BENCHMARKING

AUSTRALIA'S INTERGOVERNMENTAL FISCAL ARRANGEMENTS

FINAL REPORT

Subsidiarity Transparency Taxassignment Economic efficiency Fiscal need Equity Neutrality Predictability and flexibility Simplicity and transparency Autonomy Incentive Accountability

Neil Warren

New South Wales Government

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The report is available on NSW Treasury's website at http://www.treasury.nsw.gov.au

Letter of Communication

The Hon Michael Costa MLC
Treasurer of New South Wales
Parliament House
Macquarie Street
Sydney 2000

Dear Treasurer

I am pleased to present to you the report *Benchmarking Australia's Intergovernmental Fiscal Arrangements*.

Internationally, there has been growing interest in the decentralisation of government functions as part of the broad trend towards governments being more accountable and responsive to the needs and wishes of their people.

A particular focus of this international debate has been identifying best practices worthy of adoption generally. To assist this process, a range of benchmark criteria has been identified against which a country's intergovernmental fiscal arrangements can be assessed in terms of best practice.

This Report examines how Australia's intergovernmental fiscal arrangements perform against a range of these benchmarks. This performance is also contrasted with that of a number of other comparable federations.

The Australian Federation and its intergovernmental fiscal arrangements have a long history, although one not always well understood. A distinguishing characteristic of Australia's arrangements is that while other federations regularly review and adapt their arrangements, this is much less the case in Australia.

It is my hope that this Report will lead to a better understanding of the strengths and weaknesses of intergovernmental fiscal arrangements in Australia and that this will encourage a more constructive and informed debate of this issue.

Yours sincerely

Neil Warren
23 May 2006

Terms of Reference

International Study of the Allocation of Taxation Powers and Service Responsibilities Between Levels of Governments

The Commonwealth Treasurer has commissioned a factual study comparing Australia's taxation system with other countries. This study is to be completed by 3 April 2006.

The Commonwealth Treasurer's earlier Inter-Generational Report, his commissioned study into the Economic Implications of an Ageing Australia by the Productivity Commission and work undertaken by the States have made valuable contributions to our understanding of the future challenges the Commonwealth and State and Territory governments will have to tackle together, to provide and pay for the service needs of both the current and future generations of Australians. In these regards, COAG has now set down a new ambitious National Reform Agenda.

An examination of the international differences in the allocation of taxation powers and expenditure responsibilities between layers of government will provide additional insights that will be important to the development of the most appropriate taxation reforms consistent with the national interest.

Accordingly, the NSW Treasurer is commissioning a factual study by Dr Neil Warren, Associate Professor of Economics at the University of NSW, to supplement the study being prepared for the Commonwealth Treasurer. The comparisons will include OECD countries and other federations where the necessary information is readily available.

In particular, the NSW study will examine:

- the allocation of taxes between the Commonwealth and States with reference to arrangements in other countries;
- the way expenditure responsibilities are allocated between the Commonwealth and States with reference to arrangements in other countries;
- the extent of imbalance between expenditure responsibilities and taxation powers in Australia compared to other countries and the policy implications of any imbalance;

- domestic and international arrangements for transfers from national to subnational governments, including the relative size and distribution of such transfers and the policy implications of such arrangements; and
- the impact on the States of Commonwealth-State financial relations reforms associated with the GST.

An interim report from the study will be provided to the NSW Treasurer by 23 March 2006. A final report will be provided by 30 April 2006.

About the Author

Dr Neil Warren is Associate Professor of Economics and Head of School *designate*, Australian School of Taxation (Atax) in the Faculty of Law at the University of New South Wales. He is also Research Director of the Australian Tax Research Foundation and an advisor to the Business Coalition for Tax Reform.

His academic interests are in public sector economics with a special focus on taxation policy and distributional issues. He has authored or co-authored many articles in academic journals and conference volumes, as well as having published a number of books, government reports and many discussion and conference papers.

He has also consulted widely in the area of taxation policy, preparing numerous reports for political parties, welfare and industry groups as well as professional organisations and various State and federal Government agencies.

In the past, he co-chaired a *Review of Employers' Compliance with Workers Compensation Premiums and Payroll Tax in NSW;* was Project Director of AusAID projects in Tonga and Vanuatu; Director of Research – Committee for Economic Development of Australia (CEDA); seconded to the Office of the Economic Planning Advisory Council (EPAC) in the lead up to the 1985 National Tax Summit; an advisor to the Liberal Party's 1992 *Fightback* reform proposals; and a member of the Commonwealth Small Business Consultative Committee (1998-2003).

Acknowledgements

The Review worked to tight timeframes. It was announced on 5 March 2006, with the *Interim Report* released on 29 March 2006. The *Final Report* was scheduled for completion by 30 April 2006.

The literature on this issue is substantial both in Australia and internationally and it was no small task to bring this Report together within a tight timeframe and to the standard necessary for such an important study.

Such deadlines could only be met through the dedication of the team assembled to assist with this study. I would therefore like to acknowledge the important contribution made by a number of individuals from both within and outside NSW Treasury.

Within NSW Treasury, particular thanks go to James George. I am also grateful for the assistance and support provided by Richard Cox and Hugo Harmstorf.

Special thanks also go to Professor David Collins from Macquarie University and Jacqui McManus from Atax at the University of New South Wales who also assisted with the project.

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Acronyms

ABS	Australian Bureau of Statistics
ADB	Asian Development Bank
ATO	Australian Taxation Office
BBA	Budget Balancing Assistance
BBR	Balanced Budget Rule
BDR	Borrowing and Debt Rule
CEDA	Committee for Economic Development of Australia
CG	Central Government
CGC	Commonwealth Grants Commission
CHST	Canada Health and Social Transfer
COAG	Council of Australian Governments
CPI	Consumer Price Index
EPAC	Economic Planning Advisory Council
EU	European Union
FAG	Financial Assistance Grant
FEL	Fiscal Equalisation Law
GDP	Gross Domestic Product
GDR	German Democratic Republic
GFS	Government Finance Statistics
GMA	Guaranteed Minimum Amount
GP	General Practitioner
GSP	Gross State Product
GRG	General Revenue Grant
GST	Goods and Services Tax
HCG	Health Care Grants
HFE	Horizontal Fiscal Equalisation
HFI	Horizontal Fiscal Imbalance

HST	Harmonised Sales Tax
IGA	Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations
IMF	International Monetary Fund
IRAP	Imposta Regionale sulle Attivitá Produttive
LCA	Loan Council Allocation
NCP	National Competition Policy
NRA	National Reform Agenda
NSW	New South Wales
OECD	Organisation for Economic Cooperation and Development
OSR	Ordinary Statute Regions
PC	Productivity Commission
PIT	Personal Income Tax
PST	Provincial Sales Tax
RRP	Revenue Replacement Payment
RTS	Representative Tax System
SCG	Subcentral Government
SPP	Specific Purpose Payment
TEL	Tax and Expenditure Limitations
USA	United States of America
VAT	Value Added Tax
VFI	Vertical Fiscal Imbalance
WST	Wholesale Sales Tax

Executive Summary

This study compares and benchmarks Australian and international arrangements for the allocation of taxation powers and expenditure responsibilities between central and subnational governments, and mechanisms for fiscal transfers between governments. Key comparator federations for the purposes of this study are Austria, Canada, Germany, Switzerland and the USA. Other countries which are not federations but operate in similar ways to federations may also provide valuable insights: Italy is an example of one such country that has been included as a comparator in this study.

The conclusion of this study is that Australia performs comparatively poorly in international comparisons of intergovernmental fiscal arrangements. A review in the national interest is overdue and essential if Australia is to adequately meet the challenges of an ageing population. International experience shows that comprehensive reform to intergovernmental fiscal arrangements is being undertaken in many federations.

Australia's system of intergovernmental fiscal arrangements is characterised by very high vertical fiscal imbalance (VFI) due to inadequate State tax powers, and complex and high level equalisation. These arrangements hinder adjustments in the economy that are essential for the economy to develop and grow, as it must if Australia is to meet future challenges.

The key findings of this study, putting Australian intergovernmental fiscal arrangements into an international context, are that:

1. There is an international trend towards decentralisation.
2. There is an international trend towards assigning primary expenditure responsibility to one level of government.
3. The fiscal autonomy of States in Australia is generally more heavily circumscribed than those subnational governments in comparator federations.
4. Ensuring that tax assignment follows expenditure responsibility is important in order to ensure that subnational tax instruments are adequate to meet subnational government commitments.

5. Distribution of shared revenues from national taxes is a common practice. This often applies across all major central government taxes.
6. Most federations have a commitment to the principle of fiscal equalisation.
7. Most fiscal equalisation methodologies in comparator federations are significantly less complex and more transparent than in Australia.
8. The overriding importance of the goal of full interstate equalisation in Australia is not evident in other federations.
9. Other federal systems have equalisation processes which avoid, to a greater extent than Australia, imposing disincentives to subnational governments to provide efficient delivery of public goods and services.
10. Most countries regularly review their intergovernmental fiscal arrangements.

National and State governments in Australia have not had a serious discussion about the assignment of functions and responsibilities between the different tiers of government since prior to federation in 1901. The arrangements for financial transfers from the Commonwealth to the States have remained largely unchanged since the establishment of the Commonwealth Grants Commission in 1933. The only real area of change has been the steady decline in the revenue raising powers of the States, concomitant with the steady rise in the financial power and reach of the Commonwealth.

Australia's high level of VFI leaves States with little control over a large portion of their revenues. The level of VFI in Australia is among the highest of any federation so the problems associated with VFI, including reduced transparency for the provision of services and accountability of governments, are more significant in Australia than in other federations.

While the goods and services tax (GST) is a growth tax and will provide increased revenue to State governments, it is not a tax over which they have any substantial control. Its proceeds are distributed according to equalisation principles and highly complex methodologies applied by the Commonwealth Grants Commission, which provides advice to the Commonwealth Treasurer affecting the distribution of GST revenue. The Treasurer is ultimately responsible for deciding States' share of GST revenue. The process involves large financial transfers from donor States to recipient States, and directly impacts on the range and quality of services that the States are able to provide.

The States have substantial expenditure responsibilities – including the provision of services such as health, education, transport and policing – but do not have sufficient own-source revenue to fund these responsibilities. The States have increasing expenditure responsibilities, which will only be exacerbated with an ageing population, while at the same time diminishing sources of revenue under their control. They must rely on financial transfers from the Commonwealth, which controls most of the national tax base, for the additional revenue needed to fund their responsibilities.

In relation to the allocation of taxes between the Commonwealth and States, Australia is characterised by a tax system that is highly centralised in comparison with other federations. The broadest tax bases – personal income, corporate profits, and goods and services – are held by the Commonwealth for a number of constitutional and Commonwealth policy reasons. States rely on comparatively narrow-based and inefficient taxes such as stamp duties for their own-source taxes, while the more efficient State taxes, payroll tax and land tax, are limited in their application. Tax sharing of revenue from specified tax bases, including the personal income tax and corporate tax bases, is much more common in other federations.

Expenditure responsibilities are generally allocated between the different levels of government in a relatively consistent pattern across all federations considered by this study. The main areas of difference between Australia and the other federations identified in this study relate to health and education. Health and education spending in Australia is shared almost evenly between the Commonwealth and States, in contrast to most other federations where those responsibilities are allocated almost exclusively to a single level of government. The problems associated with overlapping expenditure responsibilities between different levels of government, and the potential for misallocation of resources and reduced accountability, are not unique to Australia. However, lack of transparency appears to be less problematic where State governments have relatively high levels of fiscal autonomy, as in Canada and the USA.

In terms of the extent of the imbalance between expenditure responsibilities and taxation powers, Australia has a very high level of VFI relative to comparator federations. In Australia, States' own-source revenues account for only 40 per cent of their own-purpose outlays, which is broadly comparable to that in Austria, but in contrast to significantly lower levels of VFI in Canada, Germany and Switzerland. The high degree of VFI in Australia results in State governments relying more heavily on financial transfers from the Commonwealth than States in comparator federations, with the exception of Austria.

In relation to domestic and international arrangements for transfers from national to subnational governments, Australia's equalisation mechanism is the most complex and comprehensive of the comparitor countries, despite Australia having relatively small economic differences across the States. For example, while Australia attempts to equalise both revenues and expenditures, Canada and Germany equalise on the revenue capacity side only.

What makes Australia's horizontal fiscal equalisation (HFE) system unique is the degree to which the equalisation objective is pursued at the expense of efficiency. In fact, the system fails to strike a balance in that it strives to achieve full horizontal equalisation without regard to the efficiency costs. Furthermore, there is no objective benchmark to assess whether Australia achieves interstate equity. It would appear that other federations acknowledge more fully than does Australia a likely trade-off between the interjurisdictional equity benchmark and achievement of other benchmarks such as efficiency, transparency and simplicity.

Australia's system of transfer payments, in particular the wide use of tied grants, gives the Commonwealth considerable power in areas over which it is not primarily responsible and serves as a vehicle for the extension of Commonwealth policy into areas for which the States are held accountable, including the provision of health and education. This often leads to the inefficient provision of those services, including the underprovision of some services. This problem, however, is not unique to Australia.

The reforms to Commonwealth-State fiscal arrangements associated with the GST, as set out in the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations,* (IGA) have exacerbated VFI – the States rely even more than previously on grants from the Commonwealth. However, these reforms did not arise from a comprehensive review of intergovernmental fiscal arrangements. Furthermore, the IGA reforms mean that a considerably larger revenue pool is subject to the equalisation process than previously. However, GST revenue grants from the Commonwealth, which replaced Financial Assistance Grants and compensated States for the abolition of several of their own taxes, are expected to grow more robustly than the sources of revenue they replaced.

This study has highlighted four critical areas in designing and evaluating intergovernmental fiscal arrangements: expenditure responsibilities; tax assignment; intergovernmental transfer arrangements; and dynamic federalism. The broadly accepted criteria, or benchmarks, against which country's should assess their intergovernmental fiscal arrangements are set out below.

Expenditure Responsibilities

Benchmark 1 **Subsidiarity:** Subnational governments should, subject to efficiency considerations, be responsible for those services whose benefits are confined primarily to their geographic area and for which residents should have a choice over both the quantity and quality of service.

Benchmark 2 **Transparency of shared expenditure functions:** When expenditure responsibilities are shared among jurisdictions, responsibilities of each tier of government should be clear and appropriate coordination mechanisms should be established.

Tax Assignment

Benchmark 3 **Tax assignment should follow expenditure responsibilities.**

Benchmark 4 **Economic efficiency of tax assignment:** Subnational governments should avoid taxes on mobile factors and tax less mobile factors.

Benchmark 5 **Fiscal need:** Tax revenues should be able to expand in line with expenditure needs.

Intergovernmental Fiscal Transfers

Benchmark 6 **Equity of intergovernmental fiscal transfers:** Subnational governments with equal fiscal needs should be treated equally.

Benchmark 7 **Neutrality:** Subnational governments should not be able to influence the grant that they receive by manipulating their expenditure or tax decisions.

Benchmark 8 **Predictability and flexibility:** Subnational governments need to be able to budget and plan for the future but, at the same time, have the flexibility to respond to changing circumstances.

Benchmark 9 **Simplicity and transparency:** The transfer mechanism or allocation formula should be readily understandable (transparent) and easy to administer (simple).

Benchmark 10 **Autonomy:** Subnational governments should have the independence to set priorities and manage services to respond to local needs.

Benchmark 11 **Incentive for sound management:** The transfer mechanism should not penalise subnational governments for sound management.

Benchmark 12 **Accountability:** The transfer system should enhance the accountability of subnational governments to their citizens.

Dynamic Federalism

Benchmark 13 **Dynamic:** The federal fiscal system should be open to comprehensive review and capable of structural change.

Australia needs to reconsider the allocation of expenditure responsibilities between levels of government, and the consequent assignment of tax bases and intergovernmental financial transfers. Over recent years, Belgium, Germany and Switzerland have all significantly revised their federal arrangements. Reforms are underway in Italy, and Austria comprehensively reviews its intergovernmental arrangements every four years.

It is advisable that any future discussion between the Commonwealth and the States about reform of the assignment of taxes, functions and responsibilities and financial transfer mechanisms be guided by the criteria set out above. It should be possible, by implementing transitional safety net arrangements – along the lines adopted for the GST related changes – to reform the current federal fiscal arrangements without disadvantaging any individual State.

However, reform will take a commitment from all levels of government and its initiation requires an effective political champion. The Council of Australian Governments (COAG), in recognising the demographic challenge, has already shown leadership with the recently agreed *National Reform Agenda*. COAG is best placed to initiate and lead any significant review of Australia's intergovernmental fiscal relations by establishing an independent and regular process of comprehensive review.

Summary and Key Findings

Introduction

The assignment of tax powers and expenditure responsibilities to the different levels of government is the key to understanding why Australia's intergovernmental fiscal arrangements and State tax systems have evolved into their present forms. This study provides the background necessary to understand the evolution of the country's federal fiscal arrangements and uses this information as the basis for evaluating these arrangements and comparing them with international practices.

Developing benchmarks for the evaluation of federal financial relations

The study establishes a set of 13 benchmarks, which are used as a framework for evaluation. These benchmarks are formulated in the light of both an examination of the potential benefits and costs of federal financial systems and a review of practices and experiences of other federal countries at comparable levels of economic development. Key comparator federations are Austria, Canada, Germany, Switzerland and the USA, although other countries which are not federations but operate in similar ways to federations are also included in the study, such as Italy.

The nature of federations

In most countries, government contains multiple tiers each with their own areas of responsibility and laws. Two systems operate, one where the main powers reside centrally – the unitary system of government – and the other where the central and subnational governments share the powers – the federal system of government. There has been an international trend in recent years towards increased decentralisation, that is, devolution of powers and responsibilities to subnational governments in both federal and unitary systems of government.

Assigning functions in a federation

Wherever national and subnational governments coexist, issues arise as to the division of tax powers and expenditure responsibilities. There is, however, the more fundamental question of what should be the assignment of *functions* in a federation. It is generally recognised that government has three broad economic functions – stabilisation, distribution and allocation.

It is widely acknowledged in the literature that the stabilisation function should be reserved exclusively for central governments, since it is the only level of government at which the relevant macroeconomic policy instruments can be used effectively. Similarly, there is a general view in the literature that the distribution function should also be performed exclusively by central government, since attempts by subnational governments to achieve redistributional goals will usually be ineffective. There is, on the other hand, no clear conclusion that the allocation function should be the exclusive preserve of a single level of government.

Thus, the issue of the assignment of expenditure responsibilities and tax powers in a federal system arises mainly in relation to the allocation function. The appropriate assignment of expenditure responsibilities will depend upon the application of certain tests to each category of expenditure. Given the desirability of the subnational governments (including State governments) having adequate taxation powers to fund their expenditure responsibilities, the assignment of these powers should logically follow from the assignment of expenditure responsibilities.

Benefits and costs of federal systems

The benefits of federalism arise from the existence of different preferences for types and levels of public services and taxes in different areas of the nation. These differences are unlikely to be satisfied in a unitary nation, with a single central government largely constrained to provide common levels of service at common tax levels.

The implementation of uniform policies across areas of disparate preferences will lead to underprovision of services in some areas compared with what those communities would prefer, and overprovision in others. In a federal system, on the other hand, the subnational governments (whether they are States, Provinces, Territories, Länder, Cantons) will not be constrained to adopt common policies and so will be able to provide service levels according to community preferences. There may also be benefits accruing from competition between subnational governments in the provision and financing of public services.

This analysis implies that the responsibility to supply specific services should be allocated to central or subnational governments according to the area over which the benefits of these services are spread. There are, however, two further circumstances in which it can be argued that expenditure responsibilities should be assigned solely to central governments:

- Economies of scale may exist in the supply of some public goods and services, so that central provision on a larger scale will be more efficient than fragmented subnational provision; and
- Public goods and services supplied by subnational governments may have spillover effects (either benefits or costs) on other jurisdictions. If these spillovers are uncompensated the level of provision will be non-optimal.

Thus efficiency considerations should also be taken into account when assigning expenditure responsibilities to central and subnational governments.

Substantial inefficiencies also can arise in federal systems. However, when such problems exist, it is usually either because expenditure responsibilities have been assigned to different government levels without sufficiently taking into account the principles of rational assignment or because insufficient attention has been paid to coordination of policies within and between levels of government.

Tax assignment in federal systems

Subnational governments should have taxing powers sufficient to fund their expenditure responsibilities. If subnational governments have inadequate revenue sources, the problem of VFI arises, and the full economic benefits of the federal system are unlikely to be realised. The assignment of expenditure responsibilities, therefore, has important implications for the assignment of tax powers.

Inequities between subnational jurisdictions

A common component of most federal systems is the objective of reducing, or in some cases eliminating, differences in the abilities of subnational governments to deliver public services. Policies to deal with such differences are referred to as horizontal fiscal equalisation (HFE). The processes of HFE can be complex and obscure and, unless carefully designed, can have perverse effects on efficiency in the delivery of public services.

Australia's current fiscal federalism

Australia's Constitution, adopted in 1901, distributed legislative power over public policies between the Commonwealth and the States in a highly decentralised pattern. The current distribution of legislative power is, however, vastly different from the original design and has become highly centralised. Further centralisation could potentially result from an unsuccessful challenge by the States to the Commonwealth's WorkChoices legislation.

The range of taxes available to the States is limited by Australia's Constitution. Under s.90, the power to impose excise and customs duties is exclusive to the Commonwealth. The States cannot impose a tax which conflicts with the guarantee enshrined in s.92 of the Constitution that "trade, commerce, and intercourse among the States … shall be absolutely free." Under s.114, the States cannot impose a tax on Commonweath property. In addition, the Commonwealth enjoys a general implied immunity from State taxation.

The Commonwealth has power pursuant to s.96 to "grant financial assistance to any State on such terms and conditions as the Parliament thinks fit." While, on the face of it, this does not appear to interfere in any way with State taxing powers, its potential to do so has been demonstrated by the Commonwealth's use of this power to limit the field of State taxation.

A major component of Australian federal fiscal arrangements is the CGC, whose current function is to provide advice, based on the principle of HFE, to the Commonwealth on the distribution of the pool of GST revenue and health care grants among the States and Territories.

A recent important development in Australian federal fiscal relations is the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* dealing with the financial implications for the States and Territories of the GST and associated reforms. However, these reforms did not arise from a comprehensive review of intergovernmental fiscal arrangements.

Major elements of the IGA provide for the:

- distribution of GST revenue to the States through untied grants based on HFE principles;
- abolition of Financial Assistance Grants (FAGs) and Revenue Replacement Payments (RRPs) to the States;

- use of the GST revenue to fund abolition of the Commonwealth wholesale sales tax and the abolition or reduction of various State taxes; and
- review by 2005 of other State taxes with a view to their possible abolition.

With the implementation of the IGA, the Commonwealth Grants Commission's fiscal equalisation process has assumed a much greater importance, since it now applies to a GST revenue pool ($39 billion) substantially larger than the earlier FAGs pool ($23 billion).[1]

Using benchmarks to evaluate Australian federal financial relations

This Report develops 13 benchmarks, using them to evaluate the performance of the Australian federal fiscal arrangements and compare those arrangements with international practice. These benchmarks are necessary because they provide a framework against which it is possible to evaluate and compare best practice.

The Report also considers the performance of other comparable federal countries against the benchmarks and compares Australia's performance against the experiences of other federations. The benchmarks are grouped under the four headings of *Expenditure Responsibilities*, *Tax Assignment*, *Intergovernmental Fiscal Transfers*, and *Dynamic Federalism.*

Expenditure Responsibilities

Benchmark 1 Subsidiarity: Subnational governments should, subject to efficiency considerations, be responsible for those services whose benefits are confined primarily to their geographic area and for which residents should have a choice over both the quantity and quality of service.

In Australia, defence services are provided entirely by the Commonwealth, as are social protection services in the area of income support. This is consistent with the principle of subsidiarity. Defence generates benefits that extend across the country, whilst income support redistributes income. Welfare and community-type social protection services are delivered locally by the States, as are public order and safety services and environmental protection services.

1 Commonwealth Government 2006-07 Budget Paper No.3, Federal Financial Relations 2006-07, p.15.

These allocations of responsibility are consistent with the benchmark, since the benefits of these services are primarily local, and the quantity and quality can be appropriately tailored to suit local tastes. Areas where there is a significant degree of overlap between Australian levels of government include health, education, economic affairs[2], housing and community amenities and recreation and culture.

Internationally, expenditure responsibilities are generally allocated between the different levels of government in a relatively consistent pattern across all federations considered by this study. Defence and social protection are largely provided by central governments. Responsibilities for economic affairs and housing and community amenities are generally shared across both levels of government. Public order and safety is generally provided by State governments, although there are certain exceptions. Environmental protection services are provided mostly by State governments in Belgium and Germany, whilst in Austria and Canada the central governments have a much greater role. Health services in other federations are provided almost entirely by either the central government or the State governments. Education is generally a State government responsibility.

The main points of difference between the Australian system and the other federations relate to the allocation of responsibility for health and education. Responsibility for health services in Australia is shared almost evenly between the Commonwealth and State Governments. By contrast, all other federations considered in this study, apart from Austria, allocate that expenditure responsibility almost exclusively to one or other level of government.

The existence in Australia of shared responsibilities in the areas of health and education creates the risk of a lack of policy coordination between the two levels of government. It also provides incentives for cost-shifting between governments, with the potential to reduce the efficiency with which public resources are allocated.

Benchmark 2 Transparency of shared expenditure functions: When expenditure responsibilities are shared among jurisdictions, responsibilities of each tier of government should be clear and appropriate coordination mechanisms should be established.

Australia has a relatively high and increasing degree of shared functions between different levels of government. For instance, the funding

2 Economic affairs include economic development, industry and treasury functions.

and delivery of transport, housing, health, aged care, disability services, education and child care services, are organised through various intergovernmental arrangements. Other areas with service interfaces between governments include environmental management, workers' compensation, occupational health and safety, industrial relations and indigenous affairs.

Australia has unusually high levels of federal/State overlap in the areas of health and education, with health being the most extreme example. In relation to health, the lack of coordination between Commonwealth and State programs is widely recognised, despite institutional arrangements including the Australian Health Ministers Conference and the Australian Health Ministers Advisory Council. Coordination of education programs is slightly better, although there is still duplication of responsibilities.

The problems associated with overlapping expenditure responsibilities between different levels of government, and the potential for misallocation of resources and reduced accountability, are not unique to Australia. While federal constitutions may assign specific powers to a particular level of government – usually federal, with all other powers assigned to another level of government – usually State, the actual expenditure responsibilities and areas of overlap are rarely so clear.

Australia, along with Austria, has unusually high levels of federal/State overlap in health (and education) responsibilities and expenditure. The problems associated with lack of transparency have reached the point in federations including Austria, Germany and Switzerland that significant reforms to expenditure responsibilities have been proposed or implemented. However, lack of transparency appears to be less problematic where State governments have relatively high levels of fiscal autonomy, as in Canada and the USA.

Tax Assignment

Benchmark 3 Tax assignment should follow expenditure responsibilities.

Australia has a very high level of VFI by international standards. The Commonwealth collects around 80 per cent of taxation revenue (including the GST), but is responsible for around 54 per cent of own-purpose spending. The States collect around 16 per cent of taxation revenue and account for around 40 per cent of own-purpose outlays.

The GST and associated reforms, including the abolition of some State taxes, have further increased the level of VFI in Australia. This is because those reforms increased States' reliance on Commonwealth grants (GST revenue grants) while at the same time reducing States' reliance on own-source taxes, and imposing additional spending responsibilities on the States.

State government expenditure in Australia represents approximately 40 per cent of total government expenditure in Australia. There is no clear trend for the relative size of State government expenditures in the federations studied.

In relation to the allocation of taxes between the Commonwealth and States, Australia is characterised by a tax system that is highly centralised in comparison to most other federations. State government own-source taxes as a proportion of total taxes is smaller in Australia than in comparator federations, with the exception of Austria.

The combination of significant expenditure responsibilities but relatively small tax powers for State governments in Australia results in a high degree of VFI in Australia. The high level of VFI in Australia is comparable to that in Austria, but in contrast to significantly lower levels of VFI in Canada, Germany and Switzerland. It results in State governments in Australia being much more dependent on fiscal transfers from central government than State governments in comparator federations, with the exception of Austria.

Benchmark 4 Economic efficiency of tax assignment: Subnational governments should avoid taxes on mobile factors and tax less mobile factors.

Efficient taxes minimise the distortion of economic decision-making and therefore have relatively little impact on the overall allocation of economic resources. All taxes cause some behavioural changes, distorting economic activity. This distortion imposes a 'dead weight cost' on the economy, acting as a drag on economic activity and reducing growth in jobs and incomes. Broad-based taxes are generally less distorting than narrow-based taxes.

State governments in Australia are forced to rely heavily on relatively inefficient, narrow-based and sometimes highly cyclical transactions-based taxes rather than on more efficient broadly-based consumption and income taxes which in Australia are central government taxes. They are forced into such tax systems through very tight constitutional constraints on their tax powers, Commonwealth policies and inter-jurisdictional tax competition.

The most economically efficient State taxes in Australia are payroll and land taxes. Since labour is a widely used component of production, the payroll tax base is relatively broad. The fixed supply of land means that land taxes will not typically reduce the ownership of land. However, while these taxes are theoretically efficient, in practice their economic efficiency is reduced by concessions which narrow the tax bases. Interstate harmonisation of payroll bases could address some of these inefficiencies. Stamp duties are relatively inefficient taxes with a volatile yield.

Australian States rely on efficient taxes for a smaller proportion of their tax revenue than other federations. While Australian States share all the revenue from the Commonwealth's GST, which is a relatively efficient tax, they have no autonomy over the rate or base. In addition, GST revenue is not shared on the basis of its State of origin – it is distributed by a Commonwealth-controlled process of fiscal equalisation.

Unlike State governments in federations such as Austria, Canada, Germany and Switzerland, Australian States do not share income taxes with the central government nor do they have the power to impose a surcharge on income taxes as State governments do in the USA.

Benchmark 5 Fiscal need: Tax revenues should be able to expand in line with expenditure needs.

The tax autonomy of subnational governments hinges on the degree of discretion available to them. Fiscal discretion is greatest if subnational governments are free to determine both the tax base and tax rate. It is also important that tax revenue is non-volatile and robust, growing broadly in line with expenditure needs.

State taxes in Australia account for just over 30 per cent of total State revenue, and represent approximately 16 per cent of total General Government tax revenue in Australia. This means that State governments in Australia have discretion over only a relatively small proportion of their total revenue, are heavily reliant on other sources of revenue – primarily grants from the Commonwealth over which they have little or no discretion – to finance their expenditures, and that tax revenue in Australia is highly centralised.

Australia has the second lowest level of fiscal autonomy of State governments among the countries examined. Only Austrian States have less discretion over their revenues. While the revenue sharing arrangements in Germany mean that the Länder share broad bases (such as income tax, company tax and VAT) with other levels of government, in practice they have very limited control over the tax bases and rates.

This is not unlike the Australian States' GST revenue sharing arrangements where the States cannot unilaterally alter the GST base or rate and so do not have the discretion available to adjust their tax revenues to meet their expenditure needs.

The low level of fiscal autonomy of State governments in Australia contrasts most starkly with US States which have few restrictions on the taxes they can levy. In Canada the Provinces and Territories have direct access to either their own Provincial Sales Taxes or their share of the Harmonised Sales Tax.

Intergovernmental Fiscal Transfers

Benchmark 6 Equity of intergovernmental fiscal transfers: Subnational governments with equal fiscal needs should be treated equally.

An important component of most federal systems is horizontal fiscal equalisation – a policy designed to correct for economic disabilities experienced by some subnational governments. These disabilities result in horizontal fiscal imbalance, a situation in which there exist differences between subnational jurisdictions in their ability to provide comparable levels of government services while imposing comparable tax burdens. These differences may arise from tax-raising disabilities (as a result, for example, of lower *per capita* taxpayer incomes) and/or cost disabilities in the provision of government services (as a result, for example, of different population age structures). Equalisation is fundamentally based on the principle of equity between subnational jurisdictions and this principle has been accepted by the Australian community.

In Australia, despite implementing equalisation, there is considerable dispute as to whether the process is successful in achieving equalisation or whether, in practice, there is overcompensation for some States. This focus on interjurisdictional equity in transfers from the Commonwealth to the States contrasts with the tradeoffs evident in the tax system between the competing objectives of equity, economic efficiency, transparency and simplicity.

Internationally, federal countries tend to concentrate on the equalisation of revenue capacities only, ignoring or paying less attention to cost disabilities in the provision of public services. In many cases the goal is the achievement of *minimum standards* of the services, rather than *full equalisation*.

It would appear that other federal countries more fully acknowledge a likely trade-off between the equity benchmark and achievement of other benchmarks. Aiming at full equalisation is likely to make it more difficult to meet other benchmarks, particularly those of efficiency, simplicity and economic management.

Benchmark 7 Neutrality: Subnational governments should not be able to influence the grant that they receive by manipulating their expenditure or tax decisions.

States in Australia rely on substantial general revenue (GST) grants from the Commonwealth whose allocation follows HFE principles. The CGC attempts to ensure that its HFE calculations are policy-neutral, basing them on common or average State policies and actual State practices. However, in reality, Australian States are able to benefit from policy reactions to the grant allocation formula. If grants are based on a formula which includes variables able to be influenced by the recipient, neutrality in the allocation of grants cannot be assured.

While the scope for non-neutralities in Australia is similar to that in other countries, other federal countries:

- rely on a less comprehensive array of tax and expenditure variables;
- apply less complexity in their HFE allocation practices; and
- place less reliance on HFE principles in the distribution of their general revenue grants, with more reliance being placed on a mix of largely exogenous variables such as State population and Gross State Product.

Australia's performance against this Benchmark compares unfavourably to that of other countries as a result of the complexity of its HFE policies and the greater opportunity for tax and expenditure variables to impact on the allocation of grants between State governments. While intergovernmental arrangements in other federations also have implications for economic efficiency, Australia stands out because of its total focus on the equitable distribution of the GST-related grants. To the extent that grants in other countries are allocated on a basis other than HFE, their grants allocation processes will have a less distorting impact on resource allocation.

Benchmark 8 Predictability and flexibility: Subnational governments need to be able to budget and plan for the future but, at the same time, have the flexibility to respond to changing circumstances.

It is important that a State government's total pool of available financial resources be predictable in absolute terms, as well as flexible enough to meet changing (and unexpected) budgetary demands. This can be achieved through a combination of grants from central government and own-source revenues. Predictability can be achieved through sharing a general revenue pool with published revenue projections. Flexibility can be achieved through a formula-driven approach that recognises the changing circumstances of State governments – and their relative position within a federation – over time. There are three basic ways to determine the total amount to be transferred (sometimes called the 'distributable pool' or the 'primary distribution'):

- on an ad hoc basis, that is, in the same way as any other budgetary expenditure;
- on a formula-driven basis, that is, as a proportion of specific State government expenditures to be reimbursed by the central government or in relation to some general characteristics of the recipient jurisdictions; or
- as a fixed proportion of central government revenues

In Australia, general revenue grants are made from the GST revenue pool. An individual State's allocation from this pool depends upon three factors:

1. the size of the total GST revenue pool,
2. the size of the population; and
3. the State's fiscal equalisation relativity, recommended by the CGC.

In practice, the size of the total GST revenue pool has proven to be relatively predictable although, like all taxes, the GST is subject to some forecasting error. In relation to the second factor influencing a State's allocation, population growth has proven to be relatively predictable. On the other hand, the extremely complex formula used to distribute the GST among the States makes prediction of the level of untied grants *for any individual State* considerably more problematical.

This means that a State's untied grant can vary by a couple of per cent from year to year. When the distribution formula is periodically reviewed (usually every five years), the variations can be considerably larger, up to around 10 per cent of the total grant. Some level of flexibility (and therefore unpredictability) is however necessary in order to make the system responsive to changes in circumstances. Australia's system of annual updates is designed to ensure that the most recent data is incorporated in the calculation of each State's share of the pool.

Tied grants vary in their predictability. They are typically subject to multi-year agreements, which make them relatively stable for the life of the agreement. However, when an agreement is rolled over, the central government can use its discretion to revise the formulas used to increase and distribute the pool of funding, making them less predictable than States would desire.

The uncertainty (predictability) costs associated with Australia's system of equalisation are higher than those in Canada and Germany. This indicates that the predictability benchmark may suffer in the absence of high levels of revenue sharing (which is applied extensively in Germany and Austria). Australian States have less fiscal autonomy than Canadian provinces and US States, so are constrained in their flexibility to meet unexpected demands on their budgets. However the system of annual updates to data applied in the CGC's methodology and periodic reviews of the distribution formula provide some flexibility in the system of general (untied) transfers.

Benchmark 9 Simplicity and transparency: The transfer mechanism or allocation formula should be readily understandable (transparent) and easy to administer (simple).

Simple transfer mechanisms and allocation formulae lead to transparency of outcomes and ease of administration. This is not simplicity for simplicity's sake. Complexity in the grants allocation methodology can be justified if it leads to efficient outcomes. However, there is no evidence that the great complexity and the data-intensive requirement of the CGC methodology are justified by the reliability of its outcomes.

Equalisation in Australia is applied to both expenditures and revenues. This involves around 40 categories of State expenditure with many factors applied to each, resulting in Australia having some 359 expense factor assessments. In the case of tax capacity, 37 revenue component assessments form the basis of the revenue capacity calculations in the formula. It also requires the use of judgement. Australia arguably has the most complex transfer mechanism of any comparitor federation.

Practices in most other federal countries are considerably less complex than in Australia. Canada equalises only on the revenue side, with the objective of 'reasonably comparable levels of public services at reasonably comparable levels of taxation across provinces'. This process apparently requires only two people. Switzerland has proposed a new equalisation program effective from 2006 which reassigns responsibilities between the federal government and Cantons and is an attempt to simplify a frequently *ad hoc* system that led to complexity and loss of the wider vision of equalisation. Germany's equalisation arrangements are relatively simple and transparent.

Benchmark 10 Autonomy: Subnational governments should have the independence to set priorities and manage services to respond to local needs.

In order to realise the benefits of a federal system, subnational governments should be able to exercise their powers independently of interference from other governments in the federation, as long as any spillover effects are properly recognised. When spillover effects arise, it is the proper responsibility for the national government to ensure that these effects are incorporated into the decisions of subnational governments.

In Australia, the Commonwealth uses tied grants, known as specific purpose payments or SPPs, to steer the policies of subnational governments. These transfers from the Commonwealth to the States are made pursuant to agreements between the two levels of government on particular policy areas.

SPPs also serve as a vehicle for the extension of Commonwealth policy into areas for which the States are held accountable. In some cases, they are little more than a mechanism for the Commonwealth to direct funds towards the Commonwealth's areas of priority rather than pursue matters of higher priority to a particular State. Current Commonwealth policy towards SPPs is seen by the States as highly inflexible and focused on input controls rather than what is achieved. The States have argued for some time that the focus in SPP agreements should be on outcome/outputs measures, in order to ensure greater focus on service delivery and to encourage efficiency improvements.

The level of State funds becoming tied up in SPP agreements is significant, constituting around 15 per cent of States' total revenues.

However, through their matching and maintenance of effort conditions, SPP agreements can control up to 33 per cent of State budget outlays. This has a significant impact on States' budget flexibility.

While other federations also have arrangements comparable to SPPs, SPPs appear to be more important in the Australian Federation. In the case of the USA, transfers from the central to State governments are mostly earmarked and relate to health – but they are far less important as a portion of State expenditure responsibility. Grants allocated to subnational levels in other federations are more often unconditional and therefore less likely to lock in State tax revenue to specific national expenditure priorities. This arises from a trend towards exclusive assignment of major expenditure responsibilities to one tier of government or another, thus making recourse to tied grants less relevant.

Benchmark 11 Incentive for sound management: The transfer mechanism should not penalise subnational governments for sound management.

In most federations, it is typical to find shared responsibilities between the central and subnational governments with the potential for ambiguous and often contradictory policy objectives. The result can be policy competition with the potential to discourage prudent subnational fiscal management. It may also encourage subnational governments to undermine national objectives through the use of tax concessions or funds from off-budget sources.

Sound management of government is fundamental to an effective federation. Clarity is crucial to the responsibilities and obligations of the subnational governments. Three key benchmarks underpin the requirement for sound management:

- Sound *budgetary* management. The accepted criteria here are that subnational deficits should not be funded centrally, and that deficit financing arrangements should be agreed with central government and open to public scrutiny.
- Sound *economic* management. Subnational economic management should not conflict with national objectives.
- Sound *public administration* management. Competency measures should be developed and applied.

Other federations have a closer alignment of taxing powers and expenditure responsibilities than Australia. The disjoint between these powers and responsibilities does not encourage responsible State budgetary practices. States are constitutionally assigned expenditure responsibilities but they have no access to their own broad-based sales tax or income tax. Accordingly, they resort to benefits principle taxation, business input taxes and taxes on asset holdings and transfers. They also resort to seeking increased federal grants, which does not encourage responsible budget practices.

The substantial dependence of the States on the central government for funding the majority of their expenditure means that the problem of State objectives coming into conflict with national objectives is much less an issue in Australia.

Benchmark 12 Accountability: The transfer system should enhance the accountability of subnational governments to their citizens.

A government is accountable to both those that fund their activities as well as those who are expected to benefit from them. Accountability is a significant concern because accountability can improve efficiency gains and is considered to be the key to improved public sector performance. There is a potential risk that intergovernmental fiscal transfers decrease the degree of accountability the recipient government has to its constituents, particularly when the transfer system is complex and non-transparent. The lack of accountability in turn potentially reduces the efficiency of resource allocation.

The relative funding responsibilities of Australia's levels of government are very poorly understood. This is largely due to the fact that many services are jointly funded by both the States and the Commonwealth. This has undermined accountability for the expenditure of this revenue. Due to constitutional restrictions on its activities, many programs funded by the Commonwealth are delivered through tied grant arrangements with the States, usually with additional State funding. Conversely, all State governments receive untied funding from the Commonwealth, which subsidises all State activities. The net result is a confused mix of responsibilities where, for almost any service delivered at the subnational level, each level of government can seek to avoid accountability by citing the involvement of the other.

In general, the transfer systems of the benchmarked countries have a negative impact on the accountability of subnational governments. In terms of complexity and transparency, Australia's transfer system is no less complex or opaque than any of those considered. In fact, the level of detail associated with the equalisation formula employed is regarded as the most comprehensive and complex. As for the level of multilevel governance and its negative impact on the transfer system, Canada, Germany and Australia all rank highly. However, again Australia is considered to have developed intergovernmental relations to the extreme, resulting in significant sharing of responsibilities in a less than transparent fashion. As a result it may be appropriate to conclude that the Australian transfer system ranks low in terms of supporting accountability of the subnational government to its constituents.

Dynamic Federalism

Benchmark 13 Dynamic: The federal fiscal system should be open to comprehensive review and capable of structural change.

