FISCAL FEDERALISM IN AUSTRALIA

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Australia displays high vertical fiscal imbalance (VFI) for historical and constitutional reasons. It also attempts to achieve the highest degree of horizontal fiscal equalization (HFE) to be found in any democratic federation. The Commonwealth Grants Commission (CGC), a non-partisan body at arm's length from politicians, oversees the regime. A recent report claims that equity, efficiency and transparency would all improve if the regime were abolished. Such a change is politically unachievable, but it raises interesting issues in public finance and public administration, which carry over to other federations and union states.

An economically efficient system would: minimize perverse incentives, especially incentives to seek rent; encourage states to grow; discourage suboptimal location decisions; minimize transaction costs. An equitable system would maximize equity between relevantly similar individuals. Aspects of the Australian system that should be copied include the non-partisan agency and the target of HFE between component parts of the country. Aspects that should be discussed and perhaps copied include the very extensive equalization, including the feature of equalizing away the effects of grants for special purposes. Aspects that should probably not be copied include the cumbersome formulae and some of the perverse methods of calculating for 'needs'. All abbreviations and acronyms are spelt out in the Appendix on page 37.

The purpose of this paper is to explain how the arrangements for fiscal federalism – that is, for revenue sharing between the Commonwealth and the States – came into being in the Commonwealth of Australia. The paper evaluates current criticisms of the regime; and assesses how far these arrangements could serve as a model for a country such as the UK, where existing arrangements are decrepit. A number of scholars, including this author, have previously recommended that the Australian arrangements be applied to the UK.

HISTORY

The Commonwealth of Australia came into existence in 1901 as the result of conventions and referendums in the six ratifying colonies. In 1933, the Commonwealth created a mechanism for distributing grant from the Commonwealth to the States which has been widely admired. Several scholars (for example, Heald and Geaughan 1996; McLean and McMillan 2003; Péloquin and Chong 2002) have recommended that it be copied elsewhere. The purpose of this paper is to describe the system of fiscal federalism

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operating in the Commonwealth of Australia and to discuss how far it could be a model for a new set of relationships between the centre and the localities in a country such as the UK.

The units of Australian federalism remain the same six colonies, now the States, plus the two self-governing Territories (ACT and NT – see Appendix). The units are extremely heterogeneous by population and land area, but the most homogeneous of any democratic federation by GDP per head. Although most people think that NT is extremely poor, and it certainly contains a massive proportion of extremely poor indigenous people, yet its GDP per head on the output measure is the second highest in Australia, because of its substantial mineral output. Table 1 presents the basic details.

Before Federation, the colonies got most of their revenue from customs and excise – 76 per cent in 1896–97. A purpose of Federation was to reduce barriers to trade such as State tariffs and railway changes of gauge at State borders (the latter not yet achieved). What the states lost in revenue from tariffs against each other, they must regain either in common Australian tariffs against the rest of the world, or from some other tax base. As in other federations, the States were divided in their relative exposure to the world economy, and hence in their median voter preference over tariff policy. The Constitution failed to carry in referendum in NSW. In subsequent bargaining, the Premiers of NSW and Victoria persuaded the other states to insert a clause (now s.96 of the Australian Constitution) empowering the Commonwealth to make grants to the States. All the action in Australian fiscal federalism now takes place under this clause.

The first Commonwealth party labels were Protection and Free Trade. The free-trading outliers were Western Australia (WA) and Tasmania. As remote primary producers with little import-substituting domestic industry, they lost out twice over from the switch from State to Australia-wide tariffs. They faced tariffs on their inputs and did not benefit from tariff protection for their outputs. The Great Depression exacerbated WA's relative position,

TABLE 1 *The units of Australian federalism*

Unit	Population, 000	Land area, km^2	GDP/head, AUD
NSW	6 643	800 640	35 021
Vic	4 854	227 420	33 882
Qld	3 670	1 730 650	28 790
WA	1 919	2 529 880	36 828
SA	1 519	983 480	27 639
Tas	473	68 400	24 062
ACT	323	2 360	40 808
NT	200	1 349 130	38 397
Australia	19 604	7 692 030	33 037

