

ANALYTIC OUTCOMES

Accountability in the Australian Federation

Background Paper for the Productivity Commission Review of Horizontal
Fiscal Equalisation

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This paper looks at how accountability for the provision of government services has been embedded in the institutional arrangements of the Federation of Australia.¹ The first section discusses the concept of accountability and the elements of which it is composed. The second section briefly reviews the history of financial relations within the Federation, concentrating on the respective roles of the Commonwealth and the States and the relationships between them. The third section looks at how the issue of accountability has been dealt with in the evolution of these arrangements. The fourth section attempts to summarise what has been learned from this history that might inform the development of mechanisms for accountability in the future.

The literature across the disciplines that are potentially relevant here is vast. This paper does no more than scratch the surface of this body of material, focussing particularly on material about Australia and on work done in the last decade or so.

1. Accountability and its elements

The phrase “being held accountable” has particular connotations that it is worth briefly exploring. Implicit is the notion that one entity, the accountable entity, has duties or obligations towards some other entity. These duties or obligations usually arise because the accountable entity has accepted a particular role. For an individual, this may be a position in an organisation or institution. For a collective or corporate entity, the role may be one of providing goods and services. The duties and obligation may be specified explicitly in a contract or a statute or they may be implicit, established by custom and practice or embedded in the mores of a society about the way its members and institutions ought to operate.

A framework of accountability requires that four elements be defined:

- Who is accountable?
- To whom are they accountable?
- For what are they accountable?
- How are they held accountable?

First, the entity or entities that are to be held accountable must be identified. If the accountability is to be effective the accountable entity or entities must be well defined and the burden of the accountability be accepted by them. The simplest case would be if one well defined entity were to be accountable, but such an individual accountability could be part of a wider network of accountabilities involving a number of accountable parties with the

¹ The national government of Australia is usually referred to as the federal government or the Commonwealth. The latter term has been adopted here. The term “the Federation” is used to refer to all sovereign government collectively. The two territories are creatures of the Commonwealth, the ACT by virtue of the Constitution and the NT by virtue of being transferred to the Commonwealth by South Australia in 1911. Although they are not sovereign entities, the Territories are treated in a similar fashion to the States for many purposes, for example, the Council of Australian Governments includes the Commonwealth, the six States, the two Territories and a representative of local government, and both the States and Territories participate in the distribution of the GST revenues. In what follows, “the States” is sometimes used to mean the six sovereign States and sometimes those together with the two Territories. It should be clear from the context which is intended.

acceptance of accountability by one party being conditional on the acceptance of accountabilities by others within the network.

Second, the party or parties to whom the accountable entity is accountable must also be identified. An accountable entity may be accountable to variety of parties for different accountabilities. For example, a listed company is accountable to its shareholders under corporations law, to its customers under the consumer law and to the wider community under the implicit social licence under which it operates.

Third, the thing or things for which the accountable entity is accountable must be defined. If the accountability is to be effective, it must be possible to unambiguously assess whether the accountability has been met or not and perhaps, depending on its nature, the extent to which it has been met. To pursue the example of a listed company, imposing the accountability of being a good corporate citizen is unlikely to be effective because the concept is ill defined and, indeed, may connote different things to the different parties involved in the accountability relationship. For shareholders, corporations law imposes a specific set of duties on the listed entity, which are monitored on the shareholders behalf by Australian Securities and Investments Commission (ASIC), and the share market offers a measure of company performance. Similarly for customers, the consumer law imposes responsibilities, for example, not engaging in deceptive or misleading conduct, with the Australian Competition and Consumer Commission (ACCC) monitoring the discharge of those responsibilities

Finally, a mechanism by which the accountable entity is to be held accountable must be established. The complexity and ultimate effectiveness of the mechanism will depend importantly on the nature of the accountability. To once more pursue the listed company example, an accountability for the market capitalisation of the company is, at least for a company whose shares are widely held, capable of direct measurement through an independent process operating at arm's length from the company: the share market. Market capitalisation will, however, only be useful as guide to a broader accountability, such as ensuring the company is well managed, if the affairs of the company are sufficiently transparent. It is the role of ASIC in enforcing the corporations law and the Australian Stock Exchange (ASX) in enforcing its listing rules to ensure that this is the case. Thus the mechanism to provide accountability for even a relatively simple objective can become complex.

The notion of holding accountable implies that there may be sanctions if the accountability has not be discharged by the accountable entity. The corporations and consumer laws provide for fines and prison terms where failures of accountability are sufficiently serious. While the share market offers shareholders the opportunity to divest themselves of shares in companies that they regard as not discharging their accountabilities, although the main effect of this may be to punish other shareholders. Whether those responsible for poor performance, the board and senior executives of the company, suffer depends on the internal accountability mechanisms that the company has adopted.

For present purposes, the accountable entities are governments state and federal. Their accountability relates to the provision of the services of government broadly defined to include legal and justice systems, defence, social services and so forth. They are accountable to the communities they serve, the whole nation in the case of the Commonwealth government and the populations of their state for state governments.

A unitary state is one with a single sovereign government in which lower levels of government are created and disposed of at the discretion of the single sovereign or national government. In such a state, the omnipotence of the national government means that it is ultimately responsible for everything. Where lower levels of government are elected, the nature and scope of their responsibility to their electors is defined by the instruments under which those governments have been established by the national government.²

Australia, of course, is not a unitary state but a federation created by the coming together of the six sovereign governments of the States and the creation of a sovereign national government by the act of federation and the adoption of a constitution. Hence, Australia has seven sovereign governments. This proliferation of sovereign governments naturally leads to the question of which government is responsible for the provision of which service.

The first recourse for answering this question in a federation is its constitution. Unfortunately, in Australia in common with the US but not Canada, the powers of the national government are specified, but not all are exclusive, and the powers of the states are determining by residual, after removing those powers which have been assigned exclusively to the national government.³ Thus powers assigned to the Commonwealth, but not exclusively so, create areas where both may operate, at least in principle. As will become apparent, this has created fertile ground for the growth of confusion about which government should be accountable for which function.⁴

The basic mechanism for holding governments accountable is the ballot box, but this is a blunt instrument. It does not allow the electorate to distinguish among different aspects of the performance of a government, or likely performance of a potential government, nor is it practical to hold elections very frequently. Whether there are less blunt, but still effective, methods for holding governments accountable is a question that will be taken up in the fourth section of this paper.

2. A brief history of federal financial relations in Australia

The act of federation through the adoption of a constitution was a unique opportunity to create a justiciable relationship between the Commonwealth and the States through the establishment of the High Court with jurisdiction over constitutional matters. While the States could subsequently make agreements with the Commonwealth, such agreements, being

² In Australia, this is analogous to the relationship between the governments of the States and the local councils created by the State governments to exercise specific functions under the authority of state legislation.

³ See Fenna (2007).

⁴ As we shall see, this confusion is compounded by the ability of the Commonwealth to exert strong influence in areas over which it has no constitutional authority.

agreements between sovereign states, could not be enforced in any court. The continuing effectiveness of any such agreement thus depends entirely on the goodwill of the parties. While the Constitution provides a process for its own amendment, experience has been that securing amendment is difficult.

The formulation of the Australian Constitution and the early history of federal financial relations reflect the economic conditions of the time and expectations about how those conditions were likely to evolve over time. While economic conditions in Australia changed dramatically in the decades following federation, the changes were not in the directions that had been anticipated. Consequently, the arrangements underpinning federal financial relations took various forms as Commonwealth and State governments attempted, within the context described in the previous paragraph, to find ways of dealing with the economic developments that had not been foreseen at federation.

Economic conditions and expectations at federation

At federation, the level of economic development varied markedly across the States. This diversity was also reflected in the fiscal capacities of the States. Although customs and excise revenues were important to all States, accounting for about three quarters of total state revenues, states such as Western Australia and Queensland had a much higher dependence on them than states like New South Wales and South Australia. Sections 86, 88 and 90 of the Constitution provide that power to impose duties of customs and of excise and the control of the payment of bounties would pass to the Commonwealth, with the Commonwealth to impose a uniform system within two years of federation. It was anticipated that this would have two immediate consequences: a major contraction in state government revenues and Commonwealth revenues far in excess of its anticipated expenditures.

To deal with these two consequences, section 87 of the Constitution specifies that, for at least the ten years following federation, the Commonwealth was to devote no more than one quarter of its revenues from duties of customs and of excise to own purpose expenditure with the balance being transferred to the states. Notably, section 87 left it to the Commonwealth to decide how to disburse its revenues once the ten year period had elapsed. Leaving the matter of payments to the states to the discretion of the Commonwealth is also a feature of section 96, which empowers the Commonwealth Parliament to “grant financial assistance to any State on such terms and conditions as the Parliament thinks fit”.

This lack of specificity in the Constitution about transfers from the Commonwealth to the States was brought about by a number of factors. First, there was disagreement amongst the States about the form any more specific provisions might take. Some favoured a population based distribution while other favoured a distribution based on the source of the revenues to be distributed. Second, there was an expectation that economic conditions across the States would converge towards conditions in the wealthier States and that this economic convergence would cause a convergence of views among the States and reduce the impact of the loss of the power to levy duties. Third was the related view that economic development, including the development of revenues bases, would be concentrated at state rather than

commonwealth level, with the economic role of the Commonwealth remaining rather restricted and subservient to that of the States.⁵ In particular, the great widening in the responsibilities of government in areas like the redistribution of income that occurred in the decades following federation was not foreseen nor was it foreseen that the primary role in many of these areas would be played by the Commonwealth.

The arrangements put in place for allocating Commonwealth revenues amongst the states in the ten years following federation were rather haphazard, being referred to rather pejoratively as “housekeeping”. A mixture of factors was taken into account and the special needs of states, like Western Australia, that had been particularly hard hit by the loss of duties were recognised. This unsatisfactory situation was tolerated largely because it was seen as a necessary, but temporary, transitional arrangement.

The second and third decades of the Federation

Section 51 of the Constitution at (xxiii) gives the Commonwealth power to legislate with respect to invalid and old-age pensions. The Commonwealth choose to exercise this power in 1908 by passing legislation providing for the introduction of means-tested 'flat-rate' age and invalid pensions, coming into operation in July 1909 and December 1910 respectively. The new Commonwealth pensions superseded state age pension schemes which had been introduced in New South Wales (1900), Victoria (1900) and Queensland (1908) and an invalid pension scheme introduced in New South Wales (1908).⁶ Besides being the first occasion on which a Commonwealth initiative displaced a state one, the introduction of national pensions substantially increased the Commonwealth's own purpose expenditures. This led to Commonwealth grants to the states being reduced to the minimum allowed under section 87.

With the ending of the transitional arrangements provided by section 87 in 1910, the Commonwealth introduced the *Surplus Revenue Act 1910*, which operated for ten years and provided the states with annual grants from the Commonwealth set at 25/- per head of population. The Act also provided temporary special grants for Western Australia. Special arrangements were also made for Tasmania shortly after passage of the Act.

The year 2010 also saw the introduction of a Commonwealth land tax. This was the first move by the Commonwealth to share an important state tax base with the States. As the decade progressed, the real value of the per capita grants to the States was severely eroded by the inflation arising from the First World War. Financial pressure on the States, particularly the smaller ones, was further increased by the introduction of a Commonwealth income tax in 1915.

The early 1920s saw much discussion but little agreement about how to relieve these pressures, which were forcing the States to increase their income taxes substantially. Some

⁵ Even at the time some acknowledged that there was no objective basis for the assumption of convergence, but its political convenience overwhelmed such misgivings. See Hancock and Smith (2001), p21

⁶ ABS (1989), p. 379.

short term relief was provided by the *Financial Agreement* of 1927 by which the Commonwealth took over the States' debts and contributed to their servicing in return for the ending of per capita payments.

The third decade of the Federation saw the initiation of a form of Commonwealth transfer that would radically change the nature of the relationship between the Commonwealth and the States: variously known as conditional payments, tied grants or specific purpose payments (SPP). The *Main Roads Development Act 1923* provided funds to the States conditional on those funds being spent in line with priorities established by the Commonwealth. It might be argued that there is a role for the national government in helping to create a national road network because externalities would prevent the States, acting individually and solely with regard to the interests of their own state, from building roads that it would be in the national interest to build. Unfortunately that argument cannot be deployed here because, according to Mathews and Jay (1972), Commonwealth funding was directed to rural roads prioritised by the Country Party.