COAG is the peak intergovernmental forum in Australia. In practice, it has tended to be dominated by the Commonwealth and has not proved to be an engine of reform in the area of intergovernmental fiscal arrangements. Although the CGC is an independent body, it is not subject to any legislated external review. Where criticisms of the CGC's methodology have been made in the past, particularly by State Governments, its reaction has tended to be defensive.

While the relationship between the tiers of government in many federations is enshrined in their constitution, this has not prevented substantial changes being made to the relationship between the tiers of government in terms of their tax assignment and expenditure responsibilities. Of all the countries reviewed here, only Austria has provision for regular review of its federal financial relations. However, Canadian, German, Italian and Swiss national governments have all recently conducted thorough reviews of their intergovernmental financial relations. This is in contrast to Australia where there has been no broad ranging review of intergovernmental fiscal arrangements covering expenditure responsibilities, tax powers and transfer mechanisms.

Key findings

The key findings of this Report, as set out below, put Australia's intergovernmental fiscal arrangements into an international context.

1. **Commitment to the principle of fiscal equalisation.** In all countries studied, with the notable exception of the USA, there is a strong commitment to the principle of equalisation – the need to improve the ability of disadvantaged subnational governments to provide adequate levels of public services. Australia has a clear commitment to the *broad principle* of interstate equalisation. However, the exact nature of the equalisation objective (whether

full or partial equalisation) and the means of achieving that objective vary from country to country. Australia has the most ambitious objective of full interjurisdictional equality.

2. **Trend to decentralisation.** There is an evident trend among federal countries comparable to Australia towards decentralisation – devolving expenditure responsibilities and/or tax powers. This decentralisation has often arisen out of reviews of federal fiscal arrangements. Australia, on the other hand, has been moving towards greater centralisation, with the Commonwealth playing an increasing role in revenue-raising and taking increased expenditure responsibilities.

3. **Review of intergovernmental fiscal arrangements.** In recent years, many federal countries have undertaken extensive reviews of their federal fiscal arrangements and, in the light of these reviews, reformed their financial relationships between national and subnational governments. In Australia, on the other hand, there has been no wide-ranging review of intergovernmental fiscal arrangements. The changes that have evolved have not been the result of a comprehensive and systematic review of Australia's intergovernmental fiscal arrangements.

4. **Adequacy of subnational tax instruments.** In Australia, there is a relative paucity of broad-based tax instruments available to the States. In some countries (e.g. Canada and the USA) broad-based taxes are available to States. In others (e.g. Germany, Austria, Italy and Switzerland) States share the revenues from such taxes with the national government, with a high proportion of the revenues being assigned to the State of origin of the tax base (using information on population, household consumption or business value-added). On the other hand, GST revenue-sharing in Australia requires that all revenue be distributed according to an equalisation formula. For own-source revenue, States are forced to resort to narrow-based taxes which have potentially high compliance costs, economic inefficiencies and inequities.

5. **Fiscal Autonomy.** The Australian States have inadequate tax instruments and, compared with other federations, are almost uniquely reliant on grants whose size and distribution are determined primarily by the Commonwealth Treasurer. The Australian States therefore have less fiscal autonomy than second

tier governments in comparator federations with the exception of Austrian States.

6. **Assignment of primary expenditure responsibility.** There is an international trend towards assigning primary expenditure responsibility to one level of government. In the case of health, for example, it is largely confined to a single level of government, whether national or subnational. In Australia on the other hand, health funding responsibilities are shared almost equally between the Commonwealth and State Governments.

7. **Distribution of shared revenues from national taxes.** In federal systems in which institutional arrangements exist to share the revenues from designated national taxes with subnational governments, Australia stands out from comparator federal countries in that GST revenue is distributed 100 per cent according to a fiscal equalisation formula. In other countries, shared revenue is, at the very least, partially distributed according to such factors as population shares or location of the consumption or production tax base.

8. **Complexity of fiscal equalisation methodologies.** Formula-based methodologies for fiscal equalisation are significantly less complex and more transparent in other comparator countries than in Australia. There is no evidence that high levels of complexity necessarily lead to more efficient outcomes.

9. **Efficiency effects of equalisation.** Other federal systems have equalisation processes which avoid, to a much greater extent than in Australia:

   - disincentives to efficiency-improving public expenditure such as infrastructure investment; and
   - barriers to structural adjustment that facilitates economic development.

   Other federations confront this issue to a lesser extent because their equalisation processes tend to concentrate more on revenue capacity, paying less attention to cost disadvantages.

10. **Primacy of equity benchmark.** The overriding importance which has been assigned in Australia to the goal of full interstate equalisation, rather than the achievement of minimum standards, has led to diminished performance against other benchmarks of a federal system. Australia's current system attempts to achieve

full equalisation, in contrast to most other federations. The result in Australia has been a high level of complexity, economic inefficiencies and a lack of transparency.

In summary, Australia performs comparatively poorly against many of the criteria which define best practice fiscal federalism. International experience shows that:

- Australia's federal financial system is clearly in need of review in the national interest;
- comprehensive reform of intergovernmental fiscal arrangements has been recently undertaken in many federations; and
- if reform is necessary this should be possible without significantly disadvantaging individual jurisdictions.

An important conclusion to be drawn from this comparison of international experience is that Australia needs an effective political champion to review current arrangements. Yet Australia, unlike most other federations, seems unwilling to critically review its intergovernmental fiscal arrangements with a view to reform. COAG has the authority to initiate and lead a comprehensive review of Australia's intergovernmental fiscal arrangements.

BENCHMARKING
AUSTRALIA'S INTERGOVERNMENTAL FISCAL ARRANGEMENTS

1 Introduction

Australia has been well served by its federal structure, enjoying more than a century of economic, political and social stability. In recent years, the Council of Australian Governments (COAG) has been the forum in which federal issues have been discussed and negotiated between the Commonwealth Prime Minister, State Premiers, the Chief Ministers of the Territories and the President of the Australian Local Government Association.

At the most recent COAG meeting, on 10 February 2006, all governments agreed to collaborate on a *National Reform Agenda*[3]. This agenda embraces reform in the areas of human capital, competition and regulatory reform, to ensure that Australia is able to deal with the challenges of demographic change and global competition.

Adding to this, the Commonwealth Treasurer commissioned on 26 February 2006 an *International Comparison of Australia's Taxes* study.[4] This study covered all forms of taxation collected in Australia at national, State and local government levels. This is OECD standard practice for international tax comparisons.[5] The report was submitted to the Commonwealth on 3 April 2006 and released on 12 April 2006.

The OECD compares and contrasts tax assignment with expenditure responsibilities in its studies of fiscal federalism. This aspect was not covered in the Commonwealth's *International Comparison of Australia's Taxes* report despite including State taxes in the review.

The purpose of this Report, *Benchmarking Australia's Intergovernmental Fiscal Arrangements*, is to complement the Commonwealth's report by benchmarking the standard and preferred practice of tax and expenditure assignment in several federations, along with financial transfer mechanisms.

Key comparator federations used in this Report are Austria, Canada, Germany, Switzerland and the USA. Other countries which are not federations but operate in similar ways to federations may also provide

3 Council of Australian Governments' Meeting 10 February 2006, *Communiqué*.
4 See <http://www.treasurer.gov.au/tsr/content/pressreleases/2006/008.asp>
5 For example, see *OECD Revenue Statistics 1965-2004*; and Joumard and Kongsrud (2003).

valuable insights; Italy is an example of one such country and has also been included as a comparator in this study.

This Report recognises that Australia's ability to deliver on COAG's *National Reform Agenda* depends on effective performance of the system of intergovernmental fiscal arrangements. It examines the potential implications for the performance of that system of:

- the way expenditure responsibilities and taxation powers are allocated between national and subnational governments; and
- the mechanisms for transfers between levels of government.

This study provides a public document that compares how Australia manages these issues with how they are managed in other federations. Similar to the Commonwealth's study, it identifies areas where Australia leads comparable countries and those areas in which it lags. This Report also suggests a way forward for Australia's system of intergovernmental fiscal arrangements.

2 Economic Theories of Federalism: A basis for developing benchmarks for evaluating fiscal federalism

In practice, no federation will operate with complete efficiency. A federal system may confer great economic benefits but also have significant adverse implications. The objective of any potential reform should be the achievement of maximum net benefits – the difference between the benefits of the system and its adverse consequences. However, meaningful reform is not possible without prior evaluation of the performance of the existing system against a set of systematic standards.

This Report develops a set of benchmarks, or performance criteria, and then proceeds to evaluate Australian federal financial relations against these benchmarks and against policies and experience in other advanced federations. Benchmarks should be developed in the light of a systematic theoretical framework. This Section presents an overview of the economic theory of federalism from which federalism benchmarks can be developed. The benchmarks themselves are developed and applied in Sections 4 to 7.

2.1 The nature of federations

In most countries, government contains multiple tiers each with their own jurisdictions and laws. Two systems operate, one where the main powers resides centrally – the unitary system of government – and the other where the central and subnational governments jointly share the powers – the federal system of government. King (1984) makes the distinction between "unitary countries, in which the whole structure, powers and operation of subnational authorities are subject to overall central government supervision, and federal countries, in which the central government and at least one tier of sub central authorities are coordinate and, in principle, independent". Unitary systems apply in France, Italy, Spain, Japan, and the United Kingdom. Federal systems apply in Austria, Belgium, Brazil, Canada, Germany, India, Mexico, Switzerland, the United States and, of course, in Australia. Federal systems typically arise when States or regions (or colonies as in Australia) federate or form a union (such as a free trade zone), in order to establish a nation – such as the Commonwealth of Australia.

However, in reality the distinction between unitary and federal systems may not be so clear cut. At one end of the spectrum, there are very few unitary countries which have not devolved some powers and responsibilities to subcentral authorities. At the other end, there are few, if any, federations in which subnational governments are fully independent of the central government. Thus, issues in the economics of federal systems, often called fiscal federalism, are not relevant solely to countries formally constituted as federations. As an example, the experiences of Italy, a country generally recognised as unitary but with some federal characteristics, can provide useful lessons.

There is no doubt that there has been an international trend in recent years towards decentralisation of government through the devolution of powers and responsibilities to subnational governments in federal countries. To quote Ebel and Yilmaz (2001):

> In the last two decades there has been a worldwide interest in decentralisation in all parts of the world. The pursuit of decentralisation is widespread as both developed and developing countries attempt to challenge central governments' monopoly of decision-making power.

Those pressures which have driven decentralisation in unitary governments aim to achieve the same objectives of a federation – thereby enabling a subnational government to provide services which better reflect their constituent's preferences. This trend is, in itself, a criterion against which the Australian federal arrangements can be assessed.

2.2 Assigning functions in a federation

Whenever national and subnational governments coexist, issues arise as to the division of *powers* and *responsibilities*. Which taxation powers and expenditure responsibilities should be assigned to one level of government or the other, and which (if any) should be shared? To answer these questions we must first address the more fundamental issue regarding the assignment of *functions* in a federal system.

It is generally recognised that government has three broad economic functions – stabilisation, distribution and allocation. How should the performance of these functions be divided between national and subnational governments?

- **Stabilisation.** The goals of economic stabilisation are economic growth, full employment and price stability. The broad tools available for the achievement of these goals are fiscal policy (tax and expenditure policies), monetary (interest rate) policy and exchange rate policy. It is widely acknowledged in the literature that this function should be reserved exclusively for central governments, since it is only at this level of government that these three policy instruments can be used effectively.

- **Distribution.** The distribution function relates to the need to produce equitable distributions of income and wealth, which usually implies some modifications of the outcomes which would arise in the absence of government intervention. The major instruments available are progressive taxes and public expenditures in such areas as health, education, housing and social welfare. Again, there is a general view in the literature that this function should be performed exclusively by the central government, since attempts by subnational governments to achieve redistributional goals will usually be subverted by the existence of labour and capital mobility. State governments may be able to achieve relatively minor redistributional objectives (for example, towards seniors) but will lack the power to achieve more ambitious objectives.
- **Allocation.** The allocation function relates to actions by government necessary to ensure an efficient allocation of resources. This may involve the provision of public goods, regulatory policies or taxes/subsidies designed to correct for market failure. Unlike the stabilisation and distribution functions discussed above, there is no clear conclusion in the literature that the allocation function should be the exclusive preserve of a single level of government.

Thus, the issue of the assignment of expenditure responsibilities and tax powers in a federal system arises in the main in relation to the allocation function. The correct assignment of expenditure responsibilities will depend upon the application of certain tests, discussed below, to each category of expenditure. Given the desirability of subnational governments having adequate taxation powers to fund their expenditure responsibilities, the assignment of these powers should logically follow from the assignment of expenditure responsibilities.

2.3 Benefits of federal systems

The potential benefits of federal systems are explored by Collins (2002). He argues that the basis for the belief in federalism is the existence of different preferences for types and levels of public services and taxes in different areas of the nation. These differences are unlikely to be satisfied in a unitary nation, with a single central government (with local government directly under its constitutional control) which will be largely constrained to provide common levels of service at common tax levels.

The implementation of uniform policies across areas of disparate preferences has substantial efficiency implications. The provision of a common level of services funded by common taxes will however lead to underprovision of services in some areas compared with what those communities would prefer, and overprovision in others. Thus, in areas of underprovision, a certain level of services is not provided *in spite of the community's being willing to pay (in terms of taxes) the costs of provision*. In areas of overprovision, services are being provided at a level *above that for which the community would be willing to bear the full costs*. In a federal system, on the other hand, the subnational governments will not be constrained to adopt common policies and so will be able to provide service levels according to that community's preferences. Some subnational governments may choose high expenditure/high tax policies. Others may choose low expenditure/low tax policy mixes.

There are various reasons why provision of some types of public service by subnational jurisdictions may better match consumer preferences than provision by the national government:

- With a multi-level system of government, politicians may have a better knowledge of voters' preferences;
- Decentralisation of government may lead to better control of public officials, because the ratio of elected representatives to public officials is higher; and
- Electors in subnational jurisdictions are more likely to be aware of the costs of the provision of public services and so are more likely to make rational decisions about appropriate levels of public service provision. These decisions are less likely to be obscured by cross-subsidies to or from other jurisdictions.

Many commentators (for example Tiebout, 1956) also see benefits of federal systems accruing from competition between governments in the provision of public services and in the financing of those services. The existence of actual or potential competition from other subnational governments, in a situation with a degree of labour mobility ("voting with their feet"), may make subnational governments more responsive to the wishes of their electorates. This issue is more clear-cut in relation to the supply and quality of public services than in subnational taxation, where competition can be either constructive or destructive.

If the above reasons for subnational provision of public goods and services were accepted, it would follow that the responsibility to supply specific services should be allocated to central or subnational governments according to the location of the beneficiaries of these services. There are, however, two complications which make the application of this rule less clear cut and has often led to the argument that expenditure responsibilities should be assigned solely to central governments: These two issues are:

- Economies of scale: This may exist in the supply of some public goods and services, so that central provision on a larger scale will be more efficient than fragmented subnational provision; and
- Spillovers: Public goods and services supplied by subnational governments may have spillover effects (either benefits or costs) on other jurisdictions. If these spillovers are uncompensated the level of provision in the jurisdiction providing these goods and services will be non-optimal. If there is central government provision, spillovers cease to be an issue in theory.

Thus, it is argued, economic efficiency considerations should also be taken into account when assigning expenditure responsibilities to central and subnational governments.

2.4 Disadvantages of federal systems

Critics of federal systems argue that substantial inefficiencies can arise from such arrangements. These generally result from a failure to observe the limits to the benefits of decentralisaton arising from the presence of spillovers and economies of scale. As a result, the following disadvantages are often cited in regard to federal systems:

- The costs of government are excessive in multi-jurisdictional countries, compared with unitary countries;
- There tends to be unnecessary duplication of functions, for example in health and education;
- Lack of coordination between the policies of subnational governments can lead to high costs borne by businesses operating

across jurisdictions. For example, there may be inconsistent definitions of the payroll tax base, and inconsistent legislation in relation to consumer protection and transport regulation;

- Destructive interjurisdictional competition may occur. For example, a State rationally attempting to apply road haulage charges which more closely reflect road track costs, in order to eliminate public subsidies to private road haulage, may be frustrated by the refusal of other States to apply similar charges. Interstate tax competition, rather than improving State tax systems, may lead to an erosion of State taxing powers, with a consequent decline in the performance of these systems.
- Subnational governments may indulge in beggar-my-neighbour policies to attract labour and capital from other States or from other countries and, in doing so, may erect barriers to goods and factor mobility.
- There may be policy conflicts between central and subnational governments, for example in workplace or native title legislation.

These problems usually exist in federations under the following circumstances:

- Either expenditure responsibilities have been assigned to different government levels without sufficiently taking into account the principles of rational assignment discussed above (and often referred to as the principle of *subsidiarity*); and/or
- Insufficient attention has been paid to horizontal coordination of policies within and between levels of government.

2.5 Tax assignment in federal systems

If the economic benefits of federal systems are to be fully realised, subnational governments should have taxing powers sufficient to permit the fulfilment of their expenditure responsibilities. This was recognised many years ago by Giblin (1926), who wrote:

> The financial relations between the component States and a Federal Government may not take up many pages of a federal constitution, but they are the chief determinant of the character of the Federation … if wide financial resources are in the hands of the Central Government, a way will always be found to extend its powers, even without formal amendment of the Constitution.

Subnational tax powers can be in terms of either own-source revenues or earmarked shares of central taxes. In the latter case, it can be argued that subnational governments need discretionary control over the amount of revenue received from shared taxes and full discretion over the disbursement of these revenues.

If subnational governments have inadequate revenue sources to fund their expenditure responsibilities, the problems of vertical fiscal imbalance arise, and the full economic benefits of the federal system are unlikely to be realised. The assignment of expenditure responsibilities therefore has important implications for the assignment of taxation powers. There exists a considerable literature on the principles which should apply in assigning tax powers in federal systems (see for example, Musgrave (1983); and Boadway, Roberts, and Shah (1994)).

2.6 Inequities between subnational jurisdictions

A common component of most federal systems is a community desire to reduce, or in some cases eliminate, differences in the abilities of subnational governments to deliver public services. Policies to deal with such differences are referred to as horizontal fiscal equalisation (HFE). They are grounded in a belief that subnational governments should have the ability to be able to deliver a common, or sometimes a minimum acceptable level of public services per head if they are willing to make an equal per capita tax effort. The processes of HFE can be unduly complex and obscure and, unless carefully designed, can have perverse effects on efficiency in the delivery of public services. The existence of economic growth and structural change suggest that HFE processes should be flexible and under continuous review.

2.7 Merits of Decentralisation

The above discussion indicates that the economic case for decentralisation is strong and where concerns exist, typically arises from a failure to recognise the limits to decentralisation in an environment where spillovers and economies of scale exist in the delivery of public goods and services.

None of this denies the efficiency benefits of decentralising the provision of some public goods and service but the contentious issue is funding their provision either through tax assignment or intergovernmental fiscal transfers.

All counties whether unitary or federal, exhibit some degree of decentralisation and confront this problem when expenditure responsibilities are assigned to subnational governments. Their responses have been diverse. Over the past few decades, comprehensive reforms to the fiscal relations between central and subnational governments have been carried out in many countries. While there has been diversity in national experiences, a clear trend has emerged toward decentralisation (Arachi and Zanardi, 2004).

In Austria a constitutional convention was established in 2004 with the task of making proposals for constitutional reform to simplify federal fiscal relations (Fuentes, Wörgötter, and Wurzel 2006). During the last decade, the Italian system of intergovernmental fiscal relations has undergone a process of radical reform (as yet incomplete) that has assigned the Italian regions new taxing powers and introduced a new system of interregional transfers. In Spain, the process of assignment of healthcare and social services spending to Autonomous Communities has been completed. In France, the constitutional reform of 2003 provides the general framework for a massive decentralisation of public functions in fields such as higher education, industrial policy and regional infrastructure.

With regard to the revision of subnational government financing systems, the reforms pursued have the general aim of improving decentralised governments' accountability, by assigning them more tax autonomy and by providing more flexibility in the use of central government financial transfers. In Italy, Spain and France decentralisation has been coupled with the assignment of new taxing powers to subnational governments.

However, the route to greater tax autonomy appears to be less certain than the route to expenditure decentralisation, given the difficulty of finding revenue-raising powers that can be transferred to subnational levels of government without raising distributional and efficiency concerns (such as tax competition and sensitivity to cyclical economic fluctuations). A trade-off seems to exist between the degree of decentralisation and the degree of tax autonomy. Spain's experience indicates a partial solution in giving subnational governments significant room for discretion in setting surcharges on taxes shared with the central government (Arachi and Zanardi, 2004).

International experience suggests that comprehensive reform to intergovernmental fiscal arrangements is being pursued and adopted to ensure they respond to new challenges and demands. Clearly this takes a commitment from central and subnational governments to a serious dialogue on ways to improve existing intergovernmental fiscal arrangements.

2.8 Benchmark Principles for Intergovernmental Fiscal Arrangements

The above discussion highlights four critical areas which need to be considered in designing and evaluating any intergovernmental fiscal arrangement: expenditure responsibility; tax assignment; intergovernmental transfers; and dynamic federalism. However, the nature of the arrangements is very complex. A whole range of issues need to be taken into account when determining an appropriate mix of expenditure responsibilities, taxing powers and intergovernmental fiscal transfers where necessary.

Considerable attention has been given to this issue from the perspective both of how best to design (ideal) fiscal federalism arrangements and how to evaluate established arrangements. The OECD, IMF, World Bank, ADB and the EU have devoted considerable time and resources to identifying best practice criteria and any tradeoffs involved in achieving the criteria.

However, there are often conflicting and competing demands between these categories and/or between levels of government. Consequently, it is essential that benchmarks based on clear principles are set when seeking to design or evaluate the fiscal federalism arrangements in a particular country.

A summary follows of the broadly accepted criteria against which countries should assess their intergovernmental fiscal arrangements.

Expenditure Responsibilities	**Benchmark 1 – Subsidiarity:** Subnational governments should, subject to efficiency considerations, be responsible for those services whose benefits are confined primarily to their geographic area and for which residents should have a choice over both the quantity and quality of service
	Benchmark 2 – Transparency of shared expenditure functions: When expenditure responsibilities are shared among jurisdictions, responsibilities of each tier of government should be clear and appropriate coordination mechanisms should be established
Tax Assignment	**Benchmark 3 – Tax assignment should follow expenditure responsibilities**
	Benchmark 4 – Economic efficiency of tax assignment: Subnational governments should avoid taxes on mobile factors and tax less mobile factors.
	Benchmark 5 – Fiscal need: Tax revenues should be able to expand in line with expenditure needs
Intergovernmental Fiscal Transfers	**Benchmark 6 – Equity of intergovernmental fiscal transfers:** Subnational governments with equal fiscal needs should be treated equally.
	Benchmark 7 – Neutrality: Subnational governments should not be able to influence the grant that they receive by manipulating their expenditure or tax decisions.
	Benchmark 8 – Predictability and flexibility: Subnational governments need to be able to budget and plan for the future but, at the same time, have the flexibility to respond to changing circumstances
	Benchmark 9 – Simplicity and transparency: The transfer mechanism or allocation formula should be readily understandable (transparent) and easy to administer (simple)
	Benchmark 10 – Autonomy: Subnational governments should have the independence to set priorities and manage services to respond to local needs
	Benchmark 11 – Incentive for sound management: The transfer mechanism should not penalise subnational governments for sound management
	Benchmark 12 – Accountability: The transfer system should enhance the accountability of subnational governments to their citizens
Dynamic Federalism	**Benchmark 13 – Dynamic:** The federal fiscal system should be open to comprehensive review and capable of structural change

It will be against these benchmark criteria that Australia's intergovernmental fiscal arrangements will be examined and contrasted with those in other comparable developed federations (Sections 4 to 7). In the following Sections of this Report each of these benchmarks is defined, and their significance and measurement discussed. Australia's performance against each benchmark is then assessed, followed by an assessment of other countries' performance against the benchmark. Every section on a benchmark then concludes with a discussion of how Australia compares against other countries. Before such an international comparative examination can be undertaken however, an overview of Australia's current fiscal federalism arrangements is outlined (Section 3).

3 Australia's Current Fiscal Federalism

This Section outlines the constitutional arrangements which are central to understanding Australia's current system of fiscal federalism, and the institutional framework within which the system has developed and operates.

3.1 Overview of Australia's constitutional and institutional arrangements with respect to Commonwealth and State financial relations

Australia's federation comprises three levels of government: the Commonwealth Government, with designated and delegated powers; six State Governments with residual powers, and two Territory Governments with State-type powers; and local government authorities with delegated powers and responsibilities. The roles and responsibilities of the Commonwealth and the six States are defined by the Australian Constitution, which was adopted in 1901 (Pincus, 2005).

3.1.1 Separation of functions/expenditure responsibilities

Australia's Constitution distributed legislative power over public policies between the Commonwealth and State governments in a highly decentralised way (Grewal and Sheehan, 2003). The division of powers under Australia's Constitution provides the Commonwealth with:

- a small number of *exclusive* powers – mainly in respect of customs and excise duties (s.86 provides that "On the establishment of the Commonwealth, the collection and control of duties of customs and of excise, and the control of the payment of bounties, shall pass to the Executive Government of the Commonwealth"), the coining of money and holding of referendums for constitutional change; and
- a large number of areas under s.51 where it can exercise powers *concurrently* with the States. For instance, s.51 provides that "The Parliament shall, subject to this Constitution, have power to make laws for the peace, order and good government of the Commonwealth with respect to: … (ii) Taxation; but so as not to discriminate between States or parts of States". To the extent that

State laws are inconsistent with those of the Commonwealth in these areas, the Commonwealth law prevails (s.109).

State governments retain responsibility for all other matters.

While the list of legislative powers for the Commonwealth does not mention a number of specific functions (for example education, environment, roads), this does not preclude action by the Commonwealth in these areas. For example, while the Commonwealth has no specific power in relation to the environment, it can legislate in this area under the external affairs power of the Constitution in support of any international agreement covering the environment. Further, the Commonwealth can influence State policies and programs by granting financial assistance on terms and conditions that it specifies (s.96) (Pincus, 2005).

The current distribution of legislative power between the Commonwealth and the States is vastly different from the original design of Australia's Constitution, with power now being highly centralised at the Commonwealth level. For the most part, this increase in Commonwealth power has occurred without formal amendment of the Constitution, that is, without the express approval of the majority of voters in the majority of States, as originally required (and set out in s.128). The High Court has played a key role in centralising power, including taxation power, at the Commonwealth level. Further centralisation could potentially result from an unsuccessful challenge by the States to the Commonwealth's WorkChoices legislation.

3.1.2 Assignment of taxing powers

The range of taxes available to the States is limited by Australia's Constitution and its interpretation by the High Court. State governments rely on relatively inefficient taxes compared with the Commonwealth. The principles of constitutional law limiting the taxing powers of the States may be distilled into three fundamental propositions[6]:

1. Pursuant to s.90, the power to impose excise and customs duties is exclusive to the Commonwealth. As a result of the High Court's interpretation of s. 90, a State may not impose a sales tax, a purchase tax or a value added tax.

6 NSW Tax Task Force, *Tax Reform and NSW Economic Development – Review of the State Tax System*, August 1988.

2. The States are not permitted to impose a tax which conflicts with the guarantee enshrined in s.92 that "trade, commerce, and intercourse among the States … shall be absolutely free."
3. The States are not permitted to impose a tax on the property of the Commonwealth (s.114). In addition, the Commonwealth enjoys a general implied immunity from State taxation.

These limitations on the States' taxing powers have resulted in a loss of self sufficiency in financing their expenditures. Alfred Deakin, one of Australia's Founding Fathers observed in 1902:

> The rights of self government of the States have been fondly supposed to be self-guarded by the Constitution. It has left them legally free, but financially bound to the chariot wheels of the Commonwealth.

Fiscal centralisation and decentralisation are normally measured in respect of the shares of subnational governments in national taxation revenues and public expenditures.[7] Table 1 provides evidence of a steep decline of fiscal decentralisation in Australia (and a corresponding steep increase in fiscal centralisation), particularly after World War II.

Table 1: Share of total taxation revenues by level of government

Year	State and Local	Commonwealth
1898-99	100	0
1901-02	87	13
1909-10	78	22
1918-19	27	73
1928-29	37	63
1938-39	41	59
1948-49	12	88
1958-59	17	83
1969-70	17	83
1979-80	20	80
1985-86	19	81
1989-90	22	78
1998-99	23	77
2001-02	18	82
2004-05	18	82

Sources: Mathews and Jay (1997, reprint of 1972 edition), pp. 54, 58, 83, 100, 152, 194, 230, 282; Mathews and Grewal (1997); and ABS, various years, Cat. No. 5512.0.

7 See for example Bird (1986) and Hunter and Shah (1996).

The figures in Table 1 show that the share of total tax revenues collected by the State (and local) governments has fallen from 87 per cent following federation to 18 per cent in 2004-05. Given their expenditure responsibilities for community services such as health and education, the centralisation of tax powers has made the States heavily dependent on Commonwealth grant funding (Grewal and Sheehan, 2003). Appendix A summarises major changes in the constitutional division of powers and their impact on decentralisation in Australia since federation, particularly with respect to the fiscal arrangements between the Commonwealth and the States.

Despite the trend towards centralisation of taxes, there have been instances where the Commonwealth has transferred taxes to the States. For example, the Commonwealth passed payroll tax to the States in 1971 and bank account debits tax in 1985 (and since abolished under the IGA).

3.1.3 Role of the High Court

It has been argued that, contrary to Deakin's assertion, Australia's Constitution did not establish a 'dysfunctional' federalism where fiscal power was concentrated heavily in one level of government (Grewal, 1997). The current constitutional assignment of tax powers could not have, by itself, created the extreme fiscal dependency of the States on the Commonwealth. Except for customs duties and excise duties, both of which were assigned exclusively to the Commonwealth, the States had access to all other taxes.

Exclusion of the States from the income tax base

The Commonwealth has power under s.96 of Australia's Constitution to "grant financial assistance to any State on such terms and conditions as the Parliament thinks fit". While this does not on its face appear to interfere in any way with State taxing powers, its potential to do so has been demonstrated by the history of the use of the provision (Saunders, 1987). Indeed, the provision has been described by one eminent writer as "a devious source of Commonwealth hegemony" (Lane, 1979, p850).

From the end of World War I until 1942 both the Commonwealth and the States levied their own income taxes. In 1942 the Commonwealth compulsorily took over all income tax collection. It did this first by raising its own tax rates to a level equivalent to that of the previous State and Commonwealth taxes combined. Secondly it legislated to give priority to the collection of Commonwealth income tax. Finally it legislated to provide for the payment of annual grants to each State, pursuant to s.96, on condition that the State did not impose its own income tax. The overall effect of the scheme was to deny the States the ability to raise their own income taxes; they were now to rely on tax reimbursement grants by the Commonwealth.

All three levels of the scheme implemented by the Commonwealth were upheld as valid by the High Court when it was challenged by South Australia in the *First Uniform Tax Case (South Australia v The Commonwealth)*.[8]

The validity of the third element of the scheme was again challenged in 1957 in the Second Uniform Tax Case (*Victoria v The Commonwealth*).[9] In that case the High Court reaffirmed its decision in *South Australia v The Commonwealth* to the effect that the Commonwealth's power under s.96 was very wide and that the terms and conditions of the challenged grants were a valid exercise of the power.

After 1959, the Commonwealth, in making general grants, ceased to stipulate that the States refrain from imposing an income tax, though an informal stipulation to that effect was made until 1976. However, in 1976 this stipulation was removed and in 1978, the Commonwealth passed the *Income Tax (Arrangements with the States) Act 1978* which facilitated the introduction of a State income tax.

In essence, that Act permitted each State to impose an income tax surcharge or to grant a rebate which would be collected or administered by the Commonwealth. No State took advantage of that legislation before it was repealed in the early 1990's, primarily because the Commonwealth did not 'make room' for a State income tax by reducing its own income tax rates to accommodate a State income tax without raising the overall level of income tax.

Exclusion of the States from the sales tax base

The range of taxes available to the States has also been severely limited by s.90 of the Constitution and the High Court's interpretation of that section. This section prohibits the States from imposing customs duties and excise duties but does not provide a clear definition of what constitutes an excise duty. The task of interpreting what constitutes an excise duty has been left to the High Court and its interpretations

8 (1942) 65 C.L.R. 373.
9 (1957) 99 C.L.R. 575.

have denied States entry not just into the narrow field of taxes on production of goods (as most economists would interpret excise duties) but also the broad field of sales taxes.

Despite States developing tax legislation carefully so as not to offend the High Court's previous interpretations of s.90, they almost invariably found new legislation struck down by the High Court under a new, narrower interpretation of s.90. In the 1970s, the States developed new taxes, which came to be known as 'business franchise fees', on petroleum products, tobacco and alcohol. In due course, these fees grew into a significant source of revenue for the States. Although levied at increasingly high rates, the fees were considered to have satisfied the criteria expounded by the High Court in previous cases until the High Court struck them down on 5 August 1997 in *Ha v NSW*.[10]

On 6 August 1997 the Commonwealth responded to this judgment by introducing a rescue package, at the States' request, to protect State finances by increasing the rates of customs and excise duties on tobacco and petroleum products and the rates of wholesale sales tax on alcoholic beverages. It then agreed to return all revenue thus collected (net of administrative costs) to the States in the form of revenue replacement payments (RRPs). These measures, further increased the level of VFI.

In his standard work on the Australian Constitution, Professor Colin Howard has said:

> The definition of excise duty cannot be counted among the High Court's successes. No escape from the morass of judicial disagreement now seems possible by curial action alone. The main consequences have been lasting uncertainty, and consequential litigation, in a significant area of liability to taxation and now a severe and unnecessary restriction on the taxation revenue of the States … The case law on s.90 suggest[s] that the High Court is by and large unsympathetic to State revenue and expenditure problems in general.[11]

An examination of the historic record shows that in fact the rationale for s.90 was to avoid the imposition of discriminatory tariffs between States and hence facilitate free interstate trade. This has led to the argument that the High Court's interpretation of s.90 is not only eco-

10 (1997) 146 ALR 355.

11 See Howard C. *Australian Constitutional Law* (3rd Ed. 1985), p.437. Another commentator has put it even more strongly: "The interpretation of section 90 – through diverse opinions, partial adherence to precedent, shifting majorities and changes to the composition of the Bench – is a complete mess": M. Coper, *Sydney Morning Herald*, 22 August 1983.

nomically and financially unsound, it is in conflict with the intentions of the founders of the federation (Lambert, 1996). Whatever the view, there is no question that s.90 has a profound impact on State tax systems.

3.1.4 Institutional Framework

The CGC is one of the key institutions in Australia's system of fiscal federalism. The CGC provides advice to the Commonwealth on the distribution of untied (GST revenue) and health care grants to the States and Territories (refer Appendices B and C). The role of the Loan Council, comprising Commonwealth and State/Territory Treasurers, has become less crucial.

Commonwealth Grants Commission

The CGC is a statutory authority operating under the *Commonwealth Grants Commission Act 1973*. The main function of the CGC is to provide advice to the Commonwealth on how the pool of GST revenue and health care grants should be distributed among the States and Territories. The CGC's advice is based on the principle of fiscal equalisation which states that[12]:

> Each State should be given the capacity to provide the average standard of State-type public services, assuming it does so at an average level of operational efficiency and makes an average effort to raise revenue from its own sources.

Equalisation is designed to equalise States' capacity to provide services (or to fund inputs), not their results (or services actually delivered – outputs). This is because the CGC's recommendations relate to untied general revenue grants and each State is free to decide its own priorities.

The CGC is an advisory body that undertakes inquiries in response to terms of reference. The Commonwealth decides the terms of reference after discussions with the States. While the resulting CGC reports are provided formally to the Commonwealth, they are made available to the States immediately thereafter. The (relativities) recommendations in those reports are considered at the Annual Treasurers' Conference (Ministerial Council on Commonwealth-State Financial Relations).

The CGC was established in 1933 to assess claims made by States for financial assistance (special grants) under s.96 of the Constitution.

12 See Commonwealth Grants Commission website at <http://www.cgc.gov.au/>

After the introduction of uniform income taxation in 1942, the capacity of all the States to raise revenue fell far short of their expenditures. The converse was true for the Commonwealth, resulting in high levels of VFI. Consequently, large payments from the Commonwealth to the States have been made in each year since.

Loan Council

The Australian Loan Council is a Ministerial Council – comprising the Commonwealth Treasurer as Chair and his/her counterparts from the States and Territories[13]. It was established in 1927 to coordinate public sector borrowings in Australia. Section 105A of the Constitution provides that the Commonwealth may make agreements with the States with respect to the public debts of the States.

The Loan Council is now mainly concerned with enhancing the transparency and accountability of public sector finances rather than, as in the past, securing adherence to strict borrowing limits. The present arrangements, introduced in 1993-94, are designed to enhance the role of financial market scrutiny as a discipline on borrowings by the public sector.

The Loan Council usually meets once a year, concurrent with the Annual Treasurers' Conference, otherwise conducting business by correspondence. Each jurisdiction nominates to Loan Council its intended borrowing allocation for the forthcoming financial year, known as its Loan Council Allocation (LCA). The LCA provides an indication of a government's probable cash call on financial markets over the year. LCA nominations are then considered by the Loan Council having regard to each jurisdiction's fiscal position and reasonable infrastructure requirements, as well as to the macroeconomic implications of the aggregate figure. Since 1993-94, the Loan Council has approved all jurisdictions' LCA nominations without change.

Each jurisdiction is required to take into account its Loan Council approved LCA in formulating its budget. Significant departures from Loan Council approved LCAs and budget time LCA estimates must be explained to the Loan Council and the public.

13 The Loan Council technically consists of the Prime Minister and the Premier/Chief Minister of each State and Territory but in practice each member is represented by a nominee, usually the Treasurer of that jurisdiction, with the Commonwealth Treasurer as Chairman.

3.1.5 Consultative Framework

Appendix C also outlines the current consultative framework for Commonwealth-State financial relations in Australia. This framework reflects two significant changes made in the early 1990s. The first was the establishment of COAG in 1992. The second, concurrent with the introduction of the GST and the associated reforms set out in the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, was a new Ministerial Council on Commonwealth-State Financial Relations (the Annual Treasurers' Conference), established in 1999. A number of other Ministerial Councils have also been established to deal with specific policy issues.

Council of Australian Governments

COAG is the peak intergovernmental forum in Australia. COAG comprises the Prime Minister (Chair), State Premiers, Territory Chief Ministers and the President of the Australian Local Government Association (ALGA). The then Prime Minister, Premiers and Chief Ministers agreed to establish COAG in May 1992. It first met in December 1992.

The role of COAG is to initiate, develop and monitor the implementation of policy reforms that are of national significance and which require cooperative action by Australian governments (for example, National Competition Policy, water reform, reform of Commonwealth and State/Territory roles in environmental regulation, the use of human embryos in medical research, counter-terrorism arrangements and restrictions on the availability of handguns). Issues may arise from, among other things: Ministerial Council deliberations; international treaties which affect the States and Territories; or major initiatives of one government (particularly the Australian Government) which impact on other governments or require the cooperation of other governments.

COAG meets on an 'as needed' basis. However, the Prime Minister stated after the April 1999 Premiers' Conference that, since there would be no further Premiers' Conferences following the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, COAG would meet at least once a year from 2000. Alternatively, COAG may settle particular issues out-of-session by correspondence. In recent years, a number of issues have been settled in this manner.

The outcomes of COAG meetings are contained in communiqués released at the end of each meeting. Where formal agreements are reached, these may be embodied in Intergovernmental Agreements.

Ministerial Council for Commonwealth-State Financial Relations (the Annual Treasurers' Conference)

The Ministerial Council's functions include:

(i) the oversight of the operation of the GST;

(ii) the oversight and coordination of the implementation of the IGA;

(iii) the review of matters of operational significance raised through the GST Administration Subcommittee;

(iv) discussion of Commonwealth Grants Commission recommendations regarding relativities prior to the Commonwealth Treasurer making a determination;

(v) monitoring compliance with the conditions governing the provision of assistance to first home owners set out in Appendix D to the IGA;

(vi) monitoring compliance with the Commonwealth's undertaking with respect to SPPs;

(vii) considering reports of the GST Administration Subcommittee on the performance of the ATO in GST administration;

(viii) reviewing the operation of the IGA over time and considering any amendments which may be proposed as a consequence of such review;

(ix) making recommendations to the Commonwealth Treasurer on the Guaranteed Minimum Amount applying to each State and Territory under the Transitional Arrangements;

(x) approving changes to the GST base which require the support of a majority of Commonwealth, State and Territory Governments;

(xi) considering on-going reform of Commonwealth-State financial relations; and

(xii) considering other matters covered in the IGA.

Under the IGA the Commonwealth Treasurer, as Chair, convenes the Ministerial Council in consultation with the other members of the

Council not less than once each financial year. If the Commonwealth Treasurer receives a request from a member of the Council, the Commonwealth Treasurer consults with the other members concerning convening a meeting.

Formally, all questions arising in the Ministerial Council are determined by unanimous agreement unless otherwise specified in the IGA. While the Ministerial Council takes decisions on most business arising from the operation of the IGA, major issues may be referred by the Ministerial Council to Heads of Government for consideration, including under the auspices of COAG.

The Ministerial Council has established a GST Administration Subcommittee comprising Commonwealth, State and Territory Treasury officials to monitor the operation of the GST, to make recommendations regarding possible changes to the GST base and rate and to monitor the ATO's performance in GST administration.

Other Ministerial Councils

There are some thirty Ministerial Councils where Commonwealth and State/Territory Ministers meet to discuss policy issues specific to their portfolio responsibilities. These issues affect both levels of government.

Ministerial Councils are the forums where grant programs are agreed. Under these grant programs the Commonwealth agrees to provide funds to the States on certain conditions. These conditions nearly always involve the States using the grants for a specific purpose (approximately 40 per cent of total transfers from the Commonwealth to the States are tied grants). These also often require States to match these grants with revenue from their own sources. GST revenue grants, comprising approximately 60 per cent of total grants, are available for general purposes. The only other untied grants are National Competition Payments, which are comparatively minor. The process for agreeing tied grants and general purpose grants is set out in Section 3.2 and in Appendix C.

Tied (Specific Purpose) Grants: Specific purpose payments from the Commonwealth to the States are grants that are tied to specific types of expenditures. The Commonwealth offers specific purpose payments for a variety of reasons, including: implementing national priorities in areas of State constitutional responsibility (for example, gun control); implementing national priorities in areas that cross State borders (for example, national land transport, salinity and water quality); complying with international obligations (for example, world heritage properties); and compensating States for policies in areas of Commonwealth constitutional responsibility that adversely impact on State finances (for example, liberalising access to Commonwealth pensioner concessions).

The conditions under which the grants are paid to States are documented in agreements that are typically renegotiated every three to five years. Because these agreements each have a limited duration, States do not have long-term certainty over this significant portion of total budget revenues. In most of the agreements, the Commonwealth requires States to spend further amounts on the same specific purpose, proportionate to the value of the Commonwealth grant. These matching requirements consequently limit budget flexibility for funding each State's own priorities in service delivery.