Source: Australian Bureau of Statistics website, *www.abs.gov.au*, various tables, consulted 2.10.02. GDP data (known in Australia as GSP, gross State product) for June 2002. Population for 31.12.2001.

and in a 1933 referendum its voters voted by a margin of 2 to 1 to secede from the Commonwealth. This induced Prime Minister Joseph Lyons (to date the only Tasmanian to hold that post) to legislate for a statutory commission to report on any application from a State for financial assistance under s.96 of the Constitution. The CGC was accordingly constituted in the same year under L.F. Giblin, a Tasmanian statistician who took an egalitarian view of the CGC's mandate in the face of objections from his chairman, who believed that this was to expand the CGC's role beyond its statutory duty to report on claims by States in difficulty. The two conceptions of the CGC's role both appeared in early statements, allowing modern commentators to pick an 'ideology' of the CGC to suit their present-day argument.

The CGC's First Report stated that 'It seems, therefore, to be unavoidable to use as some measure of disability the financial position of a State'. Successive statisticians, the most important being Giblin himself and R.L. Mathews, who became a Commissioner in 1972, elaborated formulae for evaluating 'disabilities'. By Mathews' time it had become explicit that a State suffered a disability (which could be negative) if its revenue capacity differed from the mean of the States. It also suffered a disability (again, possibly negative) if the cost of delivering services differed from the mean, for reasons such as remoteness, congestion or differential prices of wages or supplies. This approach implied that revenue and expenditure relativities must be measured across all States.

The CGC's Second Report, however, stated that 'the only ground for . . . assistance is the inability to carry on without it. . . . Some States are certainly in serious financial difficulties. It must be made possible for them to function as States of the Commonwealth at some minimum standard of efficiency' (quoted in CGC 1983, p. 36). On this conception the CGC should enquire explicitly only into conditions in claimant States, although implicitly even this necessarily involves comparison with the rest; and any special grant available only to claimants means by definition less grant available to non-claimants.

The Giblin/Mathews interpretation seems to have prevailed. The CGC has adopted successive, quite egalitarian, statements of the principle of horizontal fiscal equalization (HFE). The most recent version runs:

> 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. (Source: *www.cgc.gov.au*, consulted 02.10.2002)

Critics allege that the CGC has been surreptitiously making the formula more egalitarian over the years without statutory warrant. Its defenders reply that the CGC is entirely open about its formula, and that it would be open to States at any Premiers' Conference, or at the Intergovernmental Conference specially convened to discuss fiscal federalism in 1999, to raise the issue.

VFI AND HFE IN AUSTRALIA

From the outset, Australia has had a substantial vertical fiscal imbalance (VFI). The States have always had more line responsibilities than the Commonwealth, but the Commonwealth has always controlled more of the tax base. In the beginning, the States handed control of customs and excise, then the principal tax base, to the Commonwealth. This followed from the framers' conception of Australia as an internal free trade area surrounded by a common external tariff. Both limbs of this policy required the Commonwealth to be the taxing authority. However, the States did not concede to the Commonwealth the domestic policy areas that they had already, as colonies, been running for decades. The Australian Constitution is difficult to amend, requiring high multiple thresholds. The financial clauses have never been amended, and therefore they remain the framework into which all VFI (and HFE) arrangements must fit.

There therefore had to be a transfer mechanism. Tax receipts were transferred in *ad hoc* ways until the creation of the CGC. Although the CGC (and its critics) have always seen its role as one of securing a greater or lesser degree of HFE, the purchase for that role, and the need for some body such as the Commission, both arose from VFI. Wherever VFI exists, there must be a body or mechanism to make the required transfers. That body may or may not also attempt to achieve HFE. VFI, measured as the States' ratio of Commonwealth grant revenue to total revenue, was just below 0.4 at Federation. It declined to a little above 0.1 in 1939, soared during the Second World War and the foundation of the welfare state, peaking at 0.6 in 1959. It declined unsteadily to below 0.4 in 1999 but is now rising again due to new arrangements for revenue sharing.