This use by the Commonwealth of its powers under section 96 of the Constitution did not go unchallenged. The High Court, however, came down very clearly on the side of the Commonwealth, seeing SPPs as inducement rather than compulsion or coercion. In this the High Court followed the example previously set by the Supreme Court in the US in dealing with the grants-in-aid made by Congress.⁷ Interestingly, jurisprudence in relation to Canada has been rather less accommodating of conditionality, with the Judicial Committee of the Privy Council finding that

If on the true view of the legislation it is found that in reality in pith and substance the legislation invades civil rights within the Province or in respect of other classes of subjects otherwise encroaches upon the provincial field, the legislation will be invalid. To hold otherwise would afford the Dominion an easy passage into the provincial domain.⁸

According to some commentators, Canadian public opinion has, however, taken a more favourable view:

English-speaking Canadians tend to view the federal spending power as the source of highly valued "national" social programs.⁹

The 1930s and 1940s: introducing equalisation and uniform taxation

With the onset of the Depression in 1929, the position of the States deteriorated substantially further to the point where it was seen as threatening the future of the Federation itself. Commonwealth offers to provide assistance to South Australia in return for transfer of part of the State's railway system to the Commonwealth, and to Western Australia in return for

⁷ See Fenna (2008), pp510-11.

⁸ *The Attorney General of Canada (Appeal No. 101 of 1936) v The Attorney General of Ontario and others (Canada)* (1937)

⁹ Telford (2003), p.23.

transfer of a northwest portion of the State to the Commonwealth only served to exacerbate anti-federal feeling amongst the States.

This period of crisis saw a subtle but significant shift in the basis of the States' claims on the Commonwealth from a requirement to address the disabilities of federation to a requirement to recognise the differing needs and capacities to meet them across the states. Giblin's arguments on behalf of Tasmania were particularly well substantiated and influential, not just for his own state but on the future of federal financial relations generally.¹⁰ In 1932, following a recommendation from the its Parliament's Joint Committee on Public Accounts, the Commonwealth decided to establish the Commonwealth Grants Commission (CGC), bringing with it a formal recognition that:

Redistribution between the States was ... a necessary and permanent feature of the Federation.¹¹

The initial task of the CGC was to provide advice on how the special grants made by the Commonwealth to those states claiming to be in particular financial difficulties should be allocated. In undertaking this task the CGC first set out to devise consistent principles for the allocation of special grants:

Its First Report said special grants should enable the claimant States 'with reasonable effort, to put their finances in about as good order as that of the other States' but they were not aimed at equalising incomes or living standards of individuals in the States.¹²

Over the following two years the CGC refined this principle so that by its third report it had become:

Special grants are justified when a State through financial stress from any cause is unable to efficiently discharge its functions as a member of the federation and should be determined by the amount of help found necessary to make it possible for that State by reasonable effort to function at a standard not appreciably below that of other States.¹³

Thus the advent of the CGC moved the emphasis in allocating special grants further away from compensation for the disabilities of federation towards fiscal need and capacity. Nevertheless, the system remained one of dealing with claims for assistance from claimant states (one or more of Queensland, Western Australia, South Australia and Tasmania) rather than of general equalisation across all the States. In the period up to 1945, the assessment

¹⁰ See Hancock and Smith (2001) p.31

¹¹ Hancock and Smith (2001), p32.

¹² Commonwealth Grants Commission (2009), p31.

¹³ Commonwealth Grants Commission (1936), p75.

process included penalties for claimancy, which implied the judgement that a claimant state should make greater than standard efforts to raise revenue.¹⁴

While initially the special grants represented a substantial proportion of Commonwealth payments to the States, averaging 15.3 per cent of annual payments in the seven years 1934-35 to 1941-42, rapid increases in the size of other general revenue and specific purpose payments reduced that share to 0.3 per cent over the last 11 years of the special grants program, which terminated in 1982-83.

The other major development during this period was the Commonwealth's assumption of the sole power to levy income taxes. At federation, most States had their own income tax systems and administration.¹⁵ Different States had different tax bases and different rates. With the onset of the First World War, the Commonwealth found it necessary to raise its own income tax. The existence of two systems in every State and the lack of harmony between state tax systems caused problems. Attempts to address these through the interwar period, including with the Commonwealth offering to vacate the field and cease making grants to the States, were not successful.

In its 1975 summary of the history of federal financial relations, the Commonwealth Treasury characterises the situation of the States at the outbreak of the Second World War as follows:

... the financial resources available to the States were, for the most part, sufficient to enable them to meet their own expenditures principally from funds which they themselves were responsible for raising. Australian Government payments to them, though they had increased over the years, were still relatively small and confined to a fairly narrow field, e.g., tiding the States over difficult periods, assisting the financially weaker States, or providing funds for purposes in which the Australian Government had a common interest with the States.¹⁶

As the Second World War proceeded, however, and began to place a substantial extra burden on the Commonwealth's revenues, it raised its income taxes, causing the income tax share of total Commonwealth revenues to rise from 16 per cent in 1938-39 to 44 per cent 1941-42. In 1942 the Commonwealth legislated to increase its own income tax and to provide reimbursement grants to the states provided that they did not levy income taxes of their own.¹⁷ Although the States retained power under the Constitution to levy income taxes of their own, the arrangements introduced by this Commonwealth legislation made it practically impossible for them to do so. While increasing the efficiency of income tax collection, this assumption of sole power to levy income tax by the Commonwealth introduced a degree of vertical fiscal imbalance (VFI) not seen since federation.

¹⁴ Commonwealth Grants Commission (2009), p.32.

¹⁵ Western Australia was the last state to introduce an income tax, doing so in 1907. See ABS (1944), p.926.

¹⁶ Australian Government Publishing Service (1975), p.155.

¹⁷ This followed extensive consultation with the States which failed to secure their agreement, *ibid* pp.155-6.

The exclusion of the States from an area of taxation through this legislation was unprecedented and “has no parallel overseas”.¹⁸ It was subject of a challenge in the High Court by South Australia, but, in an extension of its judgement in the 1926 Roads Case, the Court concluded that

The Commonwealth may properly induce a State to exercise its powers ... by offering a money grant. So also the Commonwealth may properly induce a State by the same means to abstain from exercising its powers.¹⁹

The reimbursement grants to the States were based upon their average collections from taxes on income in the years 1939-40 and 1940-41. Under the legislation any State could apply for additional financial assistance if the income tax reimbursement grant appeared to be insufficient to meet that State's revenue requirements in any year, with any such application to be assessed by the CGC.

In 1943, the Commonwealth substantially increased tax rates and established the National Welfare Fund to support a national system of social security. In 1945, following an agreement with the States, the Commonwealth began to make SPPs for housing. In the same year, the Commonwealth established the Universities Commission and the Commonwealth Office of Education, with the latter to advise the Minister on the grant of financial assistance to the States for educational purposes. SPPs for the universities began at the beginning of the 1950s, initially being paid to the States, but ultimately being paid “through the States” directly to the universities. The latter part of the 1940s saw smaller SPPs established in areas such as tuberculosis control, agricultural extension services and to meet natural disasters.

After the ending of the Second World War, the Commonwealth announced that it intended to extend indefinitely the so called uniform tax arrangements introduced in 1942. In 1948, the then Prime Minister, Ben Chifley, told the Premiers that:

How much benefit the three claimant States would derive from a restoration of the taxing powers I have never been able to ascertain. Long before the introduction of uniform income tax, when the three claimant States had complete taxing power, they were not able to finance themselves ... I strongly suspect that if the Commonwealth were to return to the three claimant States their taxing power and tell them to finance themselves, they would be in great difficulty and would not know what to do.²⁰

The 1950s and 1960s: FAGs and Section 90

Over the ten years to 1957-58, payment of reimbursement grants gradually moved from a previous-collections to an adjusted-per-capita basis, with allowance being made for the demographic structure of the States' populations. Nevertheless, dissatisfaction amongst the State with federal financial relations continued to grow, resulting in a general review in 1959.

¹⁸ Fenna (2008), p511.

¹⁹ *First Uniform Tax Case* (1942), p.417.

²⁰ Stargardt (1952), p.229. Nothing in the behaviour of the States when subsequently confronted with options of the kind Chifley envisioned has called his judgment into question.

As a result of this review, tax reimbursement grants were replaced by financial assistance grants (FAGs). The effect of this change is well summarised by Julie Smith:

It is hard to find a compelling rationale for these reforms. FAGs were much more redistributive than the post-1942 tax reimbursement grants (Head 1967; Lane 1977). However, the transition from tax reimbursement to financial assistance grants was not based on any clear principles about relativities or the distribution of the surplus. FAGs relativities now reflected an arbitrary combination of adjusted per capita allocations, Grants Commission criteria of fiscal need, and political factors that were reflected in the 1958-59 grants base. As a result, over the next decade or so there was increasing arbitrariness and ad hocery in the relativities of general revenue grants and in the division between claimant States and non-claimant States. As Prest had commented in 1959, ‘if such a differential per capita is to be used, there is a strong case for basing it on some objective formula ...’²¹

Thus this period represents a low point in application of a principles-based approach to fiscal equalisation. Over the period 1959-60 to 1964-65 special grants, the element of transfers to the States allocated by the CGC, had fallen to 2.7 per cent of total transfers to the States from an average of 15.3 percent in the period 1934-35 to 1941-42. Over the period 1965-66 to 1971-72 this share fell further to 1.9 per cent, mainly due to the 218 per cent increase in SPPs between these two periods.²²

The second event of note during this period was the High Court’s decision to invalidate State receipt duties in the *Hamersley* and *Chamberlain Industries* cases.²³ This is estimated to have deprived the States of \$88.4 million for the financial year 1970-1.²⁴ This judgement was one of many relating to the meaning to be ascribed to the term “excise duty” in Section 90 of the Constitution, which gave the Commonwealth the exclusive right to impose such duties. The problem for the States was that the interpretation of the term by the High Court became wider and wider, which had the effect of the Court finding an increasing range of State taxes to breach the section and thus be invalid.²⁵ For example, in the *Hematite* case, the invalidation of a pipeline licence fee charged by the Victorian government is estimated to have reduced state revenues by a total of \$120 million in 1983-4.²⁶

By 1970 the pressure on the States was such that a new *Financial Agreement* was negotiated, involving a transfer of State debts to the Commonwealth, a new capital grants program for housing and public works, and a hand-over of the Commonwealth payroll tax to the States as a growth tax in 1971.

²¹ Hancock and Smith (2001), p37, Head (1967), Lane (1977) and Prest (1959), p.482.

²² Commonwealth Grants Commission (2009), p.109.

²³ *The State of Western Australia v. Hamersley Iron Pty Ltd* (No. 1) (1969) and *The State of Western Australia v. Chamberlain Industries Pty Ltd* (1970).

²⁴ Wade (1974).

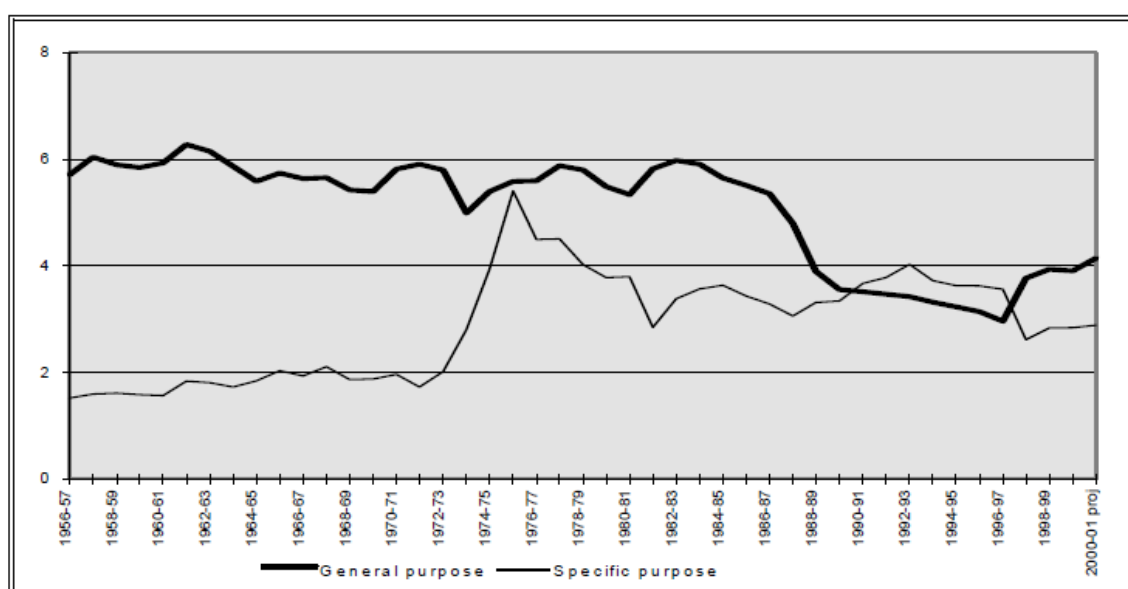
²⁵ See, for example, the analysis in Caleo (1987).