Untied (General Purpose GST Revenue) Grants: The GST revenue grants distribution arrangements are set out in the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (IGA), signed by Heads of Government in 1999. The revenue pool is determined by GST revenue raised. GST revenue is distributed among the States and Territories in accordance with HFE principles (subject to certain transitional provisions). A State or Territory's share of the revenue pool is based on its population share, adjusted by a relativity factor which embodies per capita financial needs based on recommendations of the CGC. The relativity factor for a State or Territory is determined by the Commonwealth Treasurer after consultation with each State and Territory. Unlike tied grants, GST revenue grants are freely available for use by the States and Territories for any purpose.

3.2 Recent Reforms in Australia: The GST and post-2000 federal fiscal relations

In 1999 the Prime Minister, State Premiers and Territory Chief Ministers signed the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, dealing with the financial implications for the States and Territories of the GST reforms. Major provisions of the IGA were:

- Distribution of GST revenue to the States through untied grants based on fiscal equalisation principles;

- Abolition of Financial Assistance Grants (FAGs) and Revenue Replacement Payments to the States;
- GST revenue to be used to fund abolition of the Commonwealth's wholesale sales tax (WST) and the abolition or reduction of various State taxes, including financial institutions duty, stamp duty on quoted marketable securities, debits tax and bed tax; and
- Review by 2005 of other State taxes[14] with a view to their possible abolition.

The Commonwealth makes grants to the States and Territories equivalent to the revenue from the GST subject to the arrangements under the IGA (IGA, cl.7). Through the series of offsets and other arrangements set out in the IGA (refer Appendix B) the GST revenue grants received by the States were less than the FAGs previously received from the Commonwealth. As a result, the IGA also provided transitional funding from the Commonwealth in the form of Budget Balancing Assistance to ensure the States were left no worse of during the initial years of the agreement. One of the key objectives of the IGA was that in the longer term the States would have an improved financial position (IGA, cl.2(iii)). From 2006-07 all States and Territories are estimated to be in a better position than they would have been in the absence of the reforms.[15]

Since 2000 there have been some significant moves towards further reform of State taxes. In March 2004 all States and Territories agreed to abolish the bank account debits tax by 1 July 2005. NSW had already abolished the tax from 1 January 2002. All States and Territories also committed to a review of various stamp duties on business. At the Ministerial Council's March 2005 meeting the Commonwealth argued that the GST now provided the revenue capacity to abolish most of these taxes. Accordingly, it put forward a timetable for the abolition of business stamp duties (except stamp duty on business conveyances of real property) by which these taxes would be abolished by 1 July 2007. Each State has now agreed their own timetable with the Commonwealth for the abolition of all the stamp duties

14 Stamp duty on non-residential conveyances; leases; mortgages, debentures, bonds and other loan securities; credit arrangements, instalment purchase arrangements and rental arrangements; and cheques, bills of exchange, promissory notes and unquoted marketable securities.

15 Commonwealth Budget Paper No. 3, Federal Financial Relations 2006-07, p.3.

listed for review excluding stamp duty on business conveyances of real property.

With the implementation of the IGA, the CGC's fiscal equalisation process assumed a much greater importance, since it now applies to the GST revenue pool rather than the FAGs pool. The Commonwealth Treasury has estimated that, under the previous system, the 2005-06 FAGs to which fiscal equalisation would have applied would have been $22,103m. However, the amount of GST revenue forecast to be distributed in that financial year according to the Commission's fiscal equalisation recommendations is $36,812m, almost 70 per cent higher.[16] The new system magnifies the impact of any defect in the CGC's fiscal equalisation methodology.

The CGC includes in its calculations all State taxes and a comprehensive range of public expenditure categories. The calculations produce a set of State-by-State relativities, the most recent of which, from the 2006 update, appear in Column (1) of Table 2. A relativity greater than one indicates a net disability, which will be compensated by a higher than average grant from the GST revenue pool. A relativity of less than one has the opposite implication. Column (2) shows the interstate distribution of GST revenues in 2005-06 (based on 2005-06 relativities), while column (3) shows the average annual percentage increase in GST receipts for each State since 2001-02.

Table 2: GST relativities and distribution

	State relativities in 2006 Update (1)	2005-06 GST distribution $m (2)	Ave increase p.a. in GST revenue grants 2001-02 to 2005-06 per cent (3)	Equal *per capita* redistribution per head $ (4)	State of Origin redistribution per capita $ (5)
NSW	0.87346	10,426.7	1.8	-295	-407
Vic	0.89569	7,864.5	4.6	-268	-340
Qld	1.02404	7,721.1	8.6	104	257
WA	1.00497	3,822.1	7.4	57	185
SA	1.18695	3,449.0	5.0	409	528
Tas	1.54939	1,501.4	5.8	1,258	1,525
ACT	1.14585	722.6	4.5	395	54
NT	4.32765	1,832.7	7.2	7,172	7,407
Total		37,340.1	5.0		

Sources: *Columns 1-4 : 2005-06 Budget Paper No 3, Federal Financial Relation, Commonwealth of Australia.*
Column 5: Derived using NSW Budget Papers 2005-06, Budget Statement Budget Paper No.2, Table 8.11, p.8-17.

16 Commonwealth Budget Paper No. 3, Federal Financial Relations 2006-07, Table 12, p.14.

The objective of fiscal equalisation is to redistribute from the richer to the poorer States and the mechanism applied in Australia is explained in Appendix C.

One possible measure of the redistribution is a comparison of the actual revenue distribution with an alternative hypothetical redistribution conducted on an equal *per capita* basis. Column (4) indicates the extent and direction of the total State-by-State redistribution in terms of redistribution per head. On this basis Victoria in 2005-06 contributes on average $268 per capita to people in other States, while Queensland receives an average $104 per capita from other States.

Another way to calculate the extent of this redistribution is to compare how much State populations contributed in GST revenue (the *State of Origin* payments) with how much States received back in the revenue distribution. This provides a better indication of the extent of the actual redistribution than the equal *per capita* comparison. Column (5) indicates the extent of the estimated redistribution per capita calculated on a State of origin basis.

On this basis, Victorians on average paid an estimated $340 to other States while Queenslanders on average gained an estimated $257 from other States. The redistribution calculated on a State of origin basis is clearly significantly greater than that calculated on an equal *per capita* basis.

3.3 The Next Step?

The substantial level of transfers from the Commonwealth to the States indicates the significant mismatch between expenditure responsibilities (e.g. the provision of services such as health, education, transport and policing) and own-source revenue (arising from tax assignment in the Australia's Federation). This vertical fiscal imbalance (VFI) sees States rely on fiscal transfers from the Commonwealth, which controls most of the national tax base, for the additional revenue needed to fund their responsibilities.

While Australia is not alone in dealing with the challenges posed by VFI and other fiscal arrangements between national and subnational levels of government, Australia is distinguished by its rigid system of Commonwealth-State financial relations. The changes that have occured have not been structural nor the result of a comprehensive and systematic review of Australia's intergovernmental fiscal arrangements. National and State governments in Australia have not had a substantial debate about the assignment of functions and responsibilities between the different levels of government prior to federation in 1901.

The arrangements for financial transfers from the Commonwealth to the States have remained largely unchanged since the establishment of the Commonwealth Grants Commission in 1933. The only real area of change has been the steady decline in the revenue raising powers of the States, concomitant with the steady rise in the financial power and reach of the Commonwealth.

A substantial comprehensive review of Commonwealth-State financial relations in Australia has been the subject of numerous calls by State governments. However, such a review cannot be undertaken without identifying how Australia performs against best practice in terms of intergovernmental fiscal arrangements. It is also helpful to assess how Australia compares with comparable federations.

4 Benchmarking Expenditure responsibilities

Section 2.8 outlined the benchmarks against which countries' intergovernmental fiscal arrangements should be assessed. This Section analyses the expenditure benchmarks. There are two key expenditure benchmarks: subsidiarity and transparency.

The literature explains that subsidiarity should be the defining principle for allocating expenditure responsibilities. Where shared responsibilities remain, there should be transparency about which level of government is responsible for a particular aspect of the shared responsibility as this increases the accountability of government.

4.1 Benchmark 1: Subsidiarity

Benchmark 1: Subsidiarity

Subnational governments should, subject to efficiency considerations, be responsible for those services whose benefits are confined primarily to their geographic area and for which residents should have a choice over both the quantity and quality of service.

4.1.1 Benchmark: Definition, significance and measurement

The World Bank[17] expresses the view that

> The first fundamental step in the design of a system of intergovernmental fiscal relations should be a clear assignment of functional responsibilities among different levels of government… A stable and meaningful decentralisation requires an unambiguous and well-defined institutional framework in the assignment of expenditure responsibilities among the different levels of government together with

17 World Bank Institute, Intergovernmental Fiscal Relations and Local Financial Management Program, Topic 5, The Assignment of Revenues and Expenditures in Intergovernmental Fiscal Relations, This report draws from The Tax Assignment Problem: Conceptual and Administrative Considerations in Achieving Subnational Fiscal Autonomy by Charles E. McLure and The Assignment of Expenditure Responsibilities by Jorge Martinez-Vazquez, <http://info.worldbank.org/etools/docs/library/128818/McLure%20Martinez%20The%20Assignment%20of%20Revenues%20and%20Expenditures%20in%20Intergovernmental%20Fiscal%20Relations.pdf>

sufficient budgetary autonomy to carry out the assigned responsibilities at each level of government.

This Section reviews the issues which should be considered in determining the assignment of expenditure responsibilities between national and subnational governments. The generally accepted conclusion in federal systems internationally and in the literature is that the fundamental principle for expenditure assignment should be *subsidiarity*. Subsidiarity provides the basis for which government services can reflect community preferences and local conditions and yet be delivered as efficiently as possible.

In order to deliver the types and levels of services that are most appropriately suited to their citizens, governments need to be appropriately aware of local preferences, which can vary across geographic areas within a single nation. If these geographic areas are each represented by their own subnational government, those governments can tailor the quantity and quality of service to suit regional tastes. Governments also need to be aware of the total benefits of the services they deliver. This occurs most easily when all of the users and/or beneficiaries of the services are citizens of the same subnational government.

Services that have traditionally been thought to be appropriate for subnational governments include primary and secondary education, health care, local transportation networks and care of the elderly.

On the other hand, for some services it is not feasible or appropriate to tailor the quantity and quality of service to suit subnational tastes. These services are more effectively delivered by the central government, and include:

- services generating benefits that extend across the country (for example, defence and border protection);
- services generating spillovers across the country. COAG's *National Reform Agenda*[18] recognises that policies aimed at building human capital generate positive spillovers and, in the longer term, generate benefits that extend across the country;
- services benefiting from economies of scale (for example, certain transport networks);
- services primarily redistributing income (for example, social welfare, both in cash and in kind);

18 Council of Australian Governments' Meeting 10 February 2006, *Communiqué*.

- services where uniform national standards are expected (for example, certain environmental standards).

In addition to allocating expenditure responsibilities to the appropriate level of government, it is also necessary to provide autonomy. Where responsibility is shared amongst different levels of government there is a risk of conflicting policies between them. It also provides incentives for cost-shifting between governments, potentially reducing the efficiency and accountability with which public resources are allocated.

In a paper produced for the World Bank, Shah (1994) attempted a comprehensive assignment of major public services based upon the theoretical considerations discussed above and in Section 2. His conclusions, and the brief reasons for these conclusions, are presented in Table 3 below. He makes the distinction between the assignment of "Policy, standards and oversight" on the one hand, and "Provision/ administration" on the other. This Table provides a very useful framework for the evaluation of the assignment of expenditure responsibilities in Australia and other countries.

Table 3: Conceptual basis of expenditure assignment

Expenditure category	Responsibility		Comment
	Policy standards and oversight	Provision/ administration	
Defence	F	F	Benefits and costs are national in scope
Foreign affairs	F	F	Benefits and costs are national in scope
International trade	F	F	Benefits and costs are national in scope
Monetary policy, currency, banking	F	F	Benefits and costs are national in scope
Interstate commerce	F	F	Benefits and costs are national in scope
Transfer payments to persons	F	F	Redistribution
Subsidies to business and industry	F	F	Regional development , industrial policy
Immigration	F	F	Benefits and costs are national in scope
Fiscal policy	F,S	F,S,L	Coordination is possible
Regulation	F	F,S,L	Internal common market
Natural resources	F	F,S,L	Promotes a common market

Expenditure category	Responsibility: Policy standards and oversight	Responsibility: Provision/ administration	Comment
Environment	F,S,L	S,L	Benefits and costs may be national, regional or local in scope
Industry and agriculture	F,S,L	S,L	Significant interjurisdictional spillovers
Education	F,S,L	S,L	Transfers in kind
Health	F,S,L	S,L	Transfers in kind
Social welfare	F,S,L	S,L	Transfers in kind
Police	S,L	S,L	Primarily local benefits
Parks and recreation	F,S,L	F,S,L	Primarily local responsibility, but national and provincial governments may establish own parks
Highways			
Interstate	F	S,L	Interstate common market
Intrastate	S	S,L	Intrastate benefits and costs
Local	L	L	Local benefits and costs

Note to Table 3: F is federal responsibility, S is state responsibility, L is local responsibility.
Source: adapted from Shah (1994), Table 2.

4.1.2 Australia's performance against the Benchmark

Table 4 presents IMF data on government spending allocated across broad categories for both Australia and other selected federal countries. This table provides the basis for assessing how well Australia's allocation of responsibilities compares to the subsidiarity benchmark and to international experience.

Table 4: Proportions of outlays by tier of government in selected federal countries

		Australia (2003) %	Austria (2002) %	Belgium (2002) %	Canada (2003) %	Germany (2003) %	Switzer-land (2001) %
General public services	National	83	85	89	69	56	66
	States	17	15	11	31	44	34
Defence	National	100	100	100	100	100	95
	States	0	0	0	0	0	5
Public order and safety	National	15	96	97	43	11	11
	States	85	4	3	57	89	89
Economic affairs	National	40	59	43	38	58	52
	States	60	41	57	62	42	48

		Australia (2003) %	Austria (2002) %	Belgium (2002) %	Canada (2003) %	Germany (2003) %	Switzer-land (2001) %
Environmental protection	National	21	57	6	47	16	n.a.
	States	79	43	94	53	84	n.a.
Housing and com-munity amenities	National	29	51	0	47	37	37
	States	71	49	100	53	63	63
Health	National	52	68	98	7	97	2
	States	48	32	2	93	3	98
Recreation and culture	National	43	62	16	58	13	27
	States	57	38	84	42	87	73
Education	National	40	70	16	8	4	15
	States	60	30	84	92	96	85
Social protection	National	91	90	87	71	85	80
	States	9	10	13	29	15	20
Total	National	65	80	76	47	70	56
	States	35	20	24	53	30	44

Source: IMF Government Finance Statistics Yearbook, 2004

In Australia, defence services are provided entirely by the Commonwealth, as are social protection services in the area of income support. This is consistent with the principle of subsidiarity. Defence generates benefits that extend across the country, whilst income support redistributes income.

Welfare and community-type social protection services are delivered locally by the States, as are public order and safety services and environmental protection services. These allocations of responsibility are consistent with the benchmark, since the benefits of these services are primarily local, and the quantity and quality can be appropriately tailored to suit local tastes.

Areas where there is a significant degree of overlap between Australian levels of government include health, education, economic affairs, housing and community amenities and recreation and *culture*. It is these areas that compromise the subsidiarity principle in Australia. Aspects of health and education, in particular, are key parts of the *National Reform Agenda*, and are examined further in the context of Benchmark 2 below.

4.1.3 Performance of other countries against Benchmark

Expenditure responsibilities are generally allocated between the different levels of government in a relatively consistent pattern across all federations considered by this study. Defence and social protection are largely provided by central governments, although Canadian provincial governments provide an above average share of the latter, at 29 per cent of total expenditure.

Responsibilities for economic affairs and housing and community amenities are generally shared across both levels of government. Public order and safety is generally provided by State governments, although there are certain exceptions. The Canadian central government is responsible for 43 per cent of public order and safety expenditure, while the Austrian central government is almost entirely responsible for these services.

Environmental protection services are provided mostly by State governments in Belgium and Germany, while in Austria and Canada the central governments have a much greater role, responsible for 57 per cent and 47 per cent of expenditure respectively.

Health services in other federations are provided almost entirely by either the central government or the State governments, although Austria has a greater degree of overlap than average, with the national government undertaking 68 per cent of public expenditure on health and State governments 32 per cent. Education is generally a State government responsibility, although again Austria has a greater than average degree of overlap, with a 70/30 national/State split.

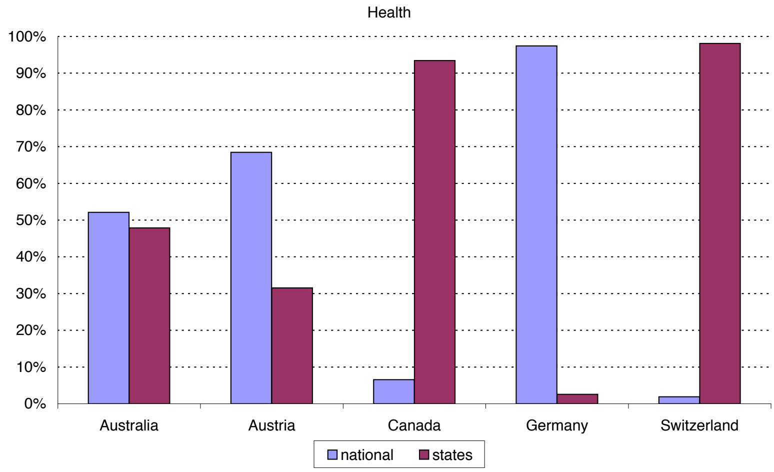
4.1.4 How Australia Compares

The main points of difference between the Australian system and the other federations relate to the allocation of responsibility for health and education.

Responsibility for health services in Australia, measured as expenditure shares, is shared almost evenly between the central (52 per cent) and State (48 per cent) governments (Figure 1). By contrast, all other federations, apart from Austria, allocate that responsibility almost exclusively to one or other level of government.

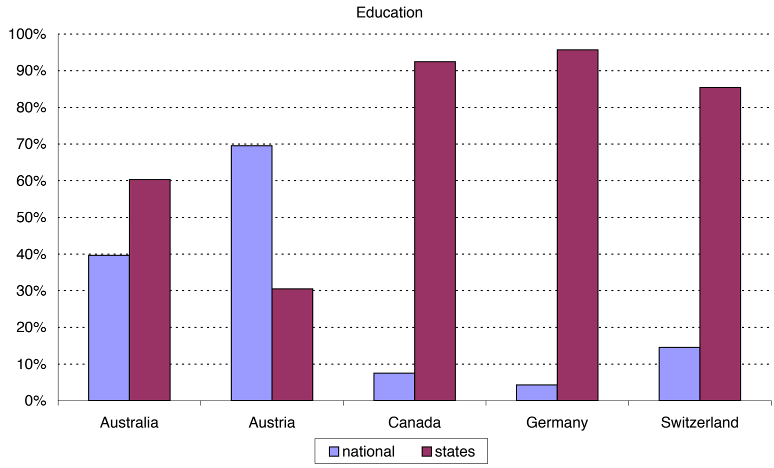
Similarly, education services in all other federations – apart from Austria – are delivered almost exclusively by the State governments. By contrast, Australia's central government is responsible for 40 per cent of the education services (Figure 2).

Figure 1: Health Expenditure – Central Government v State Government



Source: IMF Government Finance Statistics Yearbook, 2004

Figure 2: Education Expenditure – Central Government v State Government



Source: IMF Government Finance Statistics Yearbook, 2004

The existence in Australia of shared responsibilities in the areas of health and education offend the principle of subsidiarity. As a result there is a risk of a lack of policy coordination between the two levels of government. It also provides incentives for cost-shifting and duplication between governments, with the potential to reduce the efficiency with which public resources are allocated.

4.2 Benchmark 2: Transparency of shared expenditure functions

> **Benchmark 2: Transparency of shared expenditure functions.**
>
> When expenditure responsibilities are shared among jurisdictions, responsibilities of each tier of government should be clear and appropriate coordination mechanisms should be established.

4.2.1 Benchmark: Definition, significance and measurement

When expenditure responsibilities are shared among different levels of government, the responsibilities of each level of government should be clear, and appropriate coordination mechanisms should be established.

Where shared responsibilities exist for delivering services there is potential for confusion over the respective roles of the national and State governments. Transparency can suffer where the users of services are unaware of the funding arrangements or management responsibilities assumed by the different levels of government. This is particularly the case when services which appear indistinguishable to the user are funded or managed by different levels of government.

Despite the complexity of the existing arrangements in many countries, both theory and experience suggest strongly that it is important to set out expenditure responsibilities as clearly as possible in order to enhance accountability and reduce unproductive overlaps.

The possible implications of shared expenditure responsibilities that lack transparency or where coordination mechanisms are inappropriate include:

- **The quality and quantity of public services may not meet public expectations**. Where the responsibility for providing services is shared across two (or more) levels of government it is important to ensure that those services are properly coordinated so that the most efficient and effective mix is provided. Failure to establish a clear assignment of expenditure responsibilities for each level of government can become a source of conflict between national and State governments and can lead to an inefficient provision of public services. In situations where government budgets are tight, which is almost always, the lack of clear assignments may lead to the underprovision of key public services,[19] both in terms of the quality and quantity provided.

- **Accountability for the provisions of services may suffer**. In areas of shared expenditure responsibility the coordination mechanism must be sufficiently transparent to allow citizens to determine whether they are satisfied with the services, and which level of government is responsible for providing the individual elements of those services. Accountability is often best promoted by establishing a clear and close linkage between the costs and benefits of public services, so that the overall amount of expenditure responsibility assigned to a particular level of government will ideally correspond to the amount of revenues that level of government has at its potential command to invest in those services. Accountability is also relevant to intergovernmental fiscal mechanisms – refer Benchmark 12.

One of the arguments for fiscal decentralisation[20] is that bringing government closer to the people will lead to more participation in government, will likely provide an outcome that is closest to the preferences of voters, and will allow the political process to guarantee a more efficient operation of subnational government, with the results that:

- the mix of services provided will match the demands of the local population;
- governments will become more accountable to voters for the quality of services they provide; and
- local populations will be more willing to pay for public services, since their preferences will be honoured.

Experience has shown that effective decentralisation requires adaptations in institutional arrangements for intergovernmental coordination, planning, budgeting, financial reporting, and implementation. Such arrangements may encompass both specific rules (e.g. in the design of fiscal transfers) and provision for regular intergovernmental meetings and periodic reviews of intergovernmental arrangements.[21]

19 See: World Bank Institute, Expenditure Assignment, Topic 5 at <http://www1.worldbank.org/wbiep/decentralization/Course%20Topics.htm>.

20 Bahl, R. *Worldwide Trends in Fiscal Decentralisation*, World Bank, International Tax Dialogue <http://www1.worldbank.org/wbiep/decentralization/library1/bahl1.htm>

21 The World Bank Group, *Intergovernmental Fiscal Relations, Expenditure Assignment* <http://www1.worldbank.org/publicsector/decentralization/fiscal.htm>

4.2.2 Australia's performance against the benchmark

Australia has a relatively high and increasing degree of shared functions between different levels of government. For instance, the funding and delivery of transport, housing, health, aged care, disability services, education and child care services, are organised through various intergovernmental arrangements. Other areas with service interfaces between governments include environmental management, workers' compensation, occupational health and safety, industrial relations and indigenous affairs.

The design of intergovernmental arrangements for each of these areas has important implications for the cost-effective provision of services. Inefficiencies arise where there is unhelpful duplication of effort, cost shifting, and ineffective management of different parts of the overall service package. These inefficiencies are not necessarily the result of shared functions, but may be the result of ambiguity about the responsibilities or weaknesses in governance arrangements (Pincus 2005).

The Commonwealth recognises[22]

> … joint government involvement in the same functional areas raises significant challenges including complexity for the public, cost and blame shifting, and possible duplication or gaps in service delivery

and suggests

> Going forward, it will be important for the Australian Government and the States to clarify roles and responsibilities in order to improve productivity in the provision of services to the public while sustaining government finances. Clarification of roles will require consideration of national strategic priorities and judgements as to the tier of government that is likely to discharge those priorities most effectively.

Australia has unusually high levels of federal/State overlap in the areas of health and education (Figures 1 and 2) – with health being the most extreme example. In relation to health, the lack of coordination between Commonwealth and State programs is widely recognised, despite institutional arrangements including the Australian Health Ministers Conference and the Australian Health Ministers Advisory Council. Coordination of education programs is slightly better, although there is still duplication of responsibilities.

Health is a large sector of the economy, accounting for around 10 per cent of GDP and growing[23]. Health spending accounts for about

22 Commonwealth Government Budget 2005-06, Budget Paper No.1, p.4-18.

23 Council of Australian Governments' Meeting, 10 February 2006, *Communiqué*.

25 per cent of State government spending. Given the importance of the health sector to the national economy and government budgeting, the potential for misallocation of resources where spending responsibilities are unclear or uncoordinated is considerable.

Podger (2005) notes that the health system is characterised by a lack of patient-oriented care, allocative inefficiency, poor use of information technology, and poor use of competition. These problems are compounded by obstacles to workforce substitution, poor distribution and some old-fashioned workplace practices that constrain flexibility. Of particular interest to this Report and Benchmark 4 is that "every one of these structural problems is exacerbated by Australia's division of roles and responsibilities between the Commonwealth and the States."

FitzGerald (2005) notes:

> One inefficient result of a fragmented funding system under budgetary pressure is cost shifting between governments. With the Australian Government responsible for subsidising private medical services and the States funding public hospital services, there is an incentive for each level of government to design their program arrangements so that services will be delivered so that the other level of government meets the cost, even though this may result in the patient not being treated optimally. For example:
>
> - public hospitals (State funded) may refer patients being discharged to their GP (Australian Government subsidised) instead of providing post-hospital services directly;
> - on the other hand, if patients have difficulty in accessing GP services (for example, after hours), they may attend public hospital emergency departments to receive primary care services (State funded); and
> - shortages of Australian Government-subsidised residential aged care places are resulting in public hospital beds being inappropriately occupied on a long-term basis by elderly patients.
>
> These examples demonstrate that the manner in which one government funds (or fails to fund) health services can have significant flow-on implications for the health services funded by another government and result in less than optimum health care for patients. Rather than which government bears the cost, the central issue should be which setting will provide the most effective (and cost-effective) care for the patient. Current arrangements do not ensure this.

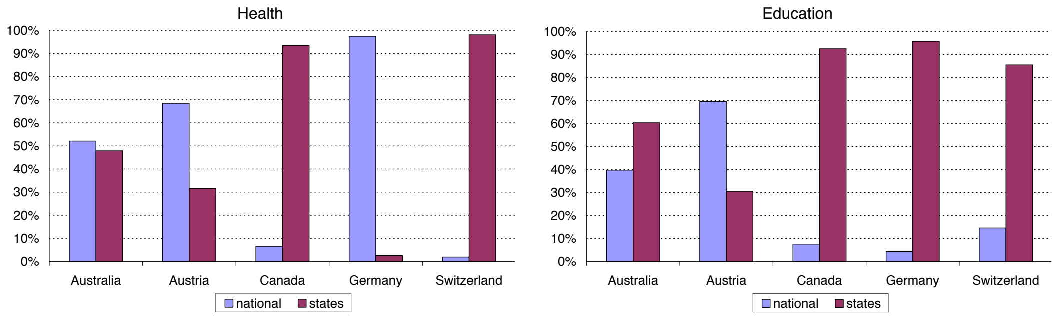
It is widely recognised that current Commonwealth-State funding arrangements create significant distortions and disincentives which prevent the adoption of a more efficient and effective allocation of health resources.[24] The lack of transparency of the current arrangements clearly leads to suboptimal outcomes and poor accountability.

Health is clearly the stand-out area of public policy in Australia which suffers from a lack of transparency. However, given the relatively high degree of shared functions between governments, other areas of public policy also suffer the same problem though not to the same degree as health. These areas include funding and delivery of transport, housing, aged care, disability services, education and child care services. The lack of coordination between Commonwealth and State programs in Australia is widely recognised, while the financial costs are not.

4.2.3 Performance of other countries against the benchmark

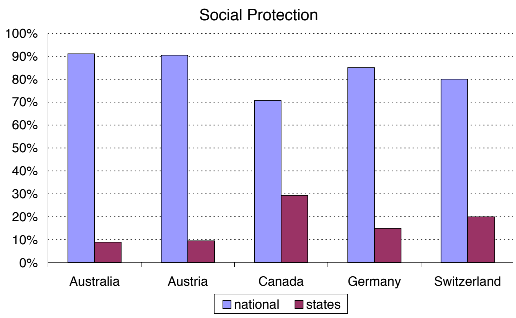
With the notable exception of defence spending (excluding Switzerland) all policy functions have some degree of shared expenditure between national and State governments. In many cases – most notably health and education – one level of government (whether it is national or State) has major expenditure responsibility for a particular policy area. Australia and Austria are the exceptions, where funding responsibilities for health and education are notably shared (Figure 3) and it may be concluded that as a result policy and service delivery in these areas in these countries is less transparent.

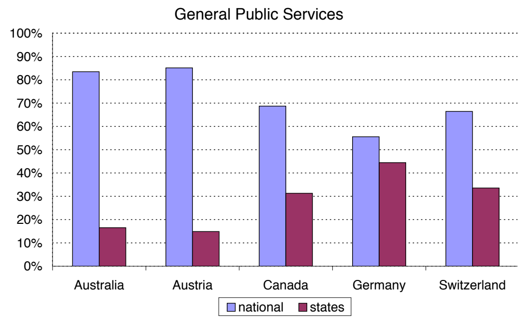
Figure 3: National versus State expenditure by policy function[25]

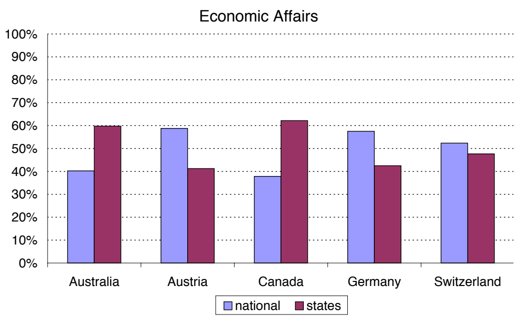


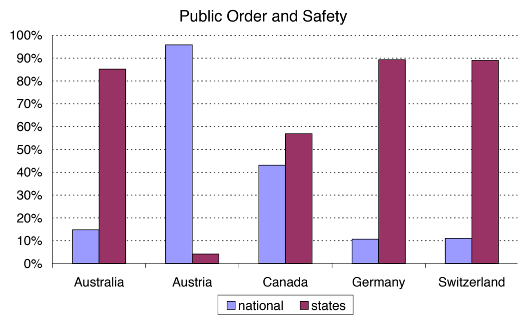
24 *Report to the NSW Treasurer and the Minister for Health*, Independent Pricing and Regulatory Tribunal of New South Wales, 1998.

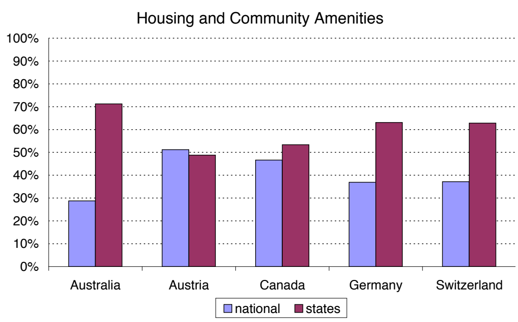
25 Data for State (and local) government in the USA was not provided in the IMF Statistics, so the graphs omit the USA.

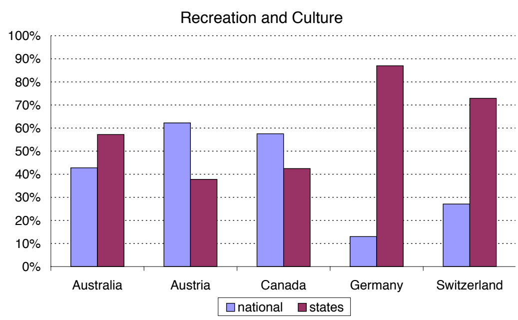


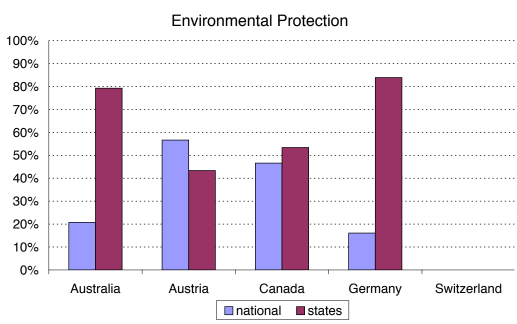


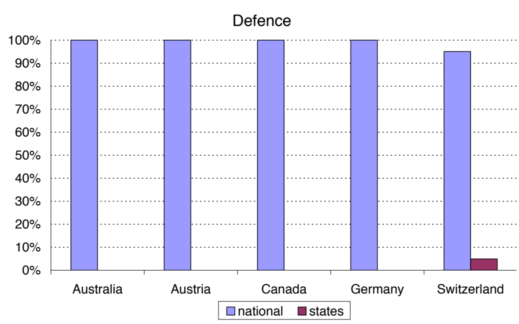












Source: IMF Government Finance Statistics Yearbook 2004.

Austria[26]	Austria is the only federation apart from Australia to have high levels of overlap in relation to health and education, based on national versus State government expenditure as set out in Figure 3. Key areas of public sector activity are subject to complex relations across the three layers of government. The Constitution lists areas in which only the federal parliament legislates. Areas not included in the list are considered to be the responsibility of the State parliaments. Major examples of federal legislative responsibilities include higher education and vocational training, some areas of social policy, such as family support and private sector pensions, and labour legislation. State legislative responsibilities include social welfare, health care in the hospital sector, some areas of primary and secondary education (such as regulation of working conditions of teachers), nature conservation, building regulations, and regional infrastructure planning, including transport. Local authorities perform policing and inspection tasks, local planning, infrastructure provision – such as water services – as well as social services. However, in many areas, decision making competencies in closely related areas are assigned across different levels of government. For example, the Constitution assigns legislative powers on the framework conditions of hospital care to the federal level, while it is the States' responsibility to legislate within this framework. In 2005, Austria reformed its health system which was fragmented between levels of government, leading to cost-shifting and perverse incentives. Now, a new federal health care agency is responsible for policies in relation to planning, sector wages, quality standards and health promotion. Hospital funding is pooled in State level funds, combining the financial resources of the federal and State governments and health insurance providers. In relation to education, while teachers' working conditions are legislated by the States, setting up curricula for schools as well as further education are responsibilities of the federal government. Responsibilities also overlap. For example, both State and local governments are responsible for the maintenance of schools. Also, most administrative tasks emanating from federal legislation are delegated to the States, and – to a lesser extent – to the municipalities. The latter also fulfil administrative functions delegated by the States. Some administrative responsibilities, such as in taxation,

26 See Fuentes, Wörgötter and Wurzel, (2006).

	security and military matters, remain with the federal government, however.
Canada	The Canadian federal government has functional responsibilities for money and banking, international trade, airlines and railways, foreign affairs, defence and employment insurance. Provincial governments have spending responsibilities for education, health, municipal institutions, social welfare, police, natural resources and highways. There are shared spending responsibilities for pensions, immigration, agriculture and industry (Delorme, 2004). The decentralisation of expenditure responsibilities is accompanied in Canada by real discretion for the provinces to tailor their programs to suit the needs and preferences of their constituents. The main issue for Canada is whether there is too much decentralisation from the point of view of efficiency. While in some areas of provincial spending, such as health, there is some degree of harmonisation, in others which are important for efficiency objectives, such as education, there is virtually none (Watts, 2005, p.37). In relation to social protection a 2001 study[27] found "a failure to coordinate income security programs" of the Canadian provincial and federal governments. Indeed, the study found that the difference in direction between the two programs was increasing, with consequent poor outcomes for users. In relation to public order and safety the apparent overlap in spending arises because criminal law is the responsibility of the federal government, which administers the criminal courts and prisons, and provincial governments provide civil courts, police and fire protection services. Due to the relatively discrete nature of these services, policy coordination is not a pressing issue. Coordination is also not a pressing issue in relation to environmental protection policy, as it comprises only 0.6 per cent of total spending by Canadian governments.
Germany[28]	Public expenditure is characterised by shared responsibilities which make for a system of quite complex overlapping competencies. The federal government is in principle responsible for matters considered to be of relevance for the whole country, as well as for the redistribution of income across the federation. Federal tasks comprise, *inter alia,* federal public transport, formulation of economic

27 See <http://www.iigr.ca/iigr.php/media/press/pr02-13-2001.html>

28 This section draws on Wurzel (1999) and *OECD Economic Survey: Germany*, 2004

	policy, supervision of competition policy, and transfers to the social security system. The Länder are responsible for all tasks which are not explicitly attributed to the federal government. Major competencies comprise the education and university systems, health and the provision of law and order. Local governments are attributed the right to control local matters such as road construction, school building, health services, public transport and energy supply, as well as the provision of social assistance. However, the functional segregation of responsibilities is not as strict as the above dichotomy suggests, and the system is now characterised by overlapping responsibilities. For example, all three levels of government and the social security system perform tasks with respect to health care: the federal government sets the pertinent legal conditions, the statutory health funds finance operating costs for hospitals, the Länder finance hospital investment and regulate hospital capacity, and local governments provide local health care services. Investment in transport and aid to enterprises are other examples where spending involves all three levels of government. Administrative responsibilities belong to a considerable degree to the States. The OECD has recognised that untangling the responsibilities of the federal government and State and local governments is one of the most pressing tasks in order for Germany to make meaningful progress on budget and structural reform. In recognition of these problems, the federal Parliament has commissioned an expert panel to make reform proposals designed to improve the allocation of responsibilities within the federal system and to foster the efficiency of public sector service provision.
Switzerland	Health and education are overwhelmingly subnational functions, based on the expenditure of national versus subnational governments, as shown in Figure 3. This clear distinction is less marked in other areas including economic affairs, and housing and community amenities. However, the high degree of budgetary interdependence between the various levels of government, through the allocation of grants, is a serious problem because it impairs transparency. Transparency is especially important in the context of direct democracy, as in Switzerland, to give the population a better

	grasp of the choices to be made and to build the necessary support for social reforms, which has been lacking so far.[29] Reforms to financial equalisation and the intergovernmental grants system currently underway in Switzerland include the disentanglement of responsibilities so there is a clear assignment of function to either the Swiss Confederation (national government) or the Cantons (States) (Fischer 2005). These reforms should be beneficial to both the responsiveness of governments to voters' preferences for government services and the accountability of governments.
USA[30]	Historically, States have enjoyed substantial fiscal autonomy which has had several beneficial effects. These include the responsiveness of public expenditure to voters' preferences and the comparatively high degree of accountability through the close link between revenue-raising powers and expenditure assignments. The fact that redistribution across jurisdictions is weak implies there is a strong link between the size of State government budgets and the community's tax burden, which strengthens the accountability of State governments and reduces incentives for exporting the cost of budget expansions to other jurisdictions. However, the complexity of the diffused system of governmental decision-making and intergovernmental relations in the USA reduces transparency and public understanding of intergovernmental fiscal arrangements. Nevertheless, the reliance on conditional transfers (tied grants – all grants from the federal to lower governments are earmarked) makes it clear that the responsibility for setting the conditions lies with the Congress and the bargaining 'free for all' that takes place is relatively open to the public to observe. (Watts, 2005, p38)

4.2.4 How Australia Compares

The problems associated with overlapping expenditure responsibilities between different levels of government, and the potential for misallocation of resources and reduced accountability, are not unique to Australia. However, lack of transparency appears to be less problematic where State governments have relatively high levels of fiscal autonomy, as in Canada and the USA.

29 See *Economic Survey of Switzerland 2006*, OECD, ch.2.
30 This section draws on Laubach (2005).

While federal constitutions may assign specific powers to a particular level of government – usually federal, with all other powers assigned to another level of government – usually State, the actual expenditure responsibilities and areas of overlap are rarely so clear. One reason is the need to have arrangements in place for intergovernmental fiscal transfers or grants because of a mismatch in State revenue raising powers and expenditure responsibilities. The system of intergovernmental financial transfers often gives one level of government (usually federal) considerable authority in areas that are explicitly the authority of another level of government (usually State) – (refer Benchmark 10).

Health is a notable example of a policy function where this is quite common. Australia, along with Austria, has unusually high levels of federal/State overlap in health (and education) responsibilities and expenditure. The lack of coordination between Commonwealth and State programs in Australia is widely recognised, as is the opportunity for cost shifting between levels of government. Similar problems in other federations including Austria, Germany and Switzerland, have reached the point where significant reforms to expenditure responsibilities have been proposed or implemented.

In Germany's case, the federal Parliament has commissioned an expert panel to make reform proposals designed to improve the allocation of responsibilities within the federal system. In Switzerland, reforms to financial equalisation and the intergovernmental grants system are currently underway with the aim of disentangling responsibilities so there is a clear assignment of function to either the national government or the States.

The reforms to Austria's health system are particularly interesting from an Australian perspective, as the health systems in both countries are the constitutional responsibility of the States, but the respective national governments have significant overlapping responsibilities. The Austrian model of pooled funding for a jointly managed system is one of a number that have been proposed as a way of addressing problems in Australia. However, no agreement has been reached in Australia on how best to consider the full range of reform options.

5 Benchmarking Taxation Assignment

Section 2.8 outlined the benchmarks against which countries intergovernmental fiscal arrangements should be assessed. This Section analyses the tax assignment benchmarks: tax assignment should follow expenditure responsibilities; subnational governments should avoid taxes on mobile factors and tax less mobile factors (economic efficiency); and tax revenues should be able to expand as fast as expenditures (fiscal need).

5.1 Benchmark 3: Tax assignment should follow expenditure responsibilities

Benchmark 3: Tax assignment should follow expenditure responsibilities.

5.1.1 Benchmark: Definition, significance, measurement

The allocation of expenditure and tax functions between the various levels of government is the most fundamental issue in a federation. Assigning responsibility for spending must precede assigning responsibility for taxation because tax assignment is generally guided by spending requirements at the different levels of government.[31] Tax assignment can take the form of own-source taxes or shares of central government taxes (refer Section 2.5). Expenditure responsibilities closely matched with revenue generation capacities reduce the need for intergovernmental fiscal transfers, reduce economic costs and distortions, and provide greater public accountability[32].

Benchmark 3 compares:

- Expenditure by level of government as a percentage of total government expenditure;
- State government own-source taxes/revenues as a percentage of total government taxes/revenues;
- State government own-source taxes/revenues as a percentage of State government expenditures; and

31 Canadian government website, <http://www.ainc-inac.gc.ca/pr/ra/ifr_ip/pbp_e.html>

32 See Benchmark 2 – 'Transparency of shared expenditure responsibilities' for a discussion of accountability for the provision of services'.