The Commonwealth took over income tax from the States in 1942. The switch was supposed to be for the duration of the war only, but it has proved permanent. In the bipartisan welfarist climate of the 1950s and 1960s, nobody except the State governments opposed the income tax power staying at Commonwealth level. When States tried to reassert their power to tax, the Commonwealth legislated to reduce its grants dollar for dollar to any State that did so. The High Court has upheld the constitutionality of the *de facto* Commonwealth monopoly of the income tax base. In practice this does not displease State Premiers, as they can spend more than they tax – a position all politicians would like to be in, but not all can.

In 1997 the High Court outlawed State 'franchise fees'. It held that they were an excise tax and hence constitutionally the province of the Commonwealth only. The Commonwealth agreed to increase its excise taxes and return the proceeds to the States, thus necessarily increasing VFI. It introduced a goods and services tax (GST, functionally equivalent to a VAT) in 1999. Australia was thus one of the last mature democracies to introduce a broad-based expenditure tax. The Commonwealth agreed that the whole proceeds of GST, net of the cost of collection, would be remitted to the

States. GST is a more robust tax base than those it replaced, and its yield is expected to grow in real terms in line with the growth of GDP. The Commonwealth makes transitional grants (shown as 'budget balancing assistance' in Table 2) to ensure that no State is worse off than under the previous arrangements.

As of autumn 2002 the Liberal-National coalition controlled the Commonwealth government, and the Australian Labor Party controlled all eight States and territories. But GST has largely removed debate about the size of the untied assistance from the system. States can increase their untied grants only by reducing those of other States and the zero-sum nature of the game has become explicit. But State politicians can plausibly say, 'It is our money, raised from our taxpayers. We want our money back' – either in the form of a distribution according to the amount of GST raised, or an equal per capita (EPC) distribution. The CGC does neither. Because of its strong version of HFE, it returns GST proceeds in such a way as to ensure that *gross* Commonwealth grants to the States (that is, the sum of tied and untied grant) satisfy its HFE criteria.

As the welfare state developed, the Commonwealth wished more and more to intervene in policy areas that were constitutionally reserved to the States. The scope to do so by constitutional amendment being extremely restricted, it did so by tied grants, known in Australia as special purpose payments (SPPs). An SPP offers a grant to a State in a policy area that is constitutionally in the State's domain, but with Commonwealth conditions attached. By financial year 2002/3, SPPs constituted AUD22bn of the total AUD54bn (that is, 40 per cent) of the volume of Commonwealth grants (see Table 2).

In pursuit of its Tasmanian conception of HFE, the Grants Commission equalizes both revenue capacity and expenditure disabilities. Péloquin and Chong (2002) show (Table 3) that Australia has the most egalitarian equalization regime of any democratic federation. The column entries in Table 3 are population-weighted standard deviations of fiscal disparities measured

TABLE 2 *Commonwealth payments to State and local government, 2002–03*

	AUDm
GST payments	29 380
Budget balancing assistance	1 741
Other untied grants	755
Subtotal: untied grants	*31 876*
SPPs to States	15 827
SPPs 'through' States to other bodies (e.g., private schools)	5 491
SPPs to local government	332
Subtotal: tied grants	*21 650*
Grand total	53 526

Source: Commonwealth Government 2002a, Budget Papers 2002/03.

TABLE 3 *Overall magnitude of revenue capacity and expenditure need disparities in selected federations, population-weighted standard deviations, $US per capita at PPP*

Federation and year		Pre-equalization	Post-equalization
Australia 2000–01 (excl. local govt)	Revenue	$136	$0
	Expenditure need	$303	$0
Germany 1999 (incl. local govt)	Revenue	$463	$142
USA 1996 (incl. local govt)	Revenue	$392	$392
	Expenditure need	$482	$482
Canada, 2001–02 (incl. local govt)	Revenue	$1020	$640
Switzerland, 1999 (incl. local government)	Revenue	$1510	$1175

Source: Derived from D. Péloquin and A. Chong (2002), Table 4.1, 'A Comparison of Fiscal Disparities and Equalisation Regimes in Selected Federations' (from paper presented to Conference of Australian Economists, Adelaide, October 2002), reproduced by kind permission.

in $US per capita at purchasing power parity. The exclusion of Australian local government does not seriously degrade their data because it is small and weak.