²⁶ *Hematite Pty Ltd and Another v. The State of Victoria* (1983). Estimates of revenue loss from Jolly (1983), p.4.

The 1970s: The explosion of SPPs and “New Federalism”

The major consequence of the election of the Whitlam Government in 1972 was a sharp increase in the diversity and volume of SPPs. The quantum of this can be seen in Figure 3.1 below, extracted from Hancock and Smith (2001), p.44. SPPs jump from around 2 percent of GDP in the prior period to peak at in excess of 5 percent of GDP in 1975-6. With general purpose payments largely unchanged at between 5 and 6 per cent of GDP, this meant that total grants to the States and through the States to local government rose from 7.5 percent of GDP in 1973-4 to 10.7 per cent of GDP in 1975-6.²⁷ Making payments to local government through the States reflected Whitlam’s long held view that local government had an important role to play in urban planning and infrastructure provision, but had been starved of funds by the States.

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



The Whitlam Government also introduced new legislation to govern the operations of the CGC: the *Grants Commission Act 1973*.²⁸ This incorporated the CGC equalisation principle into statute as “making it possible for the State, by reasonable effort, to function at a standard not appreciably below the standards of other States” and gave the Commission the additional role of advising on grants to local government.

Upon its election in 1975, the incoming Fraser Government delivered on its election promise of introducing a policy of “New Federalism”. Mathews and Grewal noted that:

There were important philosophical differences between the federalism policy of the new Government and that of the Whitlam Government ... Arguing that powers and

²⁷ Hancock and Smith (2001), p.46.

²⁸ Whitlam evinced a particular aversion to the term “Commonwealth” applied to the national government, but the prefix was restored to the name of the Commission by the Fraser Government.

functions must be distributed among the three levels of government so as to provide a barrier against what they called centralist authoritarian control, the Liberal and National Country Parties said that they viewed federalism as a philosophical rather than a structural concept, which would prevent undue concentration of powers and thus help to guarantee political and individual freedom.²⁹

As can be seen in Figure 3.1 above, these reforms included some winding back of SPPs as a share of GDP, but the share remained well above the level of the 1960s. Although general purpose grants remained at around the same level, changes were made in the way they were determined.

In 1976 the Commonwealth replaced FAGs and local government assistance with set shares of personal income tax. Based on an understanding between the Commonwealth and the States, the 1975-6 FAGs relativities were used to determine the States initial shares of their new revenue source, with adjustments based on population change to be made in future years. The States, except for New South Wales and Victoria remained free to apply for extra funding through the CGC. The new arrangements also stipulated that a review by an “independent body” should be conducted before the end of 1980-1.

After the initial stage of these reforms had been completed, the Commonwealth introduced a mechanism by which the States could return to the field of income taxation from which they had been excluded since the uniform tax arrangements introduced in 1942. The mechanism allowed the States to place a surcharge on top of the existing Commonwealth personal income tax but not to vary the base or progressivity of the system. It is sometimes argued that the Commonwealth could have done more to encourage the States to make use of the mechanism by reducing its own personal income tax rates to make room for the States. In the event, no state chose to make use of the mechanism and it was removed by the Hawke government in 1989.

The 1980s: Equalisation across all states and budget repair comes to dominate

The 1977 Premiers’ Conference agreed on the form of the review to be conducted by the end of 1980-1, but not about who should do it. On the substance of the review it was agreed that:

The review should be based on the principle that each State should be able to provide State Government services of a recurrent kind of the same standard as other States without imposing higher rates of taxes or charges; differences in revenue raising capacities and in the relative costs of providing comparable government services should be taken into account.³⁰

Critically, fiscal equalisation was to be applied across all the States. The requirement for a state to make a claim for equalisation grants was gone and the distinction between claimant

²⁹ Mathews and Grewal (1997), p.245.

³⁰ Australian Government Publishing Service (1977), p.17

states and non-claimant states went with it. Such an approach had long been advocated by academics like Russell Mathews who had said a few years earlier that there should be:

... a logical method of distributing Commonwealth grants among the States, based on systematic analysis instead of the arbitrary and inequitable decisions that have characterised recent Commonwealth policies in this field.³¹

and as Jim Hancock notes:

It made good sense for the Commonwealth to distance itself from ad hoc decisions about distributions between States.³²

The disagreement about who should do the review was finally resolved through a compromise whereby the review was conducted by a so called special division of the CGC consisting of the chair and two members of the Commission, an Associate member nominated by the two largest states and two Associate members nominated by the remaining states.

The augmented CGC reported in mid-1981. As can be seen from columns 2 and 3 in Table 3.2 below, extracted from Hancock and Smith (2001), p51, the principal feature of the proposed relativities was that the less populous states received substantially less than would have applied under the pre-existing relativities. The more populous states received more, but the change was not as great, in proportionate terms, as the loss for the less populous states.

Table 3.2
General Revenue Grant Allocations Under Old Relativities,
Change Under New Relativities and Change as a Proportion of State Receipts, 1981-82

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

Support for and opposition to the proposed relativities divided on the lines that would be expected. South Australia, however, reluctantly accepted the outcome, largely because it had recently been the beneficiary of a deal involving the transfer of the State's railway to the Commonwealth in which the State was described by Prime Minister Fraser as having "taken

³¹ Mathews (1974), p. 237

³² Hancock and Smith (2001), p51.

the Commonwealth to the cleaners”. Western Australia, in contrast, was vehemently opposed, with the Premier at the time, Sir Charles Court, expressing himself in the following terms:³³

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

Needless to say, at the Special Premiers’ Conference convened to receive the review, no agreement was possible and the gathering resolved to have the CGC conduct another review, with the old relativities to apply for 1981-2 and the Commonwealth to provide some top up funds to the larger States to reduce the disparity between the proposed and actual relativities for those states. Although, the second review narrowed the gap between the proposed and pre-existing relativities, agreement was still not forthcoming and temporary arrangements applied for the next two years.

The Hawke Government was elected in 1983 and the CGC produced a new set of relativities in 1985, which the Commonwealth declared its intention to accept. Since the 1985 relativities were closer to the pre-existing ones, this was much less difficult for the States to accept. This was the first time that a fully equalised set of relativities from the CGC had been accepted largely intact.

In 1985, the tax sharing arrangements for general revenue grants were replaced by a system of FAGs unrelated to tax receipts. The States were also to receive “identified health grants”, which had existed since 1981-2, as additional general revenue assistance. The arrangements were set to run for three years from 1985-6. In spite of these undertakings and to the concern of the States, the Commonwealth, as part of its strategy of budget repair, unilaterally reduced payments to the States. With the result that general purpose grants fell from 5.4 per cent of GDP to 2.6 per cent between 1986-7 and 1989-90. As can be seen in Figure 3.1, the share then fell further, but less sharply, through to 1996-7.

In the light of concerns currently being expressed, it is also interesting to note that, in its 1988 review, the CGC was asked to consider:

... whether, in its view, application of the fiscal equalisation principle has any significant consequences for the efficient allocation of resources across Australia.³⁴

With the CGC concluding that:

³³ On reactions to the review findings, see Hancock and Smith (2001), p52.

³⁴ Commonwealth Grants Commission (1988), p.32.

... while some of the efficiency effects have been stated incorrectly or exaggerated, the principle of fiscal equalisation does have some consequences for the efficient allocation of resources across Australia. But these consequences are not significant enough to warrant any changes in the manner in which the fiscal equalisation process is carried out.³⁵

In summary, a decade that began by holding out the promise of a new era of cooperation and stability in federal financial relations ended with that ideal seeming as far away as ever.

The 1990s: Another review, National Competition Policy and Section 90 again

As the new decade dawned the States were under severe budgetary stress and were disillusioned with the approach of the Commonwealth. The Labor Premier of South Australia, John Bannon, and the Liberal Premier of New South Wales, Nick Greiner, made a joint approach to the Commonwealth seeking a restoration of the States' access to income taxes. Unfortunately, the request became embroiled in the battle between Bob Hawke and Paul Keating for the leadership of the Labor Party and the prime ministership. When Keating, a strong opponent of the devolution of such powers, emerged victorious, the approach was doomed to failure. The period of sharp cuts to State revenues had, however, come to an end. Although, as can be seen in Figure 3.1, both general revenue assistance and SPPs as shares of GDP continued to show some volatility, generally speaking, falls in one were offset by rises in the other.

The CGC relativities presented to the 1992 Premiers' Conference proposed reductions in payments to New South Wales of \$63 million and to Victoria of \$50 million relative to the previous year. This caused these two States to comment negatively on both the specific relativities proposed and the system of fiscal equalisation that had produced them. Premier Greiner powerfully summarised the position of the two States:

The people of New South Wales are subsidising the rest of Australia. That cannot go on. I have spoken to my colleague the Attorney General about re-examining all the legal options that may be available, including a constitutional challenge to the Grants Commission situation. New South Wales and Victoria are cooperating in the preparation of an economic and social argument about the issue. It is fundamental that the two largest States address a situation that has been deteriorating for the best part of half a century and that is now presenting an absolutely unacceptable and unfair distribution of funding in relation to the people of New South Wales and Victoria.³⁶

Nevertheless, the Premiers' Conference endorsed the central principles of and need for fiscal equalisation. In the light of concerns about the implementation of equalisation, Heads of Treasuries were asked to examine the adequacy of the scope and methodology for fiscal equalisation, and the principles on which it was based. The Review was asked to focus on the complexity and transparency of the existing fiscal equalisation processes, its possible

³⁵ Ibid, p.147.

³⁶ Greiner (1992).

efficiency cost, and the possible implications for facilitating structural change throughout Australia.

Given the differences among the States and the obvious affiliation of review members with the different States, the Review was unlikely to offer a new way forward. Hancock summarises the outcome as follows:

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

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

The Review summarises the New South Wales/Victoria view as being that fiscal equalisation has efficiency costs in terms of mis-allocation of resources resulting from redistribution of income, transaction costs associated with the transfers, and incentive effects associated with the subsidisation of high cost producers of public services by low cost producers. They also rejected the idea that objectives of interpersonal horizontal equity could support a system of inter-governmental equalisation payments. In addition, even if the smaller States' theoretical rationale for fiscal equalisation were accepted, New South Wales and Victoria argued that the Grants Commission's processes could not be related to that theoretical rationale.³⁷

The principal substantive conclusions of the Review were that:

The Report recognises that fiscal equalisation is justified on equity grounds, which requires a political decision, and about which economic theory can provide little guidance.

and

... the potential of the fiscal equalisation process to create an incentive for a State or Territory to alter its revenue raising or expenditure decisions (grant design inefficiency) is difficult to assess and is probably minor.³⁸

The absence of any consensus among the States on the matters it covered was noted when the Review was presented to the 1994 Premiers' Conference and the Commonwealth merely undertook to consider matters further in consultation with the States.

³⁷ Hancock and Smith (2001), p.58-9.

³⁸ Heads of Treasuries (1994), p.v.

In 1992, the Commonwealth and the States commissioned what became known as the Hilmer Review. In 1995, following receipt of the Hilmer Report in 1993, all Australian governments reached agreement on a National Competition Policy (NCP) for Australia. The NCP was underpinned by three intergovernmental agreements:

- the *Competition Principles Agreement*
- the *Conduct Code Agreement*
- the *Agreement to Implement the National Competition Policy and Related Reforms*.

