a great disincentive against provinces using source-based taxes, since such tax collections would implicitly be subject to a very high marginal tax rate. The second reason why a system of interpersonal transfers might not be preferred, and this applies more to the case of residence-based taxes, is the constitutional reason that the federal government may not wish to undo the redistributive actions of the provinces that give rise to the NFBs in the first place. They may wish to redistribute revenues in such a way as to provide the provinces with the financial capability of conforming to nationwide horizontal equity but allowing them some leeway within that to



> conduct their own redistributive policies. There is, thus, no advantage to using interpersonal as opposed to inter governmental transfers, and the latter are presumably easier to administer."[14]

Boadway goes on to argue that

> "In determining the system of federal-provincial transfers, it is desirable that the system eliminates NFB differentials without setting up incentives for the provinces to exploit it by tax changes. One way to do this is to equalise tax capacity rather than tax revenue. It can be shown that, if all provinces behave in an identical manner when faced with the same budget opportunities, equalising tax capacities will then have the same effect as equalising actual taxes without imposing the disincentive effects."[15]

Thus, we have the argument that equalising fiscal capacities across states is a reasonable approximation for equalising interpersonal differences in NFBs, and, moreover, because of disincentive effects, constitutional reasons, and the possibility of regions exploiting equalisation through tax changes, that it is preferable to interpersonal equalisation. This is further supported by the argument, noted earlier, that since it is the chosen political *structure* which creates the potential for differential NFB's, transfers between governments, in effect, remove the potential adverse effects of political structure, while leaving differences in NFB's to reflect political choices.

An alternative explanation, of course, might be that the form of, and rationale for, equalisation in federal systems has other bases than simply the equity and efficiency arguments being considered here. We have already laid out a number of **federal** rationales, for which, indeed, **inter-regional** transfers are the **optimally desirable** response, and many of which pre-date the literature on equity and efficiency.

Even within the horizontal equity and locational efficiency framework, however, there is another telling point against the argument for interpersonal equalisation which should be noted. In particular, achieving horizontal equity and efficiency would require the central government to create vertical inequity in its tax system. There is a trade-off between horizontal equity and vertical equity which only can be resolved on the basis of value judgements.

Australia adopts the concept of equalising fiscal capacity across states, and in recent times this frequently has been supported on the basis of the broad-based horizontal equity argument. However, the equally important and interrelated arguments for equalising on efficiency grounds are not promoted in the CGCs numerous discussions. As the preceding discussion has shown, a scheme designed to correct for horizontal inequities will also correct for inefficiencies potentially

14 Boadway (1985), p 15.

15 Boadway (1985), p15. His prescription, it should be noted *is* that followed by the CGC's methodology.

created by migration in response to NFB differentials. Thus, while the CGCs procedures have not usually been explicitly defended in terms of the efficiency case, **they may in fact be efficiency enhancing, by attempting to achieve equalisation of residence and source-based tax capacities.**

Australia's form of equalisation takes the process one step further than in Canada, **by also equalising for differential expenditure needs** across states. This means that Australia's equalising grants to States also take into account both differences in the expenditure requirements arising from the composition of their populations and various cost 'disabilities' faced by the states in providing services. Australia is not totally alone in this regard. Among unitary nations with decentralised fiscal arrangements (e.g. U.K. and other European countries) often sophisticated expenditure equalisation procedures are used with respect to grants to regional and/or local governments, and Germany has some (admittedly rudimentary and modest) expenditure needs adjustments.

These expenditure needs and costs disabilities clearly are a source of horizontal inequity, because they mean that identical persons living in different states would pay differential levels of tax to receive similar levels or standards of service. On equity grounds, there is a clear case for equalising for such cost differences provided they do not reflect inefficiencies in public sector service delivery.

In efficiency terms, however, the arguments have become somewhat muddied over the years. In principle, anything (other than decision-making inefficiency) which causes NFBs to differ has the capacity to distort private locational choices unless "corrected" by equalisation transfers. On the other hand, it increasingly has been argued that "subsidising" location in high cost regions is a potential source of inefficiency. As is explained elsewhere (see Paper 3), however, in unitary systems broad equality of access to services typically is provided irrespective of relative costs. Hence, if there is an efficiency cost in this regard, it is widely present (but little questioned) in unitary systems.

Two points, however should be made in this connection. First, different NFB's arising on account of differential expenditure needs which result from, for example, different socio-demographic characteristics of State populations, appropriately should be taken into account if inefficient locational decisions, as well as horizontal inequities, are to be avoided.

Second, to the extent that taking into account high costs associated with providing services to remote and sparsely populated areas is regarded as potentially a source of inefficiency, it should be noted that the CGC procedure **only equalises for differences from the average cost of providing similar State-type services in similar high cost regions** (*not*, as often seems to be

presumed, the average cost of providing State-type services everywhere, including in low cost areas). Taking this into account, and given the likelihood that the quality and range of services provided in "remote" areas anyway will be lower than elsewhere because of high costs, it is altogether unlikely that the system offers strong encouragement to (inefficient) location in remote areas.

In summary, when one considers constitutional constraints, measurement problems, issues of vertical versus horizontal equity and incentive effects for state governments, the procedure of equalising fiscal capacities **across states**, as the CGC attempts to do, may be a feasible-best approximation to what the equity **and efficiency** arguments recommend. The Commission's equalisation for cost differences between regions (but not socio-demographic differences) has been argued to sit less easily on efficiency grounds, and the objections that typically have been made have failed to reflect the reality of CGC's actual procedures.

3.3.4 State Migration Taxes and Voluntary Inter-State Transfers

An alternative to equalisation as a means of achieving horizontal equity and efficiency in a federal economy can be constructed by drawing on the theory of club goods [for a survey of the relevant theory and literature, see Cornes and Sandler (1986)]. In particular, it might be argued that, in principle, the states could impose optimal migration taxes, or entry and exit fees, on intending migrants, which effectively make them face a cost (price) for the NFBs they receive. Migrants would then take the NFBs into account when making their migration decisions, leading to optimality. This solution is, therefore, similar to but more efficient than what happens if the NFBs are capitalised into land prices: although migrants receive the benefits of differential NFBs, they must also pay a price for them.

However, it seems likely to be neither politically nor practically feasible (in terms of calculating what the taxes should be and how to impose them) for states to impose migration taxes (and subsidies). A state tax on migrants reasonably could be construed as interfering with the free flow of people across state borders, one of the important principles of federalism. Moreover, states easily could use such taxes to restrict migration beyond what is optimal from an efficiency perspective in order to limit tax competition, a strategy which might be in their own self-interest but not in the interests of citizen-voters. In a public interest model of state behaviour, states will impose an optimal migration tax, but in a private interest model, they may very well impose sub-optimal migration taxes. The level of distortion associated with the imposition of sub-optimal migration taxes may exceed that required to eliminate inefficient migration.

Alternatively, it sometimes is argued that states may undertake voluntary lump-sum transfers among themselves in order to deter inefficient migration. Myers (1990) shows this by developing

a model of a two state federation with free migration where state governments have two choice variables: (i) the level of provision of a local public good; and (ii) an interregional transfer. He argues that, because of the free migration equilibrium condition, the public good and transfer choices of each state are interdependent, so that behaviour is strategic. On the assumption of Nash conjectures and costless mobility, Myers shows that states choose Nash equilibrium levels of contribution to the local public good and levels of voluntary interregional transfer which lead to Pareto optimality. The voluntary transfers chosen by the states, when given access to such a policy instrument, are exactly those required by the Boadway and Flatters (1982b) equalising formula. In this world, there is no need for a central government to undertake equalising transfers.

Hercowitz and Pines (1991) continue this theme by examining the conditions under which regions within a federation will seek voluntarily to transfer resources to another region in order to deter inefficient migration. They differ from Myers (1990) by studying migration in a dynamic world, where mobility is costly, and show that, in general, regions may make voluntary transfers as suggested by Myers, but that they will not be socially optimal, except in the special case (examined by Myers) of costless mobility. Hence, they argue that centralised equalising transfers are still required in order to correct for fiscal and resource rent externalities, as suggested by the Boadway and Flatters analysis.

Two interesting practical examples of such voluntary transfers are suggested by Hercowitz and Pines. The first is Germany, where what was West Germany has effectively made very large transfers to the old East Germany. They suggest that there may be rents in West Germany which the people there do not wish to have act as a lure to people to move from the east. Some of these rents, therefore, are being transferred to the old East Germany to deter migration. This is seen as being less costly, in terms of loss of economic welfare to Germany as a whole, to allowing migration from the east to the west by people wishing to share in the rents. Another example offered is the case of the province of Alberta in Canada, which established an Alberta Heritage Trust Fund using revenue from taxes on its oil industry. It is claimed that Alberta voluntarily transferred part of this fund to the rest of Canada in subsequent negotiations over federal government aid to the provinces, presumably because it was in Alberta's interests to do so to avoid fiscally-induced migration.

However, these are rather special cases where voluntarism had particular appeal or necessity. In the general on-going case for equalisation transfers, the role of the central government as a third-party seems both necessary and desirable — especially in Australia, where the States are limited in access to revenues. As we noted earlier, moreover, "voluntarism" is least likely to occur where, as in Australia, the totality of grants to the States are unilaterally controlled by the central

government, and subject to cuts in real terms: 'shares' then become the only variable States believe they can influence, and 'voluntarism' is at risk of being replaced by 'dog-eat-dog' attitudes.

In summary, while migration taxes (and subsidies) and voluntary transfers have been suggested as alternatives to equalising grants in federal systems, even if such taxes and voluntary transfers were politically and constitutionally feasible, it is unclear whether states would impose optimal taxes and make optimal voluntary transfers. These arguments, therefore, do not weaken the case for equalising fiscal capacities across regions as the feasible-best approach to equalisation on efficiency and equity grounds.

3.3.5 Empirical Tests of the Efficiency and Equity Cases

There is also a question of how important the distortions underlying the equity and efficiency cases are empirically. Four studies are noteworthy.

The first is by Courchene (1978), who addressed the general question of whether or not fiscal variables influenced migration decisions in a Canadian context. He concluded that equalisation payments, together with Canada's unemployment insurance scheme, did significantly inhibit out-migration of low income people from poorer to richer provinces. This is what one would expect equalisation to do. Courchene (1984) in revisiting his earlier analysis, concluded that:

> "....far from eliminating regional disparities, both the level of the overall transfer system and incentives embodied in it were confirming and even exacerbating them....More recently this has come to be known as the 'transfer dependency thesis'."[16]

As we previously have explained, however, transfer dependency arises principally from the failure to allow wages and prices to adjust, and from other perverse incentives (including, in Canada's case, regionally differentiated unemployment benefits arrangements), rather than from equalisation transfers *per se*.

The second study of interest was undertaken by Winer and Gauthier (1982). Their empirical work confirmed that (i) the presence of resource rents attracts migrants to a region (that is, it showed that residents do move in response to NFBs across states); and (ii) equalisation payments tend to retard inefficient out-migration from the poorer provinces. Hence, this study confirms the notion that equalisation payments can improve efficiency and equity, in the presence of fiscal inducements to inefficient migration.

16 Courchene (1984), p124. The transfer dependency thesis was discussed previously in section 2.2.

A further study, by Norrie and Percy (1984), uses a general equilibrium model to estimate the impact on migration of a one percent increase in the price of energy in a resource-rich state under the assumption that resource rents are privately owned (hence rents have no effect on migration). This improves the terms of trade for the rich region and causes inward migration. However, this migration is not inefficient (it is not *fiscally* induced). The remaining simulations undertaken by these authors all assume state ownership of resources (and rents) and allow the generation of NFBs from differential resource endowments. They show that inefficient, fiscally induced, migration is generated, in addition to the efficient migration associated with the underlying terms of trade effect. However, little guidance is given on the relative importance of the efficient terms of trade effect versus the inefficient 'NFB induced' effect.

On the basis of these results, all of which admittedly are in a Canadian context, it can be suggested that; (i) differential NFBs do exist; (ii) resource endowments are a significant contributing factor to divergences in NFBs between states; (iii) inefficient migration does occur in response to these NFB differentials; and (iv) equalisation slows this inefficient migration. Thus, the empirical evidence supports the results from the theory about the **direction of change** of the relevant variables. What it does not do with any confidence, however, is give us much guidance about the **magnitude of these changes, and their welfare consequences. For example, we do not know how much GDP is lost through inefficient migration, nor do we know how much GDP would be lost if there was no horizontal equalisation in Australia.. Moreover, none of the currently available evidence relates directly to Australia.**

3.3.6 Equalisation, Diversity and the Theory of Federalism

Earlier, the view was put that federation can be thought of as a cooperative arrangement, or contract, between politically independent states which yields a distributable social surplus. This perception of federation underlies the compensatory motive for interstate transfers discussed previously. The key benefit of union is that states can cooperate on certain activities, for example, the provision of common defence and foreign policy, but maintain a degree of sovereignty, and hence diversity according to local preferences, in other areas. Indeed, the existence of a social surplus from federation depends upon this trade-off between centralisation of some functions and decentralised provision of others. Moreover, the existence of a surplus depends on there being a preference for diversity in provision (across states) for those functions which remain decentralised.

The concept of broad-based horizontal equity achieved through equalising fiscal capacity is supportive of this view of a federal economy. It allows continued diversity in the provision of those services provided by states, and at the same time, is a reasonable (feasible-best) approximation to achieving horizontal equity and efficiency. Note that interpersonal equalisation,

which would equalise outcomes, would be 'un-federal' in the sense that it would promote uniformity in outcomes regardless of diversity in preferences across states.

3.3.7 Economic Efficiency and the Broad-Based View of Equalisation

Recall that it was argued in Section 3.2 that if the central government adopted the narrow-based view of horizontal inequity, and corrected (through equalisation) only for the impact of its own policies, then equalisation will not go far enough from an efficiency point of view. This is because such an equalisation scheme would leave some differential between NFBs. As a result, inefficient migration would not be eliminated.

Hence, on the basis of the efficiency case for equalisation, there is a need to adopt broad-based (rather than narrow-based) equalisation. Only broad-based equalisation will ensure an efficient free migration equilibrium: anything less than broad-based equalisation will involve a loss of economic efficiency and per capita well-being because some NFB differentials will remain. Hence, the efficiency case for equalisation provides a rationale for broad-based rather than narrow-based equalisation.

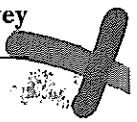
3.3.8 Summary

While there are many qualifications that can be made to the horizontal equity and locational efficiency cases for equalisation, on the available evidence it appears that the efficiency and equity arguments do have considerable application to Australia, and that they support interjurisdictional transfers as a feasible best approximation to the required equalisation payments. We reiterate, however, that, important as they may be, these cases for equalisation have received excessive weight in the literature compared to other arguments which arise from the essential fact that federation is a compact, and set of relationships, between states.

4. CONCLUDING REMARKS

The form that fiscal equalisation takes, and the degree to which it is pursued in different federations differs, reflecting differences in societal values. However, that there should be a "fiscal equalisation system" which transfers resources between sub-national jurisdictions to equalise **fiscal capacity** is widely supported, both in the literature on fiscal federalism and in the practice of most major federations.

In the conventional literature, the case for equalisation transfers has rested heavily on consideration of the effect of decentralised fiscal decision-making on horizontal equity in the



treatment of individuals across sub-national jurisdictions, and on the efficiency of individual locational (migration) decisions. While, generally, strongly supporting the need for equalisation, this literature typically has argued that the case for interjurisdictional (rather than interpersonal) transfers is somewhat uneasy.

We have indicated, however, that, even in its own terms, the literature does support interjurisdictional transfers as the feasible-best option for meeting its efficiency and equity objectives. Moreover, we have pointed out that this literature needs to be interpreted with great caution when applied to truly federal (as opposed to decentralised unitary) fiscal systems. The emphasis on individual incentives, and on horizontal equity between individuals in different jurisdictions, while not totally irrelevant to federal systems, threatens to cut across some essential features of the choice of truly **federal** political and fiscal arrangements — in particular, the requirement for preserving the autonomy of State decision-making within its own sphere, and the critical fact that a federal system is, first and foremost, a compact and set of interrelationships between governments.

Taken on its own terms, consideration of the intergovernmental nature of federal systems, nonetheless, produces a number of arguments for interjurisdictional equalisation transfers which emphasise the welfare of citizens/residents. The compensation case, the federation, nationhood and citizenship rationales, and the political autonomy and political competition cases, in particular, amount to arguments for delivering maximum benefits to citizens of all States from the autonomy and diversity facilitated in a federal system of governance. And, together, they provide an unequivocal case for comprehensive equalisation of fiscal capacity between States.

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PAPER 3

FISCAL EQUALISATION: BENCHMARKS, AND OTHER ISSUES

Cliff Walsh

1. BENCHMARK ISSUES

The literature which addresses the conceptual foundations for "equalising" interstate transfers in federal countries provides substantial support for them (see Paper 2). The supporting arguments, moreover, indicate that the transfers are required for efficiency reasons as well as (and possibly as much as) for reasons of equity; and that those arguments are at their strongest when they are built around models in which the politico-economic structures of explicitly *federal* systems of government, and the purposes of such federal structures, are fully acknowledged (e.g. Breton 1985, 1991; Courchene 1984).

The 'Confederal' (or loose Federal) Benchmark

Those who have sought to dispute the efficacy of equalisation payments in federal systems appear to have done so often by assuming away the underlying broad-ranging purposes of federal systems, and using as a notional benchmark, for efficiency and other comparisons, an arrangement in which the States are, in effect, treated as "separate nations", linked (only) by the fact that they have co-operated to establish structures to provide — federally or confederally — a limited collection of 'national' goods and services (defence and foreign affairs, and possibly social security, for example) funded by taxes raised from the citizens of member States.

Such a benchmark picture can't be rejected, conceptually, as entirely irrelevant. However, two points might be made about it.

First, the centralised provision of even a limited range of goods and services, financed from uniformly applied national taxes, will itself tend to be regionally 'equalising' if taxable capacities are less uniformly distributed across regions than are the benefits of the goods and services. In the case of defence, the implicit interregional 'transfers' might be argued to be incidental to securing the efficiency benefits of common provision of a pure public good.[1] For other centrally provided services, such as welfare benefits, any *interregional* redistribution also might be argued to be incidental to their purpose of redistributing from 'rich' to 'poor' *individuals*. However, when (as is the case in Australia) nationally funded welfare benefits provide the same level of nominal income support to all recipient classes, irrespective of regional differences in living costs, another layer of implicit regional redistribution is added. Despite the fact that this aspect of uniform

[1] Of course, in some circumstances, the distribution of tax burdens (e.g. through income taxation) *might* roughly reflect benefits perceived to be received from defence.

national provision of welfare benefits would appear *a priori* neither to be equitable nor to promote efficient location decisions by welfare beneficiaries, it goes largely unchallenged.[2] Yet within this same framework of thinking, providing equalisation transfers to give the States the *capacity* to provide similar standards of core social services where taxable capacities and costs differ systematically has been argued to be a potent source of inefficiency, and unfair to the donor States. On the face of it, these attitudes would seem to be perverse, or at least inconsistent.

Second, even setting aside the implicit interregional transfers which 'incidentally' flow from centralised provision and financing of public goods and services, where a working example of their 'benchmark' standard of a loose federal-type (or confederal) arrangement exists — i.e. in the case of the EC — substantial explicitly redistributive transfers are to be found. The EC's Structural Fund transfers to poorer regions, on recent estimates, achieve redistributive effects between EC nations in favour of Spain, Portugal, Ireland and Greece equivalent to as much as *half* of those achieved by explicit equalisation transfers between the Länder (States) in federal (Western) Germany (EC 1993). These EC transfers, to be sure, are directed specifically at improving regional infrastructure, education and training, for example (as, often, are regional development grants frequently found in unitary nations) rather than the unconditional "capacity equalising" grants found in many federal nations. Nonetheless, they are interregionally redistributive in effect and, under provisions of the Masstricht Treaty, a new set of "Cohesion Fund" transfers also are to be introduced to ease the costs for some member-states of the EC of achieving full economic and monetary union, with yet closer connections to arguments which have supported interstate transfers in fully federal nations.[3]

The Unitary Benchmark

More to the point, perhaps, it alternatively could be argued that the relevant benchmark against which to evaluate fiscal equalisation in Australia, in fact, is that of the unitary nation — a federation, in this context, being regarded as marrying on the one hand, the advantages of a unitary nation in terms of both expressing nationhood and common citizenship and facilitating common provision of defence, social security, health benefits and other services, with, on the other, a greater capacity for expression of diverse preferences for the mix (and level) of other public services - education, law and order and so on. Certainly, few in Australia would consider separating the States into sovereign nations to be a realistic alternative; and remaining as separate colonies was not a viable long-run option at the time of federation.