- transfers as a percentage of State government expenditure.

These measures give an indication of the significance of State governments in terms of their taxing powers relative to their expenditure responsibilities. However, the allocation of expenditure responsibilities and revenue sources very rarely leads to a perfect match between the two[33] resulting in VFI. The most common solution to VFI is for the central government to make transfers to subnational governments. This is only a satisfactory solution when transfers are provided with some degree of fiscal autonomy or discretion to the subnational governments (refer Section 6 'Benchmarking Intergovernmental Fiscal Transfers').

However, both political accountability and economic efficiency require that subnational governments have at least some own sources of revenues, including taxes and fees over which they have total or almost total control[34]. There are several reasons why central governments may be hesitant to assign adequate own-source revenues to subnational governments[35]:

- central government's fear of losing control over fiscal policy as a fiscal management tool;
- the perceived need for the centralised administration of the most significant taxes;
- the need to assign the most elastic and mobile sources of revenue to the central government;
- fear of tax competition among subnational governments; or
- simply a reflection of the dominant political power of the central government.

5.1.2 Australia's performance against the benchmark

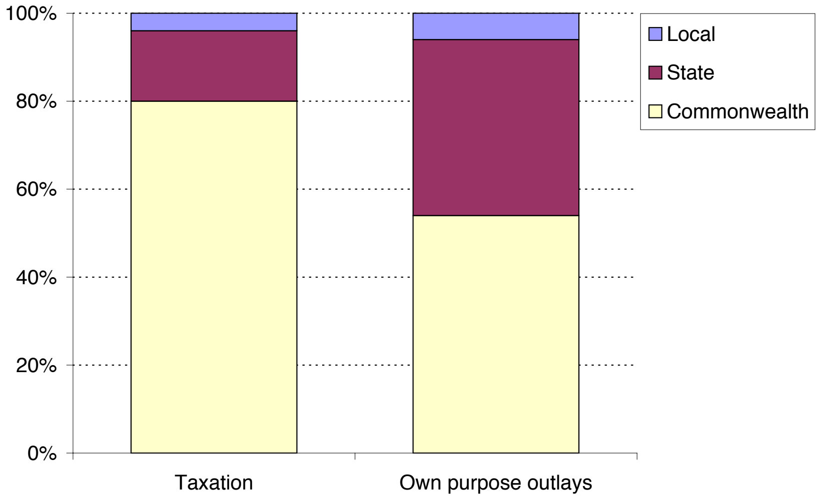
Australian States have substantial line responsibilities – such as the provision of health services, education, transport and policing – but do not have sufficient own-source revenue to fund those responsibilities. Their own-source tax and other revenues fall far short of their expenditure needs. The balance of the State's revenue is transferred from the Commonwealth through a sharing of the GST revenue,

33 See Martinez-Vazquez, J. and Boex, J. (2001).
34 This issue is discussed in further detail under Benchmark 5 – 'Fiscal Need'.
35 See Martinez-Vazquez, J. and Boex, J. (2001).

together with tied grants. Refer to Appendix C for a description of how grants are distributed in Australia.

The Commonwealth collects around 80 per cent of taxation revenue (including the GST), but is responsible for around 54 per cent of own-purpose spending. The States collect around 16 per cent of taxation revenue in Australia and account for around 40 per cent of own-purpose outlays – see Figure 4.

Figure 4: Vertical Fiscal Imbalance in Australia[36]



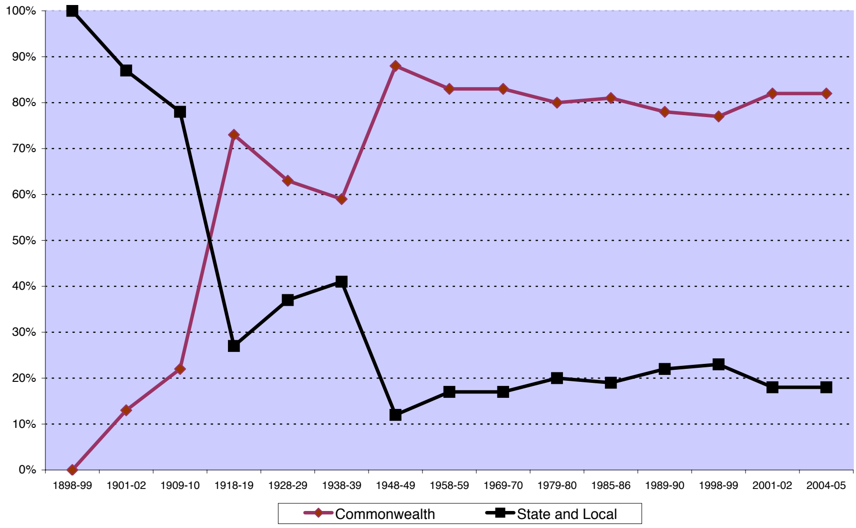
The GST and associated reforms introduced in July 2000, including the abolition of some State taxes, have further diminished the assignment of taxes to the Sates. This has resulted in the exceptionally high degree of VFI in Australia illustrated in Figure 4. This is because those reforms increased States' reliance on Commonwealth grants (GST revenue grants) while at the same time reducing States' reliance on own-source taxes.

This compounded the trend since federation to greater concentration of taxing powers in the hands of the Commonwealth (Figure 5) causing Australia to have one of the most centralised tax systems of any federation[37].

36 Own-purpose outlays include compensation of employees, use of goods and services, social benefits and other expenses, but do not include consumption of fixed capital, interest, subsidies and grants. (2004-05 data).

37 The reasons for the concentration of financial power to the Commonwealth are explained in Section 3.1 of this Report – 'Overview of Australia's constitutional and institutional arrangements with respect to Commonwealth and State financial relations'.

Figure 5: Share of total taxation revenues by level of government in Australia[38]



Sources: Mathews and Jay (1997, reprint of 1972 edition), pp. 54, 58, 83, 100, 152, 194, 230, 282; Mathews and Grewal (1997); and ABS, various years, Cat. no. 5512.0.
Note: the two sharp increases in Commonwealth taxation correspond with WWI and WWII.

However, there is a continuing misconception about the status of the GST which is important to address in order to understand the level of VFI in Australia. The Commonwealth's recent *International Comparison of Australia's Taxes* (3 April 2006) states:[39]

> The Australian Government raises 68.1 per cent of Australia's total tax burden, and State governments raise 29.0 per cent.
>
> … The tax burden of Australia's State governments increased from 6.1 per cent of GDP in 1999 to 8.5 per cent of GDP with the introduction of the goods and services tax in July 2000. The goods and services tax replaced a range of State government taxes and grants from the Australian Government. Since 2000 the tax burden of the State governments has increased by a further 8 per cent (or 0.7 percentage points), taking the State government tax burden to 9.2 per cent of GDP in 2003.

38 See also Grewal and Sheehan (2003), p.3.

39 See pages 37 and 38 of Warburton, R.F.E, and Hendy, P.W. (2006), *International Comparison of Australia's Taxes* (3 April 2006), <www.treasury.gov.au>.

These figures overstate the level of State taxes in Australia and result from classifying the GST as a State tax, as is done by the OECD and pointed out in the Commonwealth's report. However, the States do not have the constitutional power to impose a GST, the GST being a policy initiative of the Commonwealth, and is imposed under Commonwealth legislation and administered by a Commonwealth agency (the Australian Taxation Office[40]). Furthermore, both the Australian Bureau of Statistics and the International Monetary Fund classify the GST as a Commonwealth tax. For the purposes of this analysis, the GST is therefore classified as a Commonwealth tax (refer Appendix D).

5.1.3 Performance of other countries against the benchmark

This Section compares State governments in Australia with State governments in four other federations[41] in terms of:

- their relative size – measured as expenditure by level of government as a proportion of total government expenditures (Figure 6);
- own-source revenues available to them – measured as State government own-source taxes/revenues as a proportion of total government taxes/revenues (Figure 7);
- level of VFI – measured as State government own-source taxes and revenues as a proportion of State government expenditures (Figure 8); and
- transfers available to fund their expenditure responsibilities – measured as transfers as a proportion of State government expenditure, which also gives an indication of VFI (Figure 9).

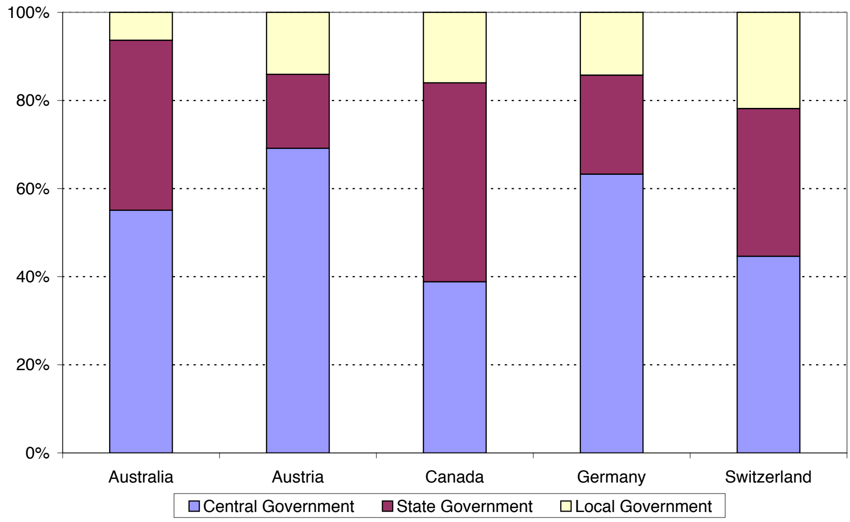
The interaction of State government expenditure responsibilities with own-source revenues available to them gives an indication of vertical fiscal balance, or imbalance as the case may be, which in the case of VFI results in the need for financial transfers from central government to fund those expenditure responsibilities.

40 Under clause 37 of the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* the States have agreed to compensate the Commonwealth for the agreed costs incurred by the Australian Taxation Office in administering the GST.

41 Austria, Canada, Germany and Switzerland.

Figure 6 compares the size of State governments relative to other levels of government within Australia and comparator federations.[42]

Figure 6: Expenditure by level of government as a proportion of total government expenditures



Source: Government Finance Statistics Yearbook 2004, International Monetary Fund

There is no consistent pattern in the size of State governments – they range from less than a fifth of total government expenditures (Austria 17 per cent) to almost half (Canada 45 per cent), with Australian, German and Swiss State governments approximately 40 per cent, 22 per cent and 33 per cent, respectively. Canada is unique in that its provincial governments together exceed the size of the central government in terms of expenditure as a proportion of total general government expenditures.

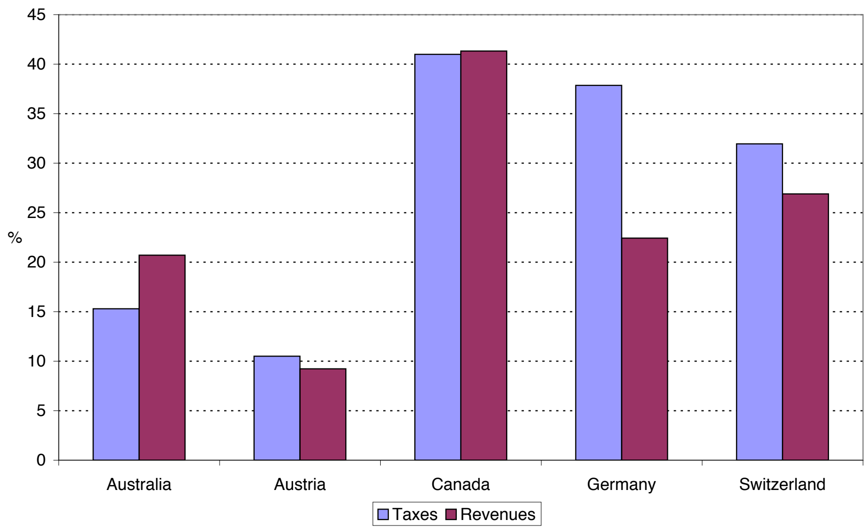
This does not necessarily mean that State governments are always significantly larger than local governments. Local governments can account for a relatively significant proportion of total government expenditures, such as in Austria (14 per cent), Canada (16 per cent), Germany (14 per cent) and Switzerland (22 per cent). This is in contrast to Australia where local government accounts for a very small proportion of total government expenditure (6 per cent)[43].

42 The USA has not been included in the comparison because the data source for the comparison did not include data for State and local governments in the USA, and using alternative data sources for the USA would have introduced inconsistencies in the comparison.

43 Source: Government Finance Statistics Yearbook 2004, International Monetary Fund.

Figure 7 sets out the own-source revenues (that is, taxes and other revenues) expressed as a percentage of total government taxes/revenues available to State governments to fund their expenditure responsibilities.

Figure 7: State government own-source taxes/revenues as a proportion of total government taxes/revenues



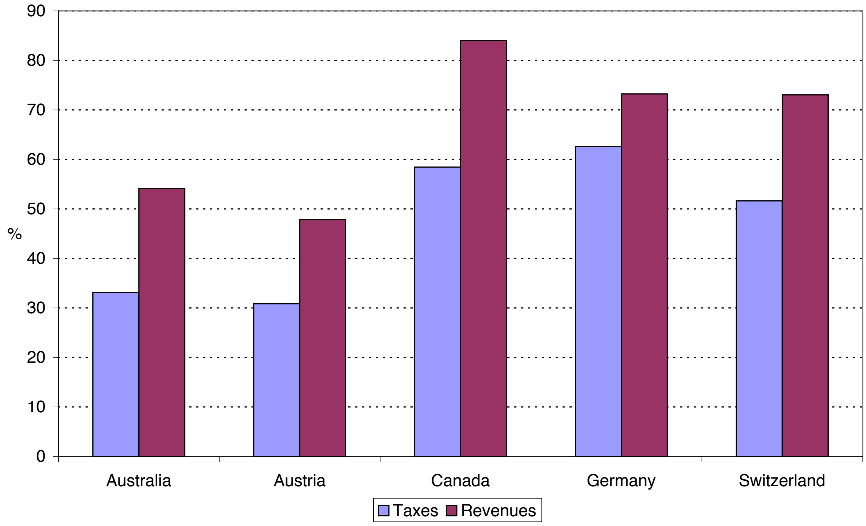
Source: Government Finance Statistics Yearbook 2004, International Monetary Fund

Figure 7 shows that State governments in Australia collected around 16 per cent of total taxes, compared with 11 per cent for State governments in Austria, 41 per cent in Canada, 38 per cent in Germany and 32 per cent in Switzerland.

Australian States collect the lowest proportion of total taxes of any of the comparator federations with the exception of Austria. In comparison, Canadian, German and Swiss State governments are responsible for a considerably higher proportion of total taxes. This means that State governments in Canada, Germany and Switzerland have the financial capacity to fund a much higher proportion of their expenditure from their own revenue sources[44] than State governments in Australia and Austria – as shown in Figure 8.

44 Including shared taxes.

Figure 8: State government own-source taxes and revenues as a proportion of State government expenditures



Source: Government Finance Statistics Yearbook 2004, International Monetary Fund

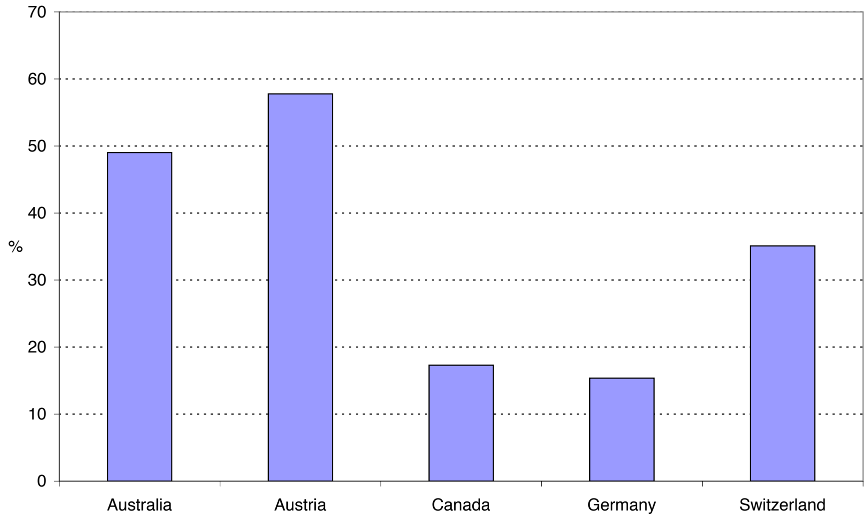
State governments in Australia have the financial capacity from their own-source taxes to fund about one-third of their expenditure (or 40 per cent of own-purpose outlays if expenses relating to consumption of fixed capital, interest, subsidies and grants are excluded – Figure 4), or about 54 per cent of their expenditure from own-source revenue (the difference is made up from other revenue sources such as dividends, investment income and sales of goods and services).

Austria shows a broadly similar profile to Australia. This is in contrast to Canada, Germany and Switzerland where State governments have the financial capacity to fund over half their expenditure from their own taxes[45] or over 70 per cent from their own-source revenues. This means that State governments in Australia suffer a significantly greater degree of VFI than State governments in Canada, Germany and Switzerland and a similar level of VFI to State governments in Austria.

The level of VFI in a federation determines the need for financial transfers from central government to State governments, as shown in Figure 9.

45 Including shared taxes.

Figure 9: Transfers as a proportion of State government expenditure



Source: Government Finance Statistics Yearbook 2004, International Monetary Fund

Figure 9 shows that transfers from the Commonwealth to States in Australia represent just under half State government expenditure. This means that State governments in Australia depend on financial transfers from the Commonwealth – in the form of tied and untied grants – to fund almost half their expenditure responsibilities.

State governments in Austria are even more heavily dependant on central government transfers, which represent almost 60 per cent of their expenditure. In contrast, State governments in Canada and Germany depend on these transfers to fund less than 20 per cent of their expenditure. State governments in Switzerland depend on transfers to fund about one-third of their expenditure.

5.1.4 How Australia Compares

State government expenditure in Australia represents approximately 40 per cent of total government expenditure in Australia. This is comparable to the level of State government spending in Switzerland, but in contrast to State government spending in Austria and Germany which accounts for just under 20 per cent and 33 per cent of total government spending respectively. Provincial governments account for just under half of total government spending in Canada. There is no clear trend for the size of State governments in federations.

In relation to the allocation of taxes between the Commonwealth and States, Australia is characterised by a tax system that is highly centralised in comparison to other federations. State government own-source taxes represent just 16 per cent of total taxes in Australia. Of the comparator federations, only Austrian State governments are responsible for a lower proportion of taxes, at 11 per cent. In contrast, State governments in Canada, Germany and Switzerland account for between around 30-40 per cent of total taxes. State governments in Australia are clearly at the lower end of tax collections as a proportion of total taxes compared to other federations.

The combination of significant expenditure responsibilities but deficient own-source taxes for State governments leads to VFI. The high level of VFI in Australia is comparable to that in Austria, but contrasts with to significantly lower levels of VFI in Canada, Germany and Switzerland. The high degree of VFI in Australia results in State governments being much more dependent on financial transfers from the Commonwealth than State governments in comparator federations, with the exception of Austria.

5.2 Benchmark 4: Economic Efficiency of Tax Assignment

Benchmark 4: Economic efficiency of tax assignment

Subnational governments should avoid taxes on mobile factors and tax less mobile factors.

5.2.1 Benchmark: Definition, significance, measurement

Benchmark 4 has two qualitative aspects: first, the economic efficiency of subnational taxes; and second, the suitability for a particular tax to be assigned to the subnational level of government. While Benchmark 4 is predominantly a qualitative benchmark, its quantitative aspects are drawn out in the international comparisons contained in this Section.

Efficient taxes are those which minimise the distortion of economic decision making and therefore have relatively little impact on the overall allocation of resources in the economy. All taxes cause some change in behaviour that distorts economic activity compared to the pre-tax environment. This distortion imposes a 'deadweight cost' on the economy in addition to the actual revenue raised by the tax – acting as a drag on economic activity and so reducing growth in jobs and keeping incomes below potential.

A general rule is that taxes set at a low rate (in proportion to the taxed item) with a wide coverage or broad base will distort economic decisions less than taxes at high rates that apply to only a small range of transactions or small sections of the community. In some cases, higher rates of tax on relatively narrow tax bases can be efficient provided the demand or supply of that good is relatively unaffected by price (price inelastic), so that the extra cost involved in payment of the tax will only have a small affect on the decision to demand/supply the good or service (examples include tobacco and petroleum taxes). Taxes that aim to correct unwanted environmental outcomes, such as pollution, can also be considered efficient as they are designed to achieve desired behavioural changes.

Along with the economic efficiency of taxes, other important features of 'good' taxes are equity, simplicity and robustness. Briefly:

- Equity refers to the extent to which tax liabilities vary in line with capacity to pay ('vertical equity') and similarity of taxpayer circumstance ('horizontal equity'). The impact of the tax system on equity is best assessed on the basis of the overall tax system as not each tax is well suited to influencing income distribution.
- Simplicity refers to the ease and cost of understanding and complying with the tax system – for both the taxpayer and the revenue collector – with the objective to minimise compliance and administrative costs as far as possible. Complex tax laws that apply different tax rates to different entities or transactions, or to the same entity or transaction in different circumstances, can significantly complicate the tax system making it harder for taxpayers to comply with, and open up opportunities for increased tax avoidance. This imposes economic costs through the need for more complex recording of activities and the need for additional accounting and legal advice to ensure compliance with tax law or to exploit loopholes.
- Robustness refers to whether revenue grows in line with economic activity, and whether revenue varies significantly from year to year. If the tax system is not robust, then there is an ongoing need to identify new sources of revenue to maintain tax collections.

In terms of the suitability of a tax to be assigned to a subnational level, the traditional theory of fiscal federalism prescribes a series of conditions subnational (or 'local') taxes must meet[46]: 'good' subnational taxes are said to be those that (1) are easy to administer subnationally; (2) are imposed solely (or mainly) on State residents; and (3) do not raise problems of competition between subnational governments or between subnational and national governments. However, there are not too many revenue sources that meet those criteria. Those that do include property taxes and betterment levies, the personal income tax (usually as a flat rate tax 'piggy-backing' on the national personal income tax), some excise taxes, taxes on vehicles, and a variety of user fees.

Table 5 provides a brief analysis of the economic efficiency of a range of taxes along with their suitability for assignment to the subnational level of government.

Table 5: Efficiency of taxes and their suitability for assignment to subnational government

Tax	Economic Efficiency	Suitability for assignment to subnational government
Taxes on income, profits and capital gains of individuals (OECD tax classification 1000)	Personal income tax is a broad based direct tax that is considered a relatively efficient tax. Income tax rates are progressive and so redistribute income from high income taxpayers to lower income taxpayers.	The literature on fiscal federalism suggests that subnational governments should minimise the use of highly mobile tax bases, redistributive taxes, and taxes subject to sharp cyclical fluctuations[a]. It thus excludes corporate income taxes and personal income taxes which are both imposed at the subnational level and subject to large interstate differentials. It also excludes redistributive personal income taxes at the State level but does not exclude a subnational surcharge on a national tax.
Corporate taxes on income, profits and capital gains (OECD tax classification 1200)	Corporate income taxes are also considered efficient. However, while they are broad based they also tend to be volatile through the economic cycle.	See comments above for personal taxes. Also, the volatility of corporate income tax revenues compared with other tax revenues (see Table 6) makes this revenue source problematic for subnational governments. This is because the financing needs for State governments' core expenditure responsibilities are often largely unresponsive to the economic cycle (e.g. education) or tend to increase during down turns (e.g. social assistance). The need to split corporate income tax revenues when a company operates in several jurisdictions can also be problematic in terms of administration and compliance.

46 See Martinez-Vazquez, J. and Boex, J. (2001).

Tax	Economic Efficiency	Suitability for assignment to subnational government
Taxes on payroll and workforce (OECD tax classification 3000)	Payroll tax is recognised by economists as an efficient tax. Although its legal incidence is on employers, its economic incidence is mostly shifted either to consumers through higher prices or employees through lower wages[b]. The aggregate impacts of payroll tax are therefore akin to those of a GST or an income tax.	Payroll tax revenue is more predictable than many taxes as it tends to grow steadily in line with wages and employment growth, making it suitable for subnational government. While a broad based payroll tax is theoretically efficient, in practice its economic efficiency can be reduced by its selective application which narrows the potential tax base considerably (e.g. through high tax free thresholds), although harmonisation of bases[c] by subnational governments could address some inefficiencies. Interstate tax competition on the tax rate can also potentially reduce the effectiveness of payroll tax as a revenue source for State government.
Taxes on property (OECD tax classification 4000)	Property taxes, such as land tax, are considered efficient – the base is immobile, the supply of land is fixed, and they are difficult to evade. Their efficiency can be reduced, however, by their selective application by having exemptions (e.g. for principal places of residence) and tax-free thresholds for those properties that would be otherwise taxable. However, taxes on financial and capital transactions (e.g. stamp duties) are generally considered inefficient because they impact on the timing of the transfer of these assets.	Property taxes have key advantages as subnational taxes. Most notably, the base is highly immobile, the tax is difficult to evade and efforts to improve local infrastructure are likely to be reflected in property values, thus increasing the yield for subnational governments. Property tax revenue is also relatively predictable. Property taxes avoid some of the pitfalls of consumption taxes making them generally attractive for subnational government use. However, they raise equity issues and their yield is often low (revenue from property taxes amounted to less than 2 per cent of tax revenue in the OECD in 2000) (Joumard and Kongsrud 2003). In the case of taxes on financial and capital transactions, while inefficient they are nonetheless suitable as State taxes because they are imposed on a relatively immobile base.

Tax	Economic Efficiency	Suitability for assignment to subnational government
Taxes on goods and services (OECD tax classification 5000, and 5110 representing VAT, sales tax and other general taxes on goods and services)	Broad-based consumption taxes (e.g. GST/VAT) are relatively efficient taxes, though their efficiency can be reduced by selective exemptions or rate reductions. Excise duties are also relatively efficient – as the demand for alcohol, tobacco and petroleum products is relatively inelastic, that is, insensitive to price changes.	Giving subnational governments discretionary powers with respect to general consumption taxes, either sales taxes or value-added taxes, may involve high compliance and administrative costs to contain tax fraud and evasion and may create distortions in interjurisdiction trade. These difficulties reduce the attractiveness of general consumption taxes for subnational governments. However, a subnational supplement to the national tax is not uncommon. In Canada, an 8 percentage point addition to the 7 per cent national GST is added by some provinces; in Italy an addition to the national VAT is added by regions in the form of a IRAP.[d] In Germany and Austria State governments share VAT revenues with the central government.
User Fees and Charges	User charging follows closely the 'benefit principle', whereby local households and businesses pay for what they get and get what they pay for. They may also act as price signals, reducing excess demand and encouraging customer-oriented management by subjecting public bodies to a market test.	Reliance on user fees and charges by subnational governments faces two main constraints. First, increasing subnational government reliance on user charges may raise equity concerns, especially where applied to core goods and services (namely education, health care and social assistance). Second, user charging is an attractive option only if the implementation costs are lower than the expected efficiency gains. Implementation costs are also likely to reflect scale economies and thus be high in the smaller jurisdictions.

a See Joumard, I. and Kongsrud, P.M. (2003b)

b The Australian Government's *International Comparison of Australia's Taxes*, 3 April 2006, recognises that while it is difficult to substantiate the actual incidence of payroll taxes, it is widespread practice to assume that taxes levied in respect of remuneration are ultimately borne by the employee (p.60).

c Harmonisation of tax bases includes common definitions, allowances and exemptions, and uniform approaches to administration. A more extended definition could include common tax rates and thresholds.

d Imposta Regionale sulle Attivitá Produttive (IRAP) is a subtraction method VAT, that is, (tax rate)*(outputs-inputs), with revenue accruing to the region where value is added.

Table 6: Volatility of revenue from various tax types

Standard deviation of the real growth rate of tax revenues, 1985-2000

	Personal Income	Corporate Income	Social Security Contributions	Property Income	Consumption	Total
Australia	6.51	11.26	---	2.83	9.21	3.87
Austria	6.05	14.32	1.44	2.98	4.74	1.98
Canada	4.83	13.84	3.97	3.12	3.11	2.31
Germany	6.90	13.07	5.12	2.97	5.49	4.79
Italy	5.52	12.45	5.77	4.41	4.75	3.03
Switzerland	5.58	8.12	2.64	3.11	5.11	2.24
USA	4.34	8.59	1.71	1.61	1.80	2.14

Source: Joumard and Kongsrud (2003b), p.190.

5.2.2 Australia's performance against the benchmark

State governments in Australia are forced to rely heavily on relatively inefficient, narrowly-based and sometimes highly cyclical transaction-based taxes. More efficient broadly-based consumption and income taxes in Australia are central government taxes. The States are forced into such tax systems through a combination of very tight constitutional constraints on their tax powers, Commonwealth government policies and interjurisdictional tax competition.

The more economically efficient State taxes in Australia are payroll tax and land tax. Payroll tax is the single most important own-source tax for some State governments, accounting for approximately 30 per cent of own-source tax revenue.[47] Payroll tax is relatively efficient as labour is a widely used component of production and so the tax base is relatively broad. Land tax is relatively efficient as its fixed supply means that taxes will not typically reduce the ownership of land. However, while a broad based payroll tax and land tax are theoretically efficient, in practice their economic efficiency is reduced by their selective application which narrows the potential tax base considerably, although harmonisation of payroll bases could address some of these inefficiencies.

47 If GST is classified as a State tax, as is done by the OECD, payroll tax accounts for 14.5 per cent of total tax revenue of the States – see Table 7.

Stamp duties[48] account for approximately 30 per cent of own-source taxes for some State governments,[49] but are relatively inefficient taxes with a volatile yield. This is especially the case with stamp duty on property purchases, which act as a disincentive to mobility and can be difficult to forecast accurately making budget management difficult. State governments also rely on gambling taxes for approximately 10 per cent of their own-source tax revenue, which tend to be narrowly based.

Since its introduction in 2000, revenue from the Commonwealth's GST has been distributed among the States and Territories under a tax sharing arrangement. The tax is shared according to CGC recommendations using methodologies based on HFE principles. While it may be suitable for many taxes to be collected at the national level, there may be costs and distortions in the federation as a result (Garnaut, 2005, p.90). The advantage of the GST is that it is a relatively broadly based and efficient 'growth' tax and therefore a robust source of revenue for the States and Territories. A disadvantage is that the States and Territories do not have discretion over the GST rate and base and so cannot unilaterally make policy adjustments to the GST to meet their fiscal needs.[50]

5.2.3 Performance of other countries against the benchmark

Table 7 sets out tax revenues of the main State taxes as a percentage of total tax revenue of State level governments, according to the OECD's classification of taxes. Some of these taxes, such as income taxes and VAT, are shared between central and subnational governments, while others such as property taxes tend to be subnational taxes only.

Figures 10 and 11 show more clearly the different countries' State governments' dependence on particular taxes in broadly descending order of efficiency:

48 Stamp duties include stamp duty on property purchases (also known as transfer duty), insurance, mortgages, marketable securities, motor vehicle registration certificates, hire of goods and leases.

49 NSW 2005-06 Budget, Budget Paper No.2.

50 Under the terms of the *Intergovernmental Agreement on the Reform of Commonwealth-State Fiscal Relations* any changes to the GST rate and base require the unanimous support of State and Territory governments, endorsement of the Commonwealth and passage of relevant legislation through the Commonwealth Parliament (clauses 31 and 32).

- the first row of graphs represent efficient taxes– taxes on income (personal and corporate) and broad-based general taxes such as VAT/GST;
- the second row represents relatively less efficient taxes – taxes on payroll and property taxes; and
- the third row represents the least efficient taxes – narrowly-based taxes on specific goods and services or on the use of goods.

From the information presented in Tables 5, 6 and 7 and Figure 10, along with the literature, it is possible to analyse subnational governments' dependency on taxes according to broad categorisations of 'efficiency', as undertaken below.

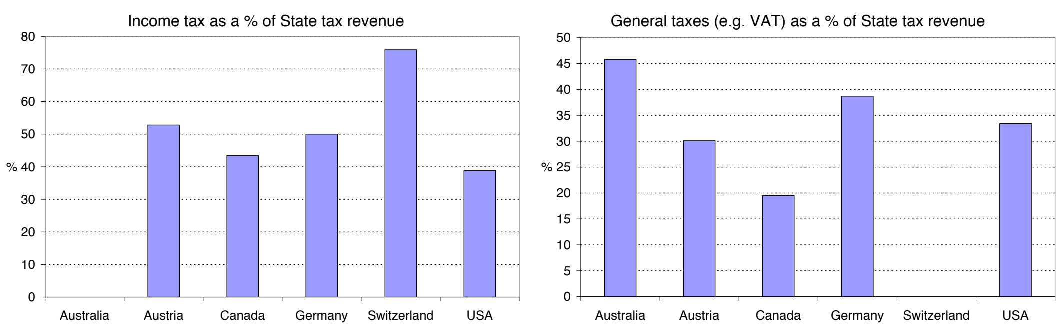
Table 7: Tax revenues of the main State taxes as a percentage of total tax revenue of State governments

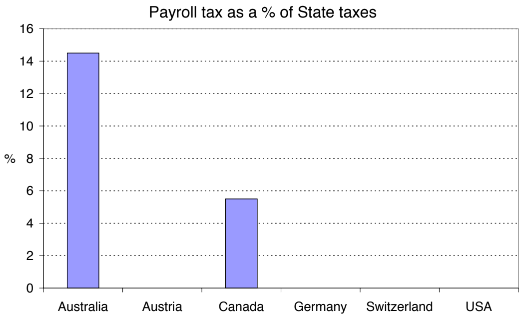
	Taxes on incomes and profits	Payroll taxes	Property taxes	General taxes (e.g. VAT)	Taxes on specific goods & services	Taxes on use of goods	Other taxes
OECD Classification	1000	3000	4000	5110	5120	5200	
Australia	0.0	14.5	22.4	45.8[a]	9.8	7.5	0.0
Austria	52.8	0.0	0.7	30.1	5.1	5.7	5.6
Canada	43.4	5.5	5.1	19.5	16.9	3.3	6.3
Germany	50.0	0.0	5.1	38.7	1.8	4.4	0.0
Switzerland	75.9	0.0	16.9	0.0	1.0	6.2	0.0
USA	38.8	0.0	3.0	33.4	15.9	8.9	0.0

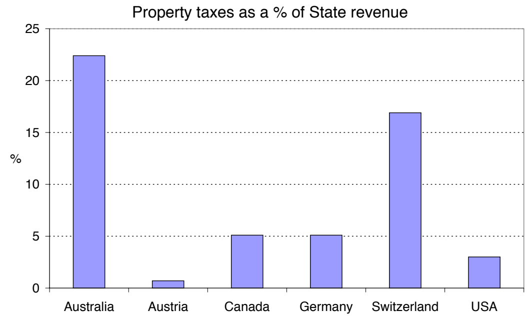
a The OECD classes the Commonwealth's GST as a State tax for statistical purposes.

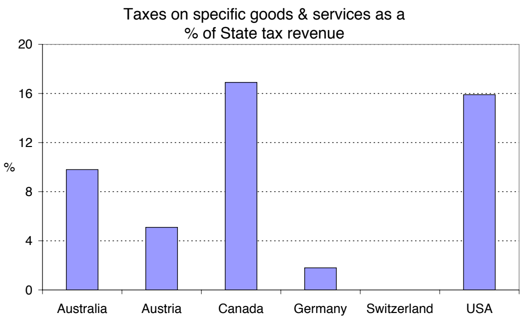
Source: OECD Revenue Statistics 1965-2004, Table 136

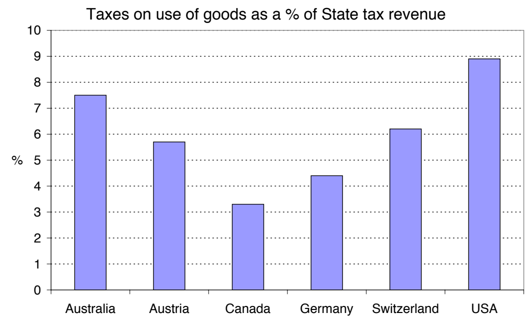
Figure 10: State government dependence on particular taxes











Source: OECD Revenue Statistics 1965-2004, Table 136

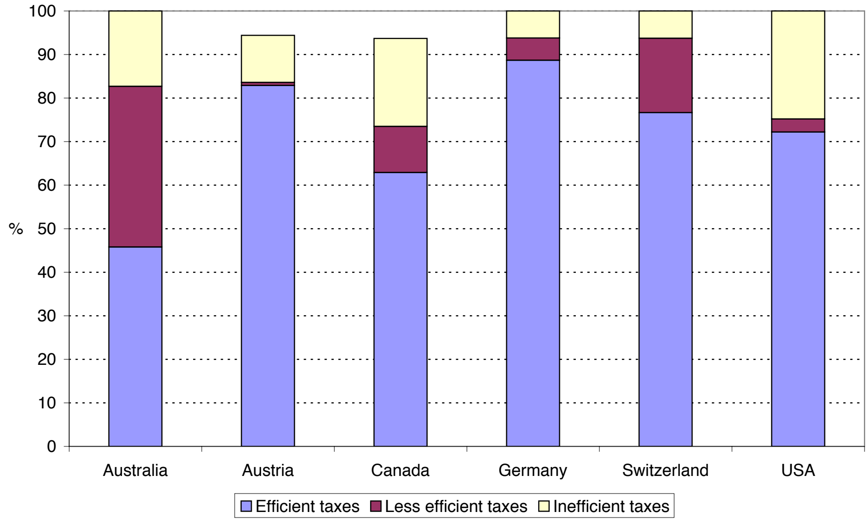
Austria	Austrian States have few sources of own-tax revenue (they account for less than 30 per cent of total State revenue and tend to be quite inefficient) and so rely heavily on shared taxes and transfers from central government. The most important shared taxes are personal income tax, corporate tax and VAT – for which the central government has full legislative responsibility (Fuentes, Wörgötter, and Wurzel, 2006). The shared taxes on which the States rely are efficient broad-based taxes.
Canada	Provincial governments in Canada raise revenue from a broad range of taxes including those on: personal and corporate income, sales and payrolls, along with property and other taxes. The most efficient taxes, on income and sales, account for over 60 per cent of the Provinces' taxes. Payroll and property taxes together account for 10 per cent, while less efficient taxes account for the balance.
Germany	Through Germany's extensive revenue sharing arrangements German Länder rely very heavily on income taxes (personal and corporate) (for 50 per cent of their tax revenue) and VAT (almost 40 per cent of their tax revenue) – generally the most efficient taxes. Both are subject to federal legislation, so the Länder have limited control over the bases, although both income tax and VAT are administered by the Länder.

Switzerland	Swiss Cantons rely very heavily on income tax (for over 75 per cent of their tax revenue) but have no access to a broad-based consumption tax, which is reserved to the central government. The second most important tax for Cantons is property taxation (over 16 per cent), which is less efficient than direct income tax. Cantons rely on the least efficient taxes for only a very small proportion of their tax revenue (just over 7 per cent).
USA	States in the USA rely heavily on income and sales taxes – 39 per cent and 33 per cent of State tax revenue respectively – albeit through surcharges on income (personal and corporate) taxes and relatively narrow sales tax bases. Nonetheless, they have autonomy over the rates. However, they also rely fairly heavily on a range of inefficient taxes (for almost 25 per cent of their tax revenue), and very little on medium efficiency taxes like payroll tax and property tax.

5.2.4 How Australia Compares

Australian States rely on efficient taxes for a smaller proportion of their tax revenue than other federations, as set out in Figure 11. The result would look even worse if the GST was not included as a State tax by the OECD, from which the data for Figure 11 is drawn.

Figure 11: Proportion of State government tax revenue from efficient sources



Source: OECD Revenue Statistics 1965-2004, Table 136.

Note 'other taxes' as set out in Table 7 have not been included so Austrian and Canadian taxes do not sum to 100 per cent.

While Australian States share the revenue from the Commonwealth's GST, which is a relatively efficient tax, they have no autonomy over the rate or base. In addition, GST revenue is not shared on the basis of its State of origin, it is distributed by a Commonwealth controlled process of fiscal equalisation. However, for consistency of analysis and comparison, the OECD data have been left unadjusted.

Unlike State governments in federations such as Austria, Canada, Germany and Switzerland, Australian States do not share income taxes with the central government nor do they have the power to impose a surcharge on income taxes as State governments do in the USA.

Australian States must rely on relatively inefficient taxes and narrowly-based taxes for their own-source taxes. While Austrian States are in a similar position with respect of their own-source taxes, those taxes represent a smaller proportion of their revenue and they also have greater access to shared efficient tax bases.

Australian States rely more heavily than other federations on 'medium efficiency' taxes like payroll tax and property tax (for about 37 per cent of their tax revenue), although these taxes could be made more economically efficient through policy adjustments. Nonetheless, payroll and property taxes are well suited to subnational governments and the States have autonomy over them (albeit subject to interstate competition). Australian States, along with Canadian Provinces and USA States, also rely on the least efficient taxes for approximately 20 per cent of their tax revenue – which is a greater proportion than in other federations.

The Commonwealth's recent *International Comparison of Australia's Taxes*[51] made a number of observations about State (and local government) taxes in Australia including:

- Australia's reliance on property and transaction taxes is relatively high compared with OECD countries. However, Australia's reliance on property and transaction taxes is more in line with the OECD-10 (a comparator subset of 10 OECD countries), despite having the highest tax burden on financial and capital transactions. (p.*xxx*)
- Australia has the equal highest tax burden of the OECD-10 countries from motor vehicles tax (0.6 per cent of GDP), which is well above the average of the OECD-10 countries of

51 See <http://comparativetaxation.treasury.gov.au/>

0.3 per cent of GDP (p.245). (Note: this observation is subject to the caveats that disaggregation of recurrent indirect taxes into subcomponents is problematic and significant classification issues exist in the data).

- While Australia has the seventh highest immovable property tax burden (1.4 per cent of GDP) of the OECD-30, it is just below the average of the OECD-10 (1.6 per cent). In Australia's case, the majority of revenue under this category is from local government rates. Land taxes levied by State and Territory governments are also a significant component. (p.279)
- Australia has the highest reliance on transaction taxes such as stamp duties on conveyances (1.6 per cent of GDP) of the OECD-10 (unweighted average of 0.7 per cent). (p.285)

The Commonwealth's recent report, however, does not recognise that the States are forced to rely on the types of taxes that they do for a number of constitutional and Commonwealth policy reasons that are outside the control of the States.

5.3 Benchmark 5: Fiscal Need

Benchmark 5: Fiscal need

Tax revenues should be able to expand in line with expenditure needs.