Under the *Agreement to Implement*, the Commonwealth agreed to provide extra financial assistance to the States “.. conditional on the States making satisfactory progress with the implementation of NCP and related reforms”.³⁹ The *Competition Principles Agreement* led to the creation of the ACCC and the National Competition Council (NCC). It also committed the States to implementing the recommendations of the Hilmer Report in a range of areas of State responsibility. The “related reforms” were a substantial agenda of reforms in areas such as water, gas, electricity and road transport and included important initiatives such as the formation of the National Electricity Market.

In commenting on these arrangements, Jonathan Pincus noted that:

The 1995 National Competition Policy introduced the concept of incentive payments to the states and territories in return for implementing agreed reforms. The payments seem to have facilitated the reform process.⁴⁰

In 1996 a new Government was elected under the leadership of Prime Minister John Howard. On coming to office, the new Government established a National Commission of Audit (NCA). The NCA recommended significant reductions in government spending. In implementing those recommendations the Commonwealth required that the States accept an effective reduction in general revenue assistance of just over 3 per cent. The NCA also questioned whether horizontal fiscal equalisation (HFE) could be achieved with less effort than was involved in the operations of the CGC, which were estimated to cost about \$6 million annually. Since the NCA did not offer any suggestions about how the effort might be reduced, the matter was not taken further.

In August 1997, the High Court brought down another of its sequence of rulings on matters falling under Section 90 of the Constitution, in this case invalidating tobacco franchise fees levied in New South Wales.⁴¹ Since this ruling would apply to all States and other products, such as petrol and liquor, the Commonwealth levied replacement taxes on tobacco, petrol and liquor with the revenue passed on to the States as Revenue Replacement Payments. This High Court judgement, in combination with those discussed earlier effectively brought about a situation where:

³⁹ National Competition Council (1997), p.33.

⁴⁰ Pincus (2008), section headed ‘The case for incentive payments’.

⁴¹ *Ha v New South Wales* (1997).

... the High Court has interpreted the concept of excise, rendering it synonymous with sales tax.⁴²

It is important to note that the assignment of these tax powers to the Commonwealth:

... is not a consequence of fiscal necessity: tax specialists agree that sales taxes suffer little from inter-jurisdictional mobility pressures and are thus well-suited to sub-national control.⁴³

2000 to 2013: Howard's ANTS and Rudd's IGA 2.0

In 2000, the Howard Government introduced a major package of tax reform, *A New Tax System* (ANTS), the major element of which was a goods and services tax (GST) to be levied at a rate of 10 percent with all the revenue to be distributed to the States based on relativities to be established by the CGC according to the principle of HFE. The package also included abolition of:

- Commonwealth wholesale sales tax
- The taxes on petrol, liquor and tobacco levied by the Commonwealth on behalf of the States
- A range of taxes levied by the States such as bed taxes and taxes on financial transactions
- FAGs payments from the Commonwealth to the States

The new arrangements were formalised in the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, which included arrangements for a transition between the pre-existing FAGs distributions to the States and the distribution of GST revenues under the new arrangements. Notwithstanding the provision in the Agreement that the GST rate not be varied without unanimous agreement between the Commonwealth and the States, since the GST was enshrined in Commonwealth legislation, it remained open to the Commonwealth to vary the parameters of the tax as it might wish.

The response of commentators was broadly to note that the new arrangements were a mixed blessing for the States:

This has represented a not inconsiderable improvement for the States in practical revenue terms, but could be said to have simultaneously made them even more dependent on the Commonwealth. As one critic has characterised the situation, the GST has enhanced their budgetary capacity while reducing their fiscal capability.⁴⁴

⁴² Fenna (2008), p.516.

⁴³ Ibid, p.515.

⁴⁴ Fenna (2008), p.516.

The introduction of the package in 2000-01 took Commonwealth taxation to a historical high of 26 per cent of GDP, an increase of 1.8 percentage points on 1999-2000. Over the same period, State and local taxes fell from 7 to 5.8 per cent of GDP.⁴⁵

In 2004, the Commonwealth asked the Productivity Commission (PC) to report on

... the impact of NCP and related reforms undertaken to date by Australian, State and Territory Governments on the Australian economy and the Australian community more broadly.⁴⁶

In summary the PC concluded that

The National Competition Policy (NCP) has been a landmark achievement in nationally coordinated economic reform. It has yielded benefits across the community, though there have been some costs and the implementation process has not been without defects.⁴⁷

The PC recommended that the progress achieved through NCP should be coordinated and built on through adoption by governments of a new National Reform Agenda (NRA).:

In sum, the Commission considers that implementation of its proposed reform agenda could play a central role in helping to enhance living standards in the face of population ageing and other major challenges ahead. Though the proposed agenda envisages further competition-related reforms, its remit is much broader — namely, to harness national coordination and cooperation to promote economic, social and environmental goals and thereby help build a more productive and sustainable Australia.⁴⁸

At its meeting in February 2006, the Council of Australian Governments (COAG) agreed that governments would “... work together to deliver a substantial new National Reform Agenda embracing human capital, competition and regulatory reform streams”.⁴⁹ In addition, COAG agreed “... in principle to establish a COAG Reform Council (CRC) to report to COAG annually on progress in implementing the National Reform Agenda.”⁵⁰ In spite of the NRA being reaffirmed by COAG at its meeting in July 2006, “...the Howard government was reluctant to go down that route.”⁵¹

In November 2007 a new government was elected under Prime Minister Kevin Rudd. Within a week of being sworn in as Prime Minister, Rudd called a meeting of state and territory leaders “to set a new framework for co-operative commonwealth–state relations” and “take

⁴⁵ ABS (2002), p.3.

⁴⁶ Productivity Commission (2005), p.iv.

⁴⁷ Ibid, p.xiii.

⁴⁸ Ibid, p.xlviii.

⁴⁹ COAG (2006).

⁵⁰ Ibid.

⁵¹ Pincus (2008).

practical steps to end the blame game”.⁵² The basis for achieving these ambitious objectives was the *Intergovernmental Agreement on Federal Financial Relations* endorsed by COAG in November 2008, which was intended to govern all policy and financial relations between the Commonwealth and the States.⁵³

Following earlier work by Fitzgerald and Garnaut and Keating *et al*, the key idea was to move to a model of cooperative federalism by the broad-banding of SPPs.⁵⁴ The Agreement broadly maintained the existing arrangements for the distribution of the GST revenues, but replaced the existing complex of SPPs with two new forms of payment: National Specific Purpose Payments (NSPPs) and National Partnership Payments (NPPs).

NSPPs were transfers from the Commonwealth to the States made in the context of a National Agreement. As the OECD noted:

This was the first time that the Commonwealth and states had documented (with a varying degree of descriptions across and within agreements) their individual and joint responsibilities for specific sectors. The overarching aim of the agreement was to improve the quality, efficiency and effectiveness of government services, among other things, through a more co-operative policy development and enhanced accountability to the public.⁵⁵

There were six National Agreements in education, skills and workforce development, healthcare, disability, affordable housing, and Indigenous reform. A National Agreement is:

An agreement defining the objectives, outcomes, outputs and performance indicators, and clarifying the roles and responsibilities, that will guide the Commonwealth, States and Territories in the delivery of services across a particular sector.⁵⁶

An NPP was made pursuant to a National Partnership Agreement, which was:

An agreement defining the objectives, outputs and performance benchmarks related to the delivery of specified projects, to facilitate reforms or to reward those jurisdictions that deliver on national reforms or achieve service delivery improvements.⁵⁷

National Agreements were intended to be the main mechanism for delivering Commonwealth funding to specific areas and to provide an ongoing mechanism for cooperation between the Commonwealth and the States in delivering service to the areas covered. National Partnership Agreements were intended to have a much narrow focus and were primarily directed at achieving short term policy objectives.

⁵² Rudd (2007).

⁵³ Commonwealth of Australia (2009), p.9.

⁵⁴ Fitzgerald and Garnaut (2002) and Keating *et al* (2007).

⁵⁵ OECD (2014), p.103.

⁵⁶ COAG (2011), p.A-1.

⁵⁷ *Ibid*.

Achieving clear and effective accountability was a key objective of the Agreement. To this end, the CRC that had been agreed in principle at the February 2006 COAG was given the role of reporting on:

- the performance of all governments against outcomes and performance benchmarks under the six National Agreements and associated National Partnerships
- whether performance benchmarks have been achieved before reward payments are made by the Commonwealth under National Partnerships
- the aggregate pace of activity progressing COAG's agreed reform agenda.⁵⁸

In 2013 the CRC summarised the progress and pace of reform under the Agreement as:

Under the IGA, substantial progress has been made towards the objectives of the COAG reform agenda. The pace of reform has been faster than would have occurred without COAG's attention. But many stakeholders consider the pace has slowed. The Commonwealth has also departed from the IGA framework in developing new reforms.⁵⁹

2013 to date: Marking time

In September 2013, Australia elected a new government under Prime Minister Tony Abbott. Unlike his predecessor with his emphasis on cooperative federalism, the new Prime Minister's saw:

... the way forward is to try to ensure that we clarify responsibilities so that each level of government, as far as possible, is sovereign in its own sphere.⁶⁰

These sentiments were reflected in the draft discussion paper produced by the Prime Minister's department:

The Commonwealth Government has committed to produce, working with the States and Territories, a White Paper on the Reform of the Federation. The White Paper will seek to clarify roles and responsibilities to ensure that, as far as possible, the States and Territories are sovereign in their own sphere.⁶¹

The Commonwealth Budget for 2014-15 contained the follow savings measure:

The Government will achieve savings of \$8.3 million over four years by ceasing the operations of the Council of Australian Governments Reform Council (CRC).⁶²

Following a change in the leadership of the Liberal Party, Malcolm Turnbull became Prime Minister on 15 September 2015. By this time, the Department of Prime Minister and Cabinet

⁵⁸ COAG Reform Council (2013), p.25.

⁵⁹ Ibid, p.28.

⁶⁰ Abbott (2013).

⁶¹ Department of Prime Minister and Cabinet (2015), p.106-7.

⁶² Commonwealth of Australia (2014), p.187.

had produced a draft discussion paper commencing the process to produce the promised White Paper, but no further progress was evident.

At the COAG meeting in April 2016, the Prime Minister raised the possibility of the States levying their own income taxes. The meeting communique records that:

COAG welcomed the Commonwealth's initiative to help resolve the longstanding problem of vertical fiscal imbalance and improve state autonomy.

There was not a consensus among states and territories (states) to support further consideration of the proposal to levy income tax on their own behalf.⁶³

In answer to a question from Senator Penny Wong at a meeting of the Finance and Public Administration References Committee a PMC officer stated that:

There will not be a green or white paper, and the work on Federation will be taken forward in the context of the work that Treasury is doing arising out of the COAG meeting in April.⁶⁴

In response to further questioning, the Senator was advised that the decision not to proceed with the papers had been taken after the COAG meeting of April 2016 by the Prime Minister.

3. Accountability in the History of the Australian Federation

There is one dominant trend that emerges clearly looking back over the history of the Australian Federation: the increasingly dominant role played by the Commonwealth. This is evident both in its influence over the policies of all levels of government and in the roles that it has come to be expected to play. We first look at the way the role of the Commonwealth has evolved to the point where its decisions will determine the future of the Federation. We then look at two examples of how the Commonwealth has employed one of its principal sources of influence over the States, the ability to impose conditions on the grants that it make to the States, and how this has affected accountabilities.

Role of the Commonwealth

Changing perceptions

In the constitutional debates leading up to federation and in the decade immediately following, the principal pre-occupation of the States was ensuring a sufficient level and fair distribution of financial support from the Commonwealth. The right of the states to a share of the Commonwealth's surplus revenue was seen as a consequence of the States, through the act of federation, creating the surplus by giving up their own rights to levy customs and excise duties. Alfred Deakin, contributing to the second session of the National Australia Convention in 1897, saw both levels of government having a common accountability

⁶³ COAG (2016), p.1.

⁶⁴ Commonwealth of Australia (2016), p.30.