In unitary systems, as a broad generalisation, governments tend to provide broadly equal access to services to people, "irrespective" of their regional location (and cost), funded from a broad-based

2 This is *not* to question the desirability of providing uniform *real* levels of support.

3 See Walsh and Petchey (1992) for a broader discussion of interregional redistribution in federal countries and its relevance to the EC.

revenue raising (tax) system uniformly applied across all regions. It probably would be an exaggeration to say this is true always and everywhere for local communities — but it seems to be broadly correct at a *regional* level. For unitary nations to do otherwise would be to create horizontal inequities between people with similar private incomes but who live in different locations and, relatedly, would promote *fiscally-induced* migration (i.e. based on capturing larger fiscal benefits, possibly at the expense of private productivity, congestion, etc.).

The net effect of this tendency is that, to the extent that average incomes (or other tax revenue bases) and/or the demand for and costs of service provision differ systematically between regions, significant interregional redistribution will occur *implicitly* in unitary systems as a result of the direct fiscal operations of the central government. This is *additional to* the effects of (explicit) transfers for interpersonal redistribution purposes (e.g. welfare benefits), which will differ systematically between regions if the distribution of potential beneficiaries does. It also is additional to any explicit (or implicit) assistance that might be given for the purpose of promoting economic development in "lagging" or "depressed" regions.

Seen in this light, there is a close relationship between what occurs explicitly in federal systems in the form of equalisation payments from "wealthier" to less wealthy states to equalise the *capacity* to provide sub-national public services and what happens in unitary systems in the form of implicit transfers between regions to equalise *access* to similar public services. The difference between equalising *capacity* and equalising *access* (or *performance*) is a significant one, of course: it lies at the heart of the claim that federal systems tend to be welfare enhancing by being able to be more responsive to differences in preferences and that, through political autonomy and creative political competition, they are more dynamically efficient than the unitary alternative. Nonetheless, the broad parallels are clear.

Of course (as noted in Paper 2, above), in practice, even unitary systems tend to decentralise at least administrative provision of services, and often give a degree of "autonomy" in decision-making to local and/or regional governments in decisions about the delivery of services.

In some cases, the funding of local governments, in large part from central government grants, involves a degree of limitation on local discretion which ensures that the system as a whole remains essentially "centralised unitary". In these cases, an explicit interregional "equalisation" component usually will be contained in central government grants, often involving expenditure as well as revenue equalisation, and frequently combined with strict guidelines about service delivery standards.

Even where a greater degree of regional or local discretion ("autonomy") over the levels or patterns of service delivery is permitted, unitary systems with fiscal decentralisation tend to put

greater emphasis on equalisation grant arrangements — and related guidelines for securing at least minimum uniform national standards — which explicitly are designed with a view to equalising *outcomes* than is the case, in principle, in essentially federal political and fiscal systems.

In contrast, in federal systems, the autonomy of sub-national governments, the capacity for diversity of outcomes in their autonomous political choices, and the experimentation innovation and competition in policy development and service delivery which is facilitated by their fiscal independence, are highly valued features of their political and fiscal arrangements. Accordingly, their fiscal equalisation arrangements are designed to preserve autonomy and the capacity for diversity and for policy innovation, while also ensuring that differences in outcomes are the result of political choices which reflect differences in preferences, not of unacceptable differences in fiscal capacities among sub-national jurisdictions.

It nonetheless is the case, of course, that underlying societal values support significant differences in the extent to which both federal and unitary nations engage in equalisation in either implicit or explicit forms. In common with some other federations (e.g. Canada and Germany), Australia has developed a 'social contract' which puts more emphasis on equalising resources *across regions* than does a federation like the United States, which tolerates a significant degree of diversity in outcomes for individuals in different regions. Likewise, unitary Britain appears to have assigned a somewhat lower priority to equality across regions than has unitary Sweden, for example.[4]

The Extent of Interregional Redistribution: Unitary and Federal Systems Compared

Although now somewhat dated, calculations undertaken for the McDougall Report (1977) for the EC indicated that the redistributive effect (i.e. the degree of reduction in initial inter-regional per capita income differences) of central government (implicit and explicit) inter-regional transfers averaged up to 45 per cent for *unitary* France, Italy and U.K., compared with about 35 per cent in *federal* Germany, Australia, Canada and USA, where fiscal equalisation (sometimes) replaces some of the implicit transfers found in unitary countries (see Table 3.1).

4 The reasons why such differences in societal values exist is, of course, an interesting subject in its own right, but one beyond the scope of this paper. It seems evident, however, that the United States (like federal Switzerland, and also perhaps unitary Britain) has a historical attachment to individualistic conceptions of liberty and welfare compared with "European" societies (and Australia) where "collective" conceptions of individualism and liberty prevail, as a result of their different historical experiences.

TABLE 3.1

Percentage Extent to Which Inter-Regional Income Differences are Reduced by Central or Federal Public Finances

	Average of individual regions' reduction in per capita personal income differences (regions un-weighted by population)	Change in Gini coefficient of regional personal income inequality due to public finances (regions weighted by population)
Federations		
Germany	29	39
Australia	53	53
Canada	32	28
USA	29	23
Average of federations	*35*	*36*
Unitary states		
France	54	52
Italy	47	44
United Kingdom	36	31
Average of unitary states	*46*	*42*
Average of federations and unitary states	**40**	**39**

Source: MacDougall Report (1977), *Report of the Study Group on the Role of Public Finance in European Integration*, Brussels: Commission of the European Communities (Vol. 1: General Report, p. 30).

What Table 3.1 clearly suggests is that, on average, the operations of central governments in European unitary nations result in a higher degree of interregional redistribution than do those of major federal nations, notwithstanding the fact that federal nations typically tend to engage more heavily in *explicit* interstate fiscal equalisation. That is, the dominance of central governments in funding services, and/or providing grants to regional and local governments, in unitary systems results in a greater degree of equalisation across regions, on average, than in federal countries where States play a bigger and more autonomous role.

The "redistributional effects" measured in the Table need to be interpreted with care, however, especially in relation to Australia which, on the surface, appears to be a distinct outlier among federal nations. First, it should be noted that the interstate transfers that cause the equalising effects include the regional benefits (implicit and explicit) of central government spending and taxing decisions, especially welfare benefits. Second, because the Table measures "equalising effects" in terms of *percentage reductions* in initial per capita income disparities between regions (or States), a similar volume of interregional transfers in two countries will be recorded as having

a greater equalising effect in the one which has *smaller* initial per capita income differences. For a host of reasons, Australia has smaller initial income differences than all other countries in Table 3.1.

Nonetheless, interpreted with due caution, the data serve to illustrate the point that substantial interregionally equalising transfers, in implicit and explicit forms, are a common feature of unitary as well as federal countries. What often is taken to differentiate the federal nations is that many of them have significant explicit fiscal equalisation programs designed to address differences in fiscal capacities among politically autonomous sub-national units which have substantial policy and service delivery responsibilities. Even in these cases, however, the magnitude of these transfers needs to be kept in proportion: international financial statistics suggest that, for Australia, (Western) Germany and Canada, the fiscal equalisation transfers which occur amount to only about 2.5 to 5 per cent of total State revenues, with Australia at the lower end of this range.

Overview

The choice of benchmarks cannot be made purely on objective criteria: but there do appear to be reasons for regarding a unitary-type alternative as coming closer to reflecting the notion of "common nationhood and citizenship but with capacity for diversity", that is embodied in Australia's model of federation in practice.

From this perspective, Australia's system of fiscal capacity equalisation can be seen as achieving what generally is accepted as appropriate and desirable in unitary nations — i.e., the use of uniform national taxation systems (or standards) to enable broadly equal access to core social services to be provided nationwide — but with the added advantages, in Australia's federal fiscal arrangements, of:

- improved well-being for citizens arising from allowing for greater diversity in outcomes where *preferences* differ between States; and

- providing the capacity for (competitive) experimentation and innovation in policy development and service delivery that comes from *the combination of* autonomy *and* a "guarantee" of balanced fiscal or financial viability of all States.[5]

Through the fiscal equalisation system, moreover, Australia has avoided the very wide (and arguably divisive) differences in outcomes for individuals in different States, and associated fiscally-induced migration to richer regions, that have been identified for example in the United States.

5 This is not to imply financially irresponsible States will be 'guaranteed' a bail-out, of course.

This discussion of 'benchmarks' also serves to highlight that *motives* for interjurisdictional transfers can be viewed more broadly than typically has been the case in the Australian debate. The EC (and its individual member states) attach some weight to transfers for purposes of securing cohesion and economic convergence — reflected in central transfers for regional development of human and physical capital. Moreover, most federations (and decentralised unitary systems) put some emphasis on transfers as a pre-requisite for the existence and stability of fiscal decentralisation or autonomy, which, it is believed, helps to promote public sector efficiency and responsiveness. Notions of federal nationhood and common citizenship also are taken to imply the need to give to sub-national jurisdictions of the capacity to provide 'comparable' service levels, and so on.

From these perspectives, arguments in Australia which suggest that the conditions which gave rise to specific "disabilities from federation" — such as protective national tariffs — have been reduced or eliminated, and hence that fiscal equalisation no longer is justified to such an extent, take on a very partial and somewhat out-dated air (even if they were not, in any event, of doubtful historical accuracy: see Paper 4).

2. THE RISKS OF PIECEMEAL REFORMS

The nature and extent of fiscal equalisation payments in Australia cannot rationally be considered in complete isolation from other aspects of federal fiscal arrangements, including especially the division of taxing powers and associated system of untied and tied grants. To do so, among other things, would risk the possibility of "reforms" to fiscal equalisation inadvertently causing greater inefficiencies and inequities in the fiscal system as a whole. The development of fiscal arrangements in Australia, indeed, must be seen as having involved the evolution of a 'package', individual elements of which offset potentially welfare reducing consequences of others.

The brief discussion which follows focuses only on some of the most obvious sources of risk from piecemeal reform to fiscal equalisation.

The VFI/HFI Interaction

Australia's fiscal equalisation "transfers" currently are deeply embedded within a system of large general revenue grants, the purpose of which (in principle) is to compensate the States (and Territories) for the limitations on their access to revenue raising sources involved in the transfer of 'monopoly' control over income taxation to the Commonwealth. Without entering fully into the debate about the capacity of the States to broaden and extend their residual tax bases, it seems reasonable to say that, under current High Court interpretations of the meaning of "duties of excise", there is little prospect of the States being able to repeat the experience prior to World

War II of largely overcoming the effects of VFI by developing the tax bases which they do have available. Nor is it clear that Commonwealth governments would want them to do so.

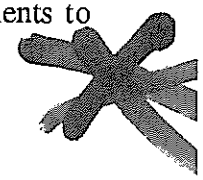
It is true that a unified system of assessment and collection of revenues from major national tax bases can result in a more efficient or effective tax system (i.e. one which minimises collection costs, opportunities for avoidance and evasion, and distortions of locational or other decisions). However, while this constitutes a case for the States agreeing (contracting) to have at least some of their taxes collected and co-ordinated centrally, it does not imply that *control* of the revenues (or the bases) should reside exclusively with the central government.

Taking into account the existing Commonwealth dominance of the taxation of incomes and of goods, and even with the current levels of grants they receive, the States are left with the task of financing over a third of their outlays from a wide range of narrow or distorting tax bases, many of which involve the particularly inefficient and distorting practice of taxing business inputs (e.g. payrolls, land, fuel etc.). The States are unable to impose a mix of taxes which is either optimal from their political decision-making perspective, or efficient from either a state or national point of view

For the economically weaker States with narrower, as well as smaller, residual tax bases, the inefficiencies are proportionately greater. This is recognised, at least implicitly, in the inclusion of revenue raising disabilities in the CGC's assessment. Clearly, however, any reduction in their share of financial assistance grants (for whatever reason) would create greater tax related inefficiencies (as well as horizontal inequities for their residents *vis a vis* those of the wealthier States) as they would be forced to try to increase revenue from their narrow and distorting residual tax bases.

In other words, there is a policy-relevant (efficiency) linkage between the degree and nature of VFI and the extent of fiscal equalisation. Without offsetting increases in their freedom *independently* to exploit what currently are Commonwealth controlled broader-based revenue sources, reductions in fiscal transfers to the fiscally weaker States would create **greater tax mix inefficiencies**. These inefficiencies, moreover, would be additional to those associated with the possibility of fiscally induced migration and the certainty of horizontal inequities being created by reduced fiscal equalisation transfers. **Clearly, restoring greater vertical fiscal balance would not reduce the need or weaken the case for fiscal equalisation**: it would, however, remove a continuing significant source of inefficiency in Australia associated with the constraints on the States' access to revenue sources. This conclusion is supported by the Report of the Working Party on Tax Powers (1991), which concluded that a substantial rebalancing of revenue raising powers between the Commonwealth and the States was desirable and capable of being achieved

without reducing the capacity of the Commonwealth to maintain fiscal equalisation payments to the less populous States.



Local Government Grants

Since the mid-1970s the Commonwealth has played a direct role in providing general revenue assistance to local governments, through grants provided to the States for this express purpose. These currently amount to about $750m (excluding *both* identified local roads grants which now have been made general purpose grants, *and* other direct and indirect payments to local government). Since 1989-90, the distribution of these grants (except for the Australian Capital Territory) has been on an equal per capita basis. (Previously the distribution had differed from an equal per capita — initially based on CGC recommendations, but increasingly over the years reflecting arbitrary Commonwealth decisions.) Within the States, the distribution between local governments is determined by State (Local Government) Grants Commissions within equalisation principles set by the Local Government (Financial Assistance) Act 1986 which are similar in intent to those used by the CGC.

The recent CGC *Report on the Interstate Distribution of General Purpose Grants for Local Governments 1991* indicated that if those grants to the States for passing on to local governments had been distributed between the States according to the Commission's usual equalisation principles, about $250 million (out of a 1990-91 total of $700m) would have been taken from New South Wales and Victoria and distributed among the other States.

There would seem to be no logical reason why grants *to* the States for their own purposes and *through* the States for distribution to their local government authorities should differ with respect to the principles used to determine their *interstate distribution.* **Failure to adjust the interstate distribution of grants for local government purposes to reflect equalisation principles introduces significant inequities and distortions into the system of general purpose grants.**

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PAPER 4

THE HISTORY OF INTERREGIONAL TRANSFERS IN AUSTRALIA

Julie P. Smith

1. INTRODUCTION

The principles underlying the Commonwealth Grants Commission's methodology for assessing grant relativities recently have come under scrutiny for a variety of reasons. In this context, it has been suggested that special assistance to the smaller states had its basis in the 'disabilities grants' of the 1920s. To the extent this were true, the move away from protectionism at the federal level would imply a questioning of the basis for fiscal equalisation.

This paper considers the origin and basis for Australia's system of special grants, and the evolution of fiscal equalisation in Australia. In examining the fiscal history, the paper assesses the possible contribution made by interregional transfers to the existence and stability of the federation, and to economic efficiency and equity.

The paper also compares modern interpretations and theories of fiscal equalisation and interregional grants with the arguments advanced for such grants in the Australian historical experience. Following Courchene (1984), it postulates both political and economic bases for such grants, identifying 'federalism', 'nationhood', fiscal disparities, economic efficiency and 'equal treatment of equal individuals' as possible rationales for such transfers.

Although there is a tendency to think only in terms of explicit transfers, such as CGC grants, as 'interregional transfers', such an analytical framework is unlikely to be appropriate for a mature federation. This analysis therefore extends broadly across the federal finance system: it includes the implications of vertical fiscal imbalance, the division of taxing powers, and to a lesser extent, public borrowing policies, insofar as they relate to horizontal balance in the Australian federation.

2. ESTABLISHING THE FEDERATION

2.1 Federal Finance, the Federation Debates and the Constitution 1893-1900

2.1.1 Gains from Trade — Forces for Federating Finances

Among the most compelling forces for federation were both economic *and* fiscal union. An unchallenged principle of federation appears to have been achieving the substantial net gains to all

the colonies from introducing intercolonial free trade. The key issues of federation centred on state rights, and the financial debate was a manifestation of this issue (Greenwood 1946). As the colonies were to be handing over their main revenue source, attention focussed on the implications of fiscal union for state government finances, rather than more thorough inquiries into general principles or possible risks associated with the federal form of government (Greenwood 1946; Black 1895).

The major financial issues were the division of the federal customs surplus, spending responsibilities and debt, and the distribution of any resulting surplus. These issues were intricately linked to each other; the federal financial settlement represented a very complex equation based on several unknowns and interrelated spending, taxation and debt related variables. Wise (1913a) commented that adjusting finances to meet the requirements of the several states was one of the great obstacles to federation.

Nevertheless, the principles underlying the discussions were very simple - the financial settlement had to be 'fair' to each state, as well as, at the bottom line, securing its financial viability. Otherwise it would not be induced to join the federation. The task according to Wise, was to find a scheme which would not operate unfairly towards the richer states (1913b). However, the federal settlement acknowledged that the financially weaker states would need to be protected from the adverse effects of federation (May 1971). As Barton commented, 'you can't do away with the solvency of the states...if the states die there is no federation' (Greenwood 1946).

2.1.2 The Federal Principle and the Federal Surplus

A search for the principles underlying interregional transfers in Australia must encompass the Constitution's financial provisions as a whole. To identify underlying principles, it is helpful to briefly trace the origins of the key financial provisions of the Constitution (S.95, S.96, S.89, S.87, S.105 and S.94).

Sections 105, 93, and 94 and 89 of the Australian Constitution are often considered as a financial protection for all the states, with S.95, S.87 and S.96 being seen as being of most interest to the financially weaker states. However, it can be argued that the general financial clauses were also fundamental to protecting the financial position of the latter. Inserting these clauses acknowledged that the financial viability of the smaller states rested not only on the 'fair' distribution of the surplus, but on how large was the surplus available for distribution. A 'fair' basis for federation had to acknowledge the small states' requirements in this regard.

In the early stages of the debate, the solution to the financial problem had seemed simple. It was recognised that in the interests of state financial stability and autonomy, as much of the tariff

revenue as possible should be returned to the states.[1] It was also envisaged, although not anticipated with pleasure, that treasurers could adjust state finances to the new federal financial structure partly by expanding their direct taxes (Black 1895; Garran 1893; Gilbert 1973, 12; Sawer 1953, 16). This presented a particular difficulty for the smaller states which had already found it necessary to impose relatively heavy direct taxes (Black 1895).[2]

The predominant solution envisaged to the problem of the federal surplus and its distribution was for the Commonwealth to take over the responsibility for servicing colonial debts.[3] As Black emphasised (1895), reducing the federal surplus in this way made the distributional issue more manageable:

> 'the smaller is the surplus, the less bitter would be the struggle for its distribution'.

There had been a strong expectation throughout the debates that federation would produce economies from consolidating states' debt in the hands of the federal government (Black 1895; Mackay-Smith 1895). This advantage was particularly compelling for the smaller states, who had an interest in ensuring all possible economies of federation were exploited.[4] According to Garran 1897:

> 'debt consolidation was generally admitted to be one of the great advantages of federation.'[5]

However, the debt issue was also important because giving the federal government responsibility for meeting the interest liabilities of the colonies would guarantee that state budgets benefited directly from the federal tariff surplus. This was a particular concern for the financially weaker states who needed at least a revenue tariff to make ends meet (Black 1895).

NSW and to a lesser extent Victoria, were less attracted to federating the debt; the former could already borrow on fine terms (Hirst 1895). As the debt service burden of both states was relatively low, they stood to gain less from such a scheme on that account (Mathews and Jay 1972; Gilbert 1973). NSW also saw little advantage to a centralised borrowing scheme which was

1 Many commentators pointed to the United States to show the dangers of an excessive federal surplus.
2 Black 1895 lists Queensland, Victoria and South Australia as being `too heavily burdened' with taxation to use this option.
3 At that time, the interest payable on state debts approximately matched the expected federal surplus.
4 And for them the interest savings from a centralised debt conversion were large.
5 This motivation was also important given the federalists need to convince the population of the economies in public finance and taxation from federation (Norris 19). Indeed, Gilbert quotes Holder as saying that `the interest savings from debt conversion, was the only financial argument of any substance found in the press and Convention debates to support Federation'.

seen to risk federal meddling in state rail construction and pricing policies.[6] At that stage, sparsely populated WA was also shown to be disadvantaged by the scheme for a per capita takeover of debt (Gilbert 1973). Clauses requiring such a federal takeover were rejected at the 1891 and 1897 conventions due to NSW opposition to increasing the federal expenditure burden with its implication of a higher tariff (Gilbert 1973).