5.3.1 *Benchmark: Definition, significance, measurement*

Tax revenues should be able to meet a government's fiscal need and so be able to expand in line with expenditure commitments and responsibilities. This can be achieved in two ways: first, where State governments have the autonomy, or discretion, to alter their taxes to raise the desired revenue (by increasing the tax rate and/or broadening the tax base); and second, where tax revenue is robust and grows in line with economic activity autonomous from changes in the tax rate or base and where volatility of tax revenues is minimised. These two means of meeting a government's fiscal need are not mutually exclusive.

The tax autonomy of a State government refers to both its *access*[52] to sufficient tax revenues to meet its expenditure needs and the degree of *control* available to it over those tax revenues. Fiscal discretion is greatest if State governments are free to determine both the taxable base and rate(s) of a particular tax, without any aggregate limits on revenues, base or rate enforced by central government. At the other extreme, central government may decide both the tax base and rates of taxes collected by State governments. In this case there is hardly any fiscal autonomy at the State level, except perhaps where the State level has administrative discretion on how to organise collection of the particular taxes.[53]

There are different ways of assessing the degree of tax autonomy provided to State governments. One way is to express the revenue from State government taxes as a percentage of total State government revenues. Another is to measure the share of State government taxes as a proportion of total tax revenues of general government (Figure 12).

In order to reflect the degree of control that subnational levels of government can exercise over taxes to which they have access, the OECD has subdivided these taxes into the following categories (ranked by decreasing order of control) (OECD 1999):

(a) subnational government sets tax rate and tax base;
(b) subnational government sets tax rate only;
(c) subnational government sets tax base only;
(d) tax sharing arrangements;
  (d1) subnational government determines revenue-split;
  (d2) revenue-split can only be changed with consent of subnational government;
  (d3) revenue-split fixed in legislation, may unilaterally be changed by central government;
  (d4) revenue-split determined by central government as part of the annual budget process;
(e) central government sets rate and base of subnational government tax.

52 In terms of access, Benchmark 3 discusses tax assignment and how VFI occurs where State governments do not have sufficient tax revenue to meet their expenditure responsibilities and rely on fiscal transfers from central government to meet these expenditure responsibilities.

53 The question of state and local tax autonomy is largely independent of who administers and collects the tax.

In cases (a), (b), (c), (d1) and (d2) subnational governments have total or a significant control over their taxes. In the remaining cases, their tax autonomy is limited or non-existent.

In practice, the organisation of governments – including their fiscal relations, constitutional arrangements and institutional details – varies considerably from one country to another. This makes it impossible to formulate a single rule which can be used to allocate taxes and their revenue to the various levels of government. Similarly, the great variety in fiscal relations complicates the application of the above categories of tax 'autonomy'.

The second means of meeting fiscal need is through having taxes that are robust – where revenue grows in line with economic activity. Taxes whose revenues increase at rates less than the rate of economic growth (or growth in expenditures), or which are volatile and potentially change countercyclically, pose problems for government budget management.

5.3.2 Australia's performance against the benchmark

Figure 12 shows that State taxes in Australia account for just over 30 per cent of total State revenue, and represent approximately 16 per cent of total General Government tax revenue in Australia. This means that State governments in Australia have discretion over only a relatively small proportion of their total revenue, are heavily reliant on other sources of revenue – primarily grants from the Commonwealth over which they have little or no discretion – to finance their expenditures, and that tax revenue in Australia is highly centralised at the federal level.

The single most important own-source tax for States in Australia is payroll tax. The revenue from this relatively broad-based tax is more predictable than many other State taxes as it tends to grow steadily in line with wages and employment growth. In contrast, stamp duties, which are the second largest source of State tax revenue, are more sensitive to transaction volumes which can change independently of broad economic conditions. Property taxes are also an important source of State government revenue. Property taxes also tend to be less volatile than other taxes (see Table 6).

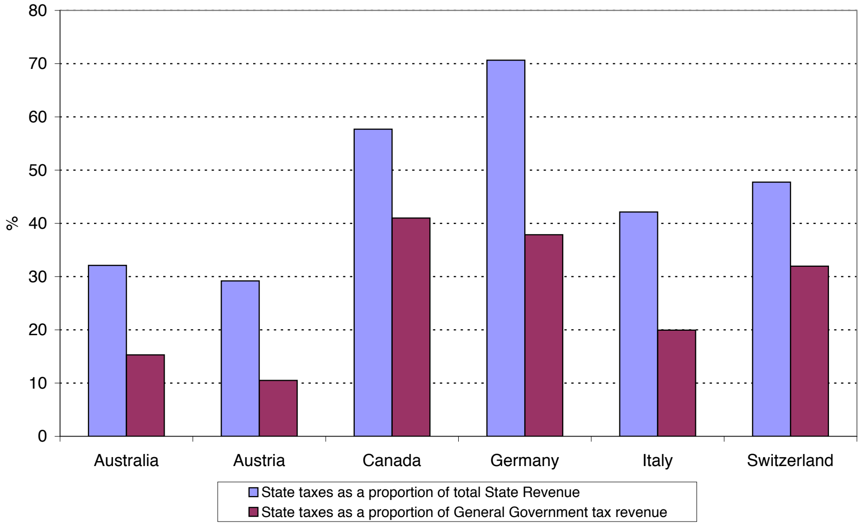
All the taxes imposed by Australian States are category (a) taxes according to the OECD's classification – State governments set the tax rate and the tax base. Notwithstanding this, implicit constraints still exist, notably interstate tax competition.

The balance of the Australian State's revenue to a large extent is derived from GST revenue grants and tied grants from the Commonwealth. The GST is a Commonwealth tax (it is enacted under Commonwealth legislation under the Commonwealth's constitutional powers and is collected by a Commonwealth agency – the Australian Taxation Office). Consequently, the States do not have discretion over the base and rate of the GST. GST revenue is distributed between the States under an intergovernmental agreement. The CGC makes recommendations regarding the sharing of the revenue using a methodology that applies fiscal equalisation principles. However, the revenue split is ultimately a decision of the Commonwealth, so the GST is a category (d4) tax – one where States' tax autonomy is limited or non-existent. The GST however is a value added tax which is considered to be a growth tax. This feature for makes GST a robust tax and therefore it fairs well on the second measure of fiscal need.

5.3.3 Performance of other countries against the benchmark

Figure 12 provides two measures of the degree of fiscal autonomy provided to State governments for each benchmark country: first, by expressing the revenue from State government taxes as a percentage of total State government revenues; and second, by measuring the share of State government taxes as a proportion of total tax revenues of general government. A summary of their current satisfaction of fiscal need follows.

Figure 12: Measures of fiscal autonomy



Source: IMF Government Finance Statistics Yearbook 2004 (note: data not available for USA)

Austria	Figure 12 shows that State taxes in Austria account for just under 30 per cent of total State revenue, and represent just 10 per cent of total General Government tax revenue. In Austria devolved taxing powers are almost absent. Subnational levels of government rely largely on shared taxes, for which the federal government has full legislative responsibilities, and on federal government transfers. The States have few sources of own tax revenues. This means that State governments in Austria, in common with Australia, have discretion over only a relatively small proportion of their total revenue, are heavily reliant on other sources of revenue – primarily shared taxes – to finance their expenditures, and that tax revenue in Austria is highly centralised level (to an even greater degree than in Australia). According to the federal Constitution, governments of each level need to be given sufficient financial resources to fulfil the tasks assigned to them. The Constitution prescribes, in principle, that financing responsibilities of different layers of government should match spending powers. As a consequence there is an elaborate system of tax sharing, transfers, and co-financing across the different layers of government. A cornerstone regulating the assignment of revenue and spending powers in Austria is given by the Fiscal Equalisation Law (FEL) which

	is pivotal in defining major intergovernmental fiscal relations in Austria. The provisions of the FEL are negotiated between the federal government, the States and the municipalities and have validity for a period of four years. The most recent update of the FEL came into force in January 2005 and determines the types of taxes to be shared between the three levels of government, the proportions according to which the revenues are allocated, and the major transfer flows between the levels of government. Most important types of taxes are shared taxes, such as personal income tax, corporate tax and value added tax, with the corresponding tax rates determined by federal legislation. The revenues of certain taxes are not shared but are kept by local and State governments according to how much revenue is generated within each State or municipality. These taxes however play a significant role only for the municipalities. The most important tax of this type is the communal tax, a tax on private enterprise payrolls, the rate of which is determined by the federal government. The FEL also determines which own-taxes can be set autonomously by the States and municipalities, respectively. Real estate tax rates are the only significant tax that can be set autonomously by subnational governments. They are determined by the municipalities subject to a ceiling determined in the FEL. Tax sharing is achieved in different stages. Distributable tax revenues are obtained after deducting some tax receipts from the total. These deducted tax revenue shares are earmarked to particular spending items. For example, a proportion of personal income tax revenue is earmarked for the financing of family benefits and is administered by an extra-budgetary fund. At the second stage the shares of tax revenues accruing to each level of government (federal government, States, municipalities) as a whole are fixed. About 73 per cent of the revenues of shared taxes accrue to the federal government, the States receive 15 per cent and the municipalities about 12 per cent.
Canada	Figure 12 shows that Provincial taxes in Canada account for nearly 60 per cent of total Provincial revenue, and represent 40 per cent of total General Government tax revenue. This means that Provincial governments in Canada have discretion over a relatively large proportion of their total revenue and that tax revenue in Canada is relatively decentralised. Provincial governments raise revenue from a broad range of taxes including those on: personal and corporate income, sales and payrolls, along with property and other taxes. Taxes on income

	and sales account for over 60 per cent of the Provincial taxes, while payroll and property taxes together account for 10 per cent. In Canada the federal GST rate is 7 per cent but the Provinces have the option of imposing an additional 8 percentage points of tax in place of their own Provincial Sales Tax (PST), resulting in a Harmonised Sales Tax (HST) with a rate of 15 per cent.
Germany[54]	Figure 12 shows that Länder taxes in Germany account for 70 per cent of total State revenue, and represent almost 40 per cent of total General Government tax revenue. This means that the Länder have discretion over a relatively high proportion of their total revenue and that tax revenue in Germany is relatively decentralised. However, these outcomes are the result of the significant role of revenue sharing in Germany. In practice the two main tax bases (income/corporate tax and VAT) are subject to federal legislation so the Länder have limited control over the bases, although both these taxes are administered by the Länder. Germany's federal revenue system has relied increasingly on tax sharing, with the fraction of own-source taxes, accruing exclusively to a particular tier of government, declining at each level. The German system of tax revenue allocation comprises two distinct processes: the first involves the division of shared taxes between the territorial authorities – the federal government, sixteen States and the local communities – according to agreed criteria, while the second adjusts the distribution of tax revenues to achieve distributional goals. The primary system of tax sharing involves three quarters of overall tax revenues in Germany being shared vertically between different layers of government (shared taxes), the remainder accruing to one particular tier only (own taxes). Shared taxes mainly comprise VAT and income taxes (personal and corporate), which account for 30 and 40 per cent of total tax revenues, respectively. The percentage shares of the Länder and the federal government in income and corporate tax revenue are stipulated in the Constitution such that any reallocation requires a constitutional change. For VAT, on the other hand, the percentage shares of the federal government and the States can be adjusted by simple legislation, subject to the consent of the States in the Upper House of the federal parliament.

54 This section draws on Wurzel (1999).

	According to the Constitution, VAT revenues should be allocated such that the coverage of expenditures by revenues is even between the federal government and the States. Accordingly, the vertical allocation of VAT receipts has been regarded as the main flexible element in the overall distribution of tax revenues between the federal government and the Länder. With respect to income tax receipts 42.5 per cent accrues to the federal government and the Länder respectively and the remaining 15 per cent accrue to the local communities. Other shared taxes are the business trade tax and the mineral oil tax. Major own taxes are tolls, the insurance tax, the tobacco tax and the "solidarity" income tax surcharge accruing to the federal government, the inheritance and the automobile tax accruing to the Länder, and the real estate tax and consumers taxes accruing to the local communities. Horizontal apportioning of income-tax revenues between the Länder proceeds according to the residence principle, that is, income tax accrues to the tax-payer's resident State. Corporate tax revenue is divided among the Länder by a formula which is based on plant location, taking into consideration that companies may have branches in different States. Another difficult horizontal assignment problem concerns VAT revenue. Neither the source nor the principal residence can be applied in a meaningful way. As a pragmatic solution, VAT revenue is simply distributed to the Länder on a per capita base.
Italy[55]	Italy's governmental structure, with five layers of government, makes direct comparisons with other federations difficult[56]. Figure 12 shows that local government taxes in Italy account for just over 40 per cent of total local revenue, and represent just 19 per cent of total General Government tax revenue. This means that local governments in Italy have discretion over a mid level proportion of their total revenue and that tax revenue in Italy is highly centralised. Italy's Ordinary Statute Regions ('Regions') had essentially no fiscal autonomy at the beginning of the 1990's. Up to 95 per cent of total expenditure was financed by transfers from central government. During the 1990's there were several attempts to increase the fiscal autonomy of the Regions.

55 For more detail see Arachi and Zanardi (2004).

56 IMF statistics do not distinguish 'State' governments in Italy, so the 'local' classification has been used in this analysis.

	In the first phase, the central government introduced instruments for fiscal autonomy through the devolution of relevant taxes to the Regions. In 1998 a regional VAT was introduced whereby the yield accrues to the Region where the value is produced. A regional surcharge on personal income tax was also introduced. However, in practice the first phase of reform had little if any impact on regional fiscal autonomy as there was little incentive for the Regions to pursue an active tax policy – they faced a soft budget constraint that was underwritten by central government and almost all the revenue was earmarked for health spending. The second phase of the reforms, completed in 2000, aimed to introduce incentives to encourage active tax policies. The 2000 reform abolished almost all grants and replaced them by the sharing of national VAT and by increases in the base rates of some minor surcharges (on personal income tax and excise on road fuel). The share of VAT going to the Regions was fixed at 38.55 per cent in order to leave unchanged the total amount of resources going to regional budgets as a whole. The VAT is apportioned to Regions in proportion to the estimated consumption of their residents. However, the distribution of grants that had been abolished was different from that of consumption, which led to large fiscal imbalances in almost every Region. To correct these imbalances a new system of equalising transfers was introduced. Overall, the new system of regional finance is expected to guarantee a budget constraint, as the central government no longer finances the Regions through discretionary transfers. In addition, in order to strengthen the incentives for autonomous tax effort, the reform abolished all constraint on the use of revenue; the additional yield generated by an autonomous tax increase can be spent freely to finance any regional expenditure programs.
Switzerland[57]	Switzerland has a relatively complex system of three layers of government: the communes at the local level; the Cantons at the intermediate level; and the Confederation at the national level. Fiscal federalism in Switzerland can be characterised in terms of overall fiscal restraint and minimising the centralisation of fiscal power. Figure 12 shows that State (Canton) government taxes in Switzerland account for nearly half of total Canton revenue, and represent almost one-third of total General Government tax revenue. This means that Canton governments in Switzerland have

57 See Dafflon (2003).

	discretion over a relatively large proportion of their total revenue and that tax revenue in Switzerland is relatively decentralised. Under Switzerland's fiscal-financial system each level of government and each government within the same level has direct access to many, but at least two major revenue sources: at the federal level, direct taxation and VAT; at the Cantonal level, direct taxation and revenue sharing plus grants; at the local level, direct taxation and user charges. Direct access to taxes and user charges at the Cantonal and local levels is important in order to maintain financial autonomy. Based on VAT with an actual normal rate of 7.6 per cent, the main consumption and expenditure taxes are exclusive and belong to the federal level. Taxation on motor vehicles is Cantonal; the Communes can levy minor taxes on dogs, entertainment and games. Direct taxation is a joint tax of the Confederation (individual income plus corporate profit), the Cantons and the Communes (individual income and wealth plus corporate profit and capital). For the Cantons and the communes, taxation of individual income and wealth and of corporate business profits and capital ("direct taxation") is the major single item of revenue sources – accounting for over 75 per cent of Canton revenue.
USA[58]	Historically, States in the USA have enjoyed a substantial degree of fiscal autonomy, as expressed in the tenth amendment to the federal Constitution, reflecting the fact that the States historically preceded, and transferred only limited powers to, the Federal Government. States are largely free in their choice of tax bases and rates, subject to only a few limitations imposed by the federal Constitution, notably that taxation of exports and imports is a federal activity and that their power to tax interstate commerce is limited. Over time a broad division of tax bases has developed by which the federal government relies almost exclusively on income taxation in the form of personal and corporate income and payroll taxes, the States on sales and, to a lesser extent, personal income taxes. Notably, the federal government does not levy a general tax on consumption, like a sales tax or VAT, nor a property tax, and most States' involvement in property taxation is negligible. Also, corporate income is a small revenue source for State and local governments. Thus, there are only two major tax bases that are

58 See Laubach (2005).

shared between levels of government: personal income between the federal and State governments, and sales between State and local governments.

While virtually all federal revenues are raised in the form of taxes, taxes account for only 44 per cent of State revenues. Nearly one-third of State revenues are derived from federal government grants; the remaining quarter is derived from various sources, including nearly 10 per cent from user charges, for example for hospital services and higher education.

Sales taxes are the single most important form of own-source revenue for States and are also of some importance for local governments. About two-thirds of sales tax receipts are derived from general sales taxes, with the remainder being selective sales taxes on specific items, most importantly motor fuels. Personal income taxes are the second most important tax revenue source for State governments. In contrast to the personal income tax, the corporate income tax plays a much smaller role at the subnational level, and one that has been steadily declining over recent decades, one reason being interjurisdictional tax competition. From a peak of nearly 10 per cent, the share of the corporate income tax in state tax revenues has declined to just over 5 per cent in 2002.

The exceptionally large extent of State fiscal autonomy enshrined in the US Constitution has produced several beneficial results. In a country as economically and demographically diverse as the United States, fiscal decentralisation has allowed State and local governments to tailor public services in a number of areas to their voters' preferences. The fact that redistribution across jurisdictions is weak implies that there is a strong link between the size of State and local government budgets and the community's tax burden, which strengthens the accountability of subnational governments and reduces incentives for exporting the cost of budget expansions to other jurisdictions.

States' autonomy in taxation underpins their independence in making choices about expenditures. Despite pronounced differences in per capita income across States, there has never been strong political support for revenue sharing or other forms of fiscal equalisation. However, the fiscal autonomy of the States is constrained by: taxpayer mobility, which limits the progressivity of personal income tax and has undermined the corporate income tax bases; and States' inability to collect sales and use taxes on remote sales.

5.3.4 How Australia Compares

Australia has the second lowest level of fiscal autonomy of State governments among the countries examined. Only Austrian States have less discretion over their revenues. While the revenue sharing arrangements in Germany mean that the Länder share broad bases (such as income tax, company tax and VAT) with other levels of government, in practice they have very limited control over the tax bases and rates. This in not unlike the Australian States GST revenue sharing arrangements where the States cannot unilaterally alter the GST base or rate and so do not have the discretion available to adjust their tax revenues to meet their expenditure needs.

The low level of fiscal autonomy of State governments in Australia contrasts most starkly with US States which have few restrictions on the taxes they can levy. In Canada the Provinces and Territories have direct access to either their own Provincial sales taxes or their share of the Harmonised Sales Tax[59].

59 In Canada the federal GST rate is 7 per cent and the Provinces and Territories have the option of imposing an additional 8 percentage points of tax in place of their own Provincial Sales Tax (PST), resulting in a Harmonised Sales Tax (HST) with a rate of 15 per cent.

6 Benchmarking Intergovernmental Fiscal Transfers

Section 2.8 outlined the benchmarks against which countries' intergovernmental fiscal arrangements should be assessed. This Section analyses intergovernmental fiscal transfers against the following benchmarks: equity of intergovernmental fiscal transfers; neutrality; predictability and flexibility; simplicity and transparency; autonomy; incentive for sound management; and accountability.

When different levels of government assume varying levels of responsibility for the provision of public services, the case can arise for some level of fiscal transfers to lower levels of government. This can have its foundation in the need to:

1. improve revenue adequacy (equalise vertically)
2. meet minimum needs (equalise horizontally through interjurisdictional redistribution)
3. account for interjurisdictional spillovers (externalities which have cross regional benefits);
4. address administrative weaknesses and streamline bureaucracy (to gain scale economies and competencies).

Any fiscal transfer systems designed to achieve these objectives should do so while satisfying a number of design benchmark principles. In this Section, the benchmark principles listed above will be used to assess the performance of the Australian system of intergovernmental fiscal transfers and contrast it with the comparator country's performance.

6.1 Benchmark 6: Equity of intergovernmental fiscal transfers

Benchmark 6: Equity of intergovernmental fiscal transfers.

Subnational governments with equal fiscal needs should be treated equally.

6.1.1 Benchmark: Definition, significance, measurement

An important component of most federal systems is horizontal fiscal equalisation (HFE) – a policy designed to correct for economic disabilities experienced by some subnational governments. These disabilities result in horizontal fiscal imbalance (HFI), a situation in which there exist differences between subnational jurisdictions in their ability to provide comparable levels of government services while imposing comparable tax burdens. These differences may arise from tax raising disabilities (for example, from lower *per capita* taxpayer incomes) and/or cost disabilities in the provision of government services (for example, from different population age structures). HFE is fundamentally based on the principle of equity between subnational jurisdictions and this principle has clearly been accepted by the Australian community. Thus, the extent to which a federal fiscal system achieves horizontal equity is an important benchmark of its performance.

6.1.2 Australia's performance against the Benchmark

The Australian system of fiscal equalisation is described in considerable detail above and in Appendices B and C. It is conducted against a background of very high VFI and a paucity of State tax instruments. There is a fixed equalisation funds pool (total GST revenue) so that equalisation becomes a zero-sum game – an increase in equalisation entitlements for one State out of a given equalisation pool inevitably implies reductions for other States. The process purports to equalise State Government *capacities* to provide a common level of public services per head if those Governments make the same own-source revenue efforts. It attempts to equalise for disabilities in both costs and revenue-raising, through a complex set of "black box" calculations examining 37 taxes and 359 expenditure categories. The calculations and recommendations for the untied grants are made by the independent CGC but the final decision must be made by the Commonwealth Treasurer. Appendices B and C detail the methodology adopted in Australia to determine the distribution of the GST between the States and Territories.

Despite the general community support for implementing HFE, there is also considerable dispute as to whether the process is successful in achieving equalisation or whether, in practice, there is overcompensation for some States. The Commission itself admits that its "processes are stretching the available data to the limit", an observation supported by its discussions with the ABS, and it has "noted that the application of new or alternative data can generate changes … that are difficult to reconcile with the extent to which the States' underlying circumstances have changed" [60]. The CGC itself has great reservations about its calculations and supports a review of its processes[61].

6.1.3 Performance of other countries against the benchmark

The information presented below summaries key points regarding comparator countries' performance against the equity benchmark. More detailed information is presented in Appendix E.

Austria	• Elaborate system of tax sharing, transfers and co-financing; • Aimed at achieving roughly equal living standards across country; • Shared taxes with rates set by federal legislation and revenue distributed according to weighted populations; • No other acknowledgment of expenditure disabilities; • States have no power to set tax rates; and • Arrangements renegotiated every four years.
Canada	• Federal grants to achieve minimum, not equalised, levels of public services; • Based on standards in five "middle rich" Provinces; • Central government supplementation of grants to provinces, if necessary, to achieve minimum standards; • Equalises revenue capacities, no account taken of expenditure disabilities; • Design of equalisation is responsibility of federal Minister of Finance; and • Comprehensive review currently being undertaken.
Germany	• Constitution allocates taxing powers and lays down rules for revenue-sharing; • All States have the same taxing powers; • Three part equalisation system: - Sharing of VAT revenue; - HFE funded by States to maintain minimum (not equalised) financial capacities; - Supplementary federal grants to raise minimum financial capacities close to national average; and • New "Solidarity Pact II" recently negotiated between federal Government and the States.

60 See Commonwealth Grants Commission (2004), *Report on State revenue sharing relativities. 2004 review*, p86-87.

61 See Commonwealth Grants Commission (2004), *Report on State revenue sharing relativities. 2004 review*, p86-87.

Italy	• Recent radical restructuring of federal financial relations; • Devolution of some taxes to regions (regional business tax and surcharge on personal income tax); • VAT revenue-sharing via untied grants distributed among regions according to regional consumption; • New horizontal equalisation between regions based on: - Fiscal capacities - Health needs - Cost disabilities; and • Aims for full equalisation by 2013.
Switzerland	• Undergoing radical restructuring of HFE arrangements; • Reassignment of expenditure responsibilities; • Reform of equalisation process which does not aim for full equalisation; • Based largely on equalisation of fiscal capacities; and • Equalisation includes both vertical and horizontal transfers.
USA	• Substantial cost and revenue disabilities across the States; and • But no mechanism for formula-based equalisation.

6.1.4 How Australia compares

The Australian federal system has three important characteristics which, taken together, put it in a highly unusual position compared with the other countries under review:

1. **High VFI.** The States have an inadequate range of tax instruments with which to fund their expenditure responsibilities. Thus, high levels of vertical grants, from the Commonwealth are necessary.
2. **HFE.** These high vertical grants are distributed either as tied grants or as untied grants allocated on horizontal fiscal equalisation principles.
3. **Full capacity equalisation.** The system attempts full capacity equalisation, taking into account both cost and revenue disabilities.

The problems with a high level of VFI are discussed elsewhere in this Report (refer Section 5) but the implication of high VFI for the equity benchmark is that, with such comparatively large vertical grants being distributed on fiscal equalisation principles, the methodology and process of HFE assume great significance. Unfortunately, both have become highly controversial. The *methodology* has been criticised by academics, consultants, State Governments and even the Governor of the Reserve Bank of Australia. The *process* is flawed because the Commonwealth Treasurer, with whom the responsibility for HFE finally lies, has declined to amend CGC's recommendations or to initiate a process of comprehensive review of the Commission's methodology. The move in 2000 to the new GST arrangements, while yielding revenue benefits to the States as a whole, substantially increased the degree of VFI and magnified the inequities resulting from the HFE process because a much larger revenue pool is now subject to equalisation. The Australian system has more ambitious, and probably worthier, objectives than the systems of HFE in other comparator countries but it is, in practice, fundamentally flawed.

In terms of the size of the revenue pool that is subject to equalisation, Australia contrasts with Canada. In Canada, the central government supplements grants to provinces, if necessary, to achieve minimum standards. This means that equalisation is not necessarily a zero-sum game for provinces in Canada (unless funds are taken away from other programs involving transfers from the central government to the provinces) and so Canada has an 'open system' of equalisation. In contrast, in Australia, equalisation is achieved from the same sized pool of funds irrespective of changes in the need for redistribution. This is achieved by redistribution between the States rather than changing the size or nature of the central government budget result or changing the distribution of resources between the central and local level of government, that is, equalisation is a zero-sum game for Australian States. Australia's 'closed system' is based on a premise that the equalisation system should not result in changes to overall public sector outcomes, whereas an open system such as Canada's allows it to do so.[62]

There has been a general international move towards greater decentralisation and devolution of fiscal responsibilities in federal systems. However, in Australia the move has been in the opposite direction.

62 See further discussion of this issue in Searle (2004).

6.2 Benchmark 7: Neutrality

Benchmark 7: Neutrality

Subnational governments should not be able to influence the grant that they receive by manipulating their expenditure or tax decisions.

6.2.1 Benchmark: Definition, significance and measurement

The conditions and terms of intergovernmental fiscal transfers should not influence the subnational government's expenditure or tax decisions, that is, they should be neutral. If grants are based on a formula that includes variables which are able to be influenced by the recipient, then neutrality in the allocation of grants cannot be assured. As a result, conditional grants and those based on equalisation principles are more likely to be less neutral than other forms of transfers.

Neutrality can be influenced with respect to: the extent to which particular subnational governments' own-source taxes are taken into account in determining transfers; application of equalisation principles in determining transfers; and the influence of transfer determination on a subnational government's tax effort.

In relation to tax assignment, the general rule is that less mobile tax bases should be the focus of subnational governments while the central government can have access to all bases. Where the same base is taxed by the central and subnational government,[63] the central government should not unilaterally exclude subnational governments from that tax. This has a non-neutral effect on subnational governments' decision making regarding their tax system.

In terms of the use of equalisation principles embedded in transfer determination, those principles should not influence a State's behaviour. Where taxes and expenditures can affect the parameters of the grant formula and as a result, the size of its grants, the transfer determination is non-neutral.

Just as the transfer formula should not encourage manipulation of subnational taxes and expenditures, nor should it affect tax effort. It is generally accepted that tax effort should be encouraged. However,

63 For example, in the case of property taxes, the subnational government could tax it on the basis of the benefits principle and the national government on the basis of equity and intergenerational concerns.

if such encouragement then results in reduced grants, tax effort will be discouraged and this will have a deleterious effect on the subnational government's incentive to grow their economy and maximising tax compliance.

6.2.2 Australia's performance against Benchmark

Australian States rely on substantial federal government general revenue grants to fund their expenditure programs. The size of the general revenue grants stems from the IGA and their allocation between the States by the Commonwealth, based on CGC advice. In this regard, the principle of equalisation is followed, which has been interpreted by the CGC to mean that[64]:

> State governments should receive funding from the Commonwealth such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.

The objective of the CGC is therefore to ensure that each State government has the financial capacity to provide the same level of service to its residents. In relation to taxes, the objective is to ensure that there is an equivalent per capita capacity to raise revenue from each source by estimating the per capita revenue each State would raise if it applied the Australian average revenue raising effort for each tax type to its revenue base for each tax.[65] This is designed to ensure that the calculations are policy neutral since they are based on common or average State policies and are derived from actual State practices.

The CGC asserts that a key principle underpinning its fiscal equalisation methodology is that the approach taken should be tax policy neutral. As a result, the CGC estimates a State's Standardised Revenue from each tax type. In making this estimate, the CGC is concerned as to whether one State made the same effort to raise revenue from its own sources as other States. In applying its principle of tax policy neutrality, the CGC effectively makes the following assumptions when estimating a State's Standardised Revenue from each tax type:

64 Commonwealth Grants Commission, (1999), *Report on General Revenue Grant Relativities 1999*, Volume 1, Main Report, p.4

65 Commonwealth Grants Commission, (2002), *State Revenue Sharing Relativities 2002 Update*, Canberra, p4-7. <http://www.cgc.gov.au/State_Pages/U2002Report.htm>

1. *Each tax adopted by any State is examined independently from all other taxes:*
   No account is taken of whether a particular State should or should not introduce a tax for economic efficiency reasons. This could be important if the economic incidence of the tax is likely to be different in each State.

2. *No interstate or international tax exporting is assumed:*
   One State may have a greater ability to export its taxes compared to another jurisdiction. While this can be captured through tax capacity measures, such measures do not indicate the jurisdiction where the tax burden might ultimately reside. This is likely to be important with gambling and tourist based taxes and could be with taxes on exported manufactured goods such as a payroll tax.

3. *No account is taken of the economic implication of tax:*
   Issues such as tax capitalisation or the economic impact of a State having taxes above or below the national average is not considered. This may have real implications in the case of property taxes when different land tax regimes adopted by different Australian States potentially result in differential impacts on asset prices in these States. No account is taken of this phenomenon and failure to do so has implications for the CGC estimates for each State's Standardised Revenue, revenue capacity and revenue effort.

4. *When States impose different progressive tax rate schedules, the CGC subsequently uses this information to estimate an effective all-State tax rate schedule. However, in doing so, the CGC ignores differences in the average value of the comparable base for taxpayers in the different States.* This is most starkly illustrated in the case of land tax and conveyancing duties. As a result, it is difficult to give a practical meaning to the resulting schedule which the CGC subsequently applies when estimating a State's Standardised Revenue for property taxes.

Each of these assumptions by the CGC offers tax planning opportunities for States in order to maximise their grant. State tax policy neutrality is therefore not assured. A State's tax policies can influence their grants in as much as their policies influence the CGC estimate of total Standardised Revenue from all State taxes. If a State abolished a tax, this should only affect the magnitude of their grant to the extent that the abolition of the tax has affected the distribution of total Standardised Revenue between all States.

Non-neutralities can therefore impact in three ways: through the central-State tax sharing arrangement; through interstate allocation of central government grants; and with regard to tax effort.

Central-State tax sharing

As noted previously, in Australia, States are only excluded in the Constitution from levying duties of customs and excise which have been interpreted by the High Court as including all sales taxes. However the active discouragement of States and Territories from imposing income taxes through the threat of reduced SPPs (by an amount equivalent to any income tax raised) is non-neutral.

This policy has not prevented the Commonwealth from sharing the personal income tax revenue with the States in the past (1976-80)[66] and now in effect the GST revenue. However, in both cases the mechanism for transferring that revenue to the States and Territories this determined on the advice of the CGC (based on principles of equalisation) which is also non-neutral.

Interstate allocation of central government grants

The majority of grants made to Australian State and Territories are based on comprehensive equalisation formula. These influence the States' and Territories' behaviour because its taxes and expenditures affect the parameters of the grant formula and as a result, the size of its grants. This issue has been examined most recently in Australia by Dahlby and Warren (2004) and in Canada by Boessenkool (2002). The observation is that Australian States and Territories can and do benefit by reacting to the grant formula. Therefore the grants are non-neutral.

Maximising tax effort (and compliance)

Australia's approach to HFE used in determining transfers does not encourage maximum enforcement of the tax laws nor is it neutral in terms of its implications for State tax design.

6.2.3 Performance of other Countries against Benchmark

While the scope for equalisation induced non-neutralities in Australia is not too different from that in other countries, what is different is that other countries have:

66 See Fisher and McManus (2004), p.333.

- less reliance on an array of both tax and expenditure variables where equalisation principles are employed
- less complexity in their equalisation allocation mechanism;
- less reliance on general revenue grants distributed through the equalisation pool (that is, 100 per cent in Australia …). More reliance on a mix of exogenous variable (e.g. population, GSP) than endogenous variables (capacity and specific expenditure costs)

With this complexity and size of the equalisation pool comes greater scope for grants to be impacted by variables in the equalisation grant allocation formula which are not determined independently of the grants themselves.

The international practice in relation to neutrality is not clear-cut with neutrality (and non-neutralities) raising itself at two level. Ideally, no one State should be able to influence its grant allocation and secondly, comprehensive consideration of a State's capacity is optimal. While Australia subscribes to both principles, internationally, the first is broadly accepted in practice but not the second, the view being that their must be some incentives for States to improve their economic position without being penalised by the equalisation mechanism

Take the case the German fiscal equalisation system and the VAT. According to Article 107, s.1, clause 4 of Germany's Constitution, at least 75 per cent of the generated VAT to which the federal States are entitled, must be distributed on a per capita basis. The remaining 25 per cent is distributed to financially weak States based on a financial strength indicator in the fiscal equalisation system(Werner 2003). However, not all taxes are included in this indicator (with 36 per cent of Municipal Taxes excluded as are some port charges) and not all persons are treated equally[67].

Also, since 2005 a Premium Model has been introduced in Germany which is "meant to provide positive incentives both to the donor States and the recipient States under the fiscal equalisation system. By disregarding a flat percentage of 12 per cent of above average tax receipts and below-average tax shortfalls, the respective Länder States are to be rewarded for positive developments regarding their tax rev-

67 See Werner (2003), p.7. In the city-states of Hamburg, Bremen and Berlin, their population is "readjusted" by being multiplied by the factor 1.35.

enues".[68] While there is some controversy over whether the outcome will be positive (Lenk and Kaiser, 2004), there is no doubt that this is the intent of government. Clearly, there is concern in Germany that even neutrality itself as a goal can pose an incentive problem for individuals States to raise their own-source revenues or take actions to build their own tax base.

Italy, like Australia, includes not only fiscal capacity but also health care needs and cost differences in providing public services, when determining its equalisation criteria. However, Italy recognises the disincentive effects of its fiscal equalisation process and has for example, made a provision in its distribution of VAT which "is primarily intended to equalise up to 90 per cent of the difference in standardised per capita at local tax revenues, leaving room for incentives to develop local tax bases" (Arachi, G. and Zanardi (2004, p337).

As Arachi and Zanardi (2004) also note:

> … some countries have implemented strategies to reduce potential disincentives associated with fiscal equalisation schemes, implying some compromise with equity objectives. In the new Spanish transfer system, transfers are designed to fill the gap between revenues and expenditure needs for each region for a base year and will not be adjusted to reflect actual growth performance of individual regions. The ongoing revision of the German model of interjurisdictional solidarity (in response to a ruling of the Constitutional Court) allows Länder to generate some own revenue that is protected against interregional redistribution so as to preserve the incentives for fiscal effort.

In Switzerland it has also been recognised that there needs to be a separation of the incentives (through federal grants) and efficiency (assignment of functions) objectives from equalisation objectives (focused on revenue capacity and cost differentials) (Dafflon, 2004).

6.2.4 How Australia Compares

Australia compares unfavourably with other countries because of the complexity of equalisation and the greater opportunity for tax and expenditure variables to impact on the allocation of grants between subnational governments. Moreover, the comprehensive and sophisticated approach has a dominant focus on neutrality which removes any incentive for a State to improve its relative position. After all, any gains made through economic development which adds to taxable

68 ibid p.10.

capacity reduces their grant entitlement under the equalisation model applied in Australia.

Moreover, in the Australian case, the equalisation mechanism goes so far as to treat SPPs as adding to a State's revenue capacity which subsequently confuses what is an incentive to particular States (from the Commonwealth) and what is designed to equalise their share of a grant pool. In contrast, in Canada central government direct grants to individual provinces are not taken into consideration when determining equalisation grants.

A consequence of Australia applying the principle of equity (Benchmark 6) through its comprehensive equalisation formula is that it impacts negatively on neutrality (Benchmark 7). Garnaut/FitzGerald (2002, p8[69]) highlight some of these negative impacts (of the non-neutral approach to fiscal federalism in Australia) in their Report:

> We have identified ten types of effects on economic efficiency and growth (also see *Issues in Commonwealth–State Funding* [Garnaut and FitzGerald 2002]):
>
> (1) *The tendency for equalising transfers to reduce the incentives for resources to locate in higher rather than lower productivity locations* – conventionally the dominant economic efficiency consideration in assessing horizontal fiscal equalisation (HFE) arrangements.
>
> (2) *The capacity for investment in human resources development in low productivity regions to enhance national economic potential.*
>
> (3) *Incentives for people to stay in locations where their marginal social product is high.* This is the converse of the effects in (1). It could be present if a lower *fiscal residuum* or other cause of divergence between private and public benefits of emigration caused some people to move out of lower income regions when their marginal social product was higher than in the higher-income region to which they were moving.
>
> (4) *Attraction and retention of high-value mobile resources in an international market.*
>
> (5) *Overhead and transaction costs of managing the system.*
>
> (6) *Duplication, lack of coordination and game playing by officials.*
>
> (7) *Enlarged role of the public sector* – recipient States are less responsive to market economy dynamics and do not spend money so closely in accord with citizens' preferences.

69 See also lengthy discussion of this issue in Chapter 10.

(8) *Grant seeking behaviour* – particularly where States have the capacity to influence the CGC's assessed standard budget.

(9) *Diluted incentives for cost reducing reforms.*

(10) *Impact on the political economy* – States are discouraged from growth promoting policies if the fiscal benefits of stronger growth are mostly transferred to others.

While the intergovernmental arrangements in other federations do have implications for economic efficiency, Australia stands out because of its total focus on the equitable distribution of the GST related grants – at any efficiency cost. In contrast, other federations explicitly recognise there is a cost with such an approach – a disincentive to improve the State – and therefore design their approach to ensure equalisation leaves some (even if small) incentive for the States to build their economy.

6.3 Benchmark 8: Predictability and flexibility

Benchmark 8: Predictability and flexibility

Subnational governments need to be able to budget and plan for the future but, at the same time, have the flexibility to respond to changing circumstances.

6.3.1 Benchmark: Definition, significance, measurement

It is important that a State government's total pool of available financial resources be predictable in absolute terms, as well as flexible enough to meet changing (and unexpected) budgetary demands.

This can be achieved through a combination of grants from central government and own-source revenues. Predictability can be achieved through sharing a general revenue pool with published revenue projections. Flexibility can be achieved through a formula-driven approach that recognises the changing circumstances of State governments – and their relative position within a federation – over time (although revenue flexibility is also available to State governments through changes to their own-source revenues, these resources are rarely sufficient to meet their own-purpose needs – see Benchmark 5 'Fiscal Need').

In the case of general revenue grants, predictability requires certainty about both the size of the available pool and each State government's share of this pool. Uncertainty can arise from changes in the grant allocation formulae or changes in the aggregate grant pool.[70]

It is generally advisable, from the points of view of both the grantor and recipient governments, that the total pool of resources to be distributed in general purpose transfers be set in a stable but flexible way (e.g. as a percentage of central taxes, adjustable every few years).

There are three basic ways to determine the total amount to be transferred (sometimes called the 'distributable pool' or the 'primary distribution'):

- on an ad hoc basis, that is, in the same way as any other budgetary expenditure;
- on a formula-driven basis, that is, as a proportion of specific State government expenditures to be reimbursed by the central government or in relation to some general characteristics of the recipient jurisdictions; or
- as a fixed proportion of central government revenues.

From the perspective of national government, the best system would probably be one where transfers are determined annually in accordance with budgetary priorities. With such a system, however, recipient governments will neither be able to budget properly nor will they face an appropriately hard budget constraint.

On the other hand, any system in which the total transferred is 'demand-driven' or 'open-ended' – driven, for example, by local expenditures or revenues (like the Canadian equalisation system) – is unlikely to be popular with central governments.

A better transfer system is one that distributes funds on the basis of a formula, as discretionary or negotiated transfers are always undesirable.

Another good system of financial transfers – one that provides both some degree of stability to State governments and some degree of flexibility to the central government – is to establish a fixed percentage of all central government taxes to be transferred. Sharing specific central government taxes is less desirable than sharing all national taxes. This is because experience shows that central governments over time to increase more those taxes which they do not have to share.

70 This section draws on the discussion in Bird and Smart (2001), p.17-18.

The grant mechanism should ensure predictability of recipient shares by publishing, say, five year projections of funding availability (Prud'homme and Shah, 2003, p.26). The transfer mechanism should also be flexible enough to handle unexpected events, cyclical down turns and reasonable investment needs. This can be achieved by focusing on cyclically adjusted targets, introducing a medium term framework or specifying escape clauses (Joumard and Kongsrud, 2002, p.203).

6.3.2 Australia's performance against the benchmark

In Australia, general revenue grants are made from the GST revenue pool. An individual State's allocation from this pool depends upon three factors:

- the size of the total GST revenue pool;
- the size of the population; and
- the State's fiscal equalisation relativity, recommended by the CGC.

In practice, the size of the total GST revenue pool has proven to be relatively predictable although, like all taxes, the GST is subject to some forecasting error.

In relation to the second factor influencing a State's allocation, population growth has proven to be relatively predictable.

On the other hand, the extremely complex formula used to distribute the GST among the States makes prediction of the level of untied grants *for any individual State* considerably more problematical.[71] The annual change in any particular State's share depends upon:

- how its revenue bases have changed relative to those of other States;
- how its expenditure needs have changed relative to those of other States;
- any directions to change the distribution formula that the central government has made during the previous year; and
- the effects of corrections to any mistakes in the way the distribution formula applies that have emerged during the previous year.