We have not to protect the people of the federated states against themselves, and there is certainly no one else to protect them against in this regard. The commonwealth consists of the people; and this power of taxation can only be exercised by and with the consent of the people.⁶⁵

Although the Constitution provided some guarantees to the States in regard to sufficiency and fairness, delivery was left largely to the discretion of the Commonwealth, particularly beyond the first decade of federation. Nevertheless, from the earliest discussions between the Commonwealth and States about the level and distribution of financial support, there is a clear sense that the States regard the Commonwealth as having a duty to assist them, particularly in the transition to the new federal arrangements. At the outset at least, it also seems that the Commonwealth accepted this. As Sir William McMillan noted at the 1897 Convention, commenting on the task the Commonwealth Parliament would confront on assuming office:

... when it has come together in its true constituted federal spirit, a chance of dealing with the thing on the only lines upon which it can be dealt with – the broad lines of federal union ...⁶⁶

A notion that the Commonwealth has a duty to hold the Federation together is a thread that runs clearly through the Commonwealth's dealing with the States over subsequent decades. The position was put forcibly by Lyndhurst Giblin in making the case for assistance for Tasmania in 1930:

If these conditions are satisfied, I submit that the responsibility is on the Commonwealth to make up what is required to enable revenue to balance expenditure. It is not a question of making a contribution towards it. If the above conditions are fairly satisfied, the obligation is on the Commonwealth to make up the deficiency in full as a vital condition for the effective working of Federation.⁶⁷

Compared with the tenor of modern advocacy of states seeking assistance and, indeed, the equalisation processes of the CGC, the conditions that such a state should satisfy, formulated by Giblin, are rather severe:

- 1) It should be taxing its people with considerably greater severity than the Australian average.
- 2) It should not, be attempting social provision on a more generous scale than the average.
- 3) Its costs of administration should be below the average.
- 4) It should for some years at least have shown moderation and caution in loan expenditure.⁶⁸

⁶⁵ New South Wales (1897), p.676.

⁶⁶ Ibid, p.823.

⁶⁷ Giblin (1930), p.59.

⁶⁸ Ibid, p.58.

The Commonwealth, while broadly and for the most part accepting this role, was at pains to point out that it could not shoulder this burden alone. Ben Chifley in 1948 said:

I have said before, and I repeat now, that the three less populous States must be assisted by the larger and more affluent States and the Commonwealth, if we are to have a national outlook on the development of Australia. Previous governments, irrespective of their political beliefs, took the same view⁶⁹

In commenting on his governments newly announced intention to introduce a GST, Prime Minister Howard offered an interesting insight into his view of Commonwealth–State relations and the role of equalisation in them:

Now the Grants Commission will decide how much Queensland gets, how much New South Wales and Western Australia get. I'm not interested in arguments between States about who's....I'm an Australian and as far as I'm concerned all Australians should be treated equally no matter where they live. I'm not interested in arguments from a State Premier that he's carrying somebody else's load. I think Bob Carr is running advertisements which frankly are a waste of his taxpayers' money. He's basically saying that we're not all meant to sort of look after each other ...⁷⁰

A rise to dominance

Over the last 120 years two parallel developments have complicated the simple vision of accountable put by Deakin that the Commonwealth and each State should be accountable for its performance to its respective electorate.

The first is the emergence of the Commonwealth as a major provider of revenue to the States. In the years leading up to the introduction of uniform income in 1942, the share of transfers from the Commonwealth in state revenues was about 15 per cent. By 1958-9, the share had climbed to over 64 per cent, before settling back to its current level of around 45 percent.⁷¹ As the OECD points out:

In addition, there is no co-occupancy of tax bases by the Commonwealth and the state governments, unlike in other more decentralised federations, such as Canada and Switzerland (for example, income tax in Canada).⁷²

The second is the increasing role the Commonwealth has sought to play, mainly through the provision of SPPs, in areas outside its exclusive jurisdiction. It is estimated that, in 2015-6, state spending totalled \$237 billion of which \$48 billion or 20 per cent was funded by tied payments from the Commonwealth.⁷³ The share was even higher in education at 31 per cent, health at 26 per cent, and transport and communications at 24 per cent.

⁶⁹ Stargardt (1952), p. 229.

⁷⁰ Howard (1998).

⁷¹ OECD (2014), p.99

⁷² Ibid, p.100.

⁷³ Commonwealth of Australia (2017), p.7.

Before looking at the separate effects of these two developments on accountability within the Federation, some consideration needs to be given to a more basic question that these two developments, taken together, raises. Alan Fenna notes that:

In all three of the Anglo federations [Australia, Canada and the US], then, the idea of a division of powers with each level enjoying its own autonomous domain in addition to areas of concurrent jurisdiction gave way to a reality in which the national government continued to enjoy its exclusive jurisdiction and the States largely had to relinquish theirs.⁷⁴

Fenna goes on to note that these developments have been particularly marked in Australia:

However, the fact that conditional grants have not been used in the US or Canada for a purpose so inimical to federalism as excluding the States from their most important tax base suggests that section 96 does enhance the Commonwealth's powers in this respect.⁷⁵

The consequence of these developments has been that, through its control of revenue flows to the States and by the structuring of its own expenditures, the Commonwealth can impose its policy ideas and priorities on the States almost regardless of their wishes. For a short period in the early 1970s, the newly elected Whitlam government did almost exactly that. More recently, but even more briefly, we saw a Prime Minister hark back to the days when the two levels of government were "sovereign in their own spheres". Since many of the changes in federal relations documented here have arisen to meet the requirements of a modern industrial country, it is difficult to see how the omelette of federal relations could be unmade.⁷⁶ With the 2008 Rudd reforms, we saw a third vision: one of partnership between the Commonwealth and the States, so called cooperative federalism.

In each of these cases, the Commonwealth called the tune and it is the way that the Commonwealth chooses to wield the power that it has now accumulated within the Federation that will determine the kind of Federation we have. The question is: Is the existence of the States, as Hawke famously claimed, an accident of history that we would have been better off without or, as for example Anne Twomey and Glenn Withers argue, an opportunity to build a better Australia.⁷⁷

For most of the last 120 years, Australia has occupied a position somewhere between these two extremes, often without any clear articulation of why that position has been chosen. Although the Commonwealth has the power to call the tune, there are serious practical difficulties, of a principal-agent kind, in the Commonwealth attempting to deliver priorities

⁷⁴ Fenna (2008), p.512

⁷⁵ Ibid.

⁷⁶ It is arguable that the affairs of the States and Commonwealth have, in fact, been inextricably entwined ever since federation.

⁷⁷ The idea was first put by Hawke in his 1979 Boyer Lectures, Hawke (1979). He has since given it another outing at the Woodford Folk Festival in late 2016. The contrary position is strongly argued in Twomey and Withers (2007).

and programs of its devising through the States.⁷⁸ If, nevertheless, the Commonwealth were to seek to supplant the States completely, equalisation would become redundant because the Commonwealth would be delivering all the services provided by government, removing all discretion from the States. From a community perspective, the Commonwealth would be entirely accountable for the outcomes that resulted and State elections would cease to have a purpose. Moving to such an extreme position really only makes sense if major amendments to the Constitution are made. While such a way forward has been advocated by some, it is difficult to see practising politicians (as against those that have retired) having the political appetite for going down such a track.⁷⁹

In rejecting doing away with States, it is important to recognise that some elements in the argument for doing so are relevant. The boundaries of the States are accidents of history rather than the deliberate application of, for example, the theoretical principles espoused by Mancur Olson.⁸⁰ Nevertheless, recent developments in economic and political theorising about the operation of a federation suggest that Australia can profit from having adopted this route to national unity. Ideas relating to accountability are central to these developments and these are discussed in the next section.

Conditionality

Attaching conditions to the provision of grants by the Commonwealth can serve a number of purposes. If, for example, the Commonwealth's objective is to ensure more resources are devoted to providing a particular service, it can make the grant conditional on the State not reducing the quantum of resources that the State devotes to providing the service. Taking a step further, if the Commonwealth aims to achieve a particular policy objective in providing a particular service, for example needs based funding in education, it can make the grant conditional on the States cooperating in the achievement of this policy objective. Both these kinds of conditionality are detrimental to accountability because they create confusion about who is responsible for what. This provokes an argument like "things aren't working well because the Commonwealth isn't providing enough money" and the response that "no, it's the States' administration of the program that's at fault".

Another use for conditionality is to persuade the States to a course of action that the Commonwealth judges to be in the national interest, but where harvesting the gains requires all governments to act together. Two examples of this kind of conditionality are provided by the introduction of a uniform national income tax by the Commonwealth in 1942 and NCP introduced in 1995.

⁷⁸ See, for example, Fenna (2008), p.522 and Walsh (2008), p. 560.

⁷⁹ An example of such advocacy is Harris (2017).

⁸⁰ Olson (1969).

Uniform Income Tax

Though perhaps not always seen in this light, the introduction of a uniform national income tax is an example of this kind of conditionality.⁸¹ The separate and independent evolution of tax systems across all governments had, by the outbreak of the Second World War, given rise to a system that was complex, cumbersome and wholly inefficient.⁸² Confronted by the need to raise substantial revenues to finance the war effort and, subsequently, major social programs, it was imperative for the Commonwealth to reform this system. It did so by increasing its own income taxes substantially and offering any state that gave up its own income tax a grant in place of the revenues thus foregone. With some reluctance and after a constitutional challenge, all the States took up the Commonwealth's offer. In securing the States' agreement it was important that the States be able to use the funds provided by the grant from the Commonwealth in exactly the same way that they would have used the own income tax revenues that they would have otherwise received. Thus the grants provided to those States accepting the offer were otherwise unconditional.⁸³

The original legislation, introduced in 1942, provided that the arrangement remain in place until one year after the ending of the War. In 1946, the Commonwealth announce its intention to extend the arrangement indefinitely with an initial increase in the size of the pool of funds to be distributed among the States to \$80 million.⁸⁴ Subsequent years saw the complex evolution of arrangements outlined in Section 2, with tax reimbursement grants becoming financial assistance grants then tax sharing grants before reverting to financial assistance grants before assuming their current form of GST revenue distributions. Midway through this process in 1968 Mathews was moved to conclude:

... that the amounts and allocations of Commonwealth payments to the States have been determined by a hotchpotch of political bargains, arbitrary and inflexible formulae and ad hoc arrangements which for the most part appear to be unrelated to national policy objectives.⁸⁵

Reflection on the accountabilities that might be associated with the introduction of uniform income tax suggests that the principal accountabilities lie with the Commonwealth. In accepting the Commonwealth's offer, the States might be regarded as being accountable for ensuring that this decision was in the best interests of their communities. Given the Commonwealth's avowed intentions as expressed in 1942 and its subsequent changes to its own income tax arrangements, it seems very likely that any State not accepting the Commonwealth's offer would have been worse off. Having accepted the offer, the accountability of the States to use the income tax revenue in the best interests of their

⁸¹ This is similar to the conclusion reached by Smith (2015). For a different view, see Maddock (1982).

⁸² For a detailed analysis of how this situation came about, see Smith (2015)

⁸³ The pool of money to be distributed to the States was set at \$67 million based on the average revenues received by the States in the two years preceding the introduction of the uniform scheme.

⁸⁴ States left in financial difficulties by these arrangements could apply for supplementary assistance with such claims being assessed by the CGC.

⁸⁵ Mathews (1969), p.83.

communities was unaffected by the revenue now being received as a transfer from the Commonwealth rather than directly from taxpayers.

The Commonwealth had accountabilities to two groups: the Australian community and the States accepting the Commonwealth's offer. The first accountability is readily dealt with because there can be little doubt that the post 1942 arrangements for income taxation was preferable for the broad community to the confused and inefficient mess that preceded it. The Commonwealth's accountability to the States is less easy to deal with because, while the Commonwealth agreed to compensate the States for the loss of their income taxing power, the specific nature of the compensation was not specified beyond the early years.

In the evolutionary process to which the system for payment of compensation to the States has been subject, two particular aspects have given rise to concerns like those expressed by Mathews: the size of the pool of funds to be delivered to the States and the principles that should determine the division of that pool amongst the States.