As federation approached with no agreement on the debt issue, NSW delegates persuaded the Convention to turn their attention turned to alternative means of distributing the surplus (Gilbert). It is nevertheless clear that the founders foresaw the transfer of debts to achieve financial independence for the states by reducing the federal surplus and reducing interest and other costs. S.105 was inserted during 1897, recognising that such a solution would be more practicable when economic convergence had brought per capita debt levels more closely in line (Gilbert).

2.1.3 The Federal Principles: Equality Between States versus Fiscal Need

Putting the debt transfer on hold made the financial problem intractable (Gilbert; Garran 1897b).

A major difficulty was the wide range in the tariffs of the different colonies, due to differing fiscal policies and resources, or consumption patterns, and the varying degrees to which they depended on customs revenues (Greenwood 1946, 50).

The 1891 convention had envisaged the surplus being distributed on a contributions or 'opimeter' basis. This arrangement suited NSW and WA, which had high per capita customs collections. NSW opposed the per capita arrangement before equal fiscal and economic capacity was achieved, as its citizens would be facing a substantial rise in taxation, to finance a substantial contribution to the revenues to other states (Mathews and Jay 1972; Black 1895; Sawer 1975). The contributions basis also appeared fairer in the short run because of large differences in the per capita consumption of dutiable items between colonies - in particular the revenue of wine drinking SA would benefit from the consumption of spirits in other colonies.

However, this distributional scheme was criticised for being inconsistent with the 'federal' principle. The other colonies preferred a per capita basis for distributing revenues. As Nash showed, the contributions basis for distribution imposed a major financial deficit in Victoria, Queensland and Tasmania, with a large gain to NSW and WA.

6 Most debt was associated with railway construction and operation. Another consideration was that federal debt consolidation was said to put existing bondholders in a preferential position through securing a Commonwealth guarantee (Mathews and Jay 1972)

The compromise was that the small states' loss of revenues on goods from other colonies would be softened by the bookkeeping arrangements, whereby revenues would be attributed to where the revenue was derived or consumed rather than where it was collected. While it would be administratively difficult, bookkeeping' would allow the revenues on interstate trade, a half of total customs collections for some states such as Tasmania, to be returned to such states.[7]

After the Adelaide Convention in 1897, Garran summarised the accepted criteria for a satisfactory financial scheme. As far as the distributional issues were concerned, the most important was the requirement of 'fairness, not only at the date of the union, but in view of their probable growth and contingencies'. It also had to be elastic enough to cope with future uncertainties, while final enough to avoid pressures for tinkering for special advantage. Finally, it should be coordinate, in minimising the dealings between federal and state governments to the narrowest and simplest possible basis.

A significant feature of these negotiations was that Tasmania and WA were seen as requiring special provision in order to enter the federation but both expressed concern at proposals for special treatment: Tasmania and WA sought general financial arrangements that met their needs rather than particular provisions. In the Tasmanian case, the problem was viewed as trivial because of its small size.[8] The possibility of WA joining the federation was not taken seriously until immediately before federation and most calculation even as late as 1897, was done on the basis that WA would not immediately join the federation.

Following the outcome of debate on the debt issue, the smaller states proposed other measures to guarantee the return of sufficient revenues to the states. As McIlwraith and Forrest had emphasised, if the financial solvency of the states could not be guaranteed, no colony could enter the federation. As a result of concerns from the smaller states about the difficult financial transition to federation, the Braddon clause came to be inserted. Under this clause, which became S.87 of the constitution, a minimum three quarters share of revenue was guaranteed to the states as a whole. This level was intended to be sufficient for the needs of the financially weaker states and had first been proposed by Holder from SA, at the 1897 Adelaide convention. The final proposal was put at the 1898 convention by Tasmania's Braddon. Wise commented that 'this clause imposed an obligation on the Commonwealth to guarantee the necessities of the states', and 'it was intended as a rough but effective guarantee for the smaller states' (1913b).

7 Queensland also relied relatively heavily on revenue from the intercolonial tariff. At the other extreme, NSW relied on intercolonial duties for less than one sixth of customs revenue. In total, around a fifth of colonial revenues came from internal trade (Wise 1913). With the change in the pattern of trade after tariffs were abolished, such states as Tasmania and Queensland would be unfairly deprived of revenues, while those with the major ports, Sydney and Melbourne, would benefit.

8 For WA a per capita distribution was eminently unsatisfactory, as that state relied almost totally on customs receipts for revenues and its per capita collections were far above that in the other states.

2.1.4 The Compromised Federal Principle: 'Assumed Equality', a Period of Transition, and Constitutional Flexibility

Nevertheless, this arrangement was not to stand, and the Braddon clause was limited to a period of 10 years at the 1899 Premiers conference. Quick and Garran (1901) commented that these financial issues nearly caused the breakup of the conference. The 10 year limitation on the duration of the Braddon clause reintroduced concerns for states such as Tasmania that federation would threaten their financial stability (May 1971, 2). With NSW adamant that the Braddon clause must be limited in time, the compromise for the small states was the insertion of S.96, giving the commonwealth a power to make grants to individual states as it saw fit.[9] This also addressed NSW concerns that under the 75 per cent revenue sharing requirement of the Braddon clause, the commonwealth would have needed to raise and distribute four times as much revenue as necessary to meet the needs of a particular state in difficulties (Mathews and Jay).

The principles underlying this provision were again, to protect all states finances sufficiently that they could join the union, and to allow sufficient flexibility to provide redress for a state that might otherwise find it financially impossible to remain within the union. In the view of Quick and Garran;

> "this section is not intended to diminish the responsibility of State Treasurers, or to inject a regular system of grants in aid. Its object is to strengthen the financial position of the Commonwealth in view of possible contingencies, by affording an escape from any excessive rigidity of the financial clauses. It is for use as a safety valve not as an open vent; and it does not contemplate financial difficulties, any more than a safety valve contemplates explosions" (Quick and Garran 871, quoted in May, 2).

According to Gilbert no-one questioned the principle of S.96 although it appears that some delegates questioned the need for such a scheme, arguing that it was already implicit in the constitution or in the fact of the union (Norris 10).[10] Goodwin (1966) concluded on the other hand that 'the question of the special obligations of the larger and more prosperous states for the relief of the less fortunate associates was a major difference of opinion that emerged as federation approached; in Sydney and Melbourne it stimulated considerable dispute'.

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9 Henry of Tasmania had proposed S.96 at the 1899 Conference (Gilbert). He argued that it was generally recognised that it was a necessity for the commonwealth to step in and aid a state that became financially embarrassed. Forrest of WA also viewed the clause as having long term significance to his state. It would appear such a clause was essential to get some states into the union (Gilbert). Gilbert (25) argues S.96 was also inserted because of uncertainty about the length of time before equal taxable capacity was achieved.

10 The clause has also been interpreted as avoiding having to make a choice between the per capita (opposed by the richer states) and the contributions basis of distributing the surplus (seen by the smaller states as too favourable to the richer states such as NSW).

It was to encourage WA into the union that S.95, the temporary special tariff for WA, was inserted just before federation. This clause recognised the special difficulties that the state would have in adjusting its finances, given its very heavy reliance on customs duties. It allowed it to continue to impose duties on goods from other colonies on a diminishing scale for five years after the uniform tariff was introduced. The bookkeeping arrangements also helped assure WA that its very high per capita revenues from customs would be returned to that state beyond that time.

As conflict arose over the distribution of the surplus, there was an increasing inclination from 1897 to leave it to the commonwealth parliament to negotiate a distribution scheme that would not threaten the solvency of any state (Walker 1897; Black 1897).[11] The commonwealth was seen as 'the great negotiator' and Griffith in particular was persuasive in the view that it was untimely for a permanent settlement of the financial issue (Gilbert 16-17, 24). The unknowns of federation itself, and the level, structure and impact of the federal tariff remained major uncertainties affecting state financial security. As Harrison Moore commented in 1910 (531),

> 'the course adopted was to make temporary provision in the Constitution and to leave the ultimate adjustment to the Commonwealth parliament when the course of years had furnished the necessary experience'.[12]

Flexibility — 'a plea for elasticity' — was another important feature of the financial provisions addressing the smaller states' need for financial security. As Wise commented

> 'it being impossible to foresee the future and with secession not possible there had to be some remedial mechanism for states with a grievance' (Wise 1913b).

By delaying the debate on a permanent scheme of federal finance until after federation, it was anticipated that the current difficulties would be more easily solved. With the state economies expected to expand and fiscal and economic capacity to converge after federation, an equal per capita basis for distributing the surplus would be at the same time 'equitable' and sufficient for the needs of the smaller states (Gilbert, Giblin).

However, there was no objective basis for this view of a natural economic and fiscal convergence. As Walker commented in 1897, 'there was nothing to warrant the view that after a period of years, per capita contributions would be equal'. However, no scheme which showed NSW as a loser was acceptable. Gilbert suggests the assumption of convergence was to get the principle of per capita distribution past NSW (Gilbert). That is, the federation could not occur unless the interregional distribution issues were set aside until later. As Giblin pointed out too,

11 This was a view being put by NSW in 1891 in respect of the debts problem (Gilbert).

12 The view was later echoed by Garran before the Commission on the Constitution in 1927-28 and by the Commonwealth Grants Commission in 1934 (Gilbert 28).

> 'there is at the outset among the zealots for federation a willingness to forget as much as possible any disparity in the federating states .. the very possibility of Federation is in the balance' (1926, 51).

Thus, the federal financial settlement can be seen as a complex balance of competing requirements which incorporated into its structure both a federating principle of a 'fair' settlement, and a principle of guaranteeing the financial viability of the weakest members, given the existing division of functions and revenue raising powers which reflected the interests of the larger states. This was implemented in the general financial provisions of the constitution (S.93 and S.89 - the 'bookkeeping provisions', S.105 and S.94) as well as the provisions that are traditionally labelled as provisions for the smaller states (eg S.96, S.95 and S.87). It also was reflected in the general openness of the financial provisions. Although some see the unsettled financial provisions of the constitution as a failure (eg Howard 1978) it appears to have been primarily a means of protecting the financial viability of the smaller states against the inevitable financial difficulties of joining the federation under the financial terms set down by NSW. Although the Commonwealth was given direct taxation powers, it was understood that this field was to be left to the states as a means of effecting their adjustment to the federal financial situation. The viability of this set of arrangements rested on the unrealistic supposition that fiscal capacity would equalise in the near future. This would give each state an equal capacity to raise revenue from direct taxes, similar development expenses and general costs of government and similar levels of debt. It would also make shifting to a per capita distribution an equitable arrangement. While uneasy at this assumption, the prospect of a per capita distribution was sufficient to entice the smaller states into the federation.

2.2 Reimbursement of Customs Revenues

2.2.1 The Period of Financial Transition, 1901-1910

Hopes that the economies and finances of the states would become more similar after federation were not quickly realised. The issues that had prevented a permanent settlement before federation were essentially those that prevented it in the first decade after federation. Once again, issues of interregional transfers were inextricably linked with the question of the federal surplus and the possibility of a debt transfer, and with the allocation of taxing powers between the federal and state governments. There was a strong presumption that the Commonwealth would not enter the direct tax field without extreme circumstances to justify it (Sawer 1956).

The first decade of negotiations on federal finances centred on developing more permanent arrangements to replace the Braddon clause. The basis for distributing the federal surplus was an important focus of several conferences of premiers between 1903 and 1910, the major concern being the extent to which payments should reflect collections or population (Prest & Mathews).

The prospect of the expiry of the revenue guarantee in 1910 created particular anxiety among the smaller states, which already were arguing that the operation of the financial clauses was unfair to them (Groenewegen XXVIII, 54-58, 49-50). After several other proposals for debt transfer (May 1971, Gilbert 1973, Groenewegen), Johnston, the Tasmanian statistician responded to Forrest's proposals (1906) by proposing a similar federal debt transfer but with a move to a modified basis of per capita grants which was eventually to become the basis for the 1909 agreement (Prest & Mathews 1980).[13]

Once the federal tariff was introduced, the collections basis for distributing revenues was replaced by the derivations basis. The latter, as we have seen, acknowledged the difficulties the financially weaker states faced in adjusting to federation, by adjusting the reimbursement of revenues to allow for the effect of free intercolonial trade on the pattern of imports and interstate trade. However, the small states were eager to end the cumbersome bookkeeping arrangements ((Groenewegen XXV), and as early as 1903 Tasmania had made representations about leakage under these arrangements (S.93) for tracing revenues to where imported goods were consumed (May). Queensland and Tasmania had both complained in the early years of federation that the bookkeeping (S.93) arrangements were not accurately recording the diversion of trade to Sydney and Melbourne that had been caused by the move to a federal tariff and internal free trade (Groenewegen XXV, 111-114).[14]

However, NSW remained reluctant to accept the per capita principle as a permanent basis for sharing out the federal surplus, unless the convergence of fiscal capacity in the smaller states reduced the effective transfer from NSW to other states.

Thus in the early days, Victoria and the smaller states such as Tasmania had pressed to balance functions with revenues by handing over railways and debts to the federal government. Such a move was also argued to reduce their interest costs. However, the issues of debt transfer, transfer of railway assets, coordination of borrowing and the extension of the Braddon revenue guarantee became entangled, as they had prior to federation (Groenewegen XXII).

The failure of the Commonwealth to take over state debts and the subsequent creation of a federal surplus was seen by smaller states such as Tasmania as 'the foundation of all our financial and other State difficulties under the present bonds of federation' (Johnston 1907). Their position continued to be that the primary difficulty was in the failure of the Commonwealth to take over

13 Johnstone (26) proposed that the modified per capita scheme would come into effect if the equal per capita grants proved 'unsatisfactory or inadequate to any state (owing, say, to some more less temporary abnormality of the constitution of its population, as is now the experience of West Australia'. An deduction would be made from the surplus, for a period of 3 to 5 years 'to make up the monetary inadequacy it might suffer' under an equal per capita scheme.

14 About a fifth of Queensland's customs and excise revenues came from the bookkeeping adjustment, and half of Tasmania's.

'such fair proportion of the public functions and financial obligations as would approximately correspond with its delegated powers to raise and control the major sources of revenue' (Johnston 1907, 23).

However, NSW and Queensland, in particular, were reluctant to agree to such a debt transfer, expressing fears that the federal parliament would wish to scrutinise expenditure of loan monies (Groenewegen, May). At the 1905 premiers' conference Queensland argued that transferring borrowing powers to the federal government was especially unfair to it and WA because it might make it impossible to develop the resources of those large states (Groenewegen XXIX, 153).

The federal government, with Turner and then Forrest as Treasurer, consistently sought long term arrangements for separating Commonwealth and state finances through proposals to take over state debts under S.105 of the Constitution (Gilbert 34, 43; Groenewegen XXIII). The Commonwealth was increasingly concerned that the expected future expansion of its expenditure commitments, notably from introducing a national old age pension, would push it into the direct tax field in competition with the states (Gilbert, 34).[15] It also desired to frame tariff policy independently of the use to which revenues were put (Sawer 1956, 49, 50, 74, 327; Gilbert, 34, 36). Although the Commonwealth continued to adhere to the bookkeeping system until 1910, the monthly payment of surplus in particular, was also a great hindrance to Commonwealth financial and budget management (Sawer 1956, 28; Gilbert 38).

Throughout the first decade, however, the larger states rejected proposals to replace surplus revenue grants with a debt takeover under S.105. Deakin's government had been prepared to retain the bookkeeping system of revenue distribution until 1906 (Sawer 1956, 50). By 1906, Deakin had proposed a fixed payment to the states coupled with a plan to take over state debts (Gilbert, 36). In 1906, he sponsored legislation, which failed only narrowly, aimed at changing the Constitution to authorise the takeover of state debts and allowing the Commonwealth to charge particular taxes to specific Commonwealth appropriations such as pensions (Sawer 1956, 49). A further Commonwealth proposal to the 1908 Premiers Conference was also rejected, again involving a debt takeover by the Commonwealth, combined with a fixed payment to the states equal to the states' debt interest obligations.

This appears to have hardened the Commonwealth's attitude, the main reasons for the rejection being that the fixed payment was considered too low especially by the financially weaker states; some states also wanted to remain sole judges of their loan raising (Gilbert, 37). The Commonwealth, on the other hand, felt pressed by its own expenditure commitments, and was reluctant to tie its own hands by committing itself to continued payments to the states as well as

15 The states refused to allow the federal government to introduce earmarked customs and excise duties on tea and kerosene to finance the introduction of a national aged pension.

carrying the burden of state debt charges (Groenewegen). This culminated in 1908, in the *Surplus Revenue Act* which among other changes, allowed surplus revenue to be charged to Commonwealth trust funds rather than being returned to the states. This particularly affected the finances of the financially weaker states.

At this stage, the need for special assistance for states which had been disadvantaged by federation had already been considered by state premiers. At the 1905 premiers conference, SA complained of the heavy direct tax burden in that state as a result of federation,[16] while Tasmania pressed for a replacement of the bookkeeping arrangements with a per capita distribution of revenues, and WA sought compensation for the dramatic drop in its revenues with the expiry of its special tariff in 1906 (Groenewegen XXVIII, 49-50).

Wide differences in entitlements under the constitution's transitional revenue sharing arrangements thus pervaded the financial negotiations throughout the decade. These factors, and the Commonwealth's refusal to countenance a state debt transfer unless all states agreed, encouraged the smaller states to again focus on ensuring a high level of Commonwealth revenue payments. They sought in particular the permanent continuation of S.87, the Constitution's transitional revenue guarantee.

These differences between the larger and smaller states combined with different perceptions of the benefits of transferring state debts to the federal government, were the main reason for the lack of agreement between the states, and with the federal government, on a satisfactory replacement for the Braddon clause (Groenewegen XXVII). Throughout the decade the larger states and Commonwealth also persisted in the view that there was no substantial permanent differences in economic strength between the states (Gilbert, 34, 43).

2.2.2 The 1910 Per Capita Agreement

After several years of unproductive negotiations on the issue, matters came to a head in 1909. Under strong political pressure from Labor, and to meet one of the popular expectations of federation, the federal government made a commitment to a national aged pensions scheme.[17] In 1909 the introduction of national old age pensions raised for the first time the prospect of a

16 While Gilbert (34) notes the reluctance of the states to increase direct taxation in this period as a means of redressing their financial situation, he makes no distinction between the more prosperous states such as NSW and those with lower tax capacity such as Tasmania and South Australia. It was clearly the smaller states that were most concerned at financial pressures to direct taxes because of the heavy burden such taxes already represented in these states.

17 It was not clear at that point, however, whether it would be financed from a land tax as proposed by Labor or by more traditional regressive taxes such as customs and excise duties. The 1905 Premiers' Conference considered the question of national aged pensions scheme, and the unsatisfactory situation whereby state residency requirements barred many citizens living in that state from access to old age pensions, was a feature of the discussions.

Commonwealth budget deficit, and the implied Commonwealth competition with states in the loans market (Sawer 1956, 75; Gilbert, 41).

Faced with this threat, a secret Premiers conference in 1909 agreed to Commonwealth proposals for payments of 25/- per capita to replace the existing arrangements from the expiry of the Braddon clause in 1910 (May, 3). The question of debt transfer was referred to a committee, as some states were concerned at the loss of autonomy that might be implied by a Commonwealth takeover of state debts and future borrowing (Gilbert, 38). The latter proposal was of most interest to the smaller states, who were more heavily burdened by debt. However, the negotiations on debt transfer stalled at that point. Subsequently, a referendum agreed to Constitutional amendments facilitating the debt transfer, but did not endorse a Constitutional amendment requiring permanent per capita grants to the states.

From 1910, under the 1910 *Surplus Revenue Act*, the states' share of the federal surplus was distributed on the per capita basis sought by the smaller states. The failure of the referendum to require per capita grants to the states resulted in these grants being paid under S.96 of the Constitution. The distributional arrangements embodied in the 1910 *Act* thus relied on the Commonwealth's S.96 grants power (rather than any constitutional guarantee to the states) for their continuity.