71 See Appendix C for an elaboration of how this approach operates in practice in Australia.

This means that a State's untied grant can vary by a couple of per cent from year to year. When the distribution formula is periodically reviewed (usually every five years), the variations can be considerably larger, up to around 10 per cent of the total grant.

Tied grants vary in their predictability. They are typically subject to multi-year agreements, which make them relatively stable for the life of the agreement. However, when an agreement is rolled over, the central government can use its discretion to revise the formulas used to increase and distribute the pool of funding, making them less predictable than States would desire.

Some level of flexibility (and therefore unpredictability) is however necessary in order to make the system responsive to changes in circumstances. Australia's system of annual updates is designed to ensure that the most recent data is incorporated in the calculation of each State's share of the pool. However it suffers from a design flaw which undermines this benefit.

The formula is based on a rolling average of five years' worth of data, applied with a year's time lag. So, for example, data from years one to five are averaged to calculate States' share of the pool in year seven (e.g. grants for 2006-07 determined using 2000-2001 to 2004-05 data). This means that movements in States' funding shares can have a pro-cyclical effect on States' local business cycles. For example:

- One jurisdiction's grant share was reduced in the mid 1990s as a result of its strong performance during the national recession earlier in the decade. However that jurisdiction underwent its own economic slowdown in the mid 1990s, at the same time as its grant was being reduced. As this jurisdiction's local slowdown became incorporated into the formula during the late 1990s its grant share increased, yet this coincided with a relative improvement in its economic fortunes.
- Another jurisdiction's grant share was reduced as a result of a housing boom which increased its own-source revenues. However, this reduction continued as the boom petered out, so that this jurisdiction's grant share fell as its own-source revenues declined.

6.3.3 Performance of other countries against the benchmark

Austria	The Fiscal Equalisation Law (FEL) is pivotal in defining major intergovernmental fiscal relations. The provisions of the law are negotiated between the federal government, the States and the municipalities and have validity for a period of four years. The FEL determines the types of taxes to be shared between the three levels of government and the proportions according to which the revenues are allocated. It also specifies major transfer flows between the levels of government. Most important types of taxes are shared taxes, such as personal income tax, corporate tax and value added tax, with the corresponding tax rates determined by federal legislation. The revenues of certain taxes are not shared but are kept by local and State governments according to how much revenue is generated within each state or municipality (Worgotte and Wurzel, 2006). The arrangements applying in Austria provide some predictability but at the price of less flexibility because of the preponderance of fixed revenue sharing arrangements and very limited State own-source tax bases.
Canada	Federal transfers in Canada use a stand-alone equalisation scheme based on formulae which are adjusted from time to time (Watts, 2005), and this indicates there is some degree of flexibility in Canada's arrangements in the medium to long term. If flexibility is required in the short term, Canadian Provinces have recourse to own-source taxes, one of which is a personal income tax surcharge. As with Australia's arrangements, Canada's arrangements are also subject to forecasting errors like any other tax, but the broad federal tax base makes it relatively more predictable than narrower subnational tax bases. Canada's 'Health and Social Transfer' was initially set in per capita terms to be equal in amount to certain (matching) transfers it replaced, and was subsequently adjusted as a function of a three-year moving average of nominal GDP growth. Under increasing budgetary pressure, the federal government both weakened the link to GDP growth (the adjustment factor was altered to GDP growth less 3 per cent) and for some years imposed a 'cap' on the absolute amount of transfers going to the richest provinces. While such measures may relieve federal finances, they obviously reduce to some extent the stability of revenue flow accruing to Canada's provinces.

Germany	In Germany shared taxes are allocated in accordance with a formula that attempts to take into account both needs and capacity. Germany's fiscal equalisation arrangements have three stages: stage 1 proves an equal per capita distribution of 75 per cent of States' share of VAT revenues to all 16 States and the remaining 25 per cent as a supplement to financially weak States; stage 2 provides a formal fiscal equalisation program where rich States contribute to the pool through a progressive tax and poor States receive a progressive subsidy from the pool; and stage 3 provides for supplementary federal grants. These arrangements are relatively simple and transparent (Shah, 2004). This formula based approach provides States with some predictability (subject to normal fluctuations in tax revenues) while providing flexibility, particularly through supplementary grants for poorer States.
Switzerland	Switzerland is currently undergoing a process of reform to its financial equalisation and intergovernmental grants system that should result in: a disentanglement of confederation/canton government responsibilities; performance oriented financing and block grants for the remaining tasks; and a new institutional framework for intercantonal cooperation. These reforms should eventually lead to a simpler, more efficient, transparent, and predictable system of intergovernmental finances. These reforms are expected to come into force in 2008 (Fischer, 2005).
USA	All grants from the federal government to lower levels of government are earmarked, or tied, and revenue sharing among the States or between the federal government and State governments does not exist. Four areas in which intergovernmental relations play an important role in program design and funding are income support, medical care for the indigent (Medicaid), highway construction and education. Jointly they account for about two-thirds of total federal grants to State governments, and education alone accounts for more than half of total grants from State to local governments. Although all of these grants are earmarked, there is considerable variation across program in the freedom the receiving governments have in allocating these funds. The fiscal rules in place have effectively disciplined State and local fiscal policies and have mostly avoided bankruptcies or bailouts by higher levels of government, but some rules appear to lack an economic rationale and could be modified so as to allow State budgets to reflect the developing needs and preferences of their constituents(Laubach, 2005).

6.3.4 *How Australia Compares*

The uncertainty (predictability) costs associated with Australia's system of equalisation are higher than those in Canada and Germany (Shah, 2005). This indicates that the predictability benchmark may suffer in the absence of high levels of revenue sharing (which is applied extensively in Germany and Austria).

Australian States have less fiscal autonomy than Canadian provinces and US States, so are constrained in their flexibility to meet unexpected demands on their budgets. However the system of annual updates to data applied in the CGC's methodology and periodic reviews of the distribution formula provide some flexibility in the system of general (untied) transfers.

With the fiscal arrangements applying since the IGA, a substantially larger share of untied grants now depend on the fiscal equalisation process and the unpredictability associated with that process which increases the difficulty of State budget management.

6.4 Benchmark 9: Simplicity and transparency

Benchmark 9: Simplicity and transparency

The transfer mechanism or allocation formula should be readily understandable (transparent) and easy to administer (simple).

6.4.1 *Benchmark: Definition, significance and measurement*

HFE mechanisms and formulae should be transparent and easily understood. The objective of HFE is some concept of equity, or fairness, between subnational governments and it is important in a genuinely cooperative federal system that fairness be not only achieved but be seen to be achieved. To achieve this goal the equalisation processes should be open, or transparent, and easily understood.

HFE processes are, by their nature, formula-based. That is, in a cooperative federal system, equalisation grants are based upon some predetermined formula rather than being solely at the discretion of the central government. In practice, equalisation formulae may relate simply to the equalisation of the fiscal capacities (the revenue-raising abilities) of subnational governments or they may, in addition, take into account cost disabilities in the provision of public services. In relation to the latter, the objective may be *full equalisation* of subnational governments' capacities to provide public services or it may be the more modest goal of providing the capacity to provide some pre-determined *minimum level* of public services.

There should be a presumption in favour of simplicity in the HFE process. This is not merely simplicity for simplicity's sake. Complexity in a grants allocation process can be justified if it can be shown to lead to efficient outcomes. Less complex processes will certainly be more readily comprehensible and, in that sense, more transparent. Simpler processes will also present less demanding data requirements and so are likely to be more robust.

There will always be a temptation to refine statistical processes in order to fine tune outcomes but such refinement is only possible if the underlying data are adequate for the task. Data at subnational levels (particularly in relation to State income, production and consumption accounts) are generally significantly less reliable than national data and may well prove to be inadequate for the purposes of complex equalisation calculations.

All other things being equal, the presumption should be in favour of simple transfer mechanisms and allocation formulae. These formulae should include no more allocation criteria than strictly necessary. Complex formulae are difficult to understand and to administer, and in the end multiple criteria may cancel each other out (Prud'homme and Shah, 2003).

6.4.2 Australia's performance against Benchmark

The objective of HFE in Australia is set out by the CGC (2004[72], p.4) as follows:

> State governments should receive funding from the pool of goods and services tax revenue and health care grants such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the same capacity to provide services at the same standard.
>
> The definition makes it clear that it is the fiscal capacity of the States that is being equalised. Fiscal equalisation is not directed towards equalisation of the circumstances of individuals, households or communities.

72 Commonwealth Grants Commission, (2004), *Report on State revenue sharing relativities, 2004 review.*

Thus the CGC recommendations to the Commonwealth Treasurer take into account both revenue-raising and cost disabilities. The objective is full equalisation between the States.

Australia's equalisation framework is highly complex and data intensive. Equalisation is applied to both expenditures and revenues, and this involves around 40 categories of State expenditure with many factors applied to each, meaning that Australia has 359 expense factor assessments. In the case of tax capacity, 37 State tax bases form the revenue assessments in the formula. The process in Australia is very labour intensive with perhaps 60-80 people involved at the Commonwealth and State levels, including 43 for the CGC alone in 2004-05.

Critics (see, for example McLain, 2004) complain the CGC regime is both data-heavy and opaque. In fact, the full details for the Commission's calculations are available, through publications and its website, in a comprehensive range of documents, discussion papers and spreadsheets. However, as the above paragraph indicates, the calculations themselves are complex, extensive and difficult to understand. It would be true to say that, outside the CGC itself, Commonwealth and State Treasuries and a few academic economists, there is a very low level of understanding of the CGC's detailed methodology.

The complexity also leads to severe, perhaps even crippling, data problems. It would be difficult to improve on the CGC's frank acknowledgment, in its 2004 relativities review, of the data problems inherent in its calculations.

> Our processes are stretching the available data to the limit. We have noted that the application of new or alternative data can generate changes in the assessed State relativities in particular categories that are difficult to reconcile with the extent to which the States' underlying circumstances have changed.
>
> The Commission's existing assessment process depends heavily on the availability of data, and the resulting relativities and grant shares are largely driven by data. We require robust, reliable, comparable and up-to-date data at a high level of disaggregation. We think it essential to have confidence in the quality of the data we are using. If we cannot have a high level of confidence in the data, we are strongly of the view that methods should be changed, rather than relying on data that might be inadequate for the purpose.
>
> Against this background, we have serious concerns. We remain uncertain that some of the data we are using are as robust and reliable as we believe is necessary. We may be pushing the data too far in some

> of the ways we use them. Particularly towards the end of this review, we observed large changes in relativities for some States flowing from the application of new data sets. The extent of the changes could not readily be explained by changes in the underlying circumstances of the States. If the data we are using are not consistently reflecting the circumstances of the States, the quality of our results is compromised.
>
> Based on discussions with the ABS, we understand that, at the major group (or two-digit level), the quality of General Purpose Classification data is "very good"; at the subgroup (or four-digit) level that we rely on extensively, it is "very patchy, unreliable and inconsistent across jurisdictions.
>
> (Commonwealth Grants Commission, 2004, pp.86-7).

If the CGC itself finds it difficult to reconcile changes in its assessed relativities with the extent to which States' underlying circumstances have changed, it is difficult to escape the conclusion that the CGC's methodology is neither simple nor transparent. Further, the CGC's concession that some of the underlying data which it uses are not adequately robust or reliable inevitably leads to the conclusion that the methodology itself is not robust.

6.4.3 Performance of other Countries against Benchmark

HFE programs have different formal objectives in different countries. The following are some examples:

Country	Objective
Australia	Capacity to provide services at the same standard with the same revenue effort and the same operational efficiency
Austria	Roughly equal living standards in all of Austria
Canada	Reasonably comparable levels of public services at reasonably comparable levels of taxation across Provinces
Germany	Equalisation to compensate for differences in the financial capacities of the Länder
Switzerland	Provision of minimum acceptable levels of certain public services without much heavier tax burdens in some Cantons than others

Table 8: Summary of fiscal equalisation processes in selected federations

	Australia	Austria	Canada	Germany	Switzerland
Legal status	Federal law	Constitution	Constitution	Constitution	Constitution
Total pool determination	GST revenue	Formula	Formula	Formula	Formula
Allocation method	Formula	Formula	Formula	Formula	Formula
Fiscal capacity equalisation?	Yes (RTS)[a]	Yes (for municipalities-weighted population density)	Yes (RTS)	Yes (actual revenues)	Yes (Major tax bases)
Fiscal need equalisation	Yes	Some (population size and density)	No	Some (population size and density)	Some
Political consensus	No	Yes	Yes (?)	Yes (?)	Maybe (?)
Who recommends	Independent agency	Negotiation between 3 tiers of govt.	Inter-governmental committees	Solidarity Pact II	Federal Government
Sunset clause	No	Yes (4 years)	Yes (5 years)	No	No
Program complexity	High	Medium	Low	Low	Medium
Review processes	No	Yes	Yes	Yes	Yes

a Representative Tax System (RTS), similar to Australia's 'Standardised Revenue' concept.

Fiscal equalisation programs also have different characteristics which affect their complexity. The following table, based on Shah (2004) and Fuentes, Wörgötter, and Wurzel (2006) provides a summary of the characteristics of fiscal equalisation processes in four comparator federations and Australia.

6.4.4 How Australia compares

Table 8 above shows that the fiscal equalisation process in Australia differs in several important respects from those of other comparator federations:

- Australia's HFE process is much more complex that in most other federations. It has a more ambitious objective (full equalisation) although it is not clear that this objective is met;
- The process of the determination of the transfer mechanism and formulae is less transparent and subject to less intergovernmental

negotiation than in other federations where the mechanisms and formulae tend to be:

- Determined by a significant degree of political consensus; and
- Subject to external or cooperative review processes.

- The complexity of the Australian process and the degree to which the outcomes are determined by unreliable data sets mean that the process is substantially less robust than those of other federations.

6.5 Benchmark 10: Autonomy

Benchmark 10: Autonomy

Subnational governments should have the independence to set priorities and manage services to respond to local needs.

6.5.1 Benchmark: Definition, significance and measurement

An important policy decision in the design of intergovernmental fiscal transfers concerns the degree of autonomy enjoyed by recipient subnational governments in spending the funds received via the transfer. In order to realise the benefits of a federal system, subnational governments must be able to exercise their powers independently of other governments in the federation.

The proper responsibility for the central government is to ensure that any spillover effects are incorporated into the decisions of subnational governments but beyond this they should not interfere with the subnational government's power to govern. The mechanisms to achieve the necessary management of spillover effects usually involve varying types of conditional intergovernmental fiscal transfers. The significance of the autonomy benchmark is in monitoring that central governments do not extend beyond their appropriate role and impinge upon the legitimate autonomy of the subnational governments. Subnational governments must therefore be able to set priorities which reflect local preferences and promote economic efficiency.

The greatest autonomy is achieved with general purpose transfers. The subnational government restrictions in spending general purpose transfers are limited to its legal functional responsibilities (usually outlined in a Constitution). Many countries have at least some general purpose allocations in their intergovernmental program. However, even then a proportion of the transfers are usually controlled to some extent by the allowable use of the funds.

Sectorally limited allocations permit the recipient subnational government to choose how to spend the funds, provided they are spent within a particular sector. This category of intergovernmental transfer is particularly relevant where the central government believes that significant benefits will flow from a specific activity, both within and beyond the subnational locality. A common example of a sector targeted using this category of intergovernmental transfer is the health sector.

At the extreme end of the spectrum is the specific purpose intergovernmental transfer. These transfers can be highly restrictive with regards to how the subnational government can spend the funds. Restrictions may apply to choices between labour and non-labour spending, or to specific projects. These restrictions potentially reduce the subnational government's autonomy over fundamental expenditure decisions. Where this occurs, the subnational government becomes an agent of the central government, practically negating the potential benefits of devolution and reducing the incentives for subnational policy development and implementation.

Specific purpose intergovernmental fiscal transfers are often made in the form of cost sharing transfers. These transfers reimburse subnational governments for expenditures on a specific activity (identified by the central government as a priority worthy of subsidisation). These specific purpose transfers can involve either total or partial cost sharing. Total cost sharing transfers reimburse subnational governments for the total costs of the specific expenditure. Cost sharing transfers (also referred to as matching arrangements) require the subnational government to contribute some minimum portion of total costs from their own resources. This form of specific purpose intergovernmental transfer distorts the subnational government's expenditure decisions. For this reason, specific purposes intergovernmental fiscal transfers should only reasonably be used to address spillover effects.

Given the various advantages and disadvantages of the different degrees of autonomy associated with different categories of intergovernmental fiscal transfers, the type or combination of transfers ultimately used in a jurisdiction will need to be carefully determined with respect to the various objectives that a federal system is intended to achieve. As McLure and Martinez-Vazquez (1994, p1) point out, this requires consideration of the level of autonomy relative to the expenditure responsibilities of the subnational government:

> A stable and meaningful decentralisation requires an unambiguous and well defined institutional framework in the assignment of expenditure responsibilities among the different levels of government together with the sufficient budgetary autonomy to carry out the assigned responsibilities at each level of government. (McLure and Martinez-Vazquez, 1994, p.1)

However, as a general principle, intergovernmental fiscal transfers should preserve a level of autonomy to subnational governments. This principle is based on the assumption that funds are transferred to responsible subnational governments that are held sufficiently accountable for their actions. Where this is the case, subnational governments should have the independence to set priorities and manage services to respond to local needs. If, however, considerable control is exerted over the spending of a subnational government, it is less able to make expenditure decisions which are fair, effective and accountable to its citizens.

Measuring the degree to which a subnational government maintains its autonomy in the light of receipt of intergovernmental fiscal transfers is best achieved through an analysis of the level of conditional transfers, the activities and expenditures controlled and the impact of those conditional transfers. Where a high proportion of a subnational government's revenue is made of conditional grants, their autonomy may be undermined.

Finally, even unrestricted grants, where they are based on an equalisation principle, may indirectly impact on subnational government decision making. Although it may be overstating the impact to say that the autonomy of the subnational government is diminished, a subnational government may feel compelled to make certain decisions in order to maintain its level of funding, based on the equalisation formula used. In this regard the equalisation grants potentially also negatively impact on economic efficiency (Joumard and Kongsrud, 2003b, p.196).

6.5.2 Australia's performance against Benchmark

An assessment of Australia's performance with respect to the level of autonomy subnational governments enjoy as a result of their receipt of intergovernmental fiscal transfers requires an analysis of the types of transfers paid to the Australian States and Territories and the extent to which they are conditional.

The mechanism which the Commonwealth uses to steer the policies of the States is the use of tied grants, known as specific purpose payments (SPP). These transfers from the Commonwealth to the States are made pursuant to agreements between the two levels of government on particular policy areas.

While the States, through the negotiation of intergovernmental agreements, assist in defining the roles and responsibilities of the levels of Government and the source of funding required to achieve them, the SPP also serve as a vehicle for the extension of Commonwealth policy into areas for which the States are responsible and will be held accountable. In some cases, SPP are little more than a mechanism for the Commonwealth to direct funds towards the Commonwealth's areas of priority rather than pursue matters of higher priorities to a particular State.

This is particularly the case where the transfer to a State is conditional on the State matching the Commonwealth's contribution to a policy area out of its own source revenues. Another common requirement is for States to maintain their own spending in particular policy areas in order to qualify for an SPP. These 'matching' and 'maintenance of effort' conditions apply to most SPP.

The level of State funds 'tied up' in SPP agreements is significant. SPP constitute around 15 per cent of States total revenues. However, through their matching and maintenance of effort conditions SPP agreements can control up to 33 per cent of State budget outlays. This has a significant impact on the States' budget flexibility.

Current Commonwealth policy towards SPP is seen by the States as highly inflexible and focused on input controls rather than what is achieved. The States have argued for some time that the focus in SPP agreements should be on outcome/outputs measures, in order to ensure greater focus on service delivery and to encourage efficiency improvements.

In recent times, individual SPP agreements have become increasingly detailed and prescriptive. SPP agreements commonly impose a number of conditions, including:

- Funds matching or 'rate of funding increase' requirements (e.g. under the Australian Health Care Agreement, States are required to match the Commonwealth's cummulative rate of growth in funding);

- Detailed policy conditions (e.g. the promotion or observance of Commonwealth industrial relations approach by requiring that States observe the Commonwealth's *National Code of Practice for the Construction Industry*, aspects of which are inconsistent with various States' existing industrial relations policy);
- Extensive reporting requirements (e.g. the Indigenous Education Agreement requires reporting against over 360 performance measures per annum); and
- Performance penalties (e.g. the Australian Water Fund Agreement provides that State breaches of other natural resource management agreements will be considered a breach of the Water Fund Agreement).

In conclusion, Australia does not perform strongly against this benchmark.

6.5.3 Performance of other Countries against Benchmark

Analysis of subnational own-source revenues versus central government transfers alone is insufficient to determine the impact intergovernmental fiscal transfers might have on the autonomy of the subnational government. Firstly the nature of the central government transfers must be determined: that is, are they tied/earmarked or unconditional. Furthermore, general funding conditions must be considered. In some cases, grants are only provided where a subnational government implements a certain type of tax or raises a certain level of own-source revenue. Consequently, a subnational government's autonomy might be impaired in a range of ways that are not immediately apparent from statistics on the subnational governments' revenue sources.

As a result, the following summaries regarding the level of autonomy with respect to intergovernmental fiscal transfers is based on a range of sources which provide both quantitative and qualitative data on the relevant country. The limitation from compiling a range of data from various sources (some not originally written in English) is that the outcomes may be subjective. The information presented has been interpreted and conclusions drawn from the judgements of a range of commentators; and different assumptions (particularly as to what is an acceptable level of autonomy for a subnational government). Given the diversity of systems operating amongst these countries however, there is a risk that in some cases comparisons are made in circumstances that are in reality not comparable. Consequently, the assessment of autonomy of subnational governments set out below should be read with caution.

Austria	Subnational levels of government rely largely on shared taxes, for which the federal government has full legislative responsibilities, and on federal government transfers. The States have few sources of tax revenues (Fuentes et al, 2006, p.8). A large proportion of municipalities' and States' tax and transfer revenues are earmarked to specific spending programs according to uniform rules across all States or municipalities in Austria, which significantly limits the extent to which the regions can take differences in local preferences into account and govern autonomously. Overall, earmarked revenues, net of additional cost sharing and transfer arrangements between State and local governments, account for about a third of the States' revenues and a half of the municipalities' total revenues. (Fuentes et al, 2006, p.11)
Canada	In terms of reliance upon own-source revenues and of the predominance of unconditional transfers, the Canadian system of fiscal federalism clearly leaves the provinces with a high degree of autonomy (Watts, 2005, p.38). Not all intergovernmental fiscal transfers are unconditional though. Two components make up the bulk of federal transfers to the provinces — Equalisation and the Canada Health and Social Transfer (CHST). Equalisation payments are made to all provinces that have tax capacities below a national standard (which currently include all but two: Alberta and Ontario). The CHST is intended to share in the provincial costs of health, social services and post-secondary education, and the federal government notionally divides the CHST into those three components. However, the funds do not need to be spent in those areas but they are not completely unconditional. For example, to be eligible, provincial public health insurance systems must comply with the criteria set out in the Canada Heath Act 1985 regarding public administration, accessibility, comprehensiveness, universality and portability. Additionally, the provinces must not impose extra billing or user fees (Boadway, 2003).

Germany	German Länder rely on a relatively high proportion of intergovernmental fiscal transfers however they have a high degree of financial autonomy. This is due to the fact that the proportion of conditional transfers and the constitutionally mandated character of the unconditional transfers from shares of federal taxes are relatively low. And in any case, the Länder are represented in the Bundesrat and therefore have some influence over their tied grants. In terms of degree of intergovernmental coordination and central influence upon Länder and local governments, the interlocking nature of decision-making on financial issues in Germany stands out. Some commentators have argued that it has been carried to excess and that the resulting "joint decision trap" has reduced autonomy, initiative and freedom of action of governments at all levels (Sharpf, 1988).
Italy	In Italy earmarked transfers have been replaced with unconditional equalisation transfers (based on national VAT revenue) since 2000. However the autonomy expected to flow from these changes is somewhat diminished by the requirement to provide health services at a specified level, both in terms of quality and quantity. This is particularly so for the smaller regions which do not enjoy the economies of scale the larger regions do (Arachi and Zanadi, 2004, p.345).
Switzerland	Switzerland continues to be considered the most decentralised federation in the world in terms of the distribution both of own-source revenues and of expenditures (Watts, 2005, p.40). Indeed, the Swiss Cantons have a rather low dependence on transfer payments from the central government. They receive less than 17 per cent of their total revenues in the form of specific grants from the Confederation. Intergovernmental fiscal transfers to Swiss cantons comprise a combination of grants (which are always specific and mostly conditional) and revenue sharing. So there is a loss of financial autonomy suffered to the extent a canton relies on a grant. The portion of grants out of total intergovernmental fiscal transfers ranges significantly across cantons from 81 per cent (Nidwald) to 35 per cent (Zoug) in 2005 (Dafflon and Tóth, 2005). The revenue sharing on the other hand always takes the form of block payments which are totally unrestricted in use at the cantonal level.

USA	Grants from the federal to the US States are all earmarked. These accounted for 32.5 per cent of the States total revenue in 2005 and cover four main areas: Medical care for the indigent (40 per cent); income support; highway construction; and education. This would suggest there is little autonomy within the US States regarding the intergovernmental fiscal transfers they receive despite more generally being considered to be rather autonomous. However, there is a considerable variation across different grants regarding the allocation of the funds by the subnational government (OECD, 2005, p.74). Finally, it is noted that the grants are typically not used to address spillovers (as the literature suggests is the main reason for specific purpose grants). Instead, the grants are focused on achieving aims of a paternalistic nature (Laubach, 2005) causing them to provide a minimum level of certain services (Inman and Rubinfeld, 1997).

6.5.4 How Australia Compares

In Australia State autonomy is much lower than in some federations such as Switzerland and Canada. The Australian States' own-source revenues are the second lowest among the comparator federations as a proportion of total general government taxes, except for Austria. The proportion of revenue received in the form of conditional specific purpose grants is higher in Australia than in any other comparator federations except the United States. Nevertheless, concern for State autonomy has meant that more than half of the federal transfers to the States are unconditional (Watts, 2005, p.41).

6.6 Benchmark 11: Incentive for sound management

Benchmark 11: Incentive for sound management

The transfer mechanism should not penalise subnational governments for sound management.

6.6.1 Benchmark: Definition, significance and measurement

In most federations, it is typical to find shared responsibilities between the central and subnational governments with the potential for ambiguous and often contradictory policy objectives. This can result from poorly defined roles and responsibilities. An overlap in these roles and reponsibilities can cause duplication and confusion about the functions, interactions and responsibilities of different levels of government. As a consequence, competition (and inconsistencies) that have the potential to discourage prudent subnational fiscal management may arise. It might also encourage the subnational government to undermine national objectives through the use of tax concessions or funds from off-budget sources.

Any lack of clarity about the roles and responsibilities of the various levels of government or the approach to resolving differences will create uncertainty. This has the potential to impart an air of unpredictability and instability that can adversely impact on economic stability and public confidence in government.

Public confidence in the integrity of government and its processes is crucial to good governance and this is especially the case in a federation where the actions of governments in the multi-tiered system have the potential to undermine public confidence in the system.

Sound management of government in a federation is therefore fundamental to an effective and economically efficient federation. Crucial here is the affect transfers from central to subnational governments may have on the clarity of the responsibilities and obligations of the subnational governments. The three key elements for the benchmark for sound economic management examined in this Section are:

- Benchmark 11.1: Sound *budgetary* management
- Benchmark 11.2: Sound *economic* management
- Benchmark 11.3: Sound *public administration* management

Benchmark 11.1: Sound *budgetary* management

The accepted criteria in federations is that in the case of budgetary management:

- subnational deficits will not be funded centrally; and
- deficit financing arrangements should be agreed with central government and open to public scrutiny.

These criteria, sometimes referred to as the budgetary principle of accountability or responsibility, must be taken into account in determining the level and distribution of transfers to subnational governments. In particular, the transfers must not impede subnational governments from abiding by the fiscal rules that guide subnational governments budgetary management (See Fiscal Rules Criteria below).

In practice three basic rules find application with subnational governments (Sutherland, Price and Joumard, 2005),:

- Balanced Budget Rule (BBR) for the public provision of goods and services;
- Borrowing and Debt Rule (BDR): Public debt only used for financing capital expenditures and/or if the subnational government can fund the debt plus interest from its current budget; and
- Tax and Expenditure Limitations (TEL) on the ability to increase spending or the tax burden.

These should be achieved without conflicting with the obligations set out in intergovernmental arrangements.

FISCAL RULES CRITERIA[73]

- Fiscal rules should be *adequate* relative to the final goal so that, for example, an expenditure ceiling might be best suited to curb public spending.
- Fiscal rules should be *consistent* with other policy objectives although this is not always possible and may result in subnational governments finding ways around it.
- The fiscal target and possible escape clauses should be *well-defined*.
- The framework should be *transparent* which makes the rule less easy to circumvent.
- Rules should be *simple* to understand and therefore attract strong public support.
- Fiscal rules should be *flexible* and able to handle unexpected events, cyclical downturns and reasonable investment needs.
- Fiscal rules should be *enforceable* which calls for a simple and well-defined fiscal rule.

The BBR benchmark and TEL are not often formerly legislated but left either to central government action or to market forces. The latter builds on the Tiebout principle that if one region steps outside the norm and consequently does not-reflect the preferences of their citizens, then the citizens will relocate. This will put pressure on that region's government to reflect the preferences of their citizens.

73 See Joumard and Kongsrud (2003) for a more extensive discussion of this box and related information.

BDR are common but are implemented in widely varying ways. In most cases a higher level of government imposes constraints on the subcentral government (with Australia, Canada, and Switzerland being exceptions). Sometimes the borrowing constraints are highly restrictive such as when they are not allowed to borrow at all (as in Denmark, or in Korea and Spain for current expenditure). In other cases, prior approval from the central government is common, with varying conditions attached such as permission to borrow in foreign currency or permission on a project by project basis or when the subcentral government breaches agreed deficit levels or where the planned borrowing is substantial.

Benchmark 11.2: Sound *economic* management

i. Subnational *economic* management should not conflict with national objectives

Any decentralisation of government functions inevitably raises the possibility of conflict between the national macroeconomic objectives and those at the subnational level. The issue here is to what extent a transfer from the central government causes the subnational government to enforce national priorities. Transfers should not encourage subnational government policies that conflict with national objectives.

The inevitable rule sought to be enforced is that the national government should have some monitoring or controlling power over the subnational governments on macroeconomic issues. This has seen the national government responsible for the national issues of monetary policy, trade, foreign affairs, defence, labour markets, capital markets, inflation and economic growth. The problem is that subnational governments also seek to maximise their own economic welfare vis-à-vis other regions. Beggar-thy-neighbour policies are therefore possible and can jeopardise the efforts of the national government to stabilise and grow the economy.

ii. The equalisation system should not hinder policies that encourage economic development (growth)

A common concern about HFE and VFI policies is their potential to discourage or hinder economic growth as a result of the way they can adversely interact with government programs which encourage economic growth in a region. For example, with growth comes a broader tax base, possibly higher asset prices, all of which imply the region has increased fiscal capacity and therefore receives a lesser share of the general grant pool. The question then is how to overcome this deleterious effect of the equalisation formula.

Three approaches find application:

- remove some subnational taxes from consideration when estimating the fiscal equalisation adjustment to grant allocation;
- exempt part of a tax (or taxes) from consideration in any fiscal equalisation adjustment; and
- do not allocate all grants through the HFE mechanism.

All three approaches find application amongst the developed federations.

Benchmark 11.3: Sound *public administration* management

i. Competency measures developed and applied

Competencies are an important consideration because in some service delivery, economies of scale might prevent subnational governments achieving competencies possible with national administration and delivery of similar services. Transfers from central governments should ensure the efficient and competent delivery of services at the sub national level.

This applies particularly to tax administration where duplication and information access problems may restrict the efficiency of the tax service. In this case, some collaboration including jointly administering taxes between tiers of government may assist in improving the effectiveness of the tax administration[74]. The intergovernmental transfer mechanism should not discourage competent administration of the tax system.

ii. Procedures in place to ensure a corruption free bureaucracy

A perceived strength of subnational governments is their closer links to the community than national governments. As a consequence, the community is perceived to have greater confidence in that level of government which more closely reflects their personal preferences in terms of public service delivery. However, subnational governments come with the risk of corruption for personal gain which is potentially more prevalent than at the national level. This corruption can occur both within the bureaucracy (because of a lack of transparency or accountability) or politically.

74 For the Swiss case, see Dafflon (2003).

6.6.2 Australia's performance against Benchmark

Most federations have a closer alignment of their taxing and expending responsibilities than is the case in Australia. An often-cited criticism of the Australian Federation is that the disjoint between expenditure and tax responsibilities does not encourage responsible State budgetary practices. This has the consequence of not encouraging sound economic management (Benchmark 11.1). As a result there may be concern regarding the level of responsible budgetary management at the subnational level. Appendix F outlines the fiscal rules applied in Australia and how they contrast with those in other countries. In most cases, fiscal rules are applied in a co-operative way.

Despite this, Australian States facing budgetary crises are still inclined to criticise the national government for inadequately funding them through general revenue grants and special purpose payments. In addition, each State has a propensity to criticise other States for obtaining a disproportionately larger share of the general revenue grant pool, thus contributing adversely to their own budgetary position. Whether a State seeks to blame other States or the national government for its predicament, this does not result in responsible budgeting practices but rather acts as a political distraction (and public distraction) from States own budgetary management.

This resort to 'blaming others' is in no small way the result of the tax-type constraint imposed by the Australian Constitution and the tax-level constraint imposed by interstate competition for the location of investment and skilled labour. Ultimately, States in the Australian federation are reluctant to: increase taxes or introduce new tax types different from those in other States; and run deficits which will burden future generations and ultimately lead to increased taxes, if resultant growth is unable to meet the cost of servicing and repaying this debt.

The key problem for Australia is that States are constitutionally assigned expenditure responsibilities but effectively have no access to their own broad based sales and income based taxes. They must resort to benefits principle (user pays) taxation; business input taxes; and taxes on assets and their transfer - or demand increased grants. This cannot encourage responsible budget practices (Benchmark 11.1).

Ensuring Benchmark 11.2: Sound *economic* management at the State level is an issue raised in the debate over competition between tiers of Government. Vertical competition arises when there is direct competition between the national and State governments and may not be a problem if it is efficiency enhancing such as through improved service delivery. Horizontal competition arises when there is competition between the States for the location of citizens and businesses. This 'voting with their feet' can have the positive effect of imposing a fiscal discipline on a State because of the threat of relocation to another State if the fiscal and regulatory frameworks are not attractive. However, it can also have a possible negative effect through the adoption of inter-state 'beggar-thy-neighbour' policies which reduce national economic efficiency by encouraging the use of resources in applications which would not have otherwise been allocated. These and other similar issues were canvassed at length in the recent Productivity Commission (2006) Roundtable on *Productive Reform in a Federal System* and will not be further reviewed in this Report. Suffice to say that such reviews are vital to a constant monitoring of the 'health' of any federation to ensure the economic management by States works in the national interest.

In practice, the Australian central government does have the ability to impose significant constraints on any one State's anti-national growth strategy. This is most effectively done through imposing financial constraints on errant States through changes to their SPPs which are at the total discretion of the central government. As a result, ultimately there are constraints on the extent to which any State can engage in activities which are clearly in conflict with national objectives.

In relation to Benchmark 11.3 – sound *public administration* management – this is best monitored by that jurisdiction which has responsibility for the particular public administration. Typically, this involves having in place agencies to independently audit public sector administrative performance and accountability regimes to ensure their efficiency and effectiveness (such as an Auditor-General). Systems can also be put in place to enable the community to provide its input or to register its concerns with the performance of the public sector. This could be through an ombudsmen or anti-corruption agencies. The Australian States and Territories all have such regimes in place either directly or indirectly.

6.6.3 Performance of other Countries against Benchmark

Appendix F outlines the fiscal rules imposed in a number of federations in pursuit of Benchmark 11.1 Sound *budgetary* management. As noted previously, in most cases the approach to applying fiscal rules and budget accountability is co-operative. What results is a range of instruments for ensuring budgetary accountability by subnational governments as outlined in Tables 9, 10, 11 and 12 for those federal countries focussed on in this Report.

Table 9: Budget balance requirements

A. Coverage and duration

	Current budget balance	Current budget balance and capital account	Current budget balance, capital account and off-budget items
Annual	Germany local Italy State Switzerland local	Canada State Germany State	Canada State
Multi-annual	Canada local	Canada local	Austria State

B. Budget concept used for application of rule

	Submitted budget	Approved budget	Realised budget with carry-over allowed	Realised budget with no carry-over allowed
Imposed			Canada local	Germany local
Negotiated binding			Austria State	Spain State
Self –imposed	Switzerland State	Canada State Germany State	Canada State	Canada State

Source: Sutherland, Price, and Joumard (2005, Table 1).

Table 10: Borrowing constraints

A. Access conditions

	Prohibited	Prior approval is required	Restricted to certain purposes	No restriction on access to borrowing
Imposed		Canada local	Germany local *Canada local* *Italy State and local*	Canada-State
Negotiated binding	Spain region (current)	Spain region (capital)		
Self imposed			*Switzerland State*	Canada State

B. Restrictions on borrowing and guarantees

	Numerical constraints				Guarantees			
	None	New borrowing	On debt level	On debt service	None	Exceptional basis	Case-by-case basis	Yes
Austria	√				√			
Canada State		√	√		√			
Canada local			√	√				√
Germany State	√				√			
Germany local		√			√			

Source: Sutherland, Price, and Joumard (2005, Table 2).

Table 11: Tax limits

Per cent of subcentral tax revenue

	Subcentral government autonomy over		Taxes are shared			Central government control
	Rate and reliefs	Rate or reliefs	With consent	By stable formula	Decided on an annual basis	
Austria	2	98				
Australia State	100					
Australia local	100					
Germany State		2.4		86.3		11.3
Germany local		33.6		47.6		1.0
Italy		55.9				44.1
Switzerland State	100					
Switzerland local	3	97				

Source: Sutherland, Price, and Joumard (2005, Table 4).

Table 12: Expenditure limits

	Expenditure limits			
	Are not used	Are set for total spending	Are set for current spending	Are set for individual spending items
Imposed		Germany local		
Negotiated but non binding		Germany State		
None	Austria State Canada State			

Source: Sutherland, Price, and Joumard (2005, Table 5).

In relation to Benchmark 11.3, sound *public administration* management, all federations give particular attention to this issue as they do to Benchmark 11.2, sound *economic* management. In some cases such as Germany, the States are more central in the nation and therefore have a greater degree of autonomy and associated economic responsibility. In those cases where the revenue from many taxes is shared (as in Germany, Italy and Austria) a greater degree of collective responsibility and accountability exists.

6.6.4 How Australia Compares

One feature distinguishing the Australian Federation from many others has been the clear and apparent lack of implied faith by the central government and the High Court in the States. Despite a growing trend towards the devolution of increased tax and expenditure responsibilities to subnational levels of government combined with greater clarity when those responsibilities are shared, the Australian federation has seen increased centralisation and less clarity where joint responsibilities exist. The Australian trend does not always work to facilitate the achievement of Benchmark 11.1 - sound *budgetary* management, because of the scope it offers both the national and subnational levels of government to not take responsibility for their own actions. As a result, a State's fiscal predicament is often blamed on the central government and issues such as weak infrastructure investment is blamed on the State government by the central government.

In relation to Benchmark 11.3, sound *public administration* management, all federations give particular attention to this issue as they do to Benchmark 11.2 sound *economic* management. Australia is comparable to most other developed nations and can not easily be distinguished from those countries adopting best practice policies.

6.7 Benchmark 12: Accountability

Benchmark 12: Accountability

The transfer system should enhance the accountability of subnational governments to their citizens.

6.7.1 Benchmark: Definition, significance and measurement

A government is accountable to both those that fund their activities as well as those who are expected to benefit from them. Accountability is a significant concern because accountability can improve efficiency gains and is considered to be the key to improved public sector performance (Bird and Smart, 2001). There is a potential risk that intergovernmental fiscal transfers decrease the degree of accountability the recipient government has to its constituents, particularly when the transfer system is complex and non-transparent (Fuentes et al, 2006, p.11). The lack of accountability in turn potentially reduces the efficiency of resource allocation.

An intergovernmental transfer made within a federation can impact on a government's accountability in various ways. Firstly, it could be argued that a clear separation of funding and receipt of public goods and services (by the government's constituents) not only removes the duty of care or accountability of the government to its constituents but also reduces the scrutiny under which the constituents place the government – that is, it might be argued that since the constituents did not pay for the public goods and services directly, they have no power to hold the government accountable. In practice, this argument does not reflect the behaviour of constituents generally. Additionally, it is a rare case when the funding party is the same as the recipient party when it comes to public goods and services. On this basis, the dependence of one level of government on another for funding does not, prima facie, reduce the recipient government's accountability to its constituents. Indeed, it will be accountable to both the funding government and its constituents.

Intergovernmental fiscal transfers can, however, impact on the recipient governments' accountability in a more significant way. The mechanisms used to distribute intergovernmental fiscal transfers can support and improve the degree to which the recipient government is accountable. This is most likely when very clear lines of delineation regarding responsibilities between governments exist and the intergovernmental fiscal transfers do not diminish these such as in the case of untied transfers (Watts, 2005, p.38).

Another approach taken to improve accountability may be to build performance measures into the transfer program. For, example transfers may be subject to renewal based on some kind of independent evaluation of the recipient government's performance. Alternatively, comparative performance measures of all recipient government's may be publicised. Note however, it is not suggested that this information is used in determining the quantum of transfers (Bird and Smart, 2001).

The more complex the transfer system however, regardless of whether the transfers are untied or not, the less transparent it will be. The lack of transparency often relates to the base elements used to determine the funding which may indirectly impact on the recipient government's ability to operate democratically in relation to all of its responsibilities. Transparency is also an issue in the context of the source of funds, how they are distributed and why they are distributed. A lack of transparency on any of these grounds is said to impact negatively on the recipient government's level of accountability.

Generally, the transfer system will be more complex and therefore less transparent the greater the proportion of grants that are earmarked or conditional. Complex arrangements regarding matching revenues for specific projects/programs, for example, and complex formulae used to generate grants based on certain characteristics/conditions such as equalisation payments (whether specific or not) are not usually considered to be transparent arrangements. The calculations and assessment of necessary conditions are difficult to make public in full and difficult to interpret and understand. Consequently, these complex arrangements reduce accountability of the recipient government to its constituents.