Table 3 shows that only Australia attempts to equalize for expenditure need, although it has the smallest disparities before equalization. The next most egalitarian federation is Germany. The USA, which does not attempt to equalize, nevertheless has smaller population-weighted standard deviations than Canada, even after the Canadian equalization process.

Table 4 introduces the CGC's mode of operation. It should be read first across and then down. Row *a* shows the mean per capita amount available from GST, net of costs of collection. Row *b* is the CGC's calculation of the states' revenue disabilities. A positive sign implies a positive disability. As expected, two of the three donor states have negative signs (NSW because of a buoyant housing market and WA because of mineral wealth). The high positive disability of the ACT, a high-income area, arises because under the Constitution (s.114), the States and the Commonwealth may not tax one

TABLE 4 *Contributions of needs to grant shares, 2002–03 (all entries are AUD per capita)*

		NSW	Vic	Qld	WA	SA	Tas	ACT	NT
Per capita share of GST pool	*a*	1 848	1 848	1 848	1 848	1 848	1 848	1 848	1 848
Needs adjustments:									
Revenue	*b*	–156	69	63	–225	336	579	272	148
Expenditure	*c*	–48	–338	–69	357	29	457	340	6 320
SPPs	*d*	33	27	29	–176	–4	–10	–20	–465
Total	$e=b+c+d$	–172	–242	23	–43	361	1 026	283	6 003
Grant entitlement	$f=a+e$	1 676	1 606	1 871	1 805	2 209	2 875	2 131	7 851
Relativity	$g=f/a$	0.906	0.868	1.012	0.976	1.194	1.554	1.152	4.245

Source: Garnaut and FitzGerald (2002), Table 4.1; cf. Commonwealth Grants Commission (2001), Table 1 (2002a) and Table A-10.

another's property. As the largest employer and property-holder in ACT is the Commonwealth, the territory's payroll and property tax base is to that extent disabled.

Row *c* of Table 4 results from an extremely detailed examination of the cost of delivering public services, and the services required to enable each State citizen to enjoy public services to the level of the average of similarly placed citizens in all States. In all states the quality of public services enjoyed by remote rural dwellers is below that enjoyed by city dwellers. The comparability exercise is designed to ensure that a rural citizen of NT has comparable outcomes to a rural citizen of NSW, and an urban citizen of NT to an urban citizen of NSW. This row gives huge per capita weighting to NT, and shows significant positive disabilities in WA (remote) and Tas (small and poor).

Row *d* compensates for the effects of SPPs. A negative sign means that the State receives above average SPP payments per capita; a positive sign means that it receives below average SPP payments per capita. Row *e* is simply the sum of the three above, and it gives the net difference for each State from an EPC distribution. This generates the absolute (row *f*) and relative (row *g*) per capita payments to each State.

The outcome is not well aligned with GDP per head, but it is not designed to be. Critics object to the high net grant per head to the high income ACT. The CGC retorts that the grant reflects what actually affects the financial capacities of State governments, given the services States in general provide and the revenues they raise. GDP or household income per head do not themselves affect State budgets. SPPs are fully equalized away. This prompts a number of questions, such as: in that case why does the Commonwealth bother to make them? And why do States bother to accept them?

(MOSTLY) AUSTRALIAN CRITICISMS OF THE SYSTEM

Changes to the regime are a zero-sum game. It is fiercely criticized by people in donor states, but it continues without substantial change. The three donor States, namely NSW, Vic and WA, commissioned the Review (Garnaut and FitzGerald 2001, 2002; Dixon *et al*. 2002; Harding *et al*. 2002), whose data are used copiously in this paper. Garnaut and FitzGerald fault the system on three grounds: equity, efficiency and transparency. I group their and my own criticisms under these headings.