However, the 1909 Per Capita Agreement and the *Surplus Revenue Act* of 1910 were resented by the smaller states because of the substantial falls in the level of surplus revenues returned to the states. (This was additional to the loss of revenues from the 1908 *Surplus Revenue Act.*) The 1910 *Act* represented a significant reduction in the overall level of revenues returned to the states.

This reduction was partly on account of the Commonwealth introducing national old age pensions, previously only paid by the larger wealthier states of NSW, Victoria and Queensland. In effect, the smaller states notably SA, Tasmania, Queensland and WA, were forced to contribute to a standard of national social services which they felt they could yet not afford (Groenewegen).[18] Significantly however, the agreement provided for South Australia, Tasmania and WA, the non-pension states, to make a lower per capita contribution to the cost of national aged pension than the other states (*Official Year Book of the Commonwealth of Australia*, No 4, 1910, 800-1, reproduced in Prest & Mathews 30-31).

This aspect of the 1910 agreement, while little noticed in the modern literature on federal financial arrangements, represented the first practical acknowledgment of interregional transfers based on

18 At that point, WA had been moving towards introducing such a pension. However, Tasmania and SA had not found it within their financial means to introduce aged pensions (Groenewegen).

'nationhood' principles, that is 'equalisation on the grounds that there is some level of essential services to which all are ... entitled, regardless of province of residence' (Courchene, 84).

Although NSW initially had opposed even the modest interregional transfers implicit in the per capita system, by the end of the decade it had generally been agreed (Prest & Mathews 5). In 1909, in presenting his proposals for a debt transfer and per capita grants, the Prime Minister Andrew Fisher had commented;

> 'I think the smaller states ... are deserving of consideration from another point of view. I am speaking from the national point of view. These smaller states must suffer in some way in regard to Federation' (May 1971, 4).

The per capita grants adopted from 1910 appeared only a minor concession to the redistributive principle. As economic and financial capacity and thus per capita consumption were expected to converge, it was expected to be neutral in its distributive effect (Gilbert, 43). However, differences did remain in the economic wealth and consumption levels of the states and, as Professor Giblin was to point out in the 1920s, this redistribution was significant in magnitude (Giblin in Prest and Mathews, 52).

The other significant redistributive provision in the 1910 arrangements was the arrangement (also under S.96) for temporary special grants to WA. The special grant to WA for ten years from 1910-11 was compensation for its large per capita contribution to customs revenue (May 4-5). The cost of the grant was also shared between the Commonwealth and the other states. The Commonwealth agreed to pay a special grant of $250,000 pa on a diminishing basis, while the States contributed the same amount from their per capita grants.

Soon after the 1910 Act, however, Tasmania was successful in having its long-standing compensation claim for revenue losses under the transitional (S.93) payments referred to a Royal Commission (May, 5). The Commission was "to investigate the alleged customs leakage of Tasmania and any losses the said state has suffered since federation". Its 1911 report confirmed Tasmania's losses from federation, notably from the federal tariff and interstate free trade. It recommended a payment of $1.8 mill, paid in equal instalments over ten years (*Royal Commission on Tasmanian Customs Leakage* Report, 1911). The first grant was paid to Tasmania in 1912-13. According to May, the general attitude to the measure was that the payment was not charity but a merely a payment which was due to the state under the general transitional financial provisions of the Constitution (May 1971, 5).

The grants to WA and Tasmania were both made, as were the per capita grants, under S.96 of the Constitution. This set the pattern for future Commonwealth grants to the states, as S.94 of the Constitution had been made ineffective by the Commonwealth *Surplus Revenue Act* of 1908. The

special payments to WA and Tasmania also set the pattern for the 1920s, being for a set period, and reducing over time. This reflected that the problem of the smaller states was still viewed as a temporary one. However, the grants acknowledged that for whatever reason, equal per capita grants under the 1910 arrangement were insufficient for these states' budgetary needs.

The need for such payments to the smaller states also highlighted the absence of follow up to the successful 1910 referendum allowing the Commonwealth take-over of states' debts. Significantly the rationale by the Commonwealth for the Tasmanian grant was the very high debt it had accumulated since Federation.

In summary then, at the end of the first decade of Federation, the 1909 Agreement with the Premiers and S.96 grants under the 1910 *Surplus Revenue Act* had become the backbone of Federal/State financial relations. Failure to redress the imbalance of revenue and expenditure responsibilities heightened both vertical and horizontal distributional tensions - as before federation, issues of vertical and horizontal fiscal balance remained interdependent. There had been a move away from the reimbursement principles of the bookkeeping clauses, although there was only a limited and temporary acceptance of the redistribution implicit in these per capita grants, as it was still assumed that all states had, or soon would have, approximately equal fiscal capacity. As all the states had reason to pretend that assuming approximately equal fiscal capacity was realistic, the per capita basis was viewed as equivalent to the previous arrangement - reimbursement of revenues on a derivation basis. If all states had equal taxable capacity, they would contribute equally per capita to federal revenues.

Modern commentaries on federal finance mistakenly view the payments to Tasmania and WA as precursors of the special grants of the 1920s which were based on fiscal need or 'disabilities' from the federal tariff. It is clear however, that such special payments to Tasmania and WA still were continuous in principle with the original federal financial compact, being essentially to offset the effect on state budget revenues of joining the federal customs union given the mismatch of state government functions and revenues. The temporary payment to WA recognised that equal per capita payments would not yet be fair to that state given that its per capita contribution to customs revenues was still significantly higher than in other states. Likewise the payment to Tasmania had its origin in the constitution's bookkeeping clauses and the derivation basis for distributing federal revenues, rather than any transfer from richer to poorer states.

In addition by the end of the first decade, the first steps had been taken, through the national scheme for aged pensions, towards implicit interregional transfers based on the 'nationhood' principle. Being a means tested scheme, the federal age pension tended to redistribute towards states with lower incomes and fiscal capacity. In addition, by providing for differential state contributions to the cost of the scheme, the 1910 agreement implicitly recognised the principle

that the lower fiscal capacity of some states needed to be taken into account in order that their residents could share in the benefits of a national standard of social security.

Time passed and the federal tariff changed to reflect protectionist rather than revenue considerations. It was to become increasingly difficult to separate such compensation for the loss of state revenues due to a uniform federal tariff and interstate free trade, from the direct and indirect effects that federation, the protectionist tariff and other policies had on state budgets.

2.3 Implicit and Explicit Interregional Transfers

2.3.1 Tax Capacity and Implicit Transfers - The Significance of World War 1

The first world war was very significant to the federal financial problem as rising federal expenditures on defence and social security forced the Commonwealth into direct tax in competition with the states (Mills 1928). Demands for continued grants to the states, including special assistance, along with increased Commonwealth commitments for war related and social services expenditures (Howard 1978; Greenwood 1946), made the Commonwealth reluctant to abandon a long term presence in income taxation (Sawer 1956, 271).

After introducing a land tax to finance the national old age pension in 1909, the Commonwealth had introduced a highly progressive income tax in 1915.[19] This, in effect, raised revenue disproportionately from the wealthier states because of their higher taxable capacity. Per capita grants from the Commonwealth thus resulted in substantial implicit transfers to states with lower average incomes (Brigden 1934; Giblin 1926; Mills 1928).[20] Giblin estimated in 1926 that the Commonwealth income tax had resulted in Tasmania paying 15s per capita and receiving 25s under the per capita grants agreement, amounting to a subsidy of over $200,000 per annum. Similarly, Queensland gained $400,000 and WA $200,000. This transfer mainly came from Victoria and South Australia:

> 'The combination of federal direct taxation with per capita distributions to the States makes an adjusting factor of the greatest nicety. so long as the federal tax is uniform and uniformly administered in all states, it cannot go wrong. The state which is flourishing at the time (or more precisely in the previous year) will pay more than the average, and the State which has had a bad year will pay less. The adjustment is automatic' (Giblin 1926, 57).

19 At the time of Federation, the conventional colonial income tax was a flat rate proportional income tax on income above a certain level. Although such a structure was partly progressive through the effect of the exemption it was not nearly as progressive as the radical principle of graduated marginal rates introduced by the Commonwealth income tax.

20 These were additional to the interregional transfers implicit in the national old age pension.

Mills (1928) also commented that while concurrent direct taxation led to the states finding it more difficult to meet their responsibilities from their own revenues, the solution was not for the Commonwealth to withdraw. Rather it was for loss making functions such as railways to be handed to the federal government. He argued that the federal income tax had become, unnoticed, 'an eminently satisfactory solution' of the federal financial problem. In accord with modern economic principles, and minimum aggregate sacrifice, the tax placed the heaviest burden on the broadest backs so that the more wealthy states contributed to the needs of the less wealthy.

On the other hand, the changed economic and fiscal circumstances of the war upset the balance of the federal financial system and raised acute new problems of double taxation (Greenwood 1946). This had particular adverse implications for the smaller states.

The federal income tax presented more of a difficulty for these states as their citizens were already facing heavy direct tax burdens. By 1911, Tasmanian taxes were $3.25 per capita compared to the average in other states of $1.83 (Mathews and Jay). The erosion of the real value of per capita grants by wartime inflation also forced the smaller states to increase their income taxes and made the smaller states more reliant on special assistance from the Commonwealth (May 1971, 6).

In 1923, the Commonwealth introduced specific purpose grants for roads, under a formula which particularly benefited the less populous states such WA, SA and Queensland, and rural interests generally (Gilbert 1973, 71; Sawer 1956, 230, 323.).[21] Mills (1928) viewed these grants as being to states 'whose needs and development responsibilities exceeded the capacity of their people and finances'. These grants might be regarded as a means of assisting convergence in the economic capacity of the states, thereby contributing to greater dynamic efficiency (Prest 1974).

2.3.2 The 1920s Negotiations and The Smaller States Problem

The 1910 Per Capita Agreement expired in 1920. From around 1919, the Commonwealth government had adopted a firm policy of ending the vertical financial imbalance which it saw as leading to duplication and irresponsibility (Sawer 1956, 223). After proposing to reduce per capita grants by 2s 6d, in view of war related increases in federal spending, in 1919 the Commonwealth proposed to abolish per capita grants in return for it substantially withdrawing from income taxation. However, state premiers refused to give up their 'moral right' to a share of customs revenue unless the Commonwealth agreed to withdraw completely from income tax.

21 The formula for grants was based two fifths on area, three fifths on population. The following year, the Commonwealth also contributed a third of the cost of standardising the rail link between NSW and Queensland. Such grants, while challenged in the High Court by the wealthier states, favoured the smaller states.

The direction these negotiations were taking was not welcomed by the small states, producing an approach from Tasmania to the Commonwealth seeking a continuation of the 1912 special grant. The 1919 talks also revived anti-federal feelings in WA (May 1971, 9).

Successive Premiers' conferences discussed these federal financial issues, with the divergent outlook of the smaller states an important feature of the negotiations. For example, at the 1923 Conference, the Commonwealth recognised the small states' financial plight by offering to make special provisions for Tasmania, WA and Queensland as part of a move to delineate federal state income taxation (May 1971, 6). Such special provisions for the states with lower taxable capacity were also a feature of the Commonwealth's proposals to the 1926 Premiers Conference for withdrawing from all direct taxes except income taxes.

Between 1919 and 1926, various alternative federal financial schemes were discussed at Premiers' conferences. Proposals to return income taxation to the states highlighted the problem that such a return to financial autonomy could cause for the smaller states. However, from the viewpoint of the smaller states, none provided a satisfactory alternative to the existing system of federal direct taxation and federal general revenue grants. If the smaller states fully replaced the lost grants with state income taxes, the burden of state income taxation would have to be very high to replace the implicit redistribution from per capita grants. As Copland pointed out (1924, 40), differences in the tax capacity of the states caused great difficulty in these tax discussions.

The economic and financial disabilities of the smaller states in the federation and the diverse nature of those difficulties were increasingly recognised at the academic and official level during the 1920s (Gilbert 70-82). It had, by then, become apparent that special assistance to Tasmania and WA was not temporary, as had been expected. Indeed, according to Greenwood, it was becoming essential to maintaining the federal system.

Influential in defining the problem was the work of Professor Giblin, the Tasmanian Statistician in 1924, later used in Tasmania's submission to the Lockyer Inquiry. Using data from the Commonwealth income tax office, he showed that the belief in convergence of taxable capacity was unfounded. He also showed that a uniform income tax applied to the different states raised only half as much revenue per capita in Tasmania as in the wealthier states. This underlined the differences in the economic, and therefore taxable, capacity of the states. Such differences in taxable capacity help explain why, at the 1926 Premiers' Conference, the states still disputed that they could make good the loss of per capita grants from the direct tax field proposed to be abandoned by the federal government.

2.3.3 Disabilities grants in the 1920s

Increasingly after the war, protectionist federal economic policies undermined the development and financial stability of the smaller states. Tariff and wages protectionism had become more prominent since the war, through the 1916 *Sugar Agreement*, the *Engineers Case* in 1920, increases in the federal tariff and the passage of the *Navigation Act* in 1921. These policies were perceived as a threat to the economies and state budgets of the smaller - and predominantly primary producer-states, to such an extent that anti-federal sentiment increased markedly by the mid 1920s.

The higher costs of buying goods from other states rather than importing from overseas added to state government expenditures in the non-manufacturing states such as WA and Tasmania. Similarly, the higher wages they were compelled to pay, for example to state railway workers under the Commonwealth's Basic Wage policy, also increased expenditures on state government operations, and raised the cost of government services. The *Navigation Act*, in applying Australian wage conditions to all coastal shipping, also raised transport costs to and around the outlying states.

Recognition of the difficulties facing the smaller states resulted in the Commonwealth providing fairly continuous special assistance to WA and Tasmania during the 1920s.[22] As Mills commented in 1933, 'no principle was evoked other than an appeal from the weaker to the stronger', with grants being for 'those states which have found the burden of federation and federal policy hard to bear'. Nevertheless, the Commonwealth was to describe grants for both Tasmania and WA as a contribution to the above average debt burden carried by these states as a result of for example, higher development related costs such as for constructing railways (Mathews and Jay).

Special assistance to WA from 1925-26 had emerged from a 1924 Tariff Board report on the state's disadvantage from federal tariff and protection policies. WA complaints about the effects on the state budget of Commonwealth protectionist measures were supported by the Tariff Board. A Royal Commission on the "Finances of WA as Affected by Federation" was established to report the following year. It was sympathetic to WA claims and recommended a grant of $900,000 per year in place of surplus revenue grants, to be paid as an alternative to the state levying its own tariff (Greenwood). The Commonwealth, however, agreed to pay only a smaller amount for a period of five years from 1925-26 (May).

22 Although the original grants to these states had expired from 1920 they were continued on an ad hoc basis throughout the 1920s, after independent inquiries into the finances of WA and Tasmania supported their claims for further assistance.

Tasmania had been seeking redress for some time for the financial disabilities of federation although it opposed the special assistance grants. Grants to Tasmania in the 1920s were a response to Tasmania's claim of disabilities from federation and federal policies. These disabilities were supposedly evidenced in Tasmania's high indebtedness, which arose mainly from unprofitable state railway operations.

Although a Royal Commission promised to Tasmania in 1925 did not eventuate, there was a special investigation by Sir Nicholas Lockyer into Tasmania's claims of disability from federation in 1926. Significantly, Tasmania's case to the Lockyer inquiry argued for grants on the grounds of "the general disabilities to which the weaker States are always liable in any system of federation...", as well as referring to the state's disabilities from protectionist federal policies. Tasmania argued that for a small, resource poor state, membership of a federation inevitably brought difficulties beyond those imposed directly by federal policy. In a federation it was more difficult to avoid raising standards of public services, and states no longer had the same liberty to "cut costs to suit their cloth." This 'demonstration effect' of federation was noted by Head (1967) as a political rationale for special grants.

At this stage Tasmania was losing population to the mainland, and this increased the difficulty of providing public services while maintaining tolerable taxation burdens (Giblin 1930; May 1971, 11). Giblin argued that Tasmanian taxes had been raised beyond economic limits in order to make ends meet (1926). Giblin put forward the alternative of differential per capita grants (Mathews & Jay, 1972, 125).

The Tasmanian Premier in 1925 also argued that its difficulties were due to its intermediate stage of economic development , and could be overcome by long term development loans (May).

Lockyer supported the state's claim for special assistance on these grounds, although making it conditional on certain reductions in state taxation (May 1971, 12). The recommended grant was based on taxable capacity, the cost of providing necessary government services, and the cost of the remedial measures proposed by the Commonwealth (May). Lockyer's recommendation for annual grants to Tasmania of $600,000 per year for five years was overtaken by the 1926 negotiations leading to the 1927 *Financial Agreement.* Coming out of the 1926 negotiations was a study by the Development and Migration Commission of Tasmania's financial problems. It too, recommended grants to Tasmania, determined with regard to taxable capacity, the cost of providing essential government services, and other remedial measures. Based on this study, a grant of $400,000 was paid to Tasmania for 1928-29 conditional on fulfilment of certain of the

Commission's recommendations. The Commonwealth appeared to agree that the solution for Tasmania was to increase its product (May).[23]

In summary, the period from 1910 to 1927 was one of exploring and testing federal financial relationships and the issues of implicit and explicit interregional transfers. It became evident that fiscal capacity was unequal, so reallocating tax powers was not a solution. Hence tentative attempts were made for Tasmania, and later SA and WA, to justify tied grants on the basis of offsetting fiscally induced economic inefficiencies or promoting economic convergence. It also became apparent especially in the case of Tasmania that grants were not a transitory phenomenon. Around the mid-1920s the principle of fiscal needs first emerged (May)

With the net economic benefits of fiscal union reducing for the less industrialised states as policies such as the protectionist tariff hindering economic development, such states as WA also began to question the overall benefit of federation. The impact of federal tariff and other policies on state development became entangled with issues of state finance because they reduced fiscal capacity and raised the costs to state governments of providing essential public services. To ensure at least the financial viability of these governments, grants were made to redress the impact of such policies on fiscal capacity, such as the 1925 disabilities grant to WA.

However, putting these special assistance grants to the smaller states on a more settled basis was deferred in 1926 and 1927 while negotiations on the broader issues of federal/finances were concluded.

3. GLUING THE FEDERATION TOGETHER IN THE HARD TIMES

3.1 Fiscal Need, The 1927 Financial Agreement and the Federal Surplus

The earliest attempts to reduce state debt interest costs - a key attraction of federation for the small states - and to reduce the surplus to more manageable levels, had failed. Divergent interests of smaller and larger states had meant that the Commonwealth withdrawal from income tax was successfully resisted by low tax capacity states as a solution to the federal financial surplus. With the strong push by the Commonwealth for more coordinate financial arrangements in the 1920s, the federal financial surplus was to be finally addressed in a manner satisfactory to the small states through the transfer of debts in 1927.

23 An indication of the linkages between the Financial Agreement and special grants is that the grant was lower than the previous years payment of $756,000 which was largely a contribution to Tasmania's high railway debt burden. This was partly because the states financial position had improved due to previous years grants and partly because the *Financial Agreement* of 1927 had been of particular benefit to Tasmania (May 17).

The Commonwealth was committed to achieving separation of federal finances, although the states generally felt no urgency to change existing arrangements (Sawer 1956, 272). By the mid 1920s, Labour Party policy was beginning to present some pressure on the states for change. Labour proposed the continuation of per capita grants under S.96 until the constitution had been reviewed, a policy which provided maximum flexibility for the Commonwealth. However, as the states came to realise, S.96 provided no guarantee of grants to them. Labour's policy emphasised that the existing legal position created considerable uncertainty, because the states per capita grants could cease whenever it suited the Commonwealth. In early 1927, after the failure of the 1926 talks to uncouple the tax bases of the Commonwealth and the states, the Commonwealth forced continued negotiations on the states by introducing legislation, the States Grants Bill, which ended per capita grants (Sawer 265). The *States Grants Act* of 1927 replaced per capita grants system with grants equal to what they would have received under the per capita system (see May, 14-15).

Existing arrangements presented difficulties for WA and Tasmania, as was evidenced by their continued need for special assistance outside the per capita grants arrangements. However, it had become clear from the May 1926 Conference that reallocating taxation between the Commonwealth and States also caused the smaller states difficulties because of their lower taxation capacity. Thus, it was realised that the Commonwealth's previous strategy did not provide a stable solution to the problems of federal finance. As any change to taxation powers required the unanimous agreement of the states the agreement of the smaller states was necessary.