In addition to the complexity and consequential reduction of transparency regarding condition transfer, accountability may also be reduced as a result of the transfer system because it reduces the recipient governments' level of decision making power. Consequently, intergovernmental fiscal transfers may negatively impact on the recipient government's accountability when the transfers are specific (earmarked) and/or conditional. Responsibility typically delegated to one level of government, for example, may be directly or indirectly affected by the conditions set for receiving a transfer or in regard to its expenditure. The exertion of power to direct the recipient government on how to expend its funds not only impacts on the recipient's autonomy (refer Benchmark 10) but also the real and perceived level of responsibility for a particular program or portfolio between the funding and recipient government. This blurring of jurisdictional responsibility reduces and in some cases negates the accountability of potentially both levels of government. [75]

The responsibilities of a particular government are also less clear when intergovernmental relations are such that multilevel governance exists. Also referred to as 'Executive federalism'[76], multilevel governance occurs in respect of intergovernmental fiscal transfers where the different levels of government jointly deliberate over the spending policies regarding those transfers, that are the responsibility of one government. In these cases, the policy decisions are made jointly through collaboration and agreement in multilevel governance systems and therefore no one level of government can be held accountable. Multilevel governance is becoming increasingly popular and yet it attracts much criticism on democratic grounds. It is said to involve 'undue secrecy, the

75 It is noted however that the requirement for clear and transparent division of responsibilities amongst levels of governments creates issues regarding the flexibility of the fiscal relationship between governments. While transparency reduces the ability to circumvent rules or creative account for their performance and therefore enhance accountability, flexibility is diminished.

76 'Executive federalism' refers to relations that are concentrated in the executive branch. This means they are monopolised by first ministers, other cabinet ministers and their senior officials, to the general exclusion of legislatures (compare the US system of direct relationships among federal and state legislators and executives (Watts, 1989; Watts, 1999)).

lack of opportunity for citizen participation, the freezing out of legislatures and the weakening of accountability of each government when acting in concert' (Brown, 2002, p.3). Performance measurement and therefore accountability are blurred to the extent that different levels of government join to engage in multilevel governance.

Measuring and enforcing accountability can be difficult generally but in a federation more so. It requires clear and correct incentives for the subnational government, together with the availability of adequate information to the government's constituents. Measures of performance in terms of outputs may have an important role in establishing and maintaining the subnational government's appropriate level of accountability to its constituents. This might include a "value for money" approach to local performance, including the evaluation of efficiency and effectiveness in service provision, and ability to cost services ex ante. The opportunity for constituents and government officials to compare the performance of a government across jurisdictions is a particularly important contribution to effective accountability. Furthermore, the constituents must be able to exercise some real influence or control over the government's service delivery system.

If performance measures are used to measure and enforce accountability, they must be based on quality data regarding the subnational's performance with respect to these responsibilities and they must be made available in a timely and accessible fashion. Performance measures for these purposes would need to be independent and compared to an agreed benchmark to maximise their effectiveness.

This benchmark focuses on the effect intergovernmental fiscal transfers have on the subnational government's accountability to its constituents with regard to its areas of responsibility. If federations and the subsequent decentralisation are to operate properly and efficiently, the subnational governments must be held accountable for their designated areas of responsibility. Accountability is not easy to enforce where the areas of responsibility are not clear and where the power to manage those responsibilities is diminished. Consequently, in order for a subnational government to be accountable, the division of responsibilities across governments must be clear and transparent. Overlapping and shared tasks between different levels of government creates potential problems and issues regarding both overall efficiency, measurement of performance and local political accountability.

6.7.2 Australia's performance against Benchmark

The relative funding responsibilities of Australia's levels of government are very poorly understood. This is largely due to the fact that many services are jointly funded by both the States and the Commonwealth. This has undermined accountability for the expenditure of revenue.

Due to constitutional restrictions on its activities, many programs funded by the Commonwealth are delivered through tied grant arrangements with the States, usually with additional State funding. Conversely, all State governments receive untied funding from the Commonwealth, which subsidises all State activities.

Critics complain that the CGC's regime is both data-heavy and opaque. As to transparency, the CGC retorts that it is open about its methods, making data available on its website. But some of its data, and its manipulations of data are very hard to see through (McLean, 2002).

Furthermore, whilst the distribution of tied grants is generally determined by the responsible Commonwealth minister, these distributions are typically overruled by the CGC. 'For most [tied grants] the CGC effectively sets aside the allocations determined by the Commonwealth under legislative and ministerial authority in the portfolio area concerned – typically in consultation with the States - and substitutes is own assessment' (Garnaut and FitzGerald, 2002).

The net result is a confused mix of responsibilities where, for almost any service delivered at the State level, each level of government can seek to avoid accountability or responsibility by citing the involvement of the other.

Australia has a relatively high and increasing degree of intergovernmental coordination. This involves decisions on the level and purpose of intergovernmental fiscal transfers,[77] and has contributed to a lack of transparency, blurring of responsibilities and diminished accountability (Painter, 1998; Brown, 2002b) (refer Section 4.2).

The mechanisms in Australia that impact on intergovernmental fiscal transfers (including their expenditure) that have the capacity to reach substantive, binding joint decisions include (referred to as the 'Australian model of intergovernmental co-decision'):

77 This shift is part of a shared agenda of microeconomic and fiscal comprehensive and coordinated reform tied into Australia's competitiveness strategy (Brown, 2002b p.10).

- The formal establishment of a Council of Australian Governments to meet at least on an annual basis;
- A parallel Leaders Forum of State and Territory First Ministers;
- A Treaty Council of First Ministers (discussed below);
- A rationalised and streamlined set of Ministerial Councils (MCs), under the scrutiny of COAG, if not always reporting directly to it;
- MCs that can take binding decisions, backed up by uniform Commonwealth and State legislation;
- Voting rules in these MCs, that allow the councils to take decisions by majority or qualified majority vote;
- Several new joint "national" agencies in fields such as environment, food standards, road transport, training, and competition policy; and
- Coordination through "non-centralised" devices such as "mutual recognition" of standards, and "negative integration" through such policies as national competition (Brown, 2002b, pp. 9-10).

This model requires leadership from the highest levels of government.

6.7.3 *Performance of other Countries against Benchmark*

This Section reviews the benchmark countries with regard to the form of intergovernmental fiscal transfers to subnational governments and their impact on the accountability of those governments to their constituents.

There is limited, if any, data directly quantifying this benchmark. However it is assessed here in terms of whether the transfer system diminishes accountability because it blurs the responsibilities of the subnational government because it:

- is complex. Systems are more complex in the case of conditional and specific or earmarked grants.
- lacks transparency regarding its calculation and distribution. Although closely relates to complexity, it is not always the case that a complex system lacks transparency.
- is determined within an environment of multilevel governance. This form of governance involves a shared approach to the responsibility for the provision of public goods and service.

Each of these features of an intergovernmental transfer system can dilute accountability of the recipient (in this case, the subnational) government to its constituents.

Austria	The large role of earmarked revenues for subnational governments in Austria increases the complexity of federal fiscal relations substantially. Most notably, the co-financing of spending items between the States and the municipalities occurs in both directions. For example, municipalities with respect to childcare facilities. The complexity of the tax sharing and transfer system overall renders the financing and delivery of services very non-transparent, reducing accountability to the local constituents (Fuentes, 2006).
Canada	The Canadian provinces' 'real discretion…to tailor their programs to suit the needs and preferences of their constituents' (Watts, 2005, p.37) is supported by the unconditional transfers they receive. There remains an argument however that provinces should not be held accountable for the state of their health system to the extent that conditions are required to be met before the Canada Health and Social Transfer (CHST) is paid. Additionally, the so called 'Executive Federalism' (or multilevel governance) that operates in Canada impacts on the quantum and use of intergovernmental fiscal transfers and as a result decreases accountability amongst all levels of government in Canada as responsibilities between governments are increasingly shared (Brown, 2002a; Brock, 1995).
Germany	Watts (2005, p.38) States with regard to Germany that the, Complexity of the fiscal relationships, the complicated constitutional law surrounding the distribution of power, and the negotiations by the executive usually behind closed doors have meant that there is very little transparency for the citizens concerning intergovernmental fiscal relations'. The resulting "joint decision trap" is also said to have reduced the freedom of action of governments at all levels (Sharpf, 1988). This lack of transparency and ability to govern directly reduces the accountability of the Länder to their constituents.

Italy	Bibee and Goglio (2002, p.27) conclude that in Italy 'the ability to make economic choices is limited by a lack of flexibility in the use of conditional grants.' An inherent lack of accountability and flexibility result. At the local government level, for example, incentives have arisen from the design of the transfer system which are characterised by insufficient devolution of both spending and financial responsibilities. This has led to inefficient outcomes and dissatisfaction with the services rendered, notably in the health care area which registered very high rates of spending growth in recent years (Bibee and Goglio, 2002, abstract). The central government however is blamed for this poor performance, based on insufficient and delayed funding and for imposing inflexible rules on the use of funds and provision of services (Emiliani, N. Lugaresi, S. and Ruggiero, E. 1997). Notably, a recent phase of administrative federalism reforms introduced new management and organisational tools to allow managers to set and pursue performance goals in conjunction with the transfer system (Bibee and Goglio, 2002, p.34). However, without the basic freedom to prioritise activities in response to local preferences, or to set output prices and negotiate for input costs with respect to market-based criteria, the level of accountability could remain low.
Switzerland	Switzerland's strong history of 'direct democracy at all levels of government have contributed to' a high level of 'democratic accountability regarding financial relationship' (Watts, 2005, p.41) despite the fact that intergovernmental fiscal transfers are all specific and typically conditional. The emerging multilevel system of governance in Switzerland through federal-canton multilateral deliberations has not impacted on the high level of democracy, transparency or accountability experienced by the Cantons to date (Watts, 2005, p.41). The Swiss confederation has set up a model contract, containing minimum standards with respect to cost transparency, rights and obligations of the partners, and overall democratic accountability to manage these arrangements (OECD, 2002).

USA	The fact that the transfers to US States are all earmarked and are used to 'impose mandated expenditure programs upon the States' (Watts, 2005, p.37) suggests a strong basis for low State accountability with respect to the outcomes of these programs. The fact that the States might adjust their behaviour to meet the designated conditions to receive the earmarked grants also indicates that the US transfer system does not support or enhance the accountability of the States to its constituents. Furthermore, the complexity of the transfer calculation and related conditions associated with the earmarked transfers decrease the transparency of the grants and contribute to the State's potential claim that they cannot be held accountable for those programs.

6.7.4 How Australia Compares

In general, it can be concluded that the transfer systems of all the benchmarked countries have a rather negative impact on the accountability of subnational governments.

In terms of complexity and transparency, Australia's transfer system is no less complex or opaque than any of those considered. In fact, the level of detail associated with the equalisation formula employed is hailed as the most comprehensive and complex (Watts, 2005). Together with the complexity of the tied grants provided in Australia, it is fair to say it has one of the most complex and least transparent transfer systems.

As for the level of multilevel governance and its negative impact on the transfer system, Canada, Germany and Australia all rank highly. However, again Australia is considered to have developed intergovernmental relations to the extreme, resulting in significant sharing of responsibilities in a less than transparent fashion (Brown, 2002).

As a result of the complexity, lack of transparency and increasing joint policy making, Australia's transfer system ranks low in terms of supporting accountability of the subnational government to its constituents.

7 Benchmarking Dynamic Federalism

Section 2.8 outlined the benchmarks against which countries intergovernmental fiscal arrangements should be assessed. This Section analyses the dynamic federalism benchmark whereby federal fiscal systems should be open to comprehensive review and capable of structural change.

7.1 Benchmark 13: Dynamic Federalism

Benchmark 13: Dynamic

The federal fiscal system should be open to comprehensive review and capable of structural change.

7.1.1 Benchmark: Definition, significance and measurement

While the responsibilities of the different tiers of government may be outlined in a constitution or some agreed statement, changing circumstances may necessitate changes to the roles of the different levels of government in a federation. For example, fiscal imbalances may be increasing or decreasing. Undesired or unexpected implications of existing federal institutions and policies may come to be recognised; one level of government may become increasingly dominant; and new possibilities may emerge from research or from the experiences of other countries.

The federal financial system in such circumstances should be capable of being adapted to respond to new challenges and demands. A framework must therefore exist to enable desirable change to be identified by a disinterested party outside the political sphere. This could be through an ongoing independent and public review mechanism which would assist in maintaining an efficient and equitable federal system. The objective of such a review would be to facilitate national welfare by enhancing change to the system.

7.1.2 Australia's performance against Benchmark

Changes to Australia's intergovernmental fiscal arrangements have to date been largely ad hoc. The federal fiscal system has not been reviewed comprehensively or shown itself open to structural change. COAG, as the peak intergovernmental forum in Australia, is the only body capable of initiating and leading such a review. While COAG's achievements include NCP and the more recently agreed NRA, it is yet to review Australia's intergovernmental fiscal arrangements.

Although important changes have occurred, including the IGA and those resulting from High Court cases, they have not been comprehensive or systematic. There has not been a fundamental review of Australia's intergovernmental fiscal arrangements encompassing expenditure responsibilities, tax powers and transfer arrangements.

Within the scope of intergovernmental fiscal arrangements, the CGC has no role in reviewing the allocation of taxing powers or expenditure responsibilities between levels of government. It's role is limited to examining aspects of intergovernmental fiscal transfers, subject to specific terms of reference as determined by the Commonwealth in consultation with the States.

Constitutional amendments have proven extremely difficult, particularly in the absence of unilateral support. However, Australia's Constitution has experienced evolutionary change through the High Court's interpretation. In the context of intergovernmental fiscal arrangements, the High Court's decisions on the Constitution's interpretation are delivered to resolve disputes over Commonwealth and/or State powers. Those disputes can be between the Commonwealth and the States but third parties have also been involved in some notable cases. In many cases, particularly those relating to tax powers, the High Court's interpretation has been centralist.

7.1.3 Performance of other Countries against Benchmark

While the relationship between the tiers of government in many federations is enshrined in their Constitution, this has not prevented substantial changes being made to the relationship between the tiers of government in terms of their tax assignment and expenditure responsibilities. Outlined below is the review processes adopted in other countries.

Austria	**Fiscal equalisation law reviewed and renegotiated between governments every four years.** In addition, there is a substantial degree of cooperation between the three levels of government.
Canada	**No formal provision for regular review of intergovernmental fiscal arrangements. Extensive independent review of fiscal equalisation currently under way.** Canada has no ongoing process for review of intergovernmental fiscal arrangements. However, in 2004 the federal Minister of Finance established an *Expert Panel on Equalisation and Territorial Formula Financing* to re-examine the methodology of the equalisation process. The panel is due to report in early 2006. It is examining such issues as the reasonableness of multiple equalisation standards, revenue coverage, measurement of expenditure needs and revenue capacities, stability and predictability of the system, and its transparency and accountability. It is intended that the new methodology should be subject to regular review.
Germany	**No formal provision for regular review of intergovernmental fiscal arrangements. 'Solidarity Pact' between federal Governments and States recently reformed.** In 2000 the national government and the Länder agreed on the *Solidarity Pact II*, a reform of the fiscal equalisation system coming into force in 2005 and lasting until 2019. There is no formal continuing review processes but there are many intergovernmental councils to coordinate the policies of the three levels of government. The most important are the Financial Planning Council and the Economic Policy Council (consisting of the federal Minister of Finance and representatives of the Länder and the Communes).
Italy	**No formal provision for regular review of intergovernmental fiscal arrangements. Recent period of extensive reform.** Italy has no provision for regular review of intergovernmental fiscal arrangements. It has, however, been undergoing extensive reform, with indications that this reform process will continue in the light of experience as the new system beds down.

Switzerland	**No formal provision for regular review of intergovernmental fiscal arrangements. Extensive reform currently being implemented.** Switzerland has no formal mechanism for regular review of intergovernmental fiscal arrangements. However, the country is currently undergoing thorough reform of its intergovernmental fiscal arrangements. The reform attempts to achieve an allocation of expenditure responsibilities closer to that indicated by the principle of subsidiarity and to improve the fiscal equalisation process.
USA	**No formal provision for regular review of intergovernmental fiscal arrangements.** The United States has no significant mechanism for the review of its intergovernmental fiscal arrangements. Direct lobbying of members of Congress appears to be the preferred option by which State Governments try to influence the formulation of policies affecting them.

Canada is constantly reviewing its fiscal federalism arrangements, spurred on in part by the very different experience of its various provinces and territories: some are rich in resources; some benefit from cross-border trade with the US; and still others are sparsely populated with modest revenue bases. While Canada like Australia has a Constitution which enshrines the tax and expenditure responsibilities of the provinces and territories, its Constitutional Court has not been overly centralist in its interpretation of the Constitution. In fact, Canada has a vibrant and ongoing debate over fiscal federalism arrangement and a demonstrated propensity by the national government to engage in debate on this issue, one which has been seen as an issue of national interest.

Germany in contrast, vests most of its power in the States and therefore is not under challenge from the central government in terms of tax and expenditure responsibilities. Most attention is paid to the revenue sharing arrangement on taxes harmonised across regions. Italy in contrast has just introduced substantial constitutional change facilitating the substantial decentralisation of government functions. Switzerland differs again in that substantial powers are vested in local government and through referendums is constantly changing its Constitution to address changing circumstances.

7.1.4 How Australia compares

Of all the countries reviewed here, only Austria has provision for regular review of its federal financial relations. However, Canadian, German, Italian and Swiss national governments have all recently conducted thorough reviews of their intergovernmental fiscal relations. This is in contrast to Australia where there has been no fundamental review of intergovernmental fiscal arrangements.

8 Conclusions

The overall conclusion of this Report is that Australia's system of intergovernmental fiscal relations performs poorly by international standards. There is a compelling argument for establishing, in some formal sense, a comprehensive and regular review process, which would constitute the first step in reform of the system.

In summary, Australia's system of intergovernmental fiscal arrangements is characterised by very high VFI, inadequate State tax powers, and complex and high level equalisation. These arrangements hinder adjustments in the economy that are essential for the economy to develop and grow, as it must if Australia is to meet future challenges, including those of an aging population.

Specific conclusions drawn with respect to this Report's Terms of Reference are outlined below.

The allocation of taxes between the Commonwealth and States with reference to arrangements in other countries

Australia is characterised by a tax system that is highly centralised in comparison with other federations. The broadest tax bases – personal income, corporate profits, and goods and services – are held by the Commonwealth for a number of constitutional and Commonwealth policy reasons. In comparator countries these tax bases are often shared.

Arrangements to make GST revenue grants to the States have done little to alter the problems facing State budgets (Groenewegen, 2006). The GST has only replaced one form of general revenue assistance with another. The GST is not a shared tax base, but is the base for calculating general revenue grants to the States. The States have no ability alter either the GST rate or its base. Furthermore, GST revenue grants are subject to high level equalisation and are therefore not distributed among the States according to where the revenue is raised, resulting in a large redistribution between States.

States rely on comparatively narrow-based and inefficient taxes such as stamp duties for their own-source taxes, while the more efficient State taxes, payroll tax and land tax, are limited in their application. Sharing tax bases, including personal income, corporate income, and goods and services, is much more common in other federations. (Refer Benchmarks 3, 4 and 5).

The way expenditure responsibilities are allocated between the Commonwealth and States with reference to arrangements in other countries

Expenditure responsibilities are generally allocated between the different levels of government in a relatively consistent pattern across comparator countries considered in this Report. The main areas of difference between Australia and the other countries relate to health and education. Health and education expenditure responsibilities in Australia are shared almost evenly between the Commonwealth and States, in contrast to most other federations where those responsibilities are allocated almost exclusively to a single level of government.

The problems associated with overlapping expenditure responsibilities between different levels of government, and the potential for misallocation of resources and reduced accountability, are not unique to Australia. However, lack of transparency appears to be less problematic where State governments have relatively high levels of fiscal autonomy, as in Canada and the USA. (Refer Benchmarks 1 and 2).

The extent of imbalance between expenditure responsibilities and taxation powers in Australia compared to other countries and the policy implications of any imbalance

The level of imbalance between expenditure responsibilities and taxation powers (VFI) in Australia is among the highest of any comparator country. It follows that the problems associated with VFI, including reduced transparency for the provision of services and accountability of governments, are more significant in Australia than in other federations.

In Australia, States' own-source revenues account for only 40 per cent of their own-purpose outlays, which is broadly comparable to that in Austria, but in contrast to significantly lower levels of VFI in Canada, Germany and Switzerland. The high degree of VFI in Australia results in State governments relying more heavily on financial transfers from the Commonwealth than subnational governments in comparator federations, with the exception of Austria. (Refer Benchmarks 1, 2, 3).

Domestic and international arrangements for transfers from national to subnational governments, including the relative size and distribution of such transfers and the policy implications of such arrangements

Australia's system of transfer payments, in particular the wide use of tied grants, gives the Commonwealth considerable power in areas over which it is not primarily responsible and serves as a vehicle for the extension of Commonwealth policy into areas for which the States are held accountable, including the provision of health and education. This often leads to the inefficient provision of those services, including the underprovision of some services. This problem, however, is not unique to Australia.

GST revenue grants, which are untied, are determined in accordance with equalisation principles. Australia's equalisation mechanism is the most complex and comprehensive among the comparator countries. For example, while Australia attempts to equalise both revenues and expenditures, Canada and Germany equalise on the revenue capacity side only.

What makes Australia's HFE system unique is the degree to which the equalisation objective is pursued at the expense of efficiency. In fact, the system fails to strike a balance in that it strives to achieve full horizontal equalisation without regard to the efficiency costs. Furthermore, there is no objective benchmark to assess whether Australia achieves interstate equity. It would appear that other federations acknowledge more fully than does Australia a likely trade-off between the interjurisdictional equity benchmark and achievement of other benchmarks such as efficiency, transparency and simplicity.

The efficiency costs of Australia's current HFE arrangements include the following:

- there is a loss in economic efficiency due to the tendency for fiscal transfers to reduce incentives for resources (including people) to move from low productivity locations to high productivity locations;
- the current system can encourage duplication and lack of coordination; and
- there is little incentive in the current system for increasing the efficiency of public services due to the focus on cost disabilities in the expenditure assessments.

(Refer Benchmarks 6 to 12).

The impact on the States of Commonwealth-State financial relations reforms associated with the GST

The reforms to Commonwealth-State fiscal arrangements associated with the GST, as set out in the IGA have exacerbated VFI – the States rely even more than previously on grants from the Commonwealth. Furthermore, the IGA reforms mean that a considerably larger revenue pool is subject to the equalisation process than previously. However GST revenue grants from the Commonwealth, which replaced FAGs and compensated States for the abolition of several of their own taxes, are expected to grow more robustly than the sources of revenue they replaced. (Refer Benchmarks 3, 5, 6 and 13).

The case for review

The conclusion drawn from this benchmarking study is that Australia must embark on a comprehensive review of its intergovernmental fiscal arrangements. The States will receive GST revenue and payments from the Commonwealth totalling an estimated $67.5 billion in 2006-07,[78] which is equivalent to 6.7 per cent of GDP. Despite the significant issues arising from Australia's intergovernmental fiscal arrangements, they have not been subject to comprehensive review or systematic reform.

Most comparator countries review the allocation of taxing powers, expenditure responsibilities and intergovernmental fiscal transfers. Where necessary, appropriate reforms have been made. In many cases, the reforms have been comprehensive and resulted in structural change. Australia, on the other hand, seems unwilling to accept the need for review, let alone comprehensive reform.

It should not take a crisis for Australia's intergovernmental fiscal arrangements to be reviewed – and if found wanting – reformed. This is particularly the case if upcoming pressures on the current arrangements are known already. Many areas of the Australian economy have undergone, or are undergoing, a process of significant reform.

Reform, including to intergovernmental fiscal arrangements, is a never-ending process if Australia is to maintain or improve its already high living standards and remain a competitive place to invest and do business. The continued need for structural reform has been expressed by Pasinetti (1993, p.6) as follows:

78 Commonwealth Government, 2006-07 Budget Paper No.3, Federal Fiscal Relations 2006-07, p.3 and Table 2 p.6.

> … it is illusory to aim at pursuing increasing wealth by taking advantage of technical progress, and at the same time pretend to keep a stationary structure of the production system. Increasing wealth will only come if an economic system is able to carry out a complex process of structural change, in which the proportions of sectoral output, of consumption and, most important of all, of employment, in different sectors, are continually changing. The process of moving labour, i.e. people, from job to job, of moving labour and capital from sector to sector and even from region to region, far from being exceptional events, appear as the very normal pattern of the growth of wealth through technical progress.

The NCP reforms already carried out or underway and the NRA recently agreed by COAG recognise this. However, reform to Australia's intergovernmental fiscal relations is a missing element of the national reform agenda despite the fact that the two are inextricably linked.

The way forward

This Report identifies a need for Australia to comprehensively review its intergovernmental fiscal arrangements. This type of review requires a commitment from all levels of government and an effective political champion. International best practice suggests that such a review would be guided by the benchmark criteria used in this Report. COAG is the only body capable of initiating and leading a review and overseeing any necessary reform of Australia's intergovernmental fiscal arrangements.

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10 Appendix A: Major changes in the constitutional division of powers and their impact on decentralisation

This section draws on Grewal and Sheehan (2003)

Year	Selected events	Impact on decentralisation
1908	The States lost their constitutional right to at least 75per cent of the Commonwealth surplus revenue under s.94	Greater dependence of States on Commonwealth
1920	New legal doctrine established by the High Court in the Engineers' case, favouring Commonwealth government	Expansion of Commonwealth powers
1923	The power of s.96 begins to unravel when road grants are introduced	Expansion of Commonwealth powers
1927	The Financial Agreement sets up Australian Loan Council, which would diminish States' borrowing powers	Expansion of Commonwealth powers
1942	Commonwealth gains exclusive power over income taxation	Greater dependence of States on Commonwealth
1951	States cannot raise sufficient borrowings and become dependent on Commonwealth Special Loans	Greater dependence of States on Commonwealth
1969	State receipts duty declared invalid by the High Court	Loss of States' independent revenue sources
1970	The High Court rules that the States cannot levy a tax on any stage of sales of a product	Loss of States' independent revenue sources
1971	Transfer of Commonwealth payroll tax to the States, with corresponding reduction in tax sharing grants	States gain independent source of revenue
1973	Commonwealth specific purpose grants mush-room under Whitlam administration	Expansion of Commonwealth powers

Year	Selected events	Impact on decentralisation
1974	Commonwealth takes over financing of tertiary education from the States	Expansion of Commonwealth powers
1976	Commonwealth stops sand mining on Fraser Island using external affairs power	Expansion of Commonwealth powers
1981	Commonwealth stops, under international treaty obligations, the proposed dams in Tasmania	Expansion of Commonwealth powers
1985	Transfer of Bank Account Debits Tax to the States, with corresponding reduction in tax sharing grants	States gain independent source of revenue
1988	Commonwealth threatens to reduce Queensland's financial assistance grants for not cooperating in the Loan Council	Unconditional grants no longer without conditions
1990	Corporations power is coordinated at the Commonwealth level, although problems remain	Expansion of Commonwealth powers
1997	The High Court declares invalid State business franchise fee on tobacco, alcohol and petrol	Greater dependence of States on Commonwealth
1998	Commonwealth introduces 'safety net' arrangements to save States' finances	Greater dependence of States on Commonwealth
1999	Intergovernmental Agreement on Commonwealth–State Financial Relations	Greater dependence of States on Commonwealth
2000	States receive GST revenue instead of revenue grants from the Commonwealth	Greater dependence of States on Commonwealth
2006	States challenge the Commonwealth's 'WorkChoices' legislation.	To be determined

11 Appendix B: The GST and post-2000 federal fiscal relations

11.1 The Intergovernmental Agreement reform package

In 1999 the Prime Minister, State Premiers and Territorial Chief Ministers signed the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (IGA)[79], which dealt with the financial implications for the States and Territories of the GST-based reforms in the tax reform package *A New Tax System* (Costello, 1998).

The major provisions of the IGA were:

- Introduction in July 2000 of a broad based GST at a single rate of ten per cent;
- No change in GST rate or base without unanimous agreement of the Governments of the States and Territories, the Commonwealth Government and both House of Representatives and Senate;
- Abolition of Financial Assistance Grants (FAGs) and revenue replacement payments (RRPs) to the States;
- An undertaking by the Commonwealth not to cut aggregate Specific Purpose Payments as part of the IGA reform process;
- GST revenue to be used to fund abolition of the Commonwealth's wholesale sales tax, and the abolition or reduction of various State taxes, including financial institutions duty, stamp duty on quoted marketable securities, debits tax and bed tax;
- Distribution of GST revenue to the States on fiscal equalisation principles;
- The States to bear the Australian Tax Office administration costs of the GST;

79 For the NSW enacted legislation which is similar to that enacted by the Commonwealth and other States and Territories, see <http://www.austlii.edu.au/au/legis/nsw/consol_act/iaia2000490/sch1.html>.

- Provisions to ensure that no State was made worse off during the transitional implementation period of the IGA, with the Commonwealth providing budget balancing assistance (BBAs) to each State until its GST receipts at least matched its guaranteed minimum amount (GMA) – that is until its receipts from the GST pool were such that its overall budgetary position was no worse than it would have been under pre-IGA arrangements;
- Review by 2005 of other State taxes with a view to their possible abolition.

The effect of these provisions is that the Commonwealth makes grants to the States and Territories equivalent to the revenue from the GST subject to the arrangements under the IGA. Through the series of offsets and other arrangements set out in the IGA the GST revenue grants received by the States were less than the FAGs previously received from the Commonwealth. These included:

- abolition or reduction of certain State taxes; and
- abolition of the Commonwealth's wholesale sales tax.

As a result, the IGA also provided transitional funding from the Commonwealth in the form of BBAs to ensure the States were left no worse of during the initial years of the agreement. One of the key objectives of the IGA was that in the longer term the States would have an improved financial position (IGA, cl.2(iii)). From 2006-07 all States and Territories are estimated to be in a better position than they would have been in the absence of the reforms.[80]

11.2 Developments since 2000

There have been some significant developments relevant to the IGA since 2000.

11.2.1 Calculation of budget balancing assistance

At the March 2002 meeting of the Ministerial Council for Commonwealth-State Financial Relations (the "Treasurers' Conference"), the Commonwealth announced a new method of calculating BBAs, no longer including consumer price index (CPI) indexation in the calculation of the value of petroleum revenue replacement revenue forgone. This change, undertaken unilaterally

80 Commonwealth Government, 2006-07 Budget Paper No. 3, Federal Financial Relations, p.3.

without the agreement of the States, had the effect of reducing the amount of budget balancing assistance which they received during the transitional period.

11.2.2 Debits tax abolition

At the March 2004 Ministerial Council meeting all States and Territories agreed to abolish the bank account debits tax by 1 July 2005. NSW had already abolished the tax from 1 January 2002.

11.2.3 Stamp duty review

At the same March 2004 meeting the Ministerial Council committed to a review of stamp duties on:

- Non-residential conveyances;
- Non-quotable market securities;
- Leases;
- Mortgages, bonds, debentures and other loan securities;
- Credit arrangements, instalment purchase arrangements and rental arrangements; and
- Cheques, bills of exchange and promissory notes.

At the Council's March 2005 meeting the Commonwealth argued that the GST was now estimated to deliver significant windfall gains to all States and therefore provided the revenue capacity to abolish most of these taxes. Accordingly it put forward a timetable for the abolition of all these taxes (except stamp duty on business conveyances of real property) such that these taxes would be abolished by 1 July 2007. Each State has now agreed their own timetable with the Commonwealth for the abolition of all the stamp duties listed for review excluding stamp duty on business conveyances of real property.

The Commonwealth has agreed to extend the transitional period to 30 June 2009 to compensate any State for a shortfall between its GST revenue provision and its GMA as part of this arrangement. In practice, according to Commonwealth Treasury calculations, this provision would apply only to NSW, since it would be the only State experiencing a shortfall.

11.2.4 Commonwealth Grants Commission methodology review

At the March 2005 meeting of the Ministerial Council, the Commonwealth and States agreed that a work program should be undertaken to review and simplify the methodology which the Commonwealth Grants Commission uses to distribute GST revenue. The Commission would be given terms of reference to guide it in simplifying the methodology it employs by 2010 and developing a continuous program of improvement. The objective would be to "place HFE on a sounder and more sustainable basis" (2005-06 Budget Paper No.3, p.121).

11.3 The fiscal equalisation process

With the implementation of the IGA, the Commonwealth Grants Commission's fiscal equalisation process assumed a much greater importance, since the GST revenue pool distributed by this process is much greater than the pre-2000 FAGs pool. For example, Commonwealth Treasury estimates that, under the previous system, the Financial Assistance Grants in 2005-06 to which fiscal equalisation would have applied would have been $22,103m. However, the actual amount of GST revenue distributed in that financial year is forecast to be $36,812m almost 70 per cent higher.

The Commission's definition of the principle of fiscal equalisation is set out in its most recent review as follows:

> State governments should receive funding from the pool of Goods and Services Tax revenue and Health Care Grants such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the same capacity to provide services at the same standard.
>
> (Commonwealth Grants Commission 2006, p.4).

The Commission emphasises that

> The definition makes it clear that it is the fiscal capacity of the States that is being equalised. Fiscal equalisation is not directed towards equalisation of the circumstances of individuals, households or communities.
>
> (Commonwealth Grants Commission 2004, p.4).

The Commission says that implementation of fiscal equalisation rests on what it calls the "three pillars":

- *Capacity equalisation*. It is capacity that is to be equalised, not performance.
- *Internal standards – what States do*. The standards the Commission applies are an average of those actually applied by the States, so that they reflect what States do. The Commission does not make judgments about what level of service might be appropriate or about appropriate benchmarks.
- *Policy neutrality*. A State's own policies or choices about the services it provides or the revenue it raises should not directly influence the level of grants it receives.

The output resulting from the Grants Commission's deliberations is a set of State-by-State relativities. The most recent relativities appear in Table 13 below. A relativity figure of one would indicate that the State in question had no net disability, in *per capita* terms, in revenue-raising ability and service costs jointly. (It could have a disadvantage in, say, revenue-raising exactly counterbalanced by an advantage in the cost of service provision). A relativity greater than one indicates a net disability, which will be compensated by higher then average grants from the GST revenue pool. A relativity of less than one has the opposite effect.

Table 13: GST relativities, 2005 and 2006

	2005 Update	2006 Update
NSW	0.86846	0.87346
Victoria	0.87552	0.89569
Queensland	1.04389	1.02404
WA	1.02500	1.00497
SA	1.20325	1.18695
Tasmania	1.55299	1.54939
ACT	1.14300	1.14585
NT	4.26682	4.32765

Source: Commonwealth Budget Paper No. 3, 2005-6, Table 1.

The Commission includes in its calculations all State taxes and a comprehensive range of public expenditure categories. Table 14 below illustrates how it applies its calculated relativities to produce the actual distribution of GST revenue, taking into account different State populations and the unquarantined health care grants (HCGs) received.

Table 14: Distribution of GST revenue in 2005-06 (estimated)

	Projected population at as end 2005	CGC per capita relativities	Weighted population (1)x(2)	Share of weighted population (per cent)	GST revenue/ HCGs pool according to (4) ($m)	HCGs ($m)	Distribution of GST revenue (5)-(6) ($m)	Per cent of GST revenue
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
NSW	6,823,074	0.86846	5,925,567	28.9	13,090.3	2,663.6	10,426.7	27.9
Vic	5,057,845	0.87552	4,428,244	21.6	9,782.5	1,918.0	7,864.5	21.1
Qld	4,006,784	1.04389	4,182,642	20.4	9,240.0	1,518.9	7,721.1	20.7
WA	2,033,048	1.02500	2,083,874	10.2	4,603.5	781.4	3,822.1	10.2
SA	1,545,119	1.20325	1,859,164	9.1	4,107.1	658.1	3,449.0	9.2
Tas	487,377	1.55299	756,892	3.7	1,672.1	170.7	1,501.4	4.0
ACT	325,748	1.14300	372,330	1.8	822.5	100.0	722.5	1.9
NT	203,744	4.26682	869,339	4.2	1,920.5	87.8	1,832.7	4.9
Total	20,482,739		20,478,052	100.0	45,238.5	7,898.5	37,340.0	100.0

Source: Commonwealth Budget Paper No. 3, 2005-06, Table 9.

The above table appeared in the May 2005 Commonwealth Budget Papers and the *per capita* relativities presented in column (2) are the 2005 relativities. These *per capita* relativities are applied to the population projections in column (1) to yield the weighted populations of column (3). The weighted populations are converted into percentage shares in column (4). These percentages are applied to the total GST revenue plus Health Care Grants pool distribution to yield the figures in column (5). From these are deducted the unquarantined HCGs of column (6) to yield the estimates for the distribution of the GST revenue to the States. *Unquarantined* in this context means not to be excluded from Commission calculations.

In its assessments of State revenue-raising capacities the Grants Commission, wherever possible, uses what are known as "partial" measures. Its 2002 Discussion Paper No. 4 describes this methodology as follows.

> In past enquiries, revenue capacities have been measured tax by tax (or tax group). Wherever possible, revenue bases have reflected the range of activities, transactions and assets that States actually tax as such bases capture the revenue raising advantages and disadvantages ("disabilities") that States face. In cases where a direct policy-neutral measure of the legal revenue base is not possible, the Commission has used a broad measure that encompasses the underlying revenue base of a particular tax (it calls these subglobal measures). For example, in gambling tax the legal revenue base would be an indicator of gambling turnover, but it is not possible to measure turnover in a way that is free of the influences

of the policies of individual States on what forms of gambling are legal and other regulatory (or promotional) policies. In this case the Commission has used household income as a broad measure of the underlying tax base.

The alternative approach is the use of "global" measures, which the Commission, in its Discussion Paper No. 4, describes as follows.

A global revenue approach reflects the view that a single broad measure could provide a good indicator of the capacity of States to raise revenue from the multiple and quite different revenue bases they actually use.

A global assessment approach would imply that equalisation is about the capacity of a community to pay taxes, whereas the present approach measures the capacity of State Governments to raise taxes. The two approaches are based on different theoretical constructs.

11.4 The fiscal equalisation outcome

Table 15 shows total GST revenues in the financial years 2001-02 to 2005-06, and the distribution of those revenues to the States. During the period since its introduction, GST revenues have risen both in real terms and significantly faster than originally forecast.

Table 15: GST revenue provision to the States (cash), 2000-01 to 2005-06

	2000-01 $m	2001-02 $m	2002-03 $m	2003-04 $m	2004-05 (e) $m	2005-06 (e) $m	Increase From 2000-01 to 2005-06 $m	Increase per cent	Average annual increase per cent
NSW	7,257.6	8,132.0	9,080.2	9,667.1	9,937.5	10,426.7	3,169.1	43.7	7.6
Vic	5,099.3	5,593.1	6,365.1	6,961.0	7,374.4	7,864.5	2,765.2	54.2	9.1
Qld	4,658.2	5,018.6	5,887.6	6,552.8	7,374.2	7,721.1	3,062.9	65.8	10.7
WA	2,374.6	2,518.1	2,910.2	3,157.9	3,643.6	3,822.1	1,447.5	61.0	10.1
SA	2,278.9	2,476.6	2,859.1	3,146.4	3,307.6	3,449.0	1,170.1	51.3	8.7
Tas	988.1	1,059.8	1,246.7	1,394.5	1,441.3	1,501.4	513.3	51.9	8.9
ACT	472.6	543.9	615.7	658.1	683.2	722.6	250.0	52.9	9.0
NT	1,225.6	1,289.8	1,514.5	1,680.9	1,743.2	1,832.7	607.1	49.5	8.5
Total	24,354.9	26,631.9	30,479.1	33,218.7	35,505.0	37,340.1	12,985.2	53.3	9.0

Source: Commonwealth 2005-06 Budget Paper No. 3, Table 3.

The objective of fiscal equalisation is to redistribute from the richer to the poorer States. Table 16 presents estimates of the extent and direction of that redistribution.

Table 16: Effects of horizontal fiscal equalisation 2005-06

	CGC GST distribution $m (1)	Equal per capita distribution $m (2)	Difference (1)-(2) $m (3)	Equal per capita redis-tribution per head $ (4)	State of Origin distribution $b (5)	Difference (1)-(5) $b (6)	State of Origin Redis-tribution per head $ (7)
NSW	10,426.7	12,438.5	-2,011.8	-295	13.2	-2.8	-407
Vic	7,864.5	9,220.4	-1,355.9	-268	9.6	-1.7	-340
Qld	7,721.1	7,304.4	416.7	104	6.7	1.0	257
WA	3,822.1	3,706.2	115.9	57	3.4	0.4	185
SA	3,449.0	2,816.7	632.3	409	2.6	0.8	528
Tas	1,501.4	888.5	612.9	1,258	0.8	0.7	1,525
ACT	722.5	593.8	128.7	395	0.7	*	54
NT	1,832.7	371.4	1,461.3	7,172	0.3	1.5	7,407
Total	37,340.0	37,340.0	0.0		37.3	-	

Source: Commonwealth 2005-06 Budget Paper No.3, Table 1 (Column 1-4); and NSW Budget 2005-06, Paper No. 2, pp. 8-17 (Column 5-7).

One possible measure of the redistribution is a comparison of the actual revenue distribution with an alternative hypothetical redistribution conducted on an equal *per capita* basis. Column (3) indicates the extent and direction of the total State-by-State redistribution on this basis, while column (4) shows what this implies in terms of redistribution per head. For example, on this basis each Victorian in 2005-06 contributes on average $268 to people in other States, while each Queenslander receives an average $104 from other States.

Another way to calculate the extent of this redistribution is to compare how much State populations contributed in GST revenue (the *State of origin* payments) with how much their States received back in the revenue distribution. This provides a better indication of the extent of the actual redistribution than the equal *per capita* comparison. It is, however, more difficult to calculate since no GST revenue statistics are collected on a State of origin basis.

Columns (6) and (7) of Table 16 indicate the extent of the estimated redistribution calculated on a State of Origin basis. On this basis, Victorians on average paid an estimated $340 to other States while Queenslander s on average gained an estimated $257 from other States. While these figures are only estimates, there is no doubt that the extent of the redistribution calculated on a State of Origin basis is significantly greater than that calculated on an equal *per capita* basis.

12 Appendix C: How Does Australia Distribute Its Grants?

When the financial cost of the subnational government's expenditure responsibilities exceeds their revenue raising capacity, transfers are required from the national (or central) government to the subnational government. Such transfers can take place in either of two basic forms: tied grants or block grants. Tied grants from the national government are conditional on a complementary allocation of funding from the subnational government own-revenue sources to a designated expenditure area. The alternative to tied grants are block (or unconditional) grants which subnational governments can expend as and where they see fit.