Equity

The primary test of equity is the vertical distribution of income. A government's policies are equitable to the extent that income per head is more equal after government intervention than before it. Therefore, in any democracy, including Australia, the primary engines of equity are the personal taxation and social security systems.

A secondary test is horizontal equity; but should that be equity among States or equity among individuals? In their Executive Summary, Garnaut and FitzGerald say baldly: '[T]he concept of equity among States has no meaning; equity must relate to outcomes for individuals and households'. In their detailed discussion they are more nuanced:

> In the early decades of the 20th century when . . . secession was considered a realistic alternative to continued membership of the Federation in some States at some times, intrinsic horizontal equity among States was probably seen as more important than it is today. Other conceptions of horizontal equity, in terms of similar treatment of individuals and households in similar circumstances wherever they live in Australia, have become relatively more important more recently. (Garnaut and FitzGerald 2002, pp. 2, 123)

Whether or not intrinsic horizontal equity among the nations and regions of the UK has meaning, or is an appropriate policy target, is considered on pp. 34–6, below.

Harding *et al*. (2002) modelled the vertical equity effects of moving from the current CGC regime either to one in which GST proceeds were distributed on an EPC basis, or to one in which they were returned to states in the proportions in which they were originally raised. Their negative results are interesting (Table 5). The data in Table 5 are for households. If calculated for individuals, the pattern is exactly similar. To derive a Gini coefficient from survey data, it is necessary to compare the income of each respondent with that of each other. A Gini coefficient of 1 denotes perfect inequality; one of 0, perfect equality (of post-transfer income, in this case). The first row of Table 5 measures the inequality of private household income, before tax and transfers. The second row measures the inequality of private household income, after adding 'Commonwealth own-purpose expenditures with personal benefits attributable to households, minus the imputed value of Commonwealth taxes paid'. The third row shows the effect of adding the 'imputed value of all SPPs delivered to and through the States and all other revenue assistance, but excluding GST-financed revenue assistance, which is allocated by the . . . CGC'. The purpose of this is to try to isolate the 'CGC effect', which appears in the fourth row.

TABLE 5 *Gini coefficients for equivalent household income measures under the current system, EPC and State of origin scenarios, 2000–01*

	Current system	Equal per capita	State of origin
Equivalent private income	0.520	0.520	0.520
Equivalent Federal income	0.297	0.297	0.297
Equivalent SPP income	0.271	0.271	0.271
Equivalent final income	0.252	0.251	0.252

Source: Adapted from Garnaut and FitzGerald 2002, Table 9.1.

Accordingly, the first three rows of table 5 are invariant. They show that personal taxation and transfers do the heavy lifting of vertical equity, and that services provided via SPPs add a modest amount more. The payload comes in the fourth row. This gives the Gini coefficients for all income sources measured in the study, namely those counted in the first three rows plus the CGC distribution of untied grant. Even though the CGC uses strong criteria of HFE, the fourth row of table 5 shows that inequality as measured by the Gini coefficient would not increase if GST revenue were distributed on either the EPC or the State of origin bases.

This is striking and counter-intuitive; how can it be? The Gini coefficient is measured across all pairs of respondents in the survey. It cannot capture the specific State effects. If, as Garnaut and FitzGerald argue, equity is wholly an interpersonal and not at all an interstate concept, this is appropriate. But this begs the question. Either of the two changes would have severe adverse consequences for the people in two small states, Tas and NT. Switching to an EPC basis, for instance (which Garnaut and FitzGerald recommend), would cost each Tasmanian about AUD 900 p.a. and each Northern Territorian about AUD 5000 p.a. The latter number is of the order of 13 per cent of GDP per head in NT. Switching to a State of origin basis would cost each Tasmanian about AUD 1500 p.a. and each Northern Territorian about AUD 5700 p.a. (Harding 2002, Fig. 3). That these dramatic numbers do not raise the overall Gini coefficient reflects the small size of these two states. The exercise shows that whether a State as such is an appropriate target of horizontal equity is a vital policy decision. If not, the CGC regime is inappropriate; if so, it may be appropriate.