By that time, Giblin's work had left the states well aware of the implications of differences in taxable capacity. The state tax burden from replacing per capita grants in the budgets of the smaller states would be impossibly high. The differences in 1926 were such that the weaker states were financially dependent on the redistributive effect of Commonwealth grants. The Commonwealth, on the other hand could not vacate the direct tax field if it was to meet its expenditure commitments and at the same time maintain grants at a level sufficient for the needs of the weaker states (Gilbert 76).[24]

In 1927, the focus of negotiations thus moved to a proposal for the Commonwealth to take over the states' debts and contribute to state debt servicing under S.105 of the Constitution, in return for ending per capita payments (Gilbert 1973, 9). This culminated in the 1927 *Financial Agreement* between the Commonwealth and the States.

24 The special assistance grants to WA and Tasmania became closely entangled with these 1927 negotiations. There was continued controversy at that time over the Commonwealth response to the recommendations of the 1925 Royal Commission on WA. The Lockyer Inquiry had also reported in 1926, and the States Grants Bill of 1927 included authorisation for the 1926-27 payments to WA and Tasmanian. Controversy over the legislation resulted in delayed payment of these grants.

The basis of settlement in the 1927 *Agreement* better reflected the needs of the smaller states than previous proposals for tax separation. For the first time, it addressed the problem of state debts by relieving the states of part of their debt servicing responsibilities. The heavy debt burden of WA and Tasmania meant that the Commonwealth's proposals for taking over states debts were clearly of interest to them, as it had been during the first decade after Federation. In particular, the provision in the *Agreement* to provide for flat rate Commonwealth contributions towards the debt sinking fund for existing debt provided the greatest relief to the four states with the heaviest debt servicing commitments in 1927. These were WA (with debt per capita of $360), SA ($306), Tasmania ($230) and Queensland ($244), with NSW and Victoria having $204 and $173 of debt per capita respectively.[25]

The 1927 *Agreement* thus played an important role in separating progress in negotiations on the general issue of vertical balance from the equally contentious issues of horizontal balance between the states. Although the *Agreement* did not resolve the problem of horizontal imbalance, the shift in the basis of negotiations made it possible to get the agreement of the smaller states to a greater separation of federal/state finances by abolishing per capita grants.

Overall, the *Agreement* provided the states with more than they would have received under the per capita grants, at least in the short term (Gilbert 1973, 96). All states, and especially the smaller states whose finances were very vulnerable to revenue shortfalls, also benefited from greater security of revenues under the *Agreement*. Unlike the S.96 grants, Commonwealth payments for debt servicing would be guaranteed by the Constitution (Gilbert 83, 89, 96). As part of the *Agreement*, a special Act was passed providing special disability grants to Tasmania (Sawer 1956, 265).

In effect, the 1927 *Financial Agreement* made it possible for the distributional issues of federal finance to be put on a new footing and addressed separately from issues of vertical financial imbalance. The Commonwealth taking over debt servicing responsibilities for states in a way which favoured the smaller states made the issue of their higher budget deficits into 'water under the bridge'. The importance of higher debt charges and development costs to the financial problems of the smaller states was later acknowledged by the Grants Commission by its concessional treatment of debt interest payments under its assessment procedures (Head 1967, 499).

However, as the federal surplus was only sufficient to take on part of the states' debt servicing burden, keeping the smaller and more indebted states afloat still rested at this stage on ad hoc

25 'The payments are equal per cent of debt per states and are in proportion therefore, to the amount of debt per head taken over from each State. States with a high amount of debt per head in 1927 stood to gain from the Commonwealth relative to others with a low debt per head' (Gilbert 93).

arrangements for special grants. Although basis principles for these grants had been emerging, these disabilities grants still had various criteria and principles to determine the amount of the grant, and had no formal institutional mechanism to ensure consistency over time and between states. Establishing such a mechanism began as soon as the 1927 agreement was signed, with negotiations on claims for special grants by Tasmania, WA and SA resuming from 1927.

3.2 The Grants Commission - the Mopping Up Operation

3.2.1 Emerging Chaos in Special Assistance to States

SA had agreed to withdraw its opposition to the Commonwealth's 1927 proposals in return for Commonwealth consideration of a request for financial assistance (May 1971, 16). In 1928, SA formally approached the Commonwealth for grant assistance. Its grounds for seeking assistance were fundamentally those of fiscal need, although it put forward arguments like those of Tasmania and Western Australia.[26] Notably, the SA submission justified such assistance "to enable it to maintain the standard of progress of the wealthier states". Evidence was put forward that it could not finance its most important operations, and it noted an implied promise that the weaker states would not be allowed to suffer through federation (Greenwood). Although the SA submission drew heavily on the approach of previous submissions by Tasmania, it was the first time a state had explicitly requested assistance on this basis (May 19).

In response, the Commonwealth appointed a Royal Commission on "The Finances of SA as Affected by Federation", which reported in 1929. Unlike previous inquiries, the Royal Commission refused to try to quantify the net balance from federation and federal policies. The Commonwealth had previously decided that the existence of a budget deficit was not itself justification for special assistance.[27] Nevertheless, adopting the approach suggested by Tasmania in previous enquiries,[28] the Commission based its recommendation for grants on the state's budget deficits after adjusting for tax capacity and level of taxation, and other items, taking this as both the need and justification for assistance (May 1971, 19). This was the first clear endorsement of the approach later adopted by the CGC.

26 That is, the protectionist tariff and wages policies, the Commonwealth Savings Bank, and participation in the World War. SA added to its claims the cost burden of the state's railway system and emphasised the changes in federal state financial arrangements and loss of revenue with the end of the Braddon clause in 1910 (May 1971, 18)

27 Although it had acknowledged that it had an interest in maintaining the stability of the federation (Mathews & Jay)

28 That is, the approach developed by Giblin as Chairman of the Tasmanian Disabilities Committee in 1925. The report of this Committee, while prepared for the aborted Royal Commission into Tasmanian finances, was the basis for later Tasmanian submissions to the Lockyer inquiry (May 1971, 12).

The entry of SA into the special grants arena highlighted the need to put grants on a more principled and predictable basis. SA's application and the suggestion the same year that Queensland might also seek a grant (May, 18) raised the prospect of assessing claims from four of the six states.

Between 1925 and 1932, there had been no fewer than seven separate official inquiries (by the Tariff Board, Sir Nicholas Lockyer, the Commonwealth Joint Parliamentary Committee on Public Accounts) and three Royal Commissions into the effects of federation on state finances of Tasmania, WA and SA. Experience with these different mechanisms and principles for assessing "disability" claims from affected states had shown the process to be costly, arbitrary, and controversial. From the point of view of the smaller states, the procedures were also demeaning. In particular the attaching of conditions to grants was highly unpopular in the recipient states..

With the arrival of the Depression in 1929, WA and Tasmania made more frequent claims for additional assistance (May 17, 20). Anti federal feeling was rife, with attention focussing on the so called "disabilities of federation". As Greenwood commented regarding the secession movement in WA,

> 'Depression transformed secession from a goal favoured by a few extremists into a movement expressing universal dissatisfaction with existing conditions'.

The increase in the federal tariff as a revenue measure in 1929 also provoked particular anger in the primary producing smaller states, notably WA which had also been especially hard hit by falling commodity prices. Conflict within the federation came to be seen as possibly threatening the federation itself, in the way that depression was threatening the political stability of other federations. As Brigden observed, "it seemed that federation everywhere might become a casualty of the Depression" (Brigden 1934, in Prest and Mathews, 217).

In late 1929, the arbitrariness and uncertainty of the special grants process had become an election issue. There was particular controversy over the Commonwealth offer of a special grant to SA in 1929 because it was conditional on the transfer of part of the SA railway system to the Commonwealth. The Opposition Leader, Scullin, promised to implement special grants to WA and Tasmania without the conditions that the Bruce-Page government was trying to attach to such grants. For example, a WA claim for a special grant in 1929 had been met with a Commonwealth offer of a special grant conditional on transfer of the NW of WA to the Commonwealth (May 19-23). Previous conditions attached to Tasmanian grants following the Lockyer inquiry were also bitterly resented in that state (May 13). Further political uproar over a grant to SA in 1930 emphasised the need to regularise assistance and determine such grants on a better coordinated, more principled and objective basis (May 22).

3.2.2 Coordination of Special Assistance

In early 1930 the recently elected Scullin government established a review by the Commonwealth Joint Committee of Public Accounts (JCPA) of "The General Question of Tasmania's Disabilities" which reported in August 1930. This review followed Tasmanian protests at the conditionality of grants recommended by the Development and Migration Commission for 1929/30. The Scullin government removed the conditions attached to both the Tasmanian and SA grants by the Bruce-Page government (see above). Controversy later in the year over the SA grant resulted in the JCPA also being asked to investigate that grant. A renewed approach by WA for additional special assistance prompted the Commonwealth to amend the terms of reference for the JCPA's investigation of SA. In March 1931, the JCPA was asked to review its recommendation on Tasmania and consider the WA claim on the same basis (May 23).

This represented the first attempt to co-ordinate the claims from grants by SA, WA and Tasmania. By that time there were three different processes and forums considering claims for special assistance by WA, Tasmania and SA.

Before it finished its work on WA, the JCPA was abandoned, but its 1930 report on Tasmania and 1931 report on SA pulled together a number of strands of thinking on the special grants issue. Most importantly, it refused to try and quantify the net disabilities of Federation, and instead followed the approach suggested in Giblin's 1930 proposals to the JCPA Tasmanian inquiry in determining its recommended grant to SA in 1931 (May 1971, 21, 25). Giblin had suggested the most practical basis was to look at a state's public accounts, and calculate the grant needed to balance the budget where the state was taxing with considerably greater severity than the Australian average; was not attempting social provision on a more generous scale that average; had below average costs of administration; and had shown moderation and caution in loan expenditure (Giblin 1930, 194).

The JCPA also called for the establishment of a permanent independent body to determine grants on a consistent and principled basis. SA and Tasmania took up the JCPA's call, and in spite of the indifference, indeed hostility of WA, the Commonwealth agreed in 1932 to establish the CGC.

3.2.3 Establishing the Grants Commission

The establishment of the CGC was a response to the political instability and conflict engendered by state financial difficulties during the Depression. It was also a formal, institutional acknowledgment that the economic and fiscal capacity of the states was not equalising. Redistribution between states was now a necessary and permanent feature of the Federation. The timing of its establishment, in the midst of the Depression and just a year after NSW effectively

declared itself bankrupt, highlights the interrelationship between vertical and horizontal fiscal imbalance.[29]

The novelty of the Grants Commission was in trying to find a systematic basis for alleviating the position of the smaller states, and removing the annual demands of the smaller states from 'the hurly burly of state politics' (Sawer 1963).

In determining its 'principles', the Commission identified and isolated horizontal rather than vertical imbalance as the task of the Commission. It also noted that such transfers were inevitable in any federation, and continuous with other transfers in the federation (May; Brigden 1934, 266).

One of the most important issues for the Commission was to find a 'principle' which could be applied with consistency to the various circumstances of the different states. To prevent political conflict with the larger states, it was also necessary for the commonwealth to find the correct balance of federal principle/generosity and conditionality/effort.

For the first few years the Commission focussed on reconciling the 'fiscal need' and 'compensation' bases for grants. It examined various factors which might produce a fiscal need for grants, such as less advanced economic development or higher development costs, lower fiscal capacity, and poverty of resources and the demonstration effect of federation.

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

In considering its approach, the CGC also was faced with the difficulty that the needs of the claimant states derived from substantially different factors. Several possible causes of difficulties for the smaller states in a federation had been identified in the 1920s. While these emphasised the effect of federal policies, they also extended in the Tasmanian case to poverty of natural resources, as well as underdevelopment, and included possible extravagance and irresponsibility by state governments. There was, by that time, considerable agreement by most states, again

29 This was also the year that the Commonwealth chose to temporarily reactivate S.94 payments to the states. Indeed, it appeared that the Commonwealth was awaiting the return of normal conditions before established permanent arrangements for special grants (May, 36).

based on experience in the 1920s, that accurate measurement and quantification of net economic "disabilities" from federation or federal policy was impractical (May 1971, 24).

Such difficulties of measuring "disabilities", and the differences between states in the nature of their claims for special assistance also underscored the need for the CGC to develop and approach which was flexible, seemed objective and was at the same time more practical than attempting to place a money value on the "net disabilities from federation".

These characteristics were found in the principle of fiscal need or "fiscal equalisation". The CGC argued as had the 1925 Tasmanian Disabilities Committee, the 1929 Royal Commission on SA and the JCPA, that the net result of any disabilities from whatever causes would be summed up in a claimant state's finances.

At the bottom line, it was not only impractical but irrelevant to try to trace the causes of a state's difficulties to federal policies or any other causes. Therefore if, on objective criteria, a state needed a grant to balance its budget, and met certain criteria for self help, then that need was in itself justification for a grant. The alternative was for the state to leave the federation, or for a state's insolvency to lead to its incorporation within another state. As the CGC was to argue in its 1936 report, "A federation only lives while its constituent parts live". In this sense special assistance to the weaker states of the federation were, as the Tasmanian Disability Committee had suggested in 1925, "a vital condition to the effective workings of the federation" (May 1971, 22).

In adopting this rationale for grants, the CGC was also, from the very beginnings, adopting an approach based on Courchene's 'federal' (or 'federation') principle. In the Case for WA (1933), it was claimed that without the guarantee of financial stability for the states, federation would not have been possible (Greenwood).

While the Commission's initial procedures for equalising state finances was comprehensive in the sense of addressing both sides of the budget, "full" fiscal equalisation, in the sense of bringing claimant states to a level of fiscal capacity equal to that of non-claimant states, was not its objective.

This appears to primarily reflect concerns that fiscal equalisation might undermine the financial responsibility of the claimant states. It also had a political rationale, acknowledging the potential objections to equalisation at a time when even the wealthiest state was in severe financial difficulties. Reflecting this, there were penalties for claimancy until the second world war, as well as deductions from grants based on judgements about the extent of a state's own responsibility for its difficulties. Because of the adverse efficiency costs of compensating on an individual basis for community losses due to poverty of a state's overall economic resources, the Commission also

concluded that the only basis for assistance could be the effects on state governments rather than individuals.[30] Maxwell later argued that if grants were made to keep an uneconomic state alive after loss of population or capital resulting from an external shock, a permanent grant might not hinder the operation of market forces (1938, 45).

Significantly, as early as its first report, the CGC abandoned any attempt to account for the disabilities of federation.[31] While it was not denied that federal policies disadvantaged some states more than others, federation itself bestowed all states with advantages. More than thirty years after federation, it was not practicable to distinguish the net impact of federation or federal policy for each state. In fact, it was by no means clear that the disabilities approach would yield the politically necessary positive case for grants to states such as SA and Tasmania (Head; Greenwood). The CGC concluded, as had the Royal Commission into SA in 1929, and the JCPA in the early 1930s, that distinguishing the causes of differences in states' prosperity was futile. In coming to this conclusion, it drew on the evidence of expert witnesses as well as the views of claimant states, although there was some disagreement within the Commission on this approach (CGC, 28). The basis adopted was to bring claimant states up to a minimum standard somewhat below that of the standard states, rather than to an average level of the standard states. In recognition of the federal principle of the grants, and no doubt reflecting public outrage at the conditionality of some previous payments, all grants were unconditional.

In summary, then, the period from the late 1920s until WWII was one in which the principle of revenue reimbursement - compensation for the loss of what might have been without federation - became progressively regarded as impracticable and irrelevant. It became impossible to disentangle the inevitable effect of economic development and restructuring after federation from the effect of federation, and federal policies. Revenue reimbursement, even on a notional basis as under the bookkeeping arrangements, became impractical as a basis for interregional transfers and redistribution.

As had been anticipated before federation, resolving the issue of the federal surplus through the 1927 *Financial Agreement* had reduced distributional issues to more manageable levels. These distributional issues were now ripe for resolution in a more systematic way than had occurred during the 1920s. The major force for institutionalising special assistance came with the Depression. The Depression placed new financial stresses on the federation, and the imbalance of states' revenue and expenditure functions again placed states under financial pressure.

30 While poverty of resources was initially rejected as a basis for grants on allocative grounds, the Commission modified this view as it became evident that such a factor was important the debilitation of state finances (Greenwood; Mathews & Jay).

31 Although, it should be noted that, in its Third Report the CGC did provide a measure of assistance to Western Australia for the adverse impact of Federal policies. Many states righters were indignant at the general rejection of the disability basis for grants, and there was general surprise that the Commission did not follow the disabilities approach (May).

Two principles for special assistance had emerged to that point - the first being compensation for the effects of federation and federal policy, and the second being that of need (Mills 1935). Although it explicitly rejected the 'disabilities approach' the approach adopted by the CGC was not novel when examined against the evolution of ideas and events during the previous decade.

The fiscal need approach boiled down to quantifying the effect on state budgets of various factors, and providing a sufficient grant to offset the adverse effect on the states financial solvency - to meet its minimum fiscal need. This reflected the 'federal' principle, ensuring the financial viability of the federation's member states, not that of equal treatment of equal individuals in different states, or fully offsetting fiscal disparities between states. As Head commented in 1967 (473-5), the CGC's approach was 'an ingenious reconciliation of the diverse arguments in a principle of financial equality'.

In bringing to the fore the 'fiscal need' principle, the Commission found it necessary to address issues of incentives on state governments and set down standards of self help. Anything less would generate the opposition of the richer states (Head 1967, 477) Thus, the principle set down in the early reports of the CGC reconciled equity and fiscal viability with incentives for self-help through adopting a minimum, rather than full equalisation standard, requiring 'greater fiscal effort' from claimant states (Head 474).

4. THE FINANCES OF THE FEDERATION 1942-1981

4.1 Reimbursement of Income Tax Revenues

4.1.1 Uniform Income Taxation and the Reimbursement Principle

At the time the Grants Commission was established, the federal surplus problem had been dealt with by the 1927 *Agreement.* Special grants were the only significant federal grants to the states.[32] Over the next 50 or so years, the Commissions special grants were to be gradually incorporated into relativities for financial assistance and tax-sharing grants to the states. At the same time there was a gradual shift from special grants to claimant states according to criteria of minimum fiscal need, to that of fiscal equalisation of all general revenue grants to all states, on the basis of relative fiscal need. In addition, while the earlier special grants incorporated elements and fiscal standards designed to the minimise concerns of the larger states at the adverse efficiency or

32 Apart from the arrangements for Commonwealth payments to the states under the Financial Agreement and specific purpose roads grants which at that time, were very minor.

incentive effects of special grants, such elements of the earlier special grants were not retained in the shift to fiscal equalisation.

This shift, again, occurred in the context of the federation's adjustment to the problems associated with vertical fiscal imbalance. In the postwar period, a federal surplus arose from the Commonwealth's income tax monopoly under the post-1942 Uniform Income Tax Arrangements. The varying income tax burdens and structures in the different states made it difficult to maximise its war revenues, without unacceptable equity implications for tax-payers in different states or on different incomes.[33] Under these arrangements the Commonwealth legislated for a uniform national income tax which effectively forced the state governments out of the field.

Paralleling the arrangements for distributing tariff revenues just after federation, the states were initially reimbursed income tax revenues according to the distribution of collections before the war, over the period 1939-41. Like the constitution's financial provisions for customs collections, the arrangements also acknowledged the particular difficulties of the smaller states: any state which felt it received an insufficient grants could apply for supplementary assistance. This was to be assessed by the Grants Commission.

However, after the war, when the federal income tax monopoly was continued, the basis for distributing tax reimbursement grants was gradually shifted to a per capita basis.[34] In another parallel with the 1910 arrangements, the federal revenue surplus was directed to funding expanded national welfare, replacing previous arrangements at the state level.[35] Unlike the 1910 Per Capita Agreement, state population was adjusted for demographic structure, in an implicit recognition of the higher costs of providing services in some of the sparsely populated states.[36] At the same time, the additional tax reimbursement grants which the smaller states (SA, Tasmania and WA) had received during the war were incorporated in an ad hoc way into the tax reimbursement grants base from 1947. Replacing previous additional assistance assessed by the Grants Commission, supplementary grants were also made on an ad hoc political basis by the commonwealth between 1947-58.

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33 In particular, poorer states such as SA had found it necessary to levy substantial tax on low income groups, which were relatively lightly taxed in some other states. Other states taxed high income earners relatively harshly. Different fiscal capacities and policies also resulted in variations in the extent of reliance on income tax revenues. This meant that, without imposing unconstitutional differential income tax burdens on the different states, the commonwealth could not fairly and effectively levy a heavy national income tax.