Chart 1: General Revenue Grants as a Proportion of Commonwealth Income Tax⁸⁶

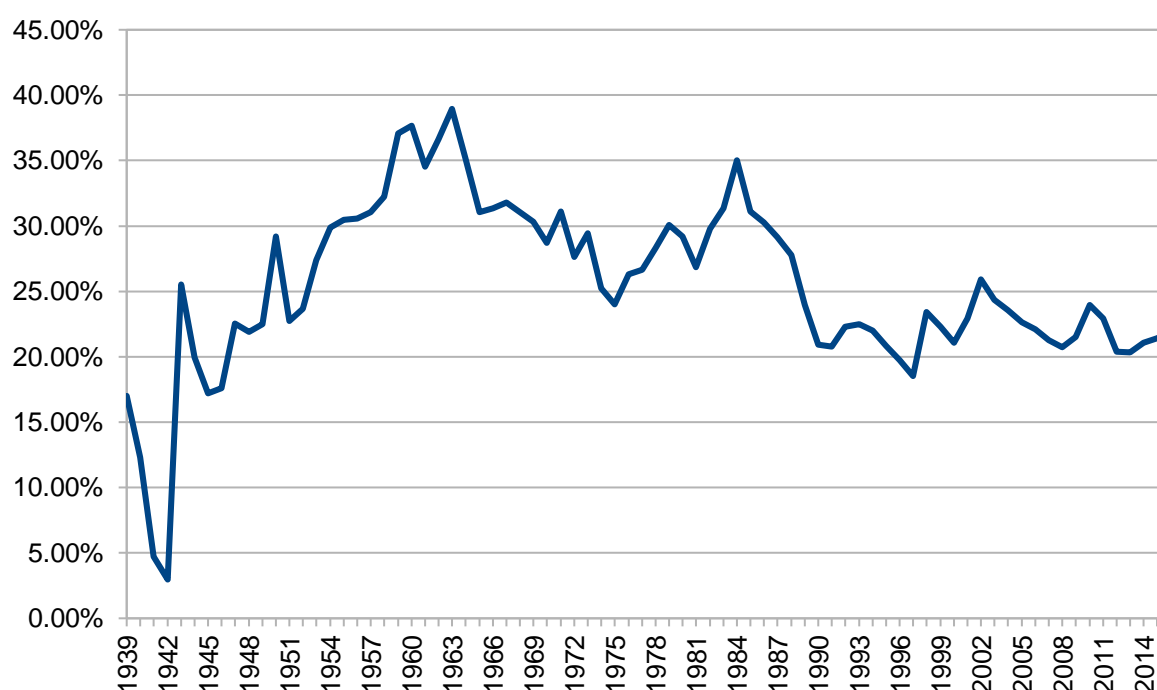


Chart 1 depicts general revenue grants as a proportion of the income tax revenues of the Commonwealth. Following the CGC, the scope of general revenue grants is based on that used in the Commonwealth budget papers. The principal component is transfers deriving directly from the introduction of uniform income tax, be they called tax reimbursement grants, financial assistance grants, tax sharing grants or GST revenue distributions. A range of lesser payments have also been included because they are frequently related to or

⁸⁶ Data on general revenue grants are sourced from Commonwealth Grants Commission (2016). Data on Commonwealth income tax are sourced from ABS (2017), and earlier issues, and from *ABS 1301.0 - Year Book Australia*, issues from 1942-43 to 1995.

determined in association with the main grant.⁸⁷ As can be seen, the proportion has varied over a considerable range since the uniform income tax became effective in 1942-43, from a low of just over 17 per cent in 1945 to a high of almost 39 per cent in 1963.⁸⁸ Since the introduction of GST sharing in 2000-01, the range of variation has been much less, from a low of 20.3 per cent in 2013 to a high of 25.9 per cent in 2002.

It is clear from this chart that the share of income taxes that the Commonwealth considered should be transferred to the States to discharge the undertakings given on the introduction of uniform income tax in 1942 and its being extended indefinitely in 1946 has varied considerably. Unfortunately, there is little objective basis to decide whether any of these various levels is more appropriate than any other. Looking at the period before the introduction of uniformity, the share of State incomes taxes in total income taxes was 76 per cent in 1938-39, but had fallen to 32 per cent in 1941-42, the year before the introduction of uniformity, as Commonwealth income tax revenues increased by over 550 per cent over this period.⁸⁹ Given the sharp increases in Commonwealth tax rates and the assumption of new responsibilities by the Commonwealth, none of these shares provides much of a guide to what might be considered reasonable as a share in subsequent decades.

Introduction of the GST and the associated arrangements for the revenues to be distributed among the States initiated a period of unprecedented clarity and simplicity in the principle that would determine the extent of general revenue assistance to the States.⁹⁰ Over the period that the GST has operated, general revenue assistance as a share of Commonwealth income tax collections has ranged between 20.3 and 25.9 per cent, averaging 22.3 per cent. While significantly less than the 32 per cent share of State income tax in total income tax immediately before the introduction of uniformity, in light of the assumption of the considerable burden of social welfare payments assumed by the Commonwealth in the years since then, it is difficult to argue that this share is manifestly unfair.

In terms of the distribution of the pool of funds among the States, the evolution of general revenue assistance is a story of a gradual, but far from smooth, shift from a compensation based system to an equalisation based one. Initial distributions were based on State income tax collections before the introduction of uniformity. In the 1950s, the basis of distribution shifted to a per capita one with allowance being made for demographic factors. The introduction of financial assistance grants in 1959 increased the complexity of the distribution process, introducing an element of fiscal need as assessed by the CGC, but with continuing

⁸⁷ For more details see Commonwealth Grants Commission (2016). A case could be made for excluding grants in lieu of royalties, but these are not large enough to affect the analysis.

⁸⁸ The chart should be treated as indicative rather than definitive. With any long run of economic data there are inevitably changes of definition at various points in the time series.

⁸⁹ Commonwealth tax revenues increased by 83 per cent in the following year and by 30 per cent in the year after that as the Commonwealth financed war expenditure and substantial expansions of the social security system.

⁹⁰ Only in the first three years of the period since the introduction of the GST, when other general revenue assistance was significant, has the GST share of general revenue assistance been less than 95 per cent and it has been consistently above 97 per cent since 2006-07.

contention among the States and between the States and the Commonwealth providing a strong political overlay to the process.

Although the Whitlam Government included an equalisation principle in its revamp of the CGC legislation in 1973, financial assistance grants continued to be based on a formula incorporating the factors identified above. As can be seen from Chart 1, the Fraser Government was more generous than its predecessor in the size of the pool, but retained a formula driven approach to distribution. It also instituted a review of the provision of general revenue assistance, reaching agreement with the States that the review be based on an equalisation principle very close to the one currently employed.

Importantly and for the first time, equalisation was to be applied across all the States rather than just to those requesting supplementary financial assistance. As recounted in Section 2, the distributional results of this review proved to be highly contentious. The CGC was required to produce two further reviews before producing a set of relativities that the Hawke Government felt able to adopt in 1985. Implementation of these relatives also involved a move away from considering tax receipts in determining the size of the pool. In fact, in the period following the adoption of the CGC relativities, the Commonwealth sharply reduced the size of the pool.

In 1989, the CGC commenced a process of providing annual updates to the distribution relativities that has continued to the present. Although the principle of HFE continued to receive support, the relativities resulting from the application of the CGC methodology for implementing the principle remained contentious. The States objecting to the various outcomes focussed on the methodology for realising HFE, rather than the principle itself.

As noted earlier, introduction of the GST stabilised the process for determining the size of the pool. It also locked in the role of the CGC in determining the distribution of the pool among the States. At this point, the Commonwealth very clearly shed any responsibility for determining the distribution. At a doorstep interview in 2006 the then Treasurer, Peter Costello, made the approach of the Commonwealth to these matters very clear, saying:

The GST is referred to an independent arbiter. It is the Commonwealth Grants Commission. It has been in existence since 1933. There is nothing new about these arguments between the States. This has been going on since 1933. The only difference is they now have more money to argue about and the terms were agreed between the States. This is a very important point. Now, New South Wales will come in here and say it needs more money. That is an argument it is having with Queensland and Western Australia. Not an argument with me. I am not going to be joining into an argument between New South Wales and Queensland and New South Wales and Western Australia and New South Wales and South Australia. Because the argument of New South Wales is that those States should get less so it can get more.⁹¹

⁹¹ Costello (2006)

This total assignment of responsibility for the distribution of GST revenues to the CGC caused serious concern in some commentators. Garnaut commented that:

They [the GST shares] were therefore to be allocated within the Commission's arcane formulae on horizontal fiscal equalisation, compounding an impediment to rational financial management, and favouring the smaller States. ... What had been a minor idiosyncrasy became a central part of the Australian fiscal system, profoundly affecting incentives for sound financial management in the Federation.⁹²

From an accountability perspective, we seem to have arrived at a situation in which no one is accepting accountability for one of the most critical aspects of federal financial relations and where there is confusion about the priority to be given to compensating the States for their loss of the power to levy income tax as against achieving HFE.⁹³

National Competition Policy

While sharing the characteristic of offering the States an incentive for adopting a particular course, NCP is sharply different from the introduction of uniform income tax in almost all other respects.

First, the propositions the States were asked to accept arose from the Hilmer Report, a review conducted by three independent persons following a process of extensive public consultation and reporting to all heads of government.⁹⁴ The terms of reference for the review were based on prior agreement with the States about the principles that should govern national competition policy and law.

Second, NCP was underpinned by a framework of agreements, each negotiated with the States between receipt of the Hilmer Report in August 1993 and formal agreement among governments in April 1995. These agreements spelled out clearly the responsibilities of the parties, including the dates by which specific results were to be achieved and the payments to be made on their achievement. Progress against agreed timelines was monitored by the NCC, newly created for these, among other, purposes.

Third, while NCP created some institutions designed to last indefinitely, like the ACCC, the program of specific reforms was time-limited, with the last National Competition Payments being made in 2007-08.

Fourth the whole exercise was subject to independent review and evaluation by the PC.⁹⁵ While generally finding that NCP had achieved most of its objectives and materially

⁹² Garnaut (2010), pp.8-9.

⁹³ The matter of the GST distribution continues to be contentious and has been the subject of a number of reviews. Most recently the review commissioned by Treasurer Wayne Swan in 2011, see The Australian Government (2012), the regular five-yearly reviews undertaken by the CGC, see for example Commonwealth Grants Commission (2015), and, of course, the current review by the PC.

⁹⁴ Australian Government Publishing Service (1993).

⁹⁵ Productivity Commission (2005).

improved productivity, this Review clearly identified areas where the achievements had fallen short of expectations and highlighted the importance of continuing reform efforts.

Establishing accountabilities was central to the NCP. Importantly, this was done through negotiations and the collective consideration of expert advice, including the Hilmer Report itself. Although the Commonwealth clearly played a leading role, with the NCP reform agenda being a natural continuation of the economic reforms already achieved by the Hawke-Keating Government following the floating of the Australian dollar in December 1983, the process of developing the agreements was designed to engage the States not dictate to them.

Conclusion

The stark differences between these two policy initiatives explain why NCP is now held up as a model for such initiatives while the repercussions of the introduction of a uniform income tax continue to bedevil federal financial relations, with the resulting contention obstructed progress on other fronts. Perhaps it is time that governments sat down and thrashed out together the purpose of general revenue assistance, including resolving the relative priorities to be attached to compensation and equalisation. One of the lessons of the success of NCP is that it is only when parties clearly understand what they are setting out to achieve and agree that the venture is worthwhile is it likely to be a success.

4. Accountability in today's Australian Federation

The first section of this paper concluded by noting that the relevant accountable entities are governments at various levels and that they are accountable for the provision of services to their communities. It also noted that the basic mechanism of accountability, the ballot box is a relatively blunt instrument. This last section of the paper is concerned with ways in which the performance of this instrument can be enhanced, for example by the provision of timely and accurate information to electorates about the performance of their governments, and supplemented, for example by facilitating some form of competition between governments in providing services.

Much of the discussion about accountability in today's Australian Federation revolves around the different forms that federalism can take and the relative importance of these to reform of the Australian Federation. We begin by briefly reviewing this discussion before looking at to the lessons learned from our review of Australia's federal history and consideration of the forms it might take in the future, with particular emphasis on the assignment of accountabilities among sovereign governments.

Various forms of federalism

The argument about the kind of federalism Australia should have can be depicted as passing through four stages.⁹⁶ The first stage is to ask how an external architect would design a federal system, applying rational principles to maximise community welfare. This is often

⁹⁶ This approach is based loosely on Part II of Walsh (2008), but differs in the details.

called functional federalism.⁹⁷ The second stage recognises that there is no external architect and that the design of the federal system must be undertaken by the parties to the federation, in Australia's case the Commonwealth and the States, and that each of these parties will have its own agenda. This might be called political economy or public choice federalism. The third stage is to argue that, in order to overcome this rivalry and secure maximum community benefit, the parties to the federation must cooperate, hence cooperative federalism. The fourth stage is to argue that the principal value of a federation is diversity among the parties of which it is composed and that an excessive focus on cooperation and achieving uniformity stifles the competition among the parties that would otherwise deliver substantial benefits to the communities that they serve. Unsurprisingly, this is referred to as competitive federalism.