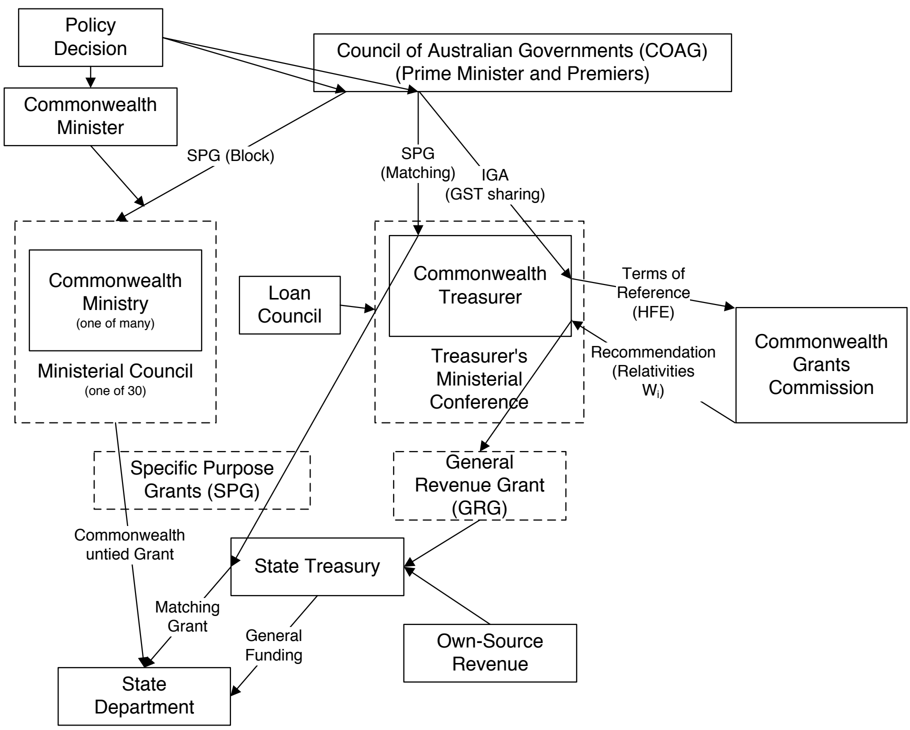
In Australia, the GST is distributed as a block grant between States and Territories on a basis agreed to by the Commonwealth and State Treasurers and undertaken by the Commonwealth Grants Commission. In the case of the SPPs, these can be either tied or block grants. The process for determining the allocation of SPP and untied grants in Australia is as shown in Figure 13 (and discussed further in Section 3.2).

It is important to note that while s.51 of the Australian Constitution grants specific legislative powers to the Commonwealth Parliament including expenditure responsibilities such as that for pensions, this has not prevented effective federal expenditure to these specific areas. This has arisen because under s.96 of the Australian Constitution, the Commonwealth Parliament has the power to make grants to any State "on such terms and conditions as the Parliament thinks fit". This effectively enables the Commonwealth to make grants conditional upon a State implementing particular policies which the Commonwealth supports in their area of legislative responsibility. Commonwealth tied grants have found extensive application in the areas of infrastructure development, health and education. While States do not have to accept these tied grants, they typically do because they act to reduce the effective own-cost of State expenditure in these areas.

While Figure 13 outlines the broad intergovernmental grant allocation process in Australia, what it doesn't show is the alternative approach to funding subnational governments in other federations. This is outlined in Figure 14 with tied grants omitted from consideration. In the case shown, a subnational government has its own-source revenue (resulting from its tax assignment) and receives block grants from the central government. These block grants can take two forms, those determined as a result of some HFE consideration and those which are not HFE related but focus on vertical fiscal imbalance (VFI).

When the focus is on VFI, the allocation of these grants is on the basis of a mechanism which redistributes a centrally collected (e.g. Canada with the HST) and administered tax back to its State of origin, or where there is agreement to share in the revenue of a specific tax. This could see the tax allocated as a grant based around the distribution of the population (that is, per capita basis); on business activity (e.g. production); household activity (e.g. consumption) or employment (e.g. wages and salaries).

Figure 13: Grant Determination Process in Australia



The alternative is a collaborative approach to revenue collection and reallocation through block grants is the allocation of a central government tax to subnational regions to reflect some level of disadvantage experienced by those regions. In this case, the focus is on HFE. When developing the HFE grant allocation mechanism, consideration has been given to both revenue and expenditure related factors. In relation to taxation, the decision is whether the focus is on capacity or actual revenue. If the base and rate of taxes are harmonised then the difference is not an issue and if not, it is. Canada, for example, only considers actual revenue whereas Australia considers revenue capacity.

Another difference is that some countries include all taxes and their revenue in their consideration of grants whereas others do not include all tax types (eg Germany) or all revenue raised from particular taxes. Australia includes all taxes and all revenue raised from those (37) taxes.

While some consideration of tax is always included in HFE, this is not always the case with expenditure which is much less often included. However, as noted previously (Benchmark 6), cost differences associated with expenditure needs can influence the capacity of a region to provide a comparable level of services across jurisdictions. Canada does not include any consideration of cost differences nor Germany. As Spahn (2001) notes:

> … Australia has put in place an explicit and ambitious equalisation scheme that aims at full budget equalisation. In establishing a point of reference for such a scheme, Australia does not only attempt to evaluate standardised taxing powers of her States, but also standardised expenditures adjusted for needs and costs differentials among jurisdictions.
>
> In Germany (like in Canada) the focus of equalisation is on taxable capacity only, with little or no concern for specific burdens. As the tax law is uniform throughout Germany (except for some limited discretion of municipalities to vary their tax rates), there is no need to standardise taxable capacity among regions (as in Canada), because effective tax collections can be considered to reflect the regional variations of tax potentials.
> (Spahn, 2001, p9)

Once a country has decided on a weighting for Splits A, B and C, the next issue to be addressed is the allocation mechanism. In the case of VFI allocation (R) based on some revenue sharing arrangement, this is relatively straightforward once the appropriate base has been determined (such as per capita or consumption distribution). This is much less the case with HFE based grant allocation which is designed to account for differences in needs and cost differential as well as taxable capacity. The methodological approach taken by the CGC in applying the HFE principles to the distribution of GST amongst Australian

States and Territories (which Spahn (2001)) termed 'ambitious') is set out in Figures 15 and 16.

According to the IGA, the share of GST revenue to be received by each State or Territory is based on its population share adjusted by a relativity factor which reflects their per capita financial needs as recommended by the CGC. These relativity factors are then determined by the Commonwealth Treasurer based on the CGC advice and consultation with each State or Territory.

Just how the CGC goes about determining those relativities is outlined in Figure 16 using State or Territory needs and cost differential as well as information on their taxable capacity. What results from this process is a series of eight per capita relativities. Tables 13 and 18 outline the relativities (W_i) applied in 2005-06. Intuitively, these weights could be thought of an equivalence measures – one person in NSW is equivalent to 1.202 Queenslanders, 1.788 Tasmanians and 4.913 Northern Territorians in terms of their relative disadvantage in the Australian Federation.

Figure 14: Generic Block Grant Allocation Process

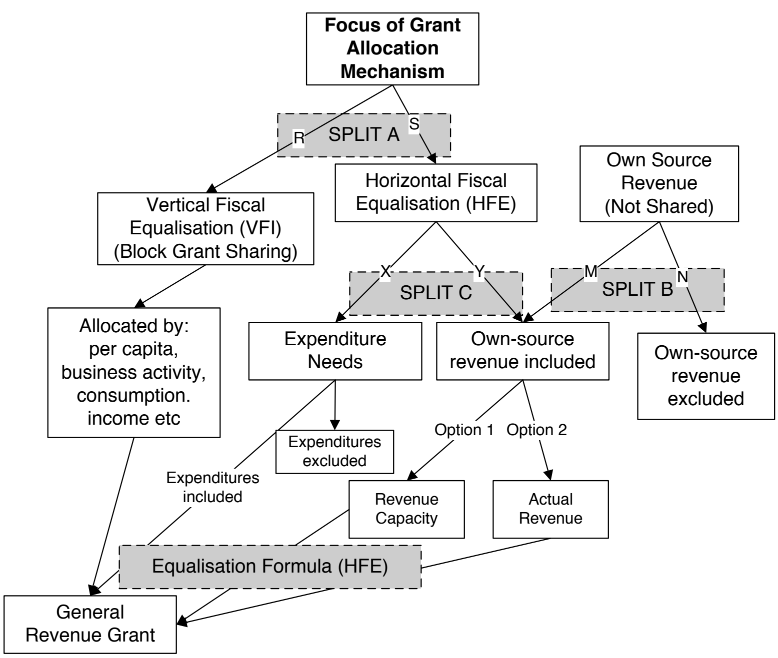


Figure 16 (and Tables 14 and 17) illustrates how this weight (W_i) is then applied to the actual population to derive an equivalent population estimate (called the *weighted population* in Tables 14 and 17) and how its distribution between the States and Territories is used as the basis for allocating the GST revenue (and Health Care Grant (HCG) pool).

Figure 15: Commonwealth Grants Commission Estimation of Relative Needs of States

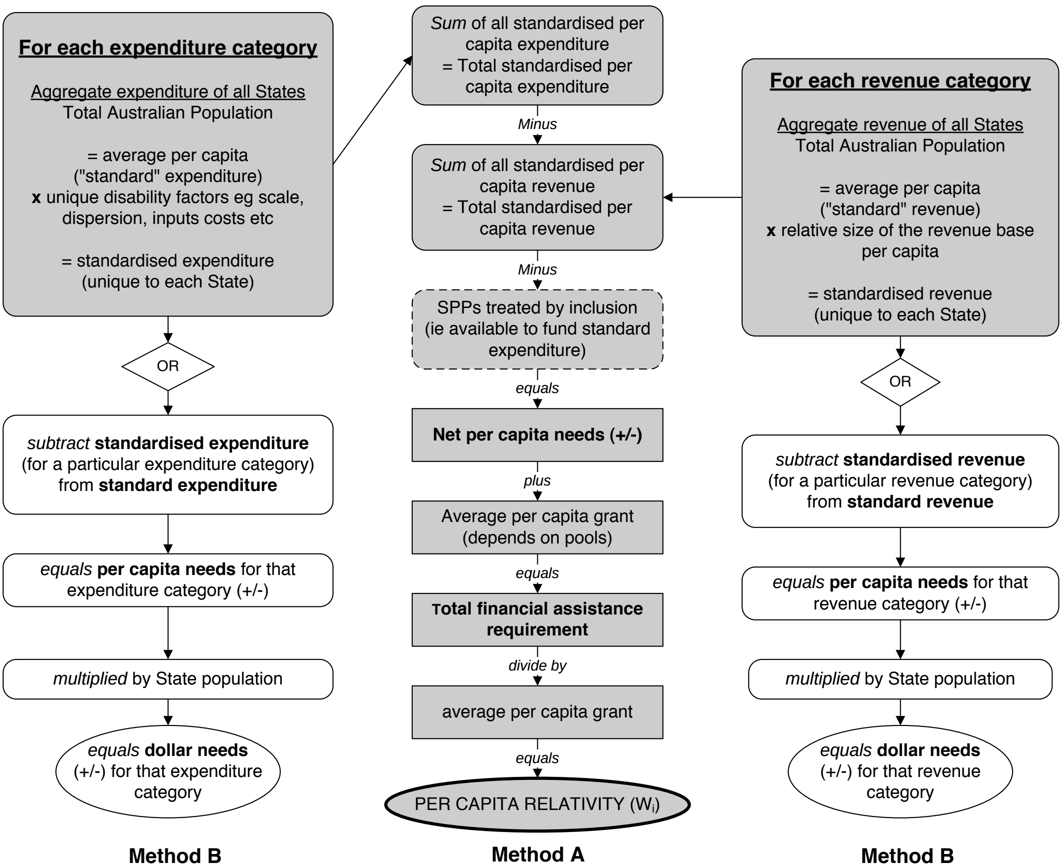


Table 17: Distribution of GST revenue 2005-06

	Projected Population as at 31 December 2005	Per capita relativities	Weighted Populations	Share of Weighted Population (%)	GST revenue/ HCGs pool according to (4) ($m)	Unquarantined Health Care Grants ($m)	Distribution of GST Revenue (5) – (6) ($m)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
NSW	6,807,152	0.86846	5,911,739	28.9	12,891.3	2,663.6	10,227.70
Vic	5,053,080	0.87552	4,424,073	21.6	9,647.3	1,918.0	7,729.20
Qld	4,002,096	1.04389	4,177,748	20.4	9,110.1	1,518.9	7,591.20
WA	2,028,737	1.02500	2,079,455	10.2	4,534.5	781.4	3,753.10
SA	1,547,010	1.20325	1,861,440	9.1	4,059.1	658.1	3,401.00
Tas	486,797	1.55299	755,991	3.7	1,648.5	170.7	1,477.80
ACT	326,408	1.14300	373,084	1.8	813.6	100.0	713.6
NT	204,928	4.26682	874,391	4.3	1,906.7	87.8	1,818.90
	20,456,208		20,457,921	100	44,611.1	7,898.5	36,712.6

Source: Table 6 <http://www.treasurer.gov.au/tsr/content/downloads/017_2006_Attachment_A.pdf>

Figure 16: Grant Estimation

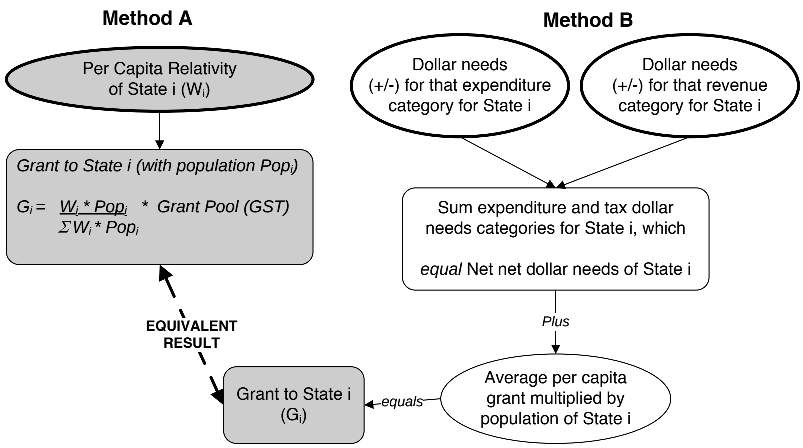


Table 18: 2005-06 Relativities

	Per capita relativities	
	CGC (W_i)	Normalised to NSW
New South Wales	0.86846	1.000
Victoria	0.87552	1.008
Queensland	1.04389	1.202
Western Australia	1.02500	1.180
South Australia	1.20325	1.385
Tasmania	1.55299	1.788
Australian Capital Territory	1.14300	1.316
Northern Territory	4.26682	4.913

Source: Table 17 above

13 Appendix D: The GST and the ABS and OECD

The ABS approach to treating GST is based on their observation that the GST revenues which the Commonwealth collects and unilaterally earmarks at its discretion for distribution to another government should be shown as revenue of the collecting government and an intergovernmental transfer to the beneficiary government. This is because the Commonwealth has the ultimate role in the determination and distribution of GST revenue.[81]

The ABS also states that:

> 20. The above discussion highlights that the Commonwealth exercises considerable influence and discretion over the setting of the GST and the distribution of its proceeds. It also suggests that, individually, the States and Territories do not have sufficient influence or discretion over the setting of the GST and the distribution of its proceeds. GST revenues will be distributed in accordance with Commonwealth Grants Commission fiscal equalisation principles in a similar manner to that already applied in the distribution of income taxes. This situation does not fit the IMF guidelines relating to the attribution of tax revenues to beneficiary governments, which means that GST revenues should not be treated as individual State or Territory tax revenue. Thus, the GST should be treated as a Commonwealth tax for government finance statistics purposes.
>
> ….
>
> 23. In the light of the above, the ABS will adopt the constitutional treatment for GST revenue and classify GST revenues as Commonwealth taxes in GFS. The distribution of GST revenues to State and Territory governments will be treated as grants. Additional amounts of funding from the Commonwealth to offset any shortfall under the transitional arrangements will be classified either as loans or grants depending on how they are provided. These transactions will be separately identified in government finance statistics. The ABS will also publish an alternative view, as a memorandum table in the analytical section of its GFS publication, showing the GST values against individual States and Territories.

81 See *ABS Information Paper: Accruals-based Government Finance Statistics*, 2000, ABS Cat 5517.0, Appendix 1 (Treatment of goods and services tax revenues in government finance statistics).

In contrast, the OECD adopts a different approach to the treatment of the GST. Initially, the OECD reported the Australian GST as a Commonwealth tax after the Commonwealth Treasury submitted the data to the OECD on the ABS basis. However, in the past year, this approach has been revised to reflect the *Interpretive Guide of the Revenue Statistics* which gives guidance (*OECD Revenue Statistics 1965-2004,* p.303) on the attribution of revenues.

This guidance states that

> 95. As a general guide tax revenues are attributed to non-collecting beneficiary governments:
>
> a) when they have exercised some influence or discretion over the setting of the tax or distribution of its proceeds; or
>
> b) when under provisions of the legislation they automatically and unconditionally receive a given percentage of the tax collected or arising in their territory; or
>
> c) when they receive tax revenue under legislation leaving no discretion to the collecting government.

The guidance in case (c) of paragraph 95, has subsequently been interpreted as implying that the GST is a State revenue because the States receive the revenue under legislation giving no discretion to the collecting government. In correspondence with the OECD, it has been highlighted that is not in fact the case with respect to the Australian GST. Furthermore, this interpretation also implies that much of the German VAT revenue is attributed to the States, where (like Australia) the rates are determined jointly by the federal and State governments.

The problem in the Australian case for the OECD approach is that it can be potentially confusing. For example, while the Commonwealth asserts that the GST is a State tax, they also state publicly that they effectively make all key decision about the structure and operation of this tax. Take the recent statement by the Commonwealth Treasurer[82]:

> I think we have got to make sure we stay in front of the pack in all areas – business areas, income tax areas – the only area I will be ruling out is the value-added tax area. This report finds that we still have comparatively low reliance on value-added tax, imagine where we were before we introduced the 10 per cent GST, but I am ruling out absolutely any increase in the GST.

82 See <http://www.treasurer.gov.au/tsr/content/transcripts/2006/038.asp>.

What is also confusing about the OECD approach to the Australian GST is a failure to recognise what the ABS acknowledges in Appendix 1 of its explanation of how it would go about treating the GST in government financial statistics when following the IMF GFS Manual 1986[83]. That is, that the introduction of the GST was accompanied by the repeal of the Wholesale Sales Tax (WST) and several other State taxes – and that the States effectively compensated the Commonwealth for the loss of WST revenue through reduced FAGs. As a consequence 100 per cent of the GST does not go to the States and nor do the States do not control the GST[84].

In summary, the confusion that arises with the OECD treatment of the GST has two key aspects.

1. The OECD allocation of 100 per cent of the GST as a State tax when effectively this is not the case (because of the Wholesale Sales Tax compensation etc). See Table 139 in *OECD Revenue Statistics 1965-2004*. Even if it was agreed that the GST rate is jointly determined, the Australian approach is not consistent with the German approach in the OECD statistics because of the effective State compensation to the Commonwealth for the repeal of the WST in Australia.

2. The OECD data for State Government Grants in Table 169 in *OECD Revenue Statistics 1965-2004* (Table 19 below) implies that Grants to States from the Commonwealth have increased when Table 139 (Table 20 below) shows that their GST revenue has also increased. This is contradictory methodology – if the States are attributed the GST revenue, they cannot also have assigned to them grants based on that same revenue. The result is an apparent double counting of the GST in the *OECD Revenue Statistics*.

83 See <http://www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/5517.0Main+Features12000?OpenDocument>

84 Ibid See ABS comments on the 5 rules outlined in Chapter II.G of the *IMF GFS Manual 1986* <http://www.imf.org/external/pubs/ft/gfs/manual/1986/eng/index.htm>. Note that this Manual has since been revised <http://www.imf.org/external/pubs/ft/gfs/manual/pdf/all.pdf> but the revised guideline (para 5.18-5.28) has not resulted in any change in the ABS position even though the IMF publication states that:

"5.20 The classification of taxes in this manual is quite similar to the classification employed in Revenue Statistics, which is published annually by the Organisation for Economic Co-operation and Development. The two primary differences are that in Revenue Statistics compulsory social security contributions are treated as taxes and the categories of taxes on goods and services and taxes on international trade and transactions are combined into a single category."

The OECD has suggested (in email correspondence with Chris Heady) that it is in fact probably more interesting to look at the degree of autonomy, rather than the formal attribution of the revenues. To this end, the OECD has recently released data on tax autonomy of subcentral governments[85] which is reproduced in Table 21 which is much more informative than Table 20, indicating that the GST is a revenue sharing arrangement between the Commonwealth and State government. It still has the Australian GST treated as a tax totally at the discretion of Australian States and Territories however, and one where all revenue collected is distributed to the States – when neither of these assumptions are in fact the case in practice.

Table 19: Non-Tax Revenues, Capital Revenues and Grants

Table 169 - Tableau 169

Australia - Australie

Non-tax revenue, capital revenue and grants, in millions of australian dollars

	1990	1995	1998	1999	2000	2001	2002	2003
General Governement (local+state+central)								
Non-tax revenue				46235	48255	45219	46796	51320
Property income				14505	15749	11539	11655	11731
Sales of goods and services				21273	21923	23624	24788	26135
Fines, penalties and forfeits				907	810	1077	1050	1190
Miscellaneous and unidentified revenue [1]				9550	9773	8979	9303	12264
Other social contributions				-	-	-	-	-
Capital revenue				4032	1408	2866	3975	3515
Central Governement								
Non-tax revenue				16649	18948	15814	18606	18872
Property income				5211	7472	4187	6256	5391
Sales of goods and services				7104	7083	8397	8920	9500
Fines, penalties and forfeits				8	-	32	12	8
Miscellaneous and unidentified revenue [1]				4326	4393	3198	3418	3973
Other social contributions				-	-	-	-	-
Capital revenue				398	-894	-844	95	5
Grants				158	130	128	153	201
State Governement								
Non-tax revenue				22868	21952	21594	20290	23048
Property income				8963	7876	6921	5034	5889
Sales of goods and services				9203	9563	9573	10002	10487
Fines, penalties and forfeits				777	683	692	857	974
Miscellaneous and unidentified revenue [1]				3925	3830	4208	4397	5698
Other social contributions				-	-	-	-	-
Capital revenue				2843	1599	2665	3072	2496
Grants				33720	35466	46738	52597	53740
Local Governement								
Non-tax revenue				6718	7355	7811	7900	9400
Property income				331	401	431	365	451
Sales of goods and services				4966	5277	5654	5866	6148
Fines, penalties and forfeits				122	127	153	181	208
Miscellaneous and unidentified revenue [1]				1299	1550	1573	1488	2593
Other social contributions				-	-	-	-	-
Capital revenue				791	703	645	806	1014
Grants				2522	2847	2786	3105	2561

1. Including voluntary transfers other than grants.

Source: OECD Revenue Statistics 1965-2004, Table 169

85 <http://www.oecd.org/dataoecd/28/33/36451568.pdf>

Table 20: Tax revenue by subsectors of government

Australia | **Australie**

Table 139 - Tableau 139

Tax revenues by sub-sectors of government

Recettes fiscales par sous-secteurs d'administration

Millions of australian dollars | Millions de dollars australiens

	Federal government Administration fédérale					State/Länder État/Länder					Local government Administrations locales					Social security Funds Administrations sécurité sociale				
	1975	1980	1990	1995	2003	1975	1980	1990	1995	2003	1975	1980	1990	1995	2003	1975	1980	1990	1995	2003
1000 Taxes on income, profits and capital gains	11831	22383	66542	82615	142067	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
1100 Of individuals	9213	17532	50062	60602	98979	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
1200 Corporate	2618	4851	16480	22013	43087	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
1300 Unallocable between 1100 and 1200	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2000 Social security contributions	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2100 Employees	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2200 Employers	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2300 Self-employed or non-employed	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2400 Unallocable between 2100, 2200 and 2300	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
3000 Taxes on payroll and workforce	54	33	1313	3065	3658	1171	1955	5802	7120	10839	-	-	-	-	-	-	-	-	-	-
4000 Taxes on property	104	43	247	8	13	882	1546	5975	7988	16683	883	1516	4205	5134	7663	-	-	-	-	-
4100 Recurrent taxes on immovable property	12	19	-	-	-	217	351	1943	1840	3804	883	1516	4205	5134	7663	-	-	-	-	-
4200 Recurrent taxes on net wealth	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
4300 Estate, inheritance and gift taxes	87	17	-	-	-	227	158	-	-	-	-	-	-	-	-	-	-	-	-	-
4400 Taxes on financial and capital transactions	4	7	247	8	13	439	1037	4032	6148	12879	-	-	-	-	-	-	-	-	-	-
4500 Non-recurrent taxes	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
4600 Other recurrent taxes on property	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
5000 Taxes on goods and services	4931	10166	24511	30004	29338	1263	2235	7883	13295	46993	-	1	22	-	-	-	-	-	-	-
5100 Taxes on production, sale, transfer, etc	4919	10115	24328	29613	28526	533	982	2885	4923	41396	-	-	-	-	-	-	-	-	-	-
5110 General taxes	1408	2102	9365	12970	1002	-	-	-	-	34121	-	-	-	-	-	-	-	-	-	-
5120 Taxes on specific goods and services	3511	8013	14963	16643	27524	533	982	2885	4923	7275	-	-	-	-	-	-	-	-	-	-
5130 Unallocable between 5110 and 5120	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
5200 Taxes on use of goods and perform activities	12	51	183	391	811	730	1253	4998	8372	5606	-	1	22	-	-	-	-	-	-	-
5300 Unallocable between 5100 and 5200	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
6000 Other taxes	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
6100 Paid solely by business	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
6200 Other	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
TOTAL TAX REVENUE	16920	32625	92613	115692	175075	3316	5736	19660	28403	74515	883	1517	4227	5134	7663	-	-	-	-	-

Statlink: *http://dx.doi.org/10.1787/081111152351*

Source: OECD Revenue Statistics 1965-2004, Table 139

Table 21: Tax autonomy of subcentral governments

Table 1. Tax autonomy of sub-central governments

2002

	Sub-central tax revenue as % of total tax revenues	As share of sub-central tax revenues: Discretion on rates and reliefs	Discretion on rates: Full	Discretion on rates: restricted	Discretion on reliefs	Tax sharing arrangements: Revenue split set by SCG	Tax sharing arrangements: Revenue split set with SCG consent	Tax sharing arrangements: Revenue split set by CG, pluriannual	Tax sharing arrangements: Revenue split set by CG, annual	Rates and reliefs set by CG	Other	Total
Australia	**31.4**											
States	28.4	54.4	-	-	-	-	45.6	-	-	-	-	100.0
Local	3.0	100.0	-	-	-	-	-	-	-	-	-	100.0
Austria	**18.4**											
States	8.8	7.0	-	-	-	-	82.7	-	-	9.6	0.8	100.0
Local	9.6	2.7	-	5.4	-	-	66.5	-	-	20.0	5.5	100.0
Belgium *												
States												
Local												
Canada	**44.1**											
Provinces	35.5	93.3	-	-	-	-	6.7	-	-	-	-	100.0
Local	8.6	1.8	95.6	-	-	-	-	-	-	2.3	0.3	100.0
Czech Republic	**12.5**											
Local	12.5	5.5	-	4.1	-	-	-	88.8	-	1.5	0.1	100.0
Denmark	**35.6**											
Local	35.6	-	86.0	4.7	-	-	-	2.9	-	6.4	-	100.0
Finland	**21.5**											
Local	21.5	-	85.3	4.6	-	-	-	-	9.9	-	0.1	100.0
France	**10.0**											
Local	10.0	72.1	-	8.5	9.1	-	-	-	-	3.8	6.6	100.0
Germany	**28.7**											
Länder	21.8	-	-	2.4	-	-	86.3	-	-	11.2	-	100.0
Local	7.0	17.6	-	33.6	-	-	47.6	-	-	1.1	0.2	100.0
Greece	**0.9**											
Local	0.9	-	-	64.6	-	35.4	-	-	-		-	100.0
Iceland	**25.2**											
Local	25.2	-	-	91.2	-	-	-	-	-	-	8.8	100.0
Italy	**16.4**											
Regional	11.3	-	-	58.8	-	-	23.7	17.6	-	-	-	100.0
Local	5.2	27.1	-	50.4	-	-	-	13.1	-	9.3	-	100.0
Japan	**26.0**											
Local	26.0	0.1	79.7	-	-	-	-	-	-	20.2	-	100.0
Korea	**18.9**											
Local	18.9	-		64.3	-	-	-	-	-	35.7	-	100.0
Mexico	**3.4**											
States	2.4	100.0		-		-			-	-	-	100.0
Local	1.0	100.0	-						-		-	100.0
Netherlands	**3.6**											
Local	3.6	-	99.2	-		-			-		0.8	100.0
Norway	**12.9**											
Local	12.9	3.3	-	96.7	-	-	-	-	-	-	-	100.0
Poland	**17.5**											
Local	17.5	-	-	23.2	-	-	-	76.4	-	0.4	-	100.0
Portugal	**6.0**											
Local	6.0	-	-	44.0	-	-	-	18.5	-	37.3	0.2	100.0
Spain *												
Regions												
Local												
Sweden	**32.1**											
Local	32.1	-	100.0	-	-	-	-	-	-	-	-	100.0
Switzerland	**43.1**											
States	27.0	90.4	-	-	-	-	9.6	-	-	-	-	100.0
Local	16.2	2.9	-	97.1	-	-	-	-	-	-	-	100.0
Turkey	**6.5**											
Local	6.5	-	-	-	-	-	-	-	-	-	100.0	100.0
United Kingdom	**4.5**											
Local	4.5	-	-	100.0	-	-	-	-	-	-	-	100.0
Unweighted Average												
States	19.9	51.5	-	6.8	-	-	37.1	2.0	-	2.3	0.3	100.0
Local	12.3	14.4	22.7	35.4	0.4	1.5	4.8	8.3	0.4	6.6	5.5	100.0

Source: National source and OECD, Revenue Statistics 1965-2004, 2005 Edition.

Source: <http://www.oecd.org/dataoecd/28/33/36451568.pdf>

14 Appendix E: Performance of other countries against equity of intergovernmental fiscal transfers (Benchmark 6)

Austria

Austria is a federation with three levels of government – the federation, States (Länder) and municipalities. Its Constitution prescribes in principle that the expenditure responsibilities of the different levels should match their spending powers. There is an elaborate system of tax sharing, transfers and co-financing across the three levels which reflect the objective of achieving roughly equal living conditions across all Austria. Regulation of the assignment of revenue and expenditure powers is achieved by the fiscal equalisation law (FEL). This law is negotiated between the three levels of government and has a life of four years before renegotiation. It determines the type of taxes to be shared between the three levels of government and the proportions according to which revenues are allocated, and specifies major intergovernmental transfer flows.

The most important revenue-raising taxes (personal income tax, corporate tax and VAT) are shared taxes with tax rates determined by federal legislation. Effectively, the States have no power to set tax rates. About 73 per cent of distributable tax revenues accrues to the federal government, about 15 per cent to the States and 12 per cent to the municipalities. The allocation of shared tax revenue across States and municipalities is based on a population distribution weighted by urban population proportions. The FEL also determines rules to reduce revenue-raising disabilities of municipalities through vertical transfers from the federal government. A substantial proportion of shared tax revenue accruing to lower levels of government is tied to specific spending items, e.g. local transport subsidies and energy conservation measures.

HFE in Austria is based only on weighted population measures, with no other acknowledgment of expenditure disabilities, although federal grants outside the tax sharing system and cofinancing arrangements apparently have a significant equalising impact. The States have no discretion in revenue-raising. The FAG is subject to regular review.

There exists a considerable degree of cooperation between the three government levels.

Canada

Canada has three levels of government – federal, provincial and territorial, and local. It has virtually no VFI. It implements two HFE schemes – *Equalisation* (for the Provinces) and *Territorial Formula Financing* (for the Territories). Both involve untied federal grants to the lower level of government. The Territorial scheme is not dealt with here.

The purpose of the *Equalisation* scheme is to offer residents across the Provinces reasonably comparable public services at reasonably comparable taxation levels. It is a formula-based revenue supplementation scheme funded by the federal Government. Canada's equalisation system is 'open-ended' in the sense that any increase in the funds necessary to achieve equalisation to some agreed standard are provided by the central government, that is, equalisation is not necessarily a zero-sum game for the provinces. However, this can have detrimental impacts on the central government budget unless funds are taken away from other programs which provide transfers from the central government to the provinces.

The standard of required revenues per person is calculated with reference to the five "middle rich" Provinces (BC, Saskatchewan, Manitoba, Ontario and Quebec). The revenue need per person for each Province is calculated (in 2004-05 about $C6,200). This is compared with the standardised own-source revenue capacity and any shortfall is covered by *Equalisation*. The program is designed to guarantee minimum levels of provincial public services, not to equalise service levels. It takes no account of provincial expenditure needs or disabilities. Its design is the responsibility of the federal Minister of Finance.

The *Equalisation* program reduces inequities rather than achieving full equalisation, and it does not correct for expenditure disabilities. It is the subject of considerable dispute between the federal Government and the Provinces. However, there is not the same level of interprovincial dispute since an increase in entitlement for one Province will not reduce the entitlements of others.

Germany

Germany has three levels of government – federal, State (Länder) and local. The Basic Law (the Constitution) explicitly list the taxes attributed to the three levels of government, so that all Länder have the same taxation powers, and sets out the rules for sharing personal income tax (PIT) and corporate tax between the federal Government and the Länder. Communes receive 15 per cent of PIT (according to place of residence of taxpayers) while the federal Government and the Länder share the rest equally (42.5 per cent each). The federal Government and the Länder share corporate income tax revenue. VAT revenue is also shared between the two levels of government on rules set by federal law. Beer duty revenue is paid in full to the Länder. There is a three part equalisation system:

- **Sharing of VAT revenue.** Currently the Länder receive 47.8 per cent of VAT revenue. Of the Länder share, 75 per cent is distributed according to the Länder population shares and 25 per cent is used for the purposes of HFE to raise the *per capita* incomes of the poorer Länder to 92 per cent of the national average.
- **HFE funded by the Länder** (because the German arrangements do not result in VFI). HFE is purely based on the financial capacities of the Länder and its objective is to ensure that no State has a financial capacity substantially less than the national average. Thus, financial capacities are not equalised but their spread is reduced.
- **Supplementary federal grants,** mainly to provide additional assistance to poorer Länder to bring their financial capacities up to 99.5 per cent of the national average and to provide financial assistance to Länder of the former GDR.

The system provides comprehensive compensation for financial disabilities but virtually no compensation for cost disabilities. The system is relatively simple and, as a result of the constitutional and legal requirements, relatively transparent.

Italy

The Italian Constitution provides for five levels of government. The country's system of fiscal federalism has undergone substantial reform in recent years, with that reform affecting largely the second tier of government – the 15 Ordinary Statute Regions (OSR). The reform has the objective of increasing their fiscal autonomy and has three components:

1. **Tax devolution.** OSRs have been given access to a regional business tax – a value-added tax levied on all businesses at a rate of 4.25 per cent, with the yield accruing to the OSR in which the value-added is produced. In addition, a regional surcharge on personal income tax (now 0.9 per cent) has been established.
2. **Replacement of existing vertical grants by a sharing of national VAT revenue.** 38.55 per cent of VAT revenue is distributed between OSRs in proportion to their residents' estimated consumption. The shared revenues are effectively untied grants, though minimum health standards are required of each OSR.
3. **New HFE system.** This system is designed to equalise public resources across OSRs by 2013. The equalising formula takes account of fiscal capacities, health needs and cost differences in the provision of public services. Equalisation is implemented through horizontal transfers between OSRs – above-average OSRs funding below-average OSRs.

The reform is designed to increase the fiscal autonomy of the OSRs and to implement comprehensive HFE, taking into account both fiscal capacity and expenditure disabilities. Doubts have been expressed as to whether these objectives will be achieved in practice.

Switzerland

Switzerland is in the course of a radical restructuring of its federal fiscal system, after a prolonged period of research and debate. The reform includes a reassignment of expenditure functions between the three levels of government – Confederation (national government), Cantons (subnational governments) and Communes (local governments) – in an attempt to move closer to the principle of subsidiarity. The change also involves a reform of the fiscal equalisation process, using both revenue-sharing and block (untied) grants from the Confederation to some Cantons. The objectives of equalisation are to ensure that each Canton has the necessary means to assume by itself the tasks that have been entrusted to it and to reduce cantonal financial disparities.

The Cantons receive a constitutionally fixed amount of federal revenue paid into an equalisation fund. Revenue equalisation is based on an index of the financial capacities of the Cantons and includes both horizontal and vertical transfers. Cantons with above average financial capacities will finance those with lower than average capacities, who will also receive vertical payments financed by the Confederation.

One objective of the reform is that the average financial resources of any of the poorer Cantons should not be below 85 per cent of the national average. Average financial capacity depends on the aggregate cantonal tax base, calculated across Cantons on a common basis, and on measures of cost disadvantages. There is also provision that Cantons which would suffer severe financial disadvantages from the change to the new scheme would receive compensation, in order to reduce political opposition to the change and to maintain political cohesion. This "cohesion fund" is funded two thirds by the Confederation and one third by the Cantons.

The Swiss process involves moving towards equalisation but does not aim for full equalisation. In doing so it concentrates on the fiscal capacities of the Cantons while also acknowledging certain cost disabilities. It recognises the need for compensation to ensure that there are no cantonal losses from the reform process.

USA

In spite of the fact that some States experience substantial cost and revenue disabilities, there is effectively no mechanism for HFE in the US. Almost all transfers from the national government to State and local governments are in the form of specific (tied) grants, many of which are for income maintenance purposes.

The American system fails to meet the benchmark of equity in the treatment of subnational governments.

15 Appendix F: Subnational Fiscal Rules

Fiscal framework and enforcement mechanisms for ensuring budget discipline at the subnational level

Country	Fiscal framework	Enforcement mechanisms
Australia	**A cooperative approach:** Federal and State borrowing are coordinated by the Australian Loan Council, taking into account each jurisdiction's fiscal position and infrastructure needs as well as macroeconomic objectives. Most States have adopted some sort of balanced budget rules.	**Market discipline:** States has to borrow on their own account, and the Loan Council provides information to the financial market on public sector borrowing plans. **Peer pressure:** If non-financial operating receipts are exceeded by more than 2 per cent in either direction, States are obliged to provide an explanation to the Loan Council. This explanation will be made public. The Loan Council is not empowered formally to approve any change, but it could pursue any concerns in the Loan Council.

Country	Fiscal framework	Enforcement mechanisms
Austria	**A cooperative approach:** An explicit Domestic Stability Pact was introduced in 1999 and the present arrangement, covering the period 2001-2004, was agreed on in October 2001. According to the Pact, municipalities as a group have to balance their budget over the period 2001-2004, while regions as a group have to produce annual surpluses of at least 0.75 per cent of GDP. This commitment is not binding for any individual municipality, but for municipalities grouped according to the *State* they belong to. The pact allocates obligations to each *State*. The targets have to be complied with ex-post. The pact provides a possibility to transfer surplus/deficit rights to other governments. No specific reference is made to the financing of public investments. **Borrowing**: No explicit restrictions on borrowing by *States*. For municipalities, borrowing is only allowed to cover extraordinary expenditures. The *States* are obliged by law to regulate local borrowing, but the regulation put in place varies significantly among different *Länder*.	**Peer pressure:** through a co-operative framework. **Financial sanctions:** Governments that fail to reach the target would have to pay a fixed and a variable fine totalling 8 per cent of the stability contribution and 15 per cent of the shortfall, respectively, up to a ceiling. Application of sanctions depends, however, on the unanimous decision of a commission involving the federal government on the one hand, and the *States* and the municipalities on the other. If compliance is re-obtained within one year, the fine is returned; otherwise, the money is allocated across the complying governments. **Escape clause:** In case of a serious economic slowdown, the sanctions do not apply.

Country	Fiscal framework	Enforcement mechanisms
Belgium	**A cooperative approach:** Permissible deficit and expenditure growth levels for the different government levels are established on the basis of recommendations by the High Council of Finance. These recommendations are published in annual reports. The deficit target refers to the overall fiscal balance. **Borrowing:** Regions and communities can issue bonds, but they must have the approval of central government.	**Peer pressure:** through a cooperative framework. **Administrative procedures:** The federal government is allowed by law to limit the borrowing of regions for a period of two years, following a recommendation from the Supervisory Council and a consultation with the regional governments. The regional level monitors the municipalities' budgets and has the power to enforce expenditure cuts or tax increases if necessary.
Canada	**No formal coordination:** A loose budget co-ordination exists via a dialogue among ministers, which takes place once a year. Most provincial and territorial governments have introduced some sort of balanced-budget legislation, while municipal governments are not allowed to show a deficit. **Borrowing:** Provincial and territorial governments have unrestricted access to borrowing, while municipal governments can only borrow for investment projects.	**Market discipline:** The federal government does not guarantee subnational debt. **Escape clauses:** In most provinces, a surplus in one year can provide an accounting reserve to be drawn on if a deficit is incurred in a subsequent year. In addition, the legislation in many provinces builds in exemptions for special events.

Country	Fiscal framework	Enforcement mechanisms
Germany	**A cooperative approach:** The major instrument for policy co-ordination is the intergovernmental Financial Planning Council (Finanzplanungsrat), consisting of the federal government, the *Länder* and representatives of the communities. A Domestic Stability Pact with spending caps for 2003 and 2004 has been agreed. **Borrowing:** Most of the sixteen *Länder* have adopted a golden rule; *that is,* borrowing is only allowed for investment expenditure. Municipalities can only use borrowing to finance capital investments if other financing is not feasible or appropriate and it is subject to regional approval.	**Peer pressure:** The Financial Planning Council (Finanzplanungsrat) is attributed the tasks of monitoring fiscal development at all levels of governments and of making recommendations for restoring fiscal discipline in cases of non-compliance.
Italy	**Fiscal rule:** A Domestic Stability Pact was enacted in 1999, imposing deficit reductions *vis-à-vis* a no-policy-change baseline on subnational governments. Debt service cannot exceed 25 per cent of current revenues. **Borrowing:** Regional and local authorities are allowed to borrow to finance capital investments.	**Peer pressure:** The Pact has a cooperative mechanism, mainly in the context of the regional and mayor's conferences, to deal with corrections of eventual overshoots. **Financial sanctions:** European sanctions will be shared among non-complying governments according to their contribution to the overshoot. **Escape clauses:** In case of unexpected events, borrowing limits can be relaxed.

Country	Fiscal framework	Enforcement mechanisms
Switzer-land	**No formal coordination:** But informal coordination takes place between the Confederation and the cantons for the preparation of the budget. **Borrowing:** Borrowing by cantons and communes is restricted to investment projects and requires popular referenda for approval.	Subnational fiscal policy is subjected to the scrutiny of citizens through popular referenda.
United States	**No formal coordination:** However, most States have introduced balanced budget rules as a legal requirement. **Borrowing:** No centrally imposed restriction on borrowing by the States.	**Market discipline:** The federal government does not guarantee subnational loans.

Source: "Annex: Ensuring fiscal discipline at subnational level: strategies and mechanisms" in Joumard and Kongsrud (2003a), p50-57