34 An attempt to return income tax to the states in 1953 stalled due to perceived technical problems and to disagreement about how states with lower taxable capacity, notably Queensland, would be 'compensated' for the change.

35 A federal unemployment and sickness benefit was introduced in 1944, and a 'contributory' national welfare fund was created in 1945.

36 A similar adjustment to procedures for standardising state expenditures had been introduced in 1937 by the Grants Commission.

4.1.2 Adjusted Per Capita Grants

By 1957-8 all general revenue grants had been moved to an adjusted population basis. SA, Tasmania and WA continued to receive special grants according to the Grants commission criteria of fiscal need. However, with pressures for expanding the role of the public sector in the post war period, and the relatively slower growth of tax reimbursement grants, such grants were increasingly out of balance with state functional responsibilities. In 1957, both Victoria and Queensland applied for special grants, forcing a general review of federal/state finances.[37]

In summary, the period from 1942 to 1959 saw the federation again struggling with the distributional issues associated with difference in fiscal capacity, accentuated by conflict over the division of the federal surplus. As was the case after federation, there was a gradual shift from revenue reimbursement to a more redistributional , adjusted per capita basis. This shift, associated with an increasing imbalance in revenue and expenditures responsibilities as the role of government expanded, again proved inadequate to the needs of the smaller states without the growth of special grants. The increasing vertical imbalance, as in the 1920s, resulting in increasing confusion and interaction between issues of vertical and horizontal fiscal imbalance.

4.2 From Charity to Equality

4.2.1 Penalties for Claimancy

Meanwhile, the 'fiscal need' basis of Grants Commission assessments was being shifted towards 'fiscal equalisation'. In its early reports, the Commission had emphasised that there was not a 'scientific' basis for penalties, and it was for the Commonwealth Parliament to judge what level of 'penalty for claimancy' should be imposed and to what standard the claimant states should be raised (May). By 1945, the Commission's 'penalty for claimancy' and adjustment for additional tax effort - the most obvious formal differences between fiscal need and fiscal equalisation - had been abandoned (Head). The decision reflected the loss of financial autonomy of the states in the wartime conditions,[38] and was associated with improved economic conditions from war spending (Brown).

This suspension of penalties had long been sought by the claimant states (Greenwood; Prest and Mathews). To the latter, these adjustments (combined with the balanced budget standard)

37 This has parallels with the increasing inadequacy of the Per Capita Grants for all states by 1926, due to the unanticipated rise in prices over the period of the agreement. Again this inadequacy was to force a shift from a reimbursement basis to a fixed grants (FAG) arrangement.

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

represented an unacceptable intrusion by the Grants Commission into state financial policies, and undermined state financial autonomy. In essence, the penalty clauses were seen as an abrogation of the federal principle. On the other hand, concerns were expressed that without the clauses, the claimant states would have less incentive to manage their finances without assistance from the federation.

4.2.2 The Balanced Budget Standard

Prosperous economic conditions during wartime and in the postwar period also pushed the Commission towards relaxing its balanced budget standard. When the larger states were running budget surpluses and accumulating reserves during the war, the claimant states argued that they would be disadvantaged in the reconstruction period because of the Commission's practice of bringing them up only to a balanced budget standard. Criticism that its procedures distorted the fiscal policies of claimant states led to the Commission effectively moving to allowing a surplus budget standard, that is full equalisation, between 1967 and 1974 (Head; Prest & Mathews).

4.2.3 Lowering the Standard - from Three to Six States

The other major move towards financial equalisation came from the late 1950s, as the Commission wrestled with the problem of whether to use a two state or four state standard. This conflict is over whether incentive effects or equity to middle ranking states such as Queensland should be the paramount consideration. With the 1959 review, and the replacement of 'tax reimbursement' grants with financial assistance grants, SA withdrew from claimancy. However, it and Queensland were still able to apply to the Commission if they felt circumstances warranted. This meant that it was difficult to determine a suitable standard against which to measure claimant states revenues and expenditures.

In the past, the Commission's three state standard had reflected the principle that the three claimant states should not be able to influence the level of their grants by their own policies. With SA's withdrawal from claimancy, using the four state standard would seem appropriate, and would avoid the possibility of 'equalising' the claimant states to a level higher than SA and Queensland. However, as both Queensland and SA could still apply for special grants, a two state standard was needed to give effect to the Commission's efficiency principle, isolating the level of grants from claimant states' own fiscal policies.

After adopting a two state standard in 1961, the Commission eventually announced its intention to adopt a four state standard from 1967. As Head/Lane/Mathews pointed out, however, the four-state standard was unstable. In the early 1970s, both Queensland and SA again became

claimant states, and attention again focussed on the appropriate basis for determining relativities for the distribution of general revenue (FAGs plus special grants).[39]

Hence, it can be seen that concerns about states' budgetary incentives diminished as economic conditions improved, and the scope for financial autonomy of the smaller states was reduced by Commonwealth imposed spending restrictions and the states' loss of income tax. Thus increasingly, it was relative not minimum financial need that determined grants, and concepts of nationhood, rather than federalism came to the fore as the basis for special grants.

4.3 Fiscal Equalisation, Equality and the 'Federal Surplus'

4.3.1 Ad hoc FAGS and Special Grants of the 1960s and 1970s

The significance of the post-1959 arrangements was that they blurred the distinction between grants for redressing horizontal fiscal imbalance on the basis of fiscal need, and general grants to offset vertical imbalance (Lane) based on tax capacity and other considerations. So that SA and Queensland would withdraw from claimancy, special grants were built into SA's FAGs base; FAGs were much more redistributional than the tax reimbursement grants (Lane; Head).

However, while problems of vertical and horizontal balance had been clearly interdependent in creating the 1959 situation, the transition from tax reimbursement to financial assistance grants was not based on any clear principles about relativities in the distribution of the surplus. FAGs relativities were based on an arbitrary combination of adjusted per capita, Grants Commission criteria of fiscal need, and political factors that were reflected in the 1958-59 grants base. But as Butlin commented in 1954,

> 'If such a differential per capita is to be used, there is a strong case for basing it on some objective formula'.

As a result, over the next decade or so, there was increasing arbitrariness and ad hocery in the relativities of general revenue grants and in the division between claimant states and non-claimant states. A transfer of state debts to the commonwealth agreed to in 1970, and the new capital grants program for housing and public works, failed to address the entangled issues of vertical and horizontal fiscal imbalance.

By 1974, Mathews pointed out that the per capita relativities reflected in current general revenue grants were grossly misaligned with estimates of relativities based on fiscal equalisation criteria.

39 The changes to FAGs relativities associated with the handing over of payroll tax to the states in 1971 further complicated the issue, a set of new grants based on (payroll) tax capacity.

Justifying a fiscal equalisation approach by reference to differences between the states in economic development, tax capacity and cost of providing services, Mathews argued that a less arbitrary approach to fiscal equalisation should be adopted. The model that he suggested was essentially adopted from 1974 when a six-state average was used in the direct assessment model for special grants, and from 1979, when the Commission's fiscal equalisation model was used to assess per capita relativities for all states' tax sharing grants, as part of the 1976 tax sharing agreement.

4.3.2 Tax Sharing and the 1981 Relativities Review

From 1976, FAGs were replaced with income tax sharing grants under the New Federalism policy of the Fraser government. Unlike the income tax reimbursement grants of the 1940s, the distribution of the grants was determined according to population not collections, but with per capita relativities based on the 1975-76 total grant relativities. This implicitly redistributed revenue from high income states to those with lower income tax capacity by raising revenue according to capacity to pay, and distributed it according to population. It being acknowledged that these relativities were arbitrary and unsatisfactory as a basis for tax sharing grants, provision was made for a general review of relativities, which the Grants Commission was asked to do in 1978.

When the Commission made its report in 1981, it showed that, based on its interpretation and application of 'the fiscal equalisation principle'[40] the existing distribution of total grants was strongly skewed towards, WA, SA and Tasmania, at the expense of NSW and Queensland in particular but also Victoria. This was because of over-equalisation in the existing distribution of tax sharing grants and some specific purpose grants as a result of some arbitrary decisions and arrangements (Mathews 1981).

There was strong opposition from WA, SA, and Tasmania to the readjustment of relativities along the lines suggested by the Commission. After a cursory examination of the Commission's report, the 1981 Premiers Conference decided to a defer a decision on the report and asked for a further inquiry taking into account additional Commonwealth and State submissions.[41]

The position of the Commonwealth was crucial - as Mathews pointed out,

40 'The principle of fiscal equalisation required that each State's tax sharing entitlements should enable it to provide government services comparable to those being provided by other states if it also imposed taxes and charges at levels comparable to those of other states' (Mathews 1981, 175).

41 The results of this 1982 inquiry were obfuscated by the terms of reference, which required a review of the distribution of the new identified health grants, without indicating whether such grants were to be integrated or separated from tax sharing grants.

> 'a major weakness of the reviews of the tax sharing arrangements was that they were carried out in two separate stages as though the question of the level and the distribution of the tax sharing arrangements were independent of each other, when in fact a decision on the distribution of grants could not be taken without regard to the total amount available. The Vertical distribution of funds as between the Commonwealth and the States and the horizontal distribution among the States themselves were necessarily interdependent under the tax sharing and fiscal equalisation system that had operated in Australia since 1976.'

However, the Commonwealth had consistently denied having responsibility for implementing new tax sharing relativities, saying that this was a matter for the States. Mathews (1981) commented:

> 'But it should have been obvious to all concerned that there was no possibility of phasing in new relativities without a substantial injection of additional funds into the tax sharing pool by the Commonwealth. The implementation of the relativities assessed by the Commission for Western Australia and Tasmania without any change in the total amount of the tax sharing grants, would have resulted in a 20 per cent reduction in their grants, while the reduction in South Australia's grants would also have been significant. There was no way in which budgetary adjustments of this magnitude could be absorbed by the States concerned.'

Thus the experience of the 1981 relativities review corresponds to experience since before federation - vertical and horizontal imbalance are inseparable because the former makes the fight over the spoils more bitter. For the smaller states, the issue is more fundamental because, to the extent they have lower fiscal capacity and higher costs of meeting Australian standards, vertical financial imbalance threatens their financial viability before it does the larger states. As Maxwell pointed out, the Australian standard is a moving target. The nationhood principle is likely to require continued interregional transfers even if economic convergence diminished the absolute magnitude of the differences in States fiscal capacities

5. CONCLUSION

There is a tendency in modern discussions of fiscal federalism to separate discussion of horizontal from vertical financial issues, and separate issues related to grants, or expenditure responsibilities, from public borrowing and debt. Throughout the course of Australia's federal fiscal history, however, issues of interregional transfers have been inseparable from the broader problems of public finance, notably the division of taxation powers and 'vertical financial imbalance', and the division of responsibility for expenditures, notably for railways and debts. This paper demonstrates the hazards of interpreting arrangements for the payment of special grants in isolation from other aspects of public finance - taxation, spending and borrowings.

Even apart from the special grants system, the structure of federal state finances has included a number of features reflecting the need to accommodate the distinct fiscal interests of the smaller states. In particular, Commonwealth specific purpose grants and the redistributive effect of Commonwealth income taxation have been noted as a means of transferring financial resources to the smaller states to assist their development to levels comparable with the richer states.

There is a modern tendency to view the apparently ad hoc 'disabilities' grants of the 1920s as forerunners of CGC special grants, or to interpret these grants in terms of the approach later set down by the CGC. In this paper it is shown that the minimum fiscal need approach adopted in 1933 was firmly entrenched in previous federal financial arrangements stretching back to federation. However, it reflected the principle, implicit in the Constitution's financial provisions, of achieving an equitable distribution of the fiscal and economic costs and benefits from federation. It is demonstrated that contrary to the modern view, significant interregional transfers in Australia commenced well before the establishment of the Commonwealth Grants Commission (CGC) in 1933, based on principles of federalism, nationhood, and differences in fiscal capacity.

Examining the formative years of federal finances demonstrates how the federal financial system had to be shaped to accommodate the smaller states and retain their support for the federation. It is shown that provision for interregional transfers was an integral element of Australia's original financial settlement, and were implicit in the agreement to federate. Providing for the financial survival of the smaller states was essential to the formation of the federation.

Early grants of special assistance to WA and Tasmania are shown to be continuous in principle with the federal compact and the constitution's financial provisions. Continued protection of the financial situation of such states was a condition of their agreement to federate. It was not fully or formally admitted until well after federation, however, that unequal fiscal capacity and economic development might mean redistributing towards the smaller states if this condition were to be met. For some time, the fiction (or, at least, unrealistic expectation) that economic and fiscal convergence would occur between the States, was used initially to partly defer, and later to obfuscate, the formal introduction of equalising transfers.

It is shown that several distinct political, economic and ethical principles for interregional transfers were tested in the Australian federation both before and during the 1920s. At this time, the federation found it necessary to acknowledge and adapt its federal financial institutions to the existence of permanent disparities in the economic and fiscal capacities of the states in order to sustain its existence as a federation. The paper also shows that, contrary to the modern characterisation of the disabilities grants in the 1920s as unprincipled and largely *ad hoc*, such grants were a rough manifestation of transfers on the basis of both need and 'just compensation'

for the costs of federation — principles of federation and nationhood which had been implicit in the irreversible agreement to federate.

Within a few decades of federation, financial transfers from richer to poorer states became deeply ingrained in Australia's federal fiscal system, reinforced by economic prosperity and the expanded role of government during the course of this century.

To the extent that principle, rather than opportunistic political bargaining, has determined the pattern of interregional transfers since 1933, it appears that the underlying principle has been political - that of federalism and nationhood. As Mills (1935) commented in trying to ascertain the economic principles underlying Grants Commission special grants, 'fiscal need' was 'a working rule expressed in the imperative', based on ethical or political, rather than strictly economic, principles.

Nevertheless, especially during the 1920s and 1930s, economic considerations tempered this political emphasis, with measures focussed on ameliorating the presumed incentives consequences of such grants, for example, the choice of equalisation standard. At times too, the Australian federation has experimented with transfers which might be argued to directly promote regional economic development: for example, Lockyer's 1925 recommendations regarding a grant to Tasmania, and the 1920s development loans and grants, and special purpose roads grants.

In the words of Greenwood (1946), 'the establishment of the Grants Commission was not a new departure in the sense of adopting a policy of special grants but a recognition of a habit which was becoming an integral part of the federal system'. Furthermore the novelty of the Commission's grants lies not in the 'principle' that it established. Rather it lies in its formal expression, which was endorsed by the federation over subsequent decades.

The Commission's criterion of 'fiscal need' encompassed in a systematic and practical way the diverse and sometimes competing economic, political and ethical principles that underpin special assistance to smaller states in a federation. As Head (1967, 473-5) later pointed out, such considerations led the CGC to 'an ingenious reconciliation of the diverse arguments in a principle of financial equality'.

The paper shows how, over subsequent decades, the Commission's 'working rule' — based on providing for minimum fiscal need - moved gradually towards 'fiscal equalisation'. Such a development, it is shown, had been sought by the smaller states prior to federating as well as throughout the transition period and the 1920s. The postwar shift from 'need' to 'fiscal equalisation' can be seen as consistent with Courchene's federation, nationhood and equity principles of interregional transfers in a way that the earlier Commission grants were not. Arising

from differences in economic development, tax capacity and cost disabilities, again, interregional transfers rested fundamentally on federal and nationhood principles. To the extent that financial equalisation promoted economic development in the smaller states along economic lines (Mathews 1974e), interregional transfers may also be said to have contributed to dynamic economic efficiency and improved resource allocation (Graham 1963; Prest).

It thus appears from this survey that the theories of interregional transfers which are based in the experience of the US federation, and emphasise principles such as horizontal interpersonal equity and reducing fiscally induced migration have contributed less Australian developments than principles of federation, and nationhood.

This may be because, in particular, secession has been a more practical proposition in Australia than in the US since the Civil War (Prest 1974). This gave a focus to maintaining state financial autonomy of the smaller states and the political stability of the federation (the 'federal' principle) as a justification for grants. Perhaps, too, economic and fiscal equalisation, and a common standard of taxation and public services has been a more achievable proposition in Australia than in other federations, due to the small number of states, the small population of the poorest states, the homogeneous economic structures and resource endowments, and cultural and political values and institutions.

The shift to full equalisation over the post World War II period, arguably, has reflected increasing emphasis on the concept of common citizenship within a single, but federal, nation. Earlier concerns about incentive effects (reflected in penalty clauses, and various standards) have been addressed by procedures to ensure policy neutrality, and to remove factors likely to support inefficiency in State decision-making (e.g. the operating outcomes of GBE's).

The complete, comprehensive and full fiscal equalisation that is now the basis for determining grant allocations in Australia also presents risks, of the political kind, as Head (1967, 477) points out,

> 'the political weakness of the equalisation system is, of course, the *possible opposition of the richer states*, which may regard the grants as an unnecessarily high insurance premium against instability or a reversal of their own fortunes. It was no doubt largely in order to minimise this danger that the Commission chose to emphasise need rather than equality as the basis of the grants'.

However, it also needs to be said that what has brought fiscal equalisation into dispute in large measure has been the substantial reduction, in real terms, in the pool of funds subject to the equalisation procedures, re-emphasising the inextricable interrelationship between vertical and

horizontal imbalance issues. Restoration of vertical equity in access to funds arguably would bring greater stability in approaches to their horizontal distribution.

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PAPER 5

FEDERALISM AND SELF-GOVERNMENT AUSTRALIAN-STYLE

Christine Fletcher

1. INTRODUCTION

According to an American scholar, the allocation of power 'is one of the oldest and most abiding problems of society' (Fesler 1949 p1). Conflict over the distribution of authority is at the centre of almost all political debates in Australia. Because of the federal element, in particular, political authority tends to be 'organised' by seemingly obscure constitutional conditions rather than by the type of clear 'allocation' or 'distribution' of power available to a central government with the strength to intervene. Moreover, disputes over authority tend to be seen in economic terms, and the adoption of the federal doctrine has meant that economic advantages go to some communities and economic disadvantages accrue to others (see The Western Australian Secessionist Act; also May, 1971).

There is, however, a powerful political dimension to the federal doctrine in Australia, as this paper will argue. For example, the democratic process is based on a set of principles designed to maintain a stable relationship between different governments and, more importantly, to foster a healthy relationship between governments and the people.

The principles of federalism developed out of the liberal democratic tradition and, at federation in 1901, the states agreed to respect those principles, in the belief that they could maintain their authority under a new commonwealth system of government. Basically, they believed that, by federating, they would protect the preferences of their respective political communities within a stable political environment secured, in part, by the establishment of a strong, but not all-powerful, national government. One of their main objectives was to construct a governmental process which would be strong enough to tolerate competition and conflict between the different communities.

The nature of the negotiating process itself is important because federalism polarises the direction of central policy decisions, creating conflict along the way. State governments have an interest in monitoring the regional policy preferences of their communities. Constitutionally, their interest is legitimated through state, territory and commonwealth parliaments, the courts, administrative power, national, state and local elections and through interjurisdictional competition for increased government resources. These elements of government, together with a wide variety of other

regional characteristics, affect the capacity of the states to access resources. Consequently, debates over how to control the shape of this governmental conglomerate are firmly focused on interpretations of 'equity', or the development of some type of economic and political equalisation criteria, which can be used by one government to exhort concessions from another. Thus, for over half a century in Australia, disputes over financial resources have been resolved through an intergovernmental 'equalisation' process.

Some argue that equalisation is the 'glue' that binds the various federal components together (see Walsh 1992). With a fair system of equalisation, state communities are less likely to feel deprived and more likely to feel satisfied and, as a consequence, the system is maintained in a stable condition: in principle at least, the culture of Australian equality is recognised. Of course, a crucial part of this stabilising process lies in the interpretation of 'equity' and this is a problem faced by governments elsewhere.

Liberal democratic systems differ in the way they interpret the principles of equity. The most obvious differences occur between unitary and federal states. Constitutionalism in unitary states such as Britain, for example, caters to central power. The distribution of political and economic equity becomes an interpersonal matter rather than an issue of fiscal sovereignty for other governments (Rhodes 1985). Whereas local and regional governments are constitutionally subservient to the central government in the unitary state, 'regional' and 'central' governments in federal systems both are authorised to share power. Ultimately, each system is steeped in a different set of political values: one only has to look at a few countries to see the extent to which national traditions vary. Variations in the interpretation of equity between the federal systems of the United States and Australia, as an example, are vastly different.