Garnaut and FitzGerald also complain that the Commonwealth cannot make the States spend money on those services which have given rise to their needs assessments. It is frequently alleged that, although the NT gets huge weighting in its assessed expenditure needs for its high rural indigenous population, it spends most of its untied grant in Darwin. In the UK, Scotland, Wales and Northern Ireland will continue to be financed by untied block grant as long as they remain devolved authorities (and *a fortiori* if the UK becomes a federation). Loss of control by the centre of the subunits' spending is a necessary and intended consequence of either devolution or federalism. However, the effect of this on HFE is indeterminate. If the upper level made smaller grants to the lower level, there is no *a priori* reason to suppose that the retaining authority would spend it in either a more egalitarian or a less egalitarian way than the devolved authority.

Efficiency

A regime such as the CGC's might be economically inefficient because:

- grants which compensate for high costs of providing services in remote (or, conversely, congested) areas encourage factors of production to stay in, or move to, such areas, when it would be more efficient if they moved to, or stayed in, cheaper areas (Scott 1952);

- there are deadweight administrative costs in managing the system of fiscal transfers;
- the system encourages actors to seek rents rather than to seek efficiency;
- it may discourage efficiency-seeking agents in the States who realize that State gains from efficiency will be taxed or equalized away from them; and
- it encourages an excessively large public sector in recipient states – this last being known in the literature as the 'flypaper effect'.

Dixon *et al*. (2002, p. 1) estimate that

> A move from the present system of Commonwealth grants to an equal-per-capita basis would be likely to increase Australian welfare by between \$150 million and \$250 million a year. . . . A move to a State-of-origin basis for Commonwealth grants would generate a welfare gain of about \$280 million a year. . . . The main mechanism underlying our results is the idea that the governments of States that are heavily subsidized under the present system (the Northern Territory, Tasmania and South Australia) make spending and tax decisions that are not closely in line with the preferences of their households. This is an example of the well-known flypaper effect. . . . The evidence that the flypaper effect is at work is that the heavily subsidized States have high per capita expenditures on State government services.

However, Dixon *et al*. beg the question. They *assume* a flypaper effect, and hence input to their model is an assumption that State governments in claimant States are too large. This generates as output the proposition that savings could be made from moving to an EPC distribution. This move would force State governments to curtail their activities (severely in Tas and NT). But they do not *prove* a flypaper effect. If the size of government in the claimant States actually accords with their citizens' preferences, then the input disappears, and the result with it. There is no *a priori* reason why poor (or small) States should offer more inefficient subsidies to their people than rich (or large) States.

Dixon *et al*. both confuse different definitions of efficiency and fail to distinguish between a 'reform' and a 'design' perspective (Brennan and Pincus 2002). A reform perspective studies an existing set of arrangements; a design perspective attempts to design arrangements from the ground up. The former is appropriate to policy discussion in Australia; the latter in the UK. The existing strong protection of small States is built into the Australian constitution. Without this protection, there would have been no Federation of the form that exists at present. The definition of 'efficiency' under which Dixon *et al*.'s efficiency gains could be realized is not the standard welfare-economic definition of a Pareto improvement (maybe after compensation). Rather, it implies that Tasmanians and NT citizens would each lose welfare substantially, while Victorians and NSW citizens would in aggregate gain more than the losers would lose. It does not ask what price the losers would demand for moving to Sydney or Melbourne.