Functional federalism

Functional federalism is essentially about how responsibility for the provision of services and the raising of taxes should be assigned across different levels of government. Walsh characterises it as follows:

... this economic theory of functional federalism provides a neat conceptualisation of a normatively desirable assignment of functions to different levels of government by trying to match service delivery functions against the geographic span of benefits they provide – local, regional or national – and mopping up the consequences of the inevitable lack of complete correspondence between jurisdictional boundaries and the geographic span of the benefits of services through a system of corrective, tied intergovernmental grants.⁹⁸

Because the emphasis is on the clear assignment of functions, functional federalism provides a ready framework for the assignment of accountabilities for service delivery: accountability for performance in delivering a service would be assigned to the level of government assigned the function of delivering the service. In addition, the national government could be held accountable, not only for the functions it has been assigned, but also for the function of recognising when “mopping up” is required and providing appropriate tied grants to deal with the situation. Under functional federalism a national government should only be providing tied grants when mopping up is required.

On the tax side, functional federalism adopts the principle that:

... the central government should levy taxes on readily-relocatable tax bases—like incomes; and leave the less mobile tax bases—like land—to the States.⁹⁹

In Australia, as noted earlier, the constitutional prohibition on the States levying excise duties combined with the High Court's interpretation of that provision has meant that the States have been effectively prevented from levying most kinds of sales tax. As a consequence of its

⁹⁷ The term “fiscal federalism” is sometimes used to describe essentially the same approach.

⁹⁸ Walsh (2008), p.558.

⁹⁹ Pincus (2010), p.6.

dominance in the two most lucrative forms of taxation, the Commonwealth collected 79 per cent of the tax revenue collected by all governments in 2015-16.¹⁰⁰ The States, in contrast, are reliant on grants from the Commonwealth to balance their budgets. In 2016-17, 44.8 per cent of State spending was supported by Commonwealth revenue.¹⁰¹ This imbalance between the revenue and spending requirements of the Commonwealth and the States is referred to as VFI.¹⁰² Although the imbalance is very marked in Australia, VFI is not a uniquely Australian phenomenon:

Vertical fiscal imbalance is common to most, if not all, federal systems.¹⁰³

It is often asserted that the marked VFI in Australia reduces the accountability of State governments for their expenditure decisions because such a high proportion of the revenue to support it is being raised by the Commonwealth. This proposition is, however, disputed:

The traditional argument against vertical fiscal imbalance – that the states will spend more wisely the revenue which they raise themselves – has a very weak basis in logic or data.¹⁰⁴

The so called “flypaper effect” is sometimes cited in support of the proposition that Commonwealth grants encourage State irresponsibility. The basis for this is summarised by Rosen:

A considerable amount of econometric work has been done on the determinants of local public spending ... Contrary to what one might expect, virtually all studies conclude that a dollar received by the community in the form of a grant results in *greater* public spending than a dollar increase in community income.¹⁰⁵

with this being interpreted to mean

... that there is fiscal illusion, in the sense that taxpayers demand less for grant moneys than they do for taxes imposed on them directly.¹⁰⁶

More recent work, however, has offered explanations for the observed phenomena that do not rely on fiscal illusion and has emphasised that, if a State decides to spend an extra dollar, it must increase its own source revenue by a dollar to finance it.¹⁰⁷ There is a world of difference between someone offering to pay your credit card bill, no matter how large it is,

¹⁰⁰ This proportion was calculated from the data in ABS (2017).

¹⁰¹ Commonwealth of Australia (2017), p.7.

¹⁰² Different analysts measure VFI in different ways. The essential point is that the Commonwealth raises significantly more revenue than it needs to fund its spending commitments, while the States do not raise enough revenue to cover theirs. Simply looking at the Commonwealth’s share of tax revenue can be misleading because it overlooks, for example, the proportion that is automatically returned to the States through the distribution of the GST, 16 per cent, and the proportion committed to social security (a field from which the States are almost entirely absent), 34 per cent.

¹⁰³ Commonwealth of Australia (2011), p.123.

¹⁰⁴ Pincus (2008), p.1.

¹⁰⁵ Rosen (1999), p.502.

¹⁰⁶ Hancock and Smith (2001), p.73.

¹⁰⁷ See Brennan and Pincus (1996) and (1998).

and someone offering to pay \$500 off your credit card bill. A potentially more serious concern is that the extent of VFI in Australia may compromise the policy independence of the States.

Public choice federalism

The fiscal strength of the Commonwealth's position presents a continuing temptation to use that strength to enter fields that have traditionally been considered the preserve of the States, such as education and health, through the use of SPPs. This is an example of public choice federalism at work. As noted earlier this has the potential to cause confusion about which government is accountable for what. As Pincus puts it:

These grants mean that there is shared and confused responsibility in the matters covered by the grants.¹⁰⁸

Two points need to be made here. First, there is disagreement about the costs associated with this overlap of responsibilities.¹⁰⁹ Second, the nature of the intrusion by the Commonwealth plays an important role in determining whether the community benefits or not as Pincus points out:

Federal funding of alternatives to what the States offer is likely to be socially-beneficial competition between governments (for example, federal funding of independent schools). In contrast, there are unlikely to be lasting and systematic benefits from 'cherry picking', or selective Commonwealth intervention in the ordinary operations of the States (for example, setting targets for school retention rates).¹¹⁰

Cooperative federalism

As we saw in the case of the 2008 initiatives by Prime Minister Rudd, particular concern to 'take practical steps to end the blame game' caused him 'to set a new framework for co-operative commonwealth-state relations'. In other words, cooperative federalism is largely a response to the perceived damage being done by the inappropriate use of SPPs. As noted earlier, accountability was a particular theme of the reforms introduced in 2008. Before examining that theme, it will be useful to take the last step in the four stage process which we have been navigating.

Competitive federalism

While partly welcoming the move to greater cooperation between levels of government, some commentators sounded a cautionary note by making an analogy between cooperation between governments and collusion between competing firms to form a cartel.¹¹¹ These

¹⁰⁸ Pincus (2010), p.3.

¹⁰⁹ See, for example, Appendix 1 of Twomey and Withers (2007).

¹¹⁰ Pincus (2010), footnote 5.

¹¹¹ This cautionary note is particularly strong in Pincus (2008) and (2010), including in the passage just quoted, in Walsh (2008) and in Twomey and Withers (2007).

commentators extoll the virtues of competitive federalism, which is seen as delivering two key benefits. First, it offers consumers of government services more choice. In the example quoted from Pincus, above, the intervention by the Commonwealth in the education field offers more consumers the choice between public and independent schools. Second, the spur of competition encourages innovation and the pursuit of higher standards of performance in the delivery of government services to the community. Competition between levels of government, for example the Commonwealth and the States, is seen as particularly valuable. Horizontal competition, for example between the States, particularly in the tax field, can lead to a 'race to the bottom' that is detrimental to community welfare.

Clearly, if the States are to be strong competitors, they must have the fiscal strength to enable them to compete. An important question that was alluded to earlier is whether the extent of VFI in Australia is doing material damage to the States' capacity to compete in this way.

In 2015-16, 55.2 per cent of the States' expenditure was financed from own source revenues, which are under the States' direct control.¹¹² A further 24.5 per cent came from distribution of the GST revenues, which are guaranteed and automatic, and other minor untied grants from the Commonwealth. The balance of 20.3 per cent being financed by tied grants; while these are made at the Commonwealth's discretion, there is close public attention to Commonwealth spending in areas like health and education and there would be a political cost to the Commonwealth from a sharp reduction in such grants. From the perspective of competitive federalism, the question of interest is: Do the States have sufficient budget flexibility to act independently?

While the States revenue base is not as strong as the Commonwealth's, it is by no means weak. In 1952 the Commonwealth ceased levying land taxes and in 1971 ceased levying payroll taxes, in both cases leaving the field to the States. In 2015-16, the three most important taxes for state governments were payroll tax, stamp duty on conveyances and land tax, collecting 28.7 per cent, 26.1 per cent and 9.2 per cent of total tax revenue, respectively.¹¹³ Much of the concern expressed about VFI seems to implicitly assume that the States have no choice but to adopt this pattern of revenue raising. This is manifestly not the case, as Walsh expressed it:

... I have also frequently pointed out that the ostensible degree of fiscal dependence of the states on the commonwealth is, at least to some degree, a choice the states have made. The most immediately obvious sense in which that is so is their natural preference for the commonwealth to raise the revenue and for them to do the spending out of (part of) it.¹¹⁴

The States have two efficient tax bases that they seem to have underutilised. As Walsh notes:

¹¹² The proportions quoted in this paragraph are calculated from data in Commonwealth of Australia (2017).

¹¹³ The proportions quoted in this paragraph are calculated from data in ABS (2017).

¹¹⁴ Walsh (2008a), p.56.

... land tax is one of the most efficient taxes available to governments because its base is immobile and its ownership readily identified; yet, the States choose to apply it to a narrow base. Similarly with payroll tax: it is no less efficient than an income tax and, indeed, it looks like a PAYE income tax but with employers being legally liable to pay it. Again, however, the States exempt a large part of its potential base (small, and increasingly medium size, businesses as measured by payroll size) and have been competing the tax rate downward on those businesses that are required to pay it.¹¹⁵

Further evidence that the States' tax base is adequate is their ambivalence towards levying income taxes of their own. Though on occasion requesting restoration of this power, for example in 1990 as noted above, they have been reluctant to accept it when offered, for example by Prime Minister Fraser through a mechanism that remained available until 1989 and again at the COAG meeting in April 2016.

Conclusion

It has been convenient to present these four aspects of federalism, functional, public choice, cooperative and competitive, as a series of stages, but that should not be taken to imply that this is an evolutionary process in which later stages are in some sense superior to earlier ones.¹¹⁶ In particular, there is no need to make a choice between cooperative and competitive federalism, as the former Executive Councillor of the CRC, Mary Ann O'Loughlin, remarked during an interview for *The Mandarin*:

I don't think the terms are mutually exclusive. I think we've always had bits of both, to be honest. Even in these most recent years, you can see performance reporting when you compare the performance of the states to each other as a bit of competitive federalism.¹¹⁷

All the considerations flowing from the four stages that have been discussed are relevant in understanding the current state of Australian federalism. It is important to note that:

- Not all functions should be centralised and neither should they all be decentralised
- Governments are concerned to retain office and will generally avoid making decisions that reduce their chances of doing so
- Well-designed cooperation between levels of government can deliver benefits to the communities they serve not available through unilateral action
- Competition between governments in the provision of services can increase the choices available to the community and act as a spur to improved performance.

¹¹⁵ Walsh (2008), p.570. Similar points are made in Pincus (2008) and (2010).

¹¹⁶ Some commentators are more inclined to an evolutionary view than others. Walsh (2008) tends to take an evolutionary view; see, for example, the discussion at p.561. Fenna (2008) is, in contrast, sceptical of the more ambitious claims of the proponents of one kind of federalism over another; see, for example, the discussion at p.525.

¹¹⁷ O'Loughlin (2014).

Lessons learned

This stocktake of the current state of the Federation enables us to focus on the mechanics of accountability and, through an understanding of these, to offer some guidance for developing future accountability arrangements.

Mechanics of accountability

Obviously, but fundamentally, we are dealing with establishing accountabilities in the relationships between sovereign governments. Moreover, the Constitution, which is the only mechanism through which accountability can be forced on governments, has proved wholly inadequate to the task of providing a framework of governance for Australia's governments in the 21st century. This has three implications. First, the required framework must be created by the governments themselves through arrangements between them that establish accountabilities.¹¹⁸ A foundational element in such arrangements has been provided through the establishment of the COAG. Secondly, if the accountabilities established by such arrangements are to be more than the blunt instrument of the ballot box, each of these accountabilities must be accepted by the government being held accountable. Thirdly, if the arrangement is to last long enough to achieve its objectives and be resilient through events like changes of government in one or more of the parties, there must be a deeper commitment to the arrangement than the convenience of a particular party in a particular set of circumstances.