In Australia, the federal principle is interpreted according to national and sub-national preferences. Australia has a complex history of state government sentiment for fiscal and political equalisation whereas American political sentiments were galvanised into a political culture with a greater attachment to independence and autonomy by the expansion of 'moving' frontier settlements. The impact of American settlement patterns has no counterpart elsewhere (see Elazar 1982).

Political cultures vary also within systems. A typical example is Canada: demands by "distinct societies" for changes to the existing federal integration, and a redistribution of political and economic power, have led to a process of constitutional unravelling (see Purvis & Raynauld 1992). On the other side of the Atlantic, European countries are attempting a process of economic ravelling: members of the EC are searching for a set of common principles which will support their desire for economic integration, and subsequent redistribution, through loose confederal arrangements (Walsh 1992). International law supporting the collection of nation

states seeking economic integration in Europe is quite different to the integration of self-governing units in a federal system of states. Both, however, require a degree of political consensus.

A political by-product of the ambiguous nature of the commonwealth constitution, consensus between governments reflects the importance of the principles which support the Australian federal compact. Clearly, some federal systems are more decentralised than others: how governments in different systems choose to apply these principles depends, to a large extent, on the constitutional configuration of authority, the political culture and, ultimately, how political communities interpret the development of the federal concept itself (Elazar 1987, Ravenhill 1990). This has consequences for the configuration of power in intergovernmental relations.

In the process of intergovernmental relations, powers are apportioned by interpretations of the federal constitution. (Howard 1968; Saunders 1991). Intergovernmental competition for the distribution of financial and political resources between the states themselves, and between the commonwealth and the states, has become an essential part of the process of self-government in Australia. It also has become a major characteristic of the federal political culture (Holmes & Sharman 1977, Fletcher 1993). Intergovernmental consensus also has been an important factor, however.

The following section (Section 2) provides a background sketch of the intergovernmental development of these principles in Australia. Political and constitutional ambiguities date back to the colonial period in Australia and it was during this period that many of the principles which now provide the ground rules for federation began to take shape. Our governing principles were created from a mixture of British practices and American federal theory, and this influenced greatly the consolidation of state political identities, federal integration and, ultimately, state attitudes to equity. Section 2 identifies the major characteristics of the mechanics of Australia federalism which support these principles. This serves as background to other questions which are raised in Section 3, 4 and 5, such as:

- what is federalism?;
- what are its costs and benefits?; and
- why was federalism selected instead of a confederal structure?

The next part of the paper, encompassed in Sections 6 and 7, emphasises the significance of federal theory in the development of equity in Australia. Political principles have been explored in an effort to determine the political and economic sentiments which drive the distribution of resources in Australia. The colonial governments had no power over each other, and it was simply impossible for the designers of the constitution to allocate powers in a way that favoured

one level of government over another. They skirted around the allocation of all but the most obviously 'national' powers when they set out the ground rules for federation. Principles such as equity, therefore, have become an important indicator of federal integration.

The purpose of the final part of the paper, presented in Section 8 and 9, is to throw light onto the parliamentary development of Australian government. Because of our peculiar mix of federal and parliamentary government, British parliamentary principles are co-equal with federal principles in Australia and, as with other characteristics of Australia's contemporary political culture, the colonial period offers a vantage point for an appraisal of the sentiment behind contemporary state self-governing identities.

2. THE DISTRIBUTION OF RESOURCES

For the best part of a century, federation in Australia has determined the way authority is allocated and the way in which we are governed. Federation ensured a continuation of state autonomy and a desire, on the part of state governments, to institutionalise their right to define equity. But it also brought the potential threat of centralisation and regional economic erosion from the newly formed commonwealth government — through constitutional interpretation, revenue collection and the distribution of commonwealth expenditure.

State political communities in Australia stood to benefit from having another 'level' of government to choose from. But they also stood to lose if their taxes were collected and withheld by a government which did not have the power to provide their citizens with the services of their choice. On some of the evidence, integration has resulted more in economic costs than in the political benefits of representation and stable government.[1] Evidence suggests that, politically, the system has fared remarkably well. The design of federalism has seen limits imposed on the less desirable aspects of government growth and centralised power. The political and economic expansion of the more powerful centralising-type governments, for example the commonwealth, New South Wales and Victoria, has been conditioned as much by the resources of the smaller states as by the functions of the system as a whole.

For the most part, federalism has tempered the force of the commonwealth's attack on state revenues, especially for the small States, by virtue of fiscal equalisation; and state governments have managed to retain a relatively firm grip on their major policy options, albeit with some

1 Mostly, costs were measured in terms of the size of the annual per capita entitlements. In Western Australia, for example, during the first five years of federation, the per capita entitlement dropped 'from $9.82 to $4.39 for the subsequent four' years (Groenewegen 1982, pxxv111).

casualties for their citizen's preferences.[2] Nonetheless, the retention of state powers owes a considerable amount to the politically salutory nature of Australian federalism, particularly in terms of the consolidation of federal principles.

Australia's development as a nation and the evolution of a federal culture based on equity are, in important ways, responsible for the successful evolution of stable federal government. The adverse affects of fiscal federalism which arose in the first few decades of this century were ushered out when the small states (for example, Western Australia, Tasmania, Queensland and, later, South Australia) managed to trump the commonwealth's rather crude initial attempts at fiscal federalism (May 1971). The commonwealth's early revenue powers and expenditure powers, notably the Braddon clause (S87) and, later, the Surplus Revenue Act 1910, were considered by the small states as a very unsatisfactory attempt at fiscal federalism. The states spent several decades trying to shake loose the negative impact of these early commonwealth impositions. The states appeared to be burdened with an unfortunate image from the outset: Deakin, who seemed to know little about the principles of federalism, said of the states: they ' will be able to claim nothing as of right, and must be content with any amount the Federal Parliament chooses to spare them' (cited in Prest & Mathews 1980, p5).

Deakin was well off course: the commonwealth constitution provides us with the basic organisational framework for the design of what Wheare (1966) refers to as 'general' government. The constitution emphasises popular democracy (people) and state sovereignty (state governments); it gives power to the people of *the states* and it ensures a degree of security for all governments in the federation (Galligan & Uhr 1990). In this context, federalism is supported by principles which are supposed to provide governments with enough constitutional resources to quarantine some of their legislative powers from the jurisdiction of other governments (Howard 1968). But, under that same set of federal principles, governments expect also to receive what they believe is an equitable, or fair share of resources - enough for them to provide goods and services to their regional communities and to retain their powers of self-government (Walsh 1989).

Government competition for fiscal autonomy is somewhat modest in Australia when compared to the United States . Differences are largely due to the evolution of the American political culture and different senses of constitutional sobriety. Both systems embody a democratic respect for intergovernmental competition for resources but, in Australia, as Walsh (1992) has argued, the 'equitable distribution of resources' has been reinforced by 'compensatory interjurisdictional transfers' (p33).[3] Walsh refers to this as the fiscal 'glue'.

2 State governments do no have adequate revenue raising powers to provide their constituents with the range of services they require: i.e. they do not have sufficient revenue to meet their constitutional obligations as major service providers.

3 Breton (1985 & 1991) writes extensively on competitive federalism in Canada.

In one very important sense, the 'glue' (equalisation) as it presently is practiced was compensation for the loss, by the states, of their revenue raising powers initially in 1901, and then again in 1942 but, in a much deeper sense, the 'glue' embodies a respect for state differences. These differences mirror what can be called, state political cultures - a dense set of values and legislative phenomena which state governments have developed over the century in response to the regional preference of their local citizens. [4] An example of this can be found in the process through which commonwealth general purpose grants are determined by taking account of state fiscal disabilities. It is important that the commonwealth recognises state disabilities - if only so that states can maintain a response to their diverse regional communities.

The powerful tax raising authority of the commonwealth government casts shadows across the principles of federalism because it impinges on the principles of state fiscal sovereignty and state self-government. The fiscal characteristics of the federal union are primarily positioned to reflect the principles of federalism. The mechanics of the system and the capacity of the less well-off states to access the federal process contribute to the essence of these principles: they affect the way in which the states define equity. These principles also underpin the notion of political and economic adequacy by driving the allocation of commonwealth money towards, or away from, the provision of regional infrastructure and goods and services (Walsh & Thomson 1992). There are, therefore, question marks over what role central authorities should play in any future prospect of equity, self-government and sovereignty in the federal system: both political and economic (Walsh 1992).

3. THE NATURE OF FEDERALISM

Federalism has been described as a system of 'dispersed majorities' (Elazar 1987, p20). As a component of theories of the state, federalism refers to methods for organising the institutions of different governments in ways that diffuse the concentration of power. It discourages centralisation, encourages governments to compete for resources and, most importantly, it provides constituents with a variety of policy options to choose from. In federal nations, such as Australia, Canada and the United States, the distribution of power between different governments is legitimated by the constitution, subject to the approval of the citizens of the country. The legitimacy required by federal constitutionalism shackles governments to each other in ways that are quite different to the less formal constitutional constraints enjoyed by stern central governments in unitary systems.

4 Holmes and Sharman (1977) have wrestled with the concept of Australian political culture.: they analysed variations in the political response of voters, in different states, to specific policy issues.

Federalism embodies a set of powerful political principles emphasising equity, fairness and consensus but, unlike unitary systems, governments in federal systems apply these principles to themselves, as well as to their citizens. Also, by virtue of the open ended nature of these principles, their application in Australia has been quite different to those that apply in the United States. As Hamilton pointed out in the Federalist Papers (chapter X, p197), 'equity' is something which ultimately the states have an obligation to define. In other words, because 'equity' is a fundamental element of federalism, it carries similar force to the concept of 'self-determination' and unless the all states contribute to its meaning then it loses its significance.[5]

Federalism is designed to *limit* the power of governments: by dividing authority, the power of one government is limited by the powers of another. The principle is to allow regional communities to retain their cultural diversity. The colonial governments wanted to build more effective regional economies by endorsing a constitutional system of guaranteed regional diversity. They were as familiar with the need to maintain regional stability as they were with principles of parliamentary government (see Finn 1987).

Limited (federal) government, by virtue of the dispersal of power and multi-government representation, does guarantee a degree of political effectiveness and fairness - in principle. There is a powerful relationship between the principles of economic efficiency and political stability and the colonial constitutionalists probably knew this. It was the intention of the colonial governments that equity in the Australian states should be preserved through federalism and self-government, (see Bailey 1980). This process involves multi-government competition and the maintenance of equity, and history tells us that all the indicators are that constitutional consensus and political compromise is essential to this process.

4. COSTS AND BENEFITS OF FEDERATION IN AUSTRALIA

As with any political system, there are social, political and economic establishment costs associated with setting up new institutions of government. The Federalist Papers provide an indication of the struggle to shape the institutions and principles of a new nation in the United States. Interpretations of democracy were fundamental to the debates over the political theory that would ultimately dominate the American constitutional configuration of power in what one scholar terms the 'first new nation state' (von Beyme, 1987, p3).

In Australia, under different historical circumstances, federation cleared the way for those interests supporting economic change. Australian federation was part of a constitutional process

5 In a federal democracy, the search for these principle is a constant part of the governmental process (see Davis 1979).

that began to take place several decades prior to 1901. Ruled, in an absentee sense, by the British imperial parliament, the colonial governments chose to replace that interdependency by reinforcing regional self-government through the design of fiscal federalism and federal constitutionalism (Mathews 1977; Galligan & Uhr 1990).

Australia was democratically mature at the time of federation - that is - all of the colonies , including the Northern Territory, were settled more or less into same territorial mode as today (with the exception of the Australian Capital Territory). Initially, the establishment 'costs' of government in Australia were measured in both economic and constitutional, rather than political, terms (Prest & Mathews 1980; Emy & Hughes 1991).

Politically, Australian federation has been a success: this can be inferred from the advent of Australia's relatively peaceful transition to nationhood. According to May (1971), the colonial governments concentrated their focus on shoring up the scope of their parliamentary powers, warding off encroachment from the money lenders and patching together solutions which would enable them to unite without sacrificing their future. The Western Australian Secessionist Act (1933/1934), for example, argued that the Commonwealth's role in the financial collection and distribution of revenue was founded on 'a cardinal principle of Federation' (p76).

For Western Australia, the 'cardinal principle' of federalism meant preventing the commonwealth from imposing its will on the states to obtain, what the smaller states believed was more than its share of resources. Its meaning also refers to state fiscal sovereignty: federal principles are supposed to insure the power of state legislative processes against commonwealth excesses.

All of the Australian states (but not all of the territories) had carved out their independent regional identities well before 1901. They had their own established constitutions and, by most accounts, they faced the federal union with a view to improving their regional economic status (for examples, see May 1971, Reid 1974, Prest & Mathews eds). Any apprehension that there might be a decline in their authority after federation, particularly on the part of Western Australia and the other smaller states, seemed to give way to confidence on the final approach to constitutionalism in 1901. Unfortunately, after federation, small state optimism was replaced at the negotiating table by a small state panic. Small states such as Western Australia, Tasmania, and later, South Australia, faced the constant fear of fiscal inequities. Within the first three decades of federation, fiscal inequities threatened the future of federal negotiations and, ultimately, the federal union itself (WA Secessionist Acts, 1933, 1934; Equity & Diversity 1983; also Fletcher 1993).[6]

6 The most common example used to illustrate this point is the situation faced by the smaller states after federation; clearly Western Australia, Tasmania and Queensland were among the most disadvantaged states during the first few decades of federation.

The most obvious changes following federation were in the provision of public and private goods (see May 1971). It was only natural that some changes were viewed with apprehension. Then, like now, central economic reform policies within the federation led some of the states to question the logic of 'national' economic issues. Economic reform in Britain had begun a century before Australia's federation, and in one sense Australia had the advantage of the British experience (Finn 1987). When it came time for the commonwealth to establish its administrative structures, it already had the colonial experience of regional development. The states emerged from a century of stable colonial government and this helped guide the commonwealth 's future organisation of its own administrative structures (for examples, see the report by Harris 1992, which outlines the organisation of government structures such as DEET & DHH&CS).

Some characteristics of self-government in Australia today were on the agenda of the British government for over fifty years prior to federation. In 1849, for example, a Privy Council Report recommended the following institutional considerations for colonial Australia: uniform tariffs, bicameral legislatures in all of the colonies, strong colonial constitutions and federation. According to Ward (1976), the federation clauses were dropped from the agenda prior to the passage of the Australian Colonies Government Act 1850 (p293). The British were concerned that the lack of an aristocracy and the egalitarianism of the seemingly classless majority in Australia would lead to an onslaught of mass democracy if constraints were not imposed on the elected regional legislatures (see Hancock 1930, also Collins 1985).

5. WHY NOT CONFEDERATION RATHER THAN FEDERATION?

The strengths of a federal system are the weaknesses of a confederation: in a confederal system there is no way of recognising the federal dimension to the political culture. Political culture in a confederation must, by necessity, remain subterranean, or restrained by single government territorial factors. Alternatively, a federal system thrives on local diversity, competition and constitutionalism, all of which are grounded in interpretations of theories of the state; these encompass liberal democracy, the principles of equity and self-government and popular sovereignty.

Constituent members of a confederal structure require strong national-type legislative support from *within* their own state. The range of policy options available to citizens are reduced drastically under a confederal system — mainly because services options are restricted to the regional government: in a confederal system there is no real national government equivalent to federal governments in federal states.

For support to be 'national', there must be a cultural belief in the preservation of a national interest and this means of course that if a state is 'national', it cannot also be confederal. However, confederal structures can and do exist (see Walsh on the European fiscal union) but, they only exist in a loose arrangement and only so long as the member nation states allow or — in a domestic sense - so long as they have the legislative support of all the participating governments. Confederalism implies a relatively tenuous form of sovereignty between governments which see the need to maintain their independence rather than place themselves in a economically and politically vulnerable position (but note Courchene & Powell 1992). [7]

Unlike the United States, Australia did not enter into a confederal arrangement before federation. However, there was a strong federal identification between the colonies. Although separate sovereign entities, they were strung together through British imperial law and, obviously, they seemed to accept that, together, they comprised 'Australia' (Ward 1976 & Finn 1987). In the United States, the national identity provided a mutual link for the Articles of Confederation. Basically, this meant that principles of sovereignty and self-government could be selectively applied to ensure that consensus was galvanised between uniting states rather than between states which were not united. Confederal systems are not integrated systems (the Federalist Papers)

There are likely to be significant differences between the sovereign status of the various constituent governments which enter into a confederal-like arrangement. As Elazar (1987) points out, a fundamental difference is one of national self-interest on the part of the constituent governments. Within confederal systems, national self-interest and weak constitutional obligation to other governments are likely to block out the ability of the constituent governments to achieve the necessary level of supra-national (collective) identification needed for the ultimate preservation of the nation state. Another main difference, which is implicit in what Elazar has said, is that individuals and local political communities are not an integral part of the central (supra-national) decision-making process of a confederation. The primary purpose of a confederation is that the national identities of the constituent governments are retained (for example, member states in the European Community).

Governments which enter into confederal arrangements are not interested in giving up their national sovereignty; they manufacture links with each other to enable them to overcome problems relating to a specific policy issue: for example, defence. In a federal arrangement on the other hand, retaining the diverse local identities become fundamental to the way the system operates as a whole.

7 Confederation should not be dismissed out of hand. In Canada, there has been a great deal of discussion on the idea of First Nation Province arranged confederally and Courchene and Powell have published details of a workable model along confederal lines.

The possibility of an Australian confederation was proposed in the early 1880s. The idea for a federal council with a legislative base to oversee various policy issues was raised at a special intercolonial council in Sydney in 1883. A number of statutory provisos were proposed regarding the relationship between constituent colonies and the limited powers of a federal council. The council was concerned with conditions in the Pacific Islands, particularly New Guinea and the New Hebrides. [8]The council was not considered to be effective and it was abandoned in 1899 at same time as the sentiment for federation was emerging (see Gollan's account of the council).

Principles of confederation are to be found in the governments of the member states, not in the overall 'national' framework. Liberal ideas were practiced in colonial Australia during the 19th century at a level which the British themselves had not, at that time, experienced (Finn 1987). Perhaps one of the reasons for this colonial liberalisation was related to Britain's earlier experience in America when, as Ward argues, they attempted to impose a conqueror's style of unyielding sovereignty onto the American communities with disastrous results. More than likely, the style of government in Australia was in keeping with the enlightened British ideas of liberal democracy at the time, helped along by the Americanisation of democracy.

In America, particularly by the last decade or so of the 19th century, liberty had become part of the language of modern American federalism. It was used to support the organisation of trade unions and, according to Bryce, it gave 'steadiness and strength' to the system of government and enhanced the process of American constitutionalism (p343). These attributes coincided with institutional stability and, in principle, when parts of the American federal model were adapted to the Australian system, stability was implied by virtue of the decisions to constitutionally guarantee the maintenance of government authority along existing regional lines. The following section takes issue with this by explaining some of the principles which support territorial and the jurisdictional integration of state governments into the federal system and in particularly some of the characteristics of traditional federal theory which influenced the design of Australian federalism at the outset.

6. FEDERAL THEORY, EQUITY AND POLITICAL STABILITY

For many decades, descriptive accounts of the growth of commonwealth powers was used as a substitute for theoretical explanations of how Australian federalism actually worked (see Crisp 1978, Bugger & Jaensch 1985, but note Sharman 1990, also Fletcher 1991). American federalism, by contrast, is rich in theory. Also, from a growth-of-government perspective, American federalism has been appraised with reference to cooperative and coercive periods,

8 When the federal council met first in 1886, it was attended by Victoria, Tasmania, Queensland, Western Australia and Fiji.

which, incidentally, Australian scholars found relatively easy to adapt to (Mathews 1977). But, unlike Australian accounts, the historical classification of American developments has been backed up by a strong tradition of American theory. Theory was implied in the Australian constitutional debates but, according to Warden's thesis (1992), other than the indirect influence of Lord Bryce 's observations of the American system there was little if any explicit discussion of principles.

The American debates concentrated on liberty, whereas, in Australia, the equitable distribution of powers and resources emerged as fundamental to the political integration of the colonies. The distribution of equity between governments, in the political sense, has not been addressed in Australia to the same extent as inequities in the distribution of financial resources among individuals. Yet, as Wheare (1966) and others have argued, equity in the process of resource distribution between government is fundamental to political stability.

Wheare's idea is that a federal democracy is more secure if all governments agree to cooperate rather than if large governments try to coerce small governments. Part of the criteria for stable government and regional autonomy depends on the political distinctiveness of regional communities and, also, how well governments have coped with the distribution of resources and the interpretation of their governing principles (see Watts 1966).