The dynamic efficiency disadvantages of the CGC regime are impossible to quantify since they depend on unmeasurable counterfactuals. Some submissions to the Garnaut–FitzGerald review (notably Court 2002; Tasman Economics 2002) complain that the regime inhibits States from promoting economic development (or, more generally, growth-friendly policies), if they rationally anticipate that the proceeds of such development will be equalized away from them. It is easier for State officials to seek rents than to seek growth. An obvious form of rent-seeking is to exaggerate one's disabilities. It is a piece of CGC lore that States never invite the Commission to visit their prosperous communities.

The point cannot be quantified but it is extremely important for institutional designers. Fundamentally, it concerns the marginal tax rates faced by subnational politicians. If the marginal tax rate is 100 per cent or higher, the arguments of Court and Tasman Economics have force. If it is below 100 per cent, then a State is in the same position as an income tax payer who faces a positive marginal tax rate greater than zero but below 100 per cent. Some but not all of the possible growth-promoting things a State may do will be done. Any State growth of this sort faces a high marginal tax rate. But that is a consequence of VFI rather than of HFE. As a State contains, at maximum, 33 per cent of Australia's population, it cannot rationally expect more than its population share of any returns from growth.

This criticism implies that the CGC regime may be too egalitarian for economic efficiency. On the revenue side, it equalizes fully for States' disabilities. Recall that these may be negative. If the effect of WA's increasing mining production (assuming, for the sake of argument, that this increase was due to the policies of the WA government) is to broaden its tax base, but this then attracts a pro rata decrease in the State's disabilities, then indeed it faces a marginal tax rate of 100 per cent.

A related issue concerns the CGC's practice of fully equalizing away the effects of SPPs (see Table 4, row *d*). Why then does the Commonwealth offer them? And why do States accept them if they come with attached conditions that may displease the State? The answers seem to involve the following:

- the five-year rolling average used by the CGC;
- time horizons;
- the political incentives facing politicians and line-department bureaucrats; and
- inadequate information.

As the CGC operates on a rolling average of five years' data, each year determining a new relativity (that is, a new value for the vector of weightings in Table 4, row *g*), there is a lag in the equalizing away of SPPs. The full five-year lag is always longer than the time to the next Commonwealth election *and* the next State election. Commonwealth elections must be at most three years apart (Constitution, s.28) and State elections may never be further than four years apart. Therefore, even if politicians understand the CGC's equalizing-away procedures, they may rationally support SPPs.

SPPs may be good for credit claiming. The same sum of money can be claimed twice, both by Commonwealth and by State politicians. As State elections cannot coincide with Commonwealth elections, the public may not detect the double counting. An SPP may also represent a coalition between the line departments of the Commonwealth and the State(s) that oversee the function in question. Both gain from earmarking the grant to their function against their respective Treasuries who may wish more flexibility.

Finally, few politicians in Australia appear to know how the CGC regime works. In Australia, as in other bicameral systems, politicians who wield vetoes over policy, especially in the Senate, can block government action unless they get a pay-off for their State. Politicians would not do this energetically if they realized that any pay-off they get by this means can be equalized away by the CGC regime over a maximum of five years. Whether as a consequence of this or not, the Australian Senate is much less of a pork-barrelling assembly than its US counterpart.

Transparency

Critics complain that the CGC regime is both data-heavy and opaque. The CGC retorts that it is utterly open about its methods, putting thousands of pages of documents on the Web and publishing over 2000 pages of hard copy data every year. But some of its data manipulation remains opaque. To assess expenditure need for every service in every State demands voluminous data from the Australian Bureau of Statistics. It also involves numerous judgement calls.

The proportion of indigenous people in the population is a powerful driver of needs assessments. It is well known that indigenous people suffer poor health, poor education and dramatically lower life expectancy than the non-indigenous population. Accordingly, all needs formulae have a heavy weighting for indigeneity. But who is indigenous? The data source is the Census, where indigeneity is self-reported. Self-reporting exaggerates the indigenous share of the population in Tas (where at 3.7 per cent it is the second-highest of any State), and depresses it in NT. The reasons for the first are unknown. The reason for the second is the difficulty of finding the entire population in remote areas, where some of them may be away from their settlements for long periods of time. But there is no realistic alternative to self-reporting. Attempts by the official peak organization of indigenous people, ATSIC, to determine authoritatively who is and who is not indigenous are currently ending in tears and the courts. So a powerful driver of need in each State is an unreliable number.