The fundamental insight of public choice federalism can be helpful in dealing with these challenges. This recognises that governments are driven primarily by the desire to remain in power. In a democracy, that means being seen as likely to do a better job of looking after the welfare of the community than any alternative government. This means that a government is more likely to become a party to an arrangement and accept the accountabilities it implies if it believes that the community that it serves considers that the proposed arrangement will make that community better off. The continuance of that belief will encourage continued adherence to the arrangement and an incoming government is more likely to continue support of an arrangement if it shares such a belief with its predecessor. Support is also more likely from a government that feels it fully understands the implications of a proposed arrangement for itself and the community it serves and if it can credibly claim political credit for the benefits that flow from the arrangement.

Whether by design or not, the process of development of NCP had characteristics that reflected these insights. It was developed in a highly collegiate fashion and went to some lengths to ensure that the benefits that derived from it were distributed widely and fairly. The collegiate development ensured that governments could take ownership and be confident that they would benefit from participation. The wide and fair distribution of benefits justified the belief of the participant governments that NCP would be good for them.

¹¹⁸ "Arrangements" could include mechanisms to facilitate regular discussion between governments, understandings reached in such discussion which may be recorded in communiques or formal written agreements, and the establishment of institutions.

The nature of the accountabilities assigned will affect both the willingness to accept them and the effectiveness of the arrangement in achieving its objectives. Functional federalism suggests that an accountability should be appropriate to the level of government that carries it, not assigning control of inflation to a sub-national government, and clearly defined. As O’Loughlin commented three years into the *Intergovernmental Agreement on Federal Financial Relations*:

Progress should also be assessed against clear milestones and outcomes and ambitious benchmarks. The aim is to encourage – even pressure – governments to take action in response to performance feedback.¹¹⁹

Accountabilities also need to be designed with an eye to public choice federalism. The government being asked to accept an accountability must see it as in its interest to do so. This means, not only that accepting the accountability would benefit the community served by the government, but that the government be likely to receive political credit from that community for its role in delivering the benefit. The quantum of credit needs to be sufficient to offset any political risk the government may see in accepting the accountability. As noted above, the context in which the government is asked to accept the accountability will also affect its assessment of whether it should accept the accountability.

If they are to be effective in delivering benefits, arrangements must also strike an appropriate balance between cooperative and competitive federalism. The importance of the two sides of this coin was emphasised by O’Loughlin:

It’s absolutely a collaboration around the overall objective, but how they go about it in taking account of their individual circumstances, and individual populations, demographics and economic conditions, is something that is important, that we also allow space for, and then you can get a lot of healthy differences. People can learn from those differences, too.¹²⁰

In achieving this balance, it is particularly important that the Commonwealth not abuse its fiscal strength to dictate the conduct of policy to the States. In an earlier quote, Pincus identified “selective Commonwealth intervention in the ordinary operations of the States” as unlikely to deliver “lasting and systematic benefits”. In the quest for accountability that pressures the States, as O’Loughlin suggests, the temptation to selectively intervene can be very strong. Giving in to this temptation is likely to be counterproductive. A State that considers the Commonwealth to have overstepped the mark may either walk away from the arrangement containing the selective intervention or, possibly more likely and more damagingly, seek to create the appearance of meeting the accountability in the letter while rejecting the spirit of the offending aspect of the arrangement.

¹¹⁹ O’Loughlin (2013), p.380.

¹²⁰ O’Loughlin (2014).

The National Partnership Agreements introduced in the *Intergovernmental Agreement on Federal Financial Relations* seem to have become a vehicle for selective intervention, as the National Commission of Audit noted:

The new arrangements did not deliver expected results. While there was an initial decrease in the number of funding agreements with States, the number grew again as Commonwealth ministers sought to prescribe particular policy directions or categorise policies and projects as being of significant national importance.

As noted by the Productivity Commission, by the end of 2010 the Intergovernmental Agreement and associated Council of Australian Governments architecture had created a catalogue of over 300 documents, including six National Agreements, 51 National Partnership Agreements and 230 Implementation Plans.

This proliferation of agreements increased administrative costs through the burden of negotiating and managing agreements, including the reporting required from the States to qualify for payments.¹²¹

Ways of trying to avoid the imposition of such accountabilities include ensuring that the framework of accountabilities is developed and agreed collegiately, and restricting grants by the Commonwealth to cases where they are economically justified. Such justifications could include cases where benefits are expected to accrue disproportionately to the Commonwealth or a State suffers disproportionately as a result of accepting an arrangement.¹²² Where the Commonwealth makes a contribution to funding a function in order to gain political approval from its constituency, it is reasonable to expect the States to accept that this should give the Commonwealth a seat at the table in setting policy in the area.¹²³ It is not, however, reasonable for the Commonwealth to expect to dictate policy in these circumstances.

As we have noted, the ultimate accountability of governments is to the communities they serve. Those communities are, however, likely to be in some difficulty in assessing the performance of governments if left to their own devices. This creates a role for a trusted intermediary to assist communities in assessing how well their governments have performed. As O'Loughlin put it in commenting on the role played by the CRC:

We would say that the really important characteristics of our role were that we were both independent and publicly accountable. Now, it doesn't have to be obviously done by us, but we would hope that in some form those arrangements would continue ...¹²⁴

In the role described here, the CRC itself has accountabilities in two directions, to governments and the communities served by those governments, to report clearly and

¹²¹ Commonwealth of Australia (2014a), pp.25-6.

¹²² This latter kind of assistance should desirably be limited to short term adjustment assistance.

¹²³ The reality today is that, regardless of what the Constitution may say, the expectation of the Australian community is that the Commonwealth will be heavily involved in areas like education and health. Therefore, the Commonwealth may suffer political detriment if it is not seen to involve itself in these areas.

¹²⁴ O'Loughlin, (2014).

accurately on the performance of those governments against the accountabilities that they have established. Although, as O'Loughlin implies, there are others who could do the job, the CRC was a creature of the COAG rather than an agency of any of its constituent governments. Thus, it fits rather naturally into arrangements that are aiming to be collegiate and create an environment of mutual accountability. This is not to deny others a role. The PC has clearly made a major contribution in identifying opportunities for worthwhile initiatives and in measuring the performance of initiatives undertaken, including through facilitating fruitful discussion about the best ways to undertake this task.¹²⁵

Although the primary function of an entity like the CRC is to play the role of trusted intermediary, it can, as the CRC indeed did, fulfil a number of other functions. It can, for example, usefully comment on why some accountabilities were discharged while other were not, identifying those factors that seem to yield unexpectedly good performance and those that seem to have the opposite effect. In playing such a role, it may be helpful for the CRC-type body to have access to information about the execution of accountabilities that goes beyond whether or not the accountability was discharged. Care must be taken in gathering this information to ensure that intermediate targets that may be useful in analysing performance are not confused with accountabilities and that providing this additional information does not become burdensome for the accountable entity in the way that the National Commission of Audit claimed had occurred with National Partnership Agreements.

Principles for the formulation of arrangements between governments

Specific accountabilities will depend on the objectives being sought through a particular arrangement or set of arrangements between governments. It is possible, however, to identify some principles that the design and formulation of such arrangements might usefully follow to increase adherence to the agreements upon which the arrangements are based, ensure the resilience of the arrangements, and maximise the benefits that governments and, more importantly, their communities gain from the arrangements. Such principles might include requiring all government parties to:¹²⁶

- Accept that COAG is the appropriate body through which to develop, implement, and oversight such arrangements and that all activities within these spheres should take place under its authority¹²⁷

¹²⁵ Reference has already been made to the PC's role in assessing the consequences of NCP, Productivity Commission (2005). On the technical side, it has taken a lead role in facilitating discussion on topics such as benchmarking the performance of the public sector, for example, Productivity Commission and Forum of Federations (2012).

¹²⁶ These are high level principles. There is a wealth of material on issues arising in particular areas of service provision. Among the more important of these are reports by the CRC and the PC.

¹²⁷ There may be occasions of national emergency when the Commonwealth needs to act alone. The introduction of uniform income tax in 1942 might have been such an occasion. Its indefinite extension in 1946 is difficult to portray as such. The transactional approach taken in 1946, which was also characteristic of all subsequent attempts to settle federal financial arrangements at least until 2000, encouraged the identification of winners and losers rather than fostering a sense of shared national purpose.

- Acknowledge that the overarching objective is the improvement of the welfare of the Australian community¹²⁸
- Be based upon the joint acceptance by all potential parties that there are some issues that an arrangement between them could potential address
- Seek advice from an independent expert body, developed through a process of public consultation, on ways of responding to the issues that have been identified
 - Where appropriate this might include subjecting proposed initiatives to an independent assessment (for example, by the PC) to see whether they are capable of delivering the benefits sought
 - Include provisions for the assessment of whether the community is actually better off as a result of the measures contained in the arrangement coming into effect
 - Design accountabilities that are appropriate to the level of government being asked to accept them, with the outcome that the accountability relates to being within the reasonable control of the relevant government
- Include measures in the arrangement to ensure that benefits are distributed fairly across jurisdictions, recognising, for example, that:
 - given the structure of the Australian tax system, revenue benefits will often accrue disproportionately to the Commonwealth
 - some sections of the community may be adversely impacted by the proposed arrangement
- Be wary of unduly constraining participant governments in the ways they may choose to discharge accountabilities that they have accepted
- While recognising the role of cooperation where it may be in the national interest for more than one level of government to be involved in the provision of a service, also recognise the potential value in a variety of initiatives being undertaken by different levels of government in a given policy area
- Ensure that SPPs are used in ways that improve community welfare rather than to give the Commonwealth a disproportionate role in matters that are properly the province of the States
- Establish and maintain an independent body, funded by and reporting to the COAG, to monitor and report on the discharge of accountabilities accepted under arrangements established by COAG, such a body to
 - consult closely with governments and stake holders in formulating its conclusions

¹²⁸ The welfare of the Australian community needs to be interpreted broadly to include measures that improve the efficiency with which resources are utilised and the closer matching of the use of resources to community priorities. Thus an initiative such as the National Disability Insurance Scheme might both improve the efficiency with which resources are deployed to care for the disabled and increase the quantity of resources devoted to this task on social justice grounds.

- make its findings and relevant deliberations publicly available
- provide advice to COAG on how performance under COAG arrangements can be improved

Concluding remarks

In 2010 the CRC made the following comments on progress in implementing the *Intergovernmental Agreement on Federal Financial Relations* and the challenges that lay ahead:

Many of the key features of the new framework will require cultural change in the way all governments approach intergovernmental relations, policy development and service delivery—both across and within governments.

....

To realise the promise of policy and service delivery innovation to improve the wellbeing of Australians will require the Commonwealth to trust in and allow the States and Territories the freedom to deliver on outcomes.

...

Respect for roles is the basis of clarity of roles and responsibilities.

...

Accountability can help drive reforms to improve wellbeing if it is done honestly and credibly. ... a core principle of accountability that is enshrined in the *Intergovernmental Agreement on Federal Financial Relations* is transparency ...¹²⁹

The elements identified here as vital to the success of arrangements to govern the relationship between governments are not things that can be guaranteed by any agreement. In this section of the paper we have tried to identify features in an arrangement that would encourage and support the emergence of the elements that the CRC identifies, but no agreement can supply leadership and commitment.

This paper has tried to recognise the realities of relationships between governments by adopting the insights offered by public choice federalism. Chief among these is that a major motivation of governments is to be seen by their electorates as more attractive than any alternative. In this paper, it has been implicitly assumed that the main way governments will pursue this objective is by seeking to make themselves look better than the alternative. There is, of course, another strategy: to seek to make alternative governments look worse than themselves. That other strategy seems to have become more popular in Australia over the last decade. Its widespread adoption can lead to the denial of accountability for anything by all parties with predictably bad outcomes for the Australian community.

¹²⁹ COAG Reform Council (2010), pp.14-5.

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Acronyms

ACCC	Australian Competition and Consumer Commission
ANTS	A New Tax System
ASIC	Australian Securities and Investments Commission
ASX	Australian Stock Exchange
CGC	Commonwealth Grants Commission
COAG	Council of Australian Governments
CRC	COAG Reform Council
FAG	financial assistance grant
GST	goods and services tax
HFE	horizontal fiscal equalisation
NCA	National Commission of Audit
NCC	National Competition Council
NPP	National Partnership Payment
NSPP	National Specific Purpose Payment
NCP	National Competition Policy
PC	Productivity Commission
SPP	specific purpose payments
VFI	vertical fiscal imbalance