Wheare believes that the constitutional principles of federalism insure government integrity against erosion by stabilising the process. He argues that stability in the federal system depends on how equity is interpreted and how well the larger states can adapt to 'the pace of the slowest and smallest' (1966, p142). This is particularly significant for the states in their management of resources: for example, how they can influence the commonwealth collection and re-distribution of 'national' resources (see Walsh & Thomson 1992).

Interpretations of the equity principle vary from regime to regime. At a general level, in a multi-government federal regime, the distribution of equity is built around the idea of selective choice on the part of a plurality of states all of whom have the constitutional power to define 'equity'. In the westminster model, on the other hand, equity is associated with the interpersonal distribution of resources; access to resources is designed for people, rather than for governments. In constitutional terms, equity in the westminster system is supported by a central, democratically elected authority. Politically, even with revenue raising inconsistencies, this is quite different to the dispersed authority of regional governments in Australia.

These questions were central to the American debates in the 18th century. For example, in the Federalist Papers, Hamilton argues that state governments should have coequal authority in revenue terms (p205). Coequality was considered to be a 'coordinate' power because it raised the

issue of state authority within the resource distribution process of government. Equity meant that the states had an independent, as well as a dependent, role within the federation. Particular importance was placed on the issue of state independence because, at the time Hamilton was writing, under the proposed model for American federation, the states anticipated that there would be costs involved in creating a new 'general' government which might range wide over state jurisdiction.

As a solution to the perceived inequities in a federal system, Wheare (1966) suggests that federation will provide a safeguard for the smaller states against economic erosion by the more dominant industrial states. Federation is even more likely to provide safeguards if political communities have a stable history before they federate. He says that there must be economic harmony and that this may be achieved through a balance between other components of the system; this occurs because 'the legal and political pluralism of the federation is imposed upon the alleged unity of economic affairs' (p127). There is nothing to say that harmony cannot be achieved through developing an equitable process for the purpose of coordinating a variety of regional economies. The problem lies in being able to recognise that there may be a diverse range of regional economies hidden by a national aggregate (see Harris 1992 for an interesting analysis).

Wheare provides a detailed analysis of the revenue power of, what he terms, the 'general' governments in Canada, Australian and the United States but he does not deal directly with federalism as a form of representation. Representation is implied throughout his discussion on constitutionalism and legislatures but the authoritative power of local communities to alter the organisation of all governments is not linked explicitly to a federal theory of representation.

On the other hand, Wheare addresses community diversity through what he terms 'moderating factors' (p124). Moderating factors are 'changes in the organisation of industry, agriculture, increased population, and the development of new territories' (p124). Today, these are among the most complex and disputed areas of policy: they involve taxes, tariffs and infrastructure costs. A major moderating factor is, of course, the equity principle. Equity is sometimes confused with equality; they are, however, contrasting concepts. The next section sorts through some of the characteristics which distinguish one from the other.

7. EQUALITY

Equality and equity are quite different principles. There is a dilemma in the arguments for political equality. As Dahl (1985) points out, 'equality is clearly a *necessary* condition for democracy, it may not be a necessary condition for liberty' (p9). In fact, his argument draws attention to the fact that equality might pose a threat to liberty, particularly if equality is imposed. This is true.

Equality in subsidies or fiscal transfers is designed to iron out differences rather than encourage healthy diversity. In a unitary system, equality flows from the centralising elements with, of course, the admirable intention of substituting resources to communities which have been unfairly treated as a result of political and economic circumstances. However, equality of outcomes is another matter: outcomes are not equal. People and governments can have equal access to resources, and equal treatment by governments, but they do no expect all outcomes to be the same. In this sense, equality conflicts with the federal principles which encourage government responsiveness. How can state governments respond to the demand of their regional political communities if a national government persists in pushing state responsiveness aside in favour of central decision-making policies?

Bryce confused equality with equity. In Bryce's (1888a) mind, there were really two types of 'equality' both of which had traces of equity suited, perhaps, to the interpersonal distribution of political resources (p525). Type '1' was 'legal equality' (private property rights and all the benefits of adult franchise) and type '2' was the right to education and other social and economic benefits.

Bryce did not extend rights to governments. Bryce was an Englishman: he did not have to confront the principles of federalism and equality of access to constitutional which was practiced between governments in the United State and, later, in Australia. If Bryce's work on the American Commonwealth is to be taken seriously, then it is worth mentioning his views on 'true faults of American democracy' (p325). He spent some time trying to sort through what was 'a question of ends or a question of means' and concluded that 'some ends are means to larger ends, and some means are desired not only for the sake of larger ends, but for their own sakes also' (p325).

In more recent times, Bryce probably would have been spoken of the 'ends and means' in other terms, such as why participation in the federal *process* is so significant for reaching an intergovernmental policy compromise on the meaning of equity. The next section takes this argument further by explaining the relationship between federalism processes and notions of territorial size and sovereignty which, according to some scholars (such as Montesquieu), were considered to be fundamental to the success of a democracy. This provides a useful back-drop for observing the amalgamation of Australian federalism with the British parliamentary model of democracy.

8. 'SIZE AND DEMOCRACY'[9]

The effect of community pressure on the regional/colonial governments in 19th century Australia was restricted by a range of factors: communications, the limited size of government, restricted franchise arrangements and the simple two tier system of government. The two tier system included the colonial parliament and governing boards at a local level (Finn 1987).

In the process of the emerging democracies, colonial policies covered virtually any area of government which the respective governments decided to take on, so long as the authority of the imperial parliament (British) was not breached (Finn 1987). Governments structured their policies to suit their own peculiar circumstances, such as populations, distance and environment. Blainey (1966/1980) has written extensively on this. The fact that some colonies were larger than others did not appear to bother the colonial communities. Some communities probably would have liked to covert the resources of other communities, particularly when gold was discovered but, by and large, the territorial size of the Australian colonies was generally used to describe circumstances rather than as a measure of democracy or the independence of the regional communities (see Blainey 1966/1980 but note also Clark 1973).

In the United States, on the other hand, because of arable land, wealth, increasing population movements and an early focus on the value of powerful constitutionalism, the relationship between continental size and republicanism itself became an issue for debate. Madison (1961) takes this up in the Federalist Papers (see also Dahl & Tuft 1973, p11). Madison was attracted to Montesquieu's view of constitutional design, in particular, they way in which Montesquieu stressed the importance of adopting principles to ensure that *sub*-national governments remained free from national government subversion (see Madison, p 303).

Madison (1961) was intrigued by Montesquieu's theory of republicanism. Montesquieu argued that there was a relationship between the size and the independence enjoyed by the nation state and Madison wanted to apply the theory to the American federation. However, there is one important distinction between the ideas of Madison and Montesquieu: Madison's interpretation was based on larger (the Union), rather than smaller units of government. He argued that Americans were advantaged by the size of their continent because it invited a greater diversity of interests (the states). His main concern was that the political values of the system would support the process of government which would ultimately proceed once the mechanics of the system began to work. If the principles of constitutionalism could be galvanised then so also could the political values of the regional communities. This meant that the diverse collection of political communities which comprised America could safely retain their own political values without

9 See Dahl & Tuft's (1973) account of Maddison's argument of the size of the Republic.

having to expose their political entitlements to erosion by 'a majority of the whole' (Dahl & Tuft p11).

Dahl and Tuft (1973), in their analysis of size and democracy, argue that authority in small, or unitary nation states, may be institutionally less messy and administratively easier to organise than an unwieldy, or federated, nation state. Federation brings with it less knowledge of the complexities of the nation state and therefore, the possibility that conflict is increased: for the system to survive there is a need for more institutions to cope with conflict; the need for differences to be negotiated increases; more resources have to be shared; and, finally, more emphasis is placed on organising principles of fairness and equity into the decision-making process (pp92-5).

'Size and democracy' are fundamental to the distribution of resources in Australia but not in the same manner as those in the United States. They are, however, related to the chief elements of self-government and fiscal sovereignty. The also play a part in the determinations of the fiscal equalisation process in Australia: the size of states/territories, in terms of the territorial base and population distribution are, in very simple terms, part of the criteria used by the Commonwealth Grants Commission (1992) in its assessment of state expenditure capacities. Indeed, these same elements (of size) are used also by the 'bigger' states in an effort to gain a greater share of resources on the basis of their relatively large populations. Reasons for fiscal equalisation are grounded in the federal principle of state constitutionalism and, of course, in the playing field of state politics (see Lumb 1989).

When different governments have the constitutional authority to pursue their own legislative actions, raise their own revenue and determine their policy roles, they also have sovereign rights. Sovereignty is linked to self-government through constitutional powers of the constituent governments, dependency relationships and through the ability of the governing units to raise revenue (see Walsh 1992). The design of a system in which power is formally shared with other governments involves, inevitably, setting up and maintaining a process for sharing revenue; in liberal democratic systems, governments can only collect and distribute revenue if they have the constitutional authority of the people.

Fiscal sovereignty, in Wheare's (1963) view, must be constitutionally entrenched so that any action on the part of one government to pose a risk to another government is minimised. He argues that 'Grants ... must not depend, of course, upon the good will of the contributing government. They must be obligatory contributions about which the contributing government has no discretion' (p97).

The paradox in this is: Wheare is right in guarding the states' purse against central avarice by literally binding the commonwealth to its constitutional obligations but, in so doing, a shadow is cast across the covenant. It is obvious also, from the text of Howard 1968, and in interpretations of the constitution itself, that the colonial governments appeared to have no intention of handing over their fiscal sovereignty to another government that they, themselves, designed. Sovereignty and self-government in a federal system are among the more difficult questions of governmental authority to resolve.

The power to tax and constitutional sovereignty have always been the main resource of government authority in Australia. Even during the colonial period, self-government was based on regional governments' ability to raise their own revenue. Since federation, state governments have been conscious of the need to distinguish their regional communities from each other and they have played a critical role, as both a group with a common aim and as individual self-governments, in developing their own policies of equity through the intergovernmental process of fiscal equalisation (see Walsh 1992, Mathews 1977, Fletcher 1993).

Sovereign authority among nation states is vastly different to the authority of sub-national government to collect tax: as Hawtrey (1930) argues: 'If the community of States were subject to law in the same way as a community of individuals, the rights of each State would be defined by law and would be enforceable by law but no such law exists'(p24). Tax is a domestic activity of governments: sovereignty, on the other hand, is largely the preserve of nation states, although, the issue is really more complex than this: in a parliamentary sense, people also are sovereign. Sovereignty becomes even more exceptional if the nation state is also a federal state.[10] As Howard (1968) points out, many of the judicial statements associated with taxing powers over the past century have been 'dramatically' (p73) illustrated with reference to state authority. He cites the following consideration by Dixon J, the High Court, 1947:

> 'What is important is the firm adherence to the principle that the federal power of taxation will not support a law which places a special burden upon the States... The federal system itself is the foundation of the restraint upon the use of the power to control the states' (p73).

This has been interpreted as leaving the states' authority exposed to the commonwealth's voracious nature but, clearly, federalism itself was considered a serious, if not a sufficient, limit on centralised authority. In essence, it was considered important to distinguish between tax laws

10 People can be termed 'sovereign' through parliamentary and congressional representation- this is the case in both Britain and the United States. The difference between these two systems is that, in the United States, the states also have sovereign authority through the division of authority between dozens of governments. In Britain, there is only one sovereign government much to the satisfaction of Bryce (1888b),who had little time for the 'exaggerated devotion to popular sovereignty' in the United States (p331). See also Fletcher (1992a) 'Altered States?'

that positively discriminated against state governments and laws that incidentally impeded state authority (see p73 in Howard).

Federalism may aggravate problems of equity and stability but, by the same token, it offers a stable political environment for resource competition and, ultimately, it provides institutions for propping up a process of political consensus. Federalism is not a 'style' of government which can be changed in the name of administrative reform or economic efficiency or with the absence of political conflict. Federalism embodies theories of the nation state; it is a set of established democratic principles which drive the fundamental doctrines of representative self-government into place.

Government practices and procedures are constantly changing and being reshaped by community demands and by the functions of representatives in the country's several legislatures. Multi-government activity means that policy reshaping is an ongoing process and, in a sense, this contributes to the complexities of the Australian political formula for governing. For example, federalism is sometimes explained in terms of 'centralisation' or 'decentralisation'. This view suggests that jurisdictions, or the dispersal of power, is controlled by either the commonwealth's expansion of its own authority or by the commonwealth 'decentralising' power to the states. Such a view is simplistic and misleading.

According to May (1971), 'since the citizens of the state are, in aggregate, the citizens of the nation, 'State' interests penetrate the national government's jurisdiction and 'national ' interests penetrate the States" (p27). Of course, few if any policy jurisdictions are totally exclusive. Other than constitutionally defined heads of power, no government has *exclusive* rights to claim an entire policy jurisdiction for itself; jurisdictions are determined by constituent demands.

In practice, the system is geared to anticipate that, over time, citizens might choose different governments for goods and service deliveries (see Walsh & Thomson 1992). This is not to say that there are no problems: Sharman, for one, argue that 'the modern parliamentary executive is at odds with the dispersal of power that underpins the idea of federalism' (p205). However, these are problems of liberal democracies - they are fundamentally related to representative government. Therefore, any convergence that occurs is part of an ongoing process of government.

The sections, which follow, set out the British influence on the liberalisation of colonial parliamentary government. For example, British parliamentary principles, although seemingly antagonistic towards the disaggregation of authority in Australia, appeared to contribute directly to the principles of federalism through the development of colonial laws.

9. FROM NATIONAL IMPERIAL TO LOCAL COLONIAL

Before the colonies agreed to federate, there already was a direct relationship between the applied principles of British parliamentary liberalism in Australia and an 'Australian' multiple legislative identity which, according to Finn's (1987) account of 19th century responsible government, was derived from British constitutionalism and Australian localism: the former helped in developing a national focus for determining the shape of the latter. The colonisation of British laws was expanded and enriched by the borrowed principles of American federalism and this provided a solid background for the natural evolution of a federal form of government (see Reid 1974, also Emy 1993).

The colonials used Lord Bryce's (1888a & 1888b) perceptions of the American model to guide their deliberations. Many of the principles of liberalism, self-government and sovereignty which supported the general aims of mixed governmental powers in the American federal system were carried along by political theorists, such as Bryce, Dicey and Wheare, and deposited in the seams of the Australian federal institutions (see Warden 1992). Bryce, it seems, was the most influential and clearly, much of Bryce's work on federalism was written against an historical backdrop of European experiences.

The blueprint for the Australian federal experience on the other hand, while it was based on perceptions of theory which people like Bryce brought together, was really a result of the cumulative effect of laws in both America and England (Dicey 1959).

European powers were the most dominant at the time Bryce was writing and, many of the constraints on government authority in his part of the world were shaped by emerging party systems, legislative changes, electoral systems and labour movements rather than federalism. Much of what Bryce had to say on federalism was based on his assumptions about democracy and liberalism. Both of these elements were already being hammered into the construction of colonial parliaments through the developing process of English and Australian law (see Finn 1987). The move towards federation was set to become part of a natural progression towards security and unity for the colonial regimes.

According to Ward (1976) and Finn (1987), many British 'national' laws were the forerunners of Australia's local laws. The fact that the British felt unable to control the increasing political virility of the colonies without complex adjustments to the colonial legislative process gave the colonial governments the power to change the face of British authority in Australia (see Clark 1973). Colonial local law was a result of British statutes designed for the purpose of delegating law making powers to the colonial governments so, in practice and in principle, what the British perceived as 'local' the Australian colonial governments could interpret as national; that is, they

were national in the sense that the laws expanded the range of choice available to the colonial governments, allowing them to agree on a national approach to a policy issue (Finn 1987).

Ward (1976) argues that the British saw the colonial institutions in Australia as 'theirs' and they went to great lengths to protect the governing institutions of 'their' system against political tyranny which might be created by colonial democratisation (p243). The essence of English political theory was the belief that serious problems of governing could arise if mass democracy went unrestrained in the colonies. In practice, the British were advocating liberal democracy in the colonies at the time J.S. Mill was setting forth his political theory. This was quite an achievement for a country founded on a penal settlement where power was absolute (see Ward 1976, p131). Mill was said to be 'over impressed' by the new liberal concept of self-government in the British colonies (Ward 1976).

The struggle for resource supremacy between governments in Australia was anticipated by the British parliament before the liberalisation of the franchise had taken on significance in the colonies. The evidence for this can be seen in the various pieces of Imperial legislation in which the British conceded power to colonial demands to strengthen their legislative status, first under Colonial Laws Validity Act in 1865 and again, later, under the Statute of Westminster 1931.

The whole of Australia, including areas which had not, at that time, achieved self-government (such as South Australia 1832 and the Northern Territory 1863), was declared a British dependency in 1829. The colonies attained sovereignty through the development of their legislative procedures and, other than imperial parliamentary supremacy in international affairs, the colonies had authority to establish all domestic, or municipal, laws (see Finn 1987; also, Paton 1952). The idea of the Colonial Laws Validity Act protected the positions of both Britain and the colonial governments inasmuch as it was supposed to insure that no unwanted foreign power (other than Britain) would nudge itself into the position of a law-maker in place of the British parliament.

The Colonial Laws Validity Act of 1865 was replaced by the Statute of Westminster in 1931. At the time that the Statute of Westminster was enacted, the Australian states were demanding that the British parliament secure their authority as sovereign powers within the terms of the Statute as a safeguard against the potential supremacy of the politically ambitious commonwealth parliament (Wheare 1960). As Finn (1987) and also Paton (1952) point out, the basis for the Australian law regime is English but each body of state/territory law and administrative practice is characterised by the regional differences . These regional differences are mirrored in state legislative values, political culture and the fundamental organising principles of federalism.

10. CONCLUSION

The primary effect of federation was in the transformation of a group of constitutionally separate colonial regional governments into a politically and economically affluent group of states. Their objective was to consolidate their power through their existing governing institutions as well as through those of the commonwealth. According to some of the complaints by states, such as Western Australia, they put a great deal of stress on the preservation of their own regional integrity.

Since then, democratic integrity in Australia has been expressed through the equitable distribution of resources. Federal integration is based on political principles as well as economic principles. Because federalism is community driven, and organised by intergovernmental competition, it is also economically and politically imprecise. From a democratic perspective, if not from an economic perspective, imprecision is one of the system's virtues. Unfortunately, these principles are often overlooked by economic and administrative 'reformers' in their haste to 'correct' the messy functions of federalism (for examples of economic oversimplification, see Oates 1972 and, for a view of administrative simplicity, see Wiltshire 1990).

Each Australian state has a history of regional laws and a political tradition dating back to the colonial period. Their current identities were formed during that period and, inasmuch as they represent their regional constituents, the principles which legitimate their claims to sovereignty and self-government are a consolidating element in the development of federalism in the system overall.

There is no uniform method for defining equity in a federal scheme. To do so would be to render useless the principles of state self-determination. [11] All citizens and all governments are entitled to define equity. Ideally, equity is determined by the preferences of the citizens of each state and territory, particularly equity of access to the decision-making process which leads to the distribution of resources. Governments should have the capacity to fulfil their constitutional obligation to their citizens (by meeting their political responsibilities and providing services). There is no 'national' aggregate of equity; equity is not uniform across states; nor is it controlled by central governments. Equity is supported by principles of state sovereignty. It can be constitutionalised, but only in principle. Equity, therefore, may be found in the federal process.

Typically, equity is thought of in terms of an outcome of goods and service deliveries which is matched across regions. However, in a federal system, state governments have the power to organise their own resources and this is not always consistent with traditional notions of equity which might be apparent in unitary systems.

11 See Wildavsky's (1984) views on equity and federalism.

The Australian states have been agitating against the commonwealth government, and against each other, to retain their self-governing identities and their resource generating capacity for decades. Under present arrangements, they do this through a process of bargaining with central revenue raising authorities. For economic reasons, pressure from the more populous state governments threaten to change the rules of game by redefining the federal principles, particularly equity. Federal integration changed the future distribution of authority in 1901: since then, the principle of equity continues to be refined by interpretations of fairness in the fiscal equalisation process. Fiscal equalisation is the 'glue' that supports integration. Indeed, interpretations of fairness stem, in part, from the development of the Australian political culture — it has been woven through the debates on uniformity and diversity, and it manifested itself in tariff policy, welfare, the electoral system and other peculiarly Australian institutions. Fiscal equalisation is also backed up by fairness and, blended together, these elements encourage the system to 'ravel' into very federal activities.

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