Secondly, how do you determine objectively the expenditure need for, say, schools? The school-age population in each State, the proportion of students who stay on beyond the minimum school-leaving age, and the proportion who attend private schools, are all known. Australia makes SPPs 'through' States to private schools. If a State has an above-average proportion of students who leave at the first opportunity, do you raise its grant to enable it to improve its human capital, or reduce its grant because it incurs lower costs? If a State has an above-average proportion of students in private schools, do you raise its grant because they incur higher costs per head, or reduce its grant because the State is not educating them? The CGC formulae reduce grant in the first case and raise it in the second, but in each case a good argument from equity, efficiency, or both, could be made for doing the opposite.

Finally, the not-quite-regression procedures of the CGC are opaque. Its needs factors are a mixture of demographic and other drivers. Demographic features include age, sex, prevalence of low income, of rurality, of indigeneity and of non-Anglophone families. Other features include scale economies, dispersion, wage costs (when not directly affected by government policy), and cross-border spillovers (the last relatively minor in Australia with its huge distances and small population). The CGC empirically determines the size and direction of the effects. Note that if (for example) low income reduces demand for a service, the CGC assesses that as a lowering of need for that service. This of course has the effect that if low-income Australians use a particular service least, the grants mechanism gives most money to those States with the fewest low-income citizens. The CGC's methodology – to give an example – implies that the higher the per capita income in a State, the more it 'needs' funding for its opera house.

Poverty and indigeneity increase both demand for, and per capita cost of, health and welfare services. Poverty and indigeneity are strongly correlated. The standard method of dealing with this problem in regression analysis is to enter both of the two predictors and their interaction into the model, with the intention of measuring the interaction effects as well as the direct effects. As the CGC eschews regression, it is forced to take elaborate, unreliable and awkward steps to avoid double counting (Péloquin 2002).

But why not simply use a regression model, in which the problem of interactions would be much more tractable? One objection would be that a regression model with only eight cases would be unstable. The same objection is made by those who wish to fend off alternatives to the current Barnett method of assigning block grants to the UK devolved authorities (Midwinter 2000, 2002). The CGC's own objection is different. It is that it does not wish its model to be an impenetrable 'black box'. It believes that to use a regression model would reduce its transparency. It does use regression models as a check on the outcomes of its expenditure formulae.

One problem common to the CGC regime and the English Standard Spending Assessment (SSA) regime is how to avoid perverse incentives for units to become, or remain, inefficient. If the cost of providing a service is estimated from the costs that the existing States (respectively, local authorities) have incurred in providing it, the perverse incentives are obvious. The

UK Government has called this the problem of 'regression against past spending'. The CGC is also sensitive to the issue, as it tries to weight for only those costs which governments cannot change – for example, those deriving from climate or sparsity of population. But in any regime it is difficult to segregate those drivers of costs that governments can do nothing at all about. Governments can affect even sparsity of population.

LESSONS FOR THE UK

It is widely accepted that the UK arrangements for both VFI and HFE need urgent repairs (Heald and Geaughan 1996; *New Economy* June 2000 (the whole issue); Barnett 2001; MacKay 2001; Gripaios 2002; McLean and McMillan 2003):

- Completely different regimes cover Scotland, Wales and Northern Ireland (the DAs) on the one hand and the English regions on the other.
- The Barnett formula can be expected to converge on EPC, which is inappropriate for the DAs, all of which have above-average expenditure needs.
- The Barnett regime makes incremental block grant to each DA a function of incremental expenditure in England, a number over which it has no control. Furthermore, if the current offer of elected assemblies for (some) Government Office regions of England is taken up, the starting-point for Barnett calculations, namely an 'England' spending total, erodes (Heald and Short 2002).
- Conversely, the Barnett regime allows DAs to vire (i.e. transfer spending) between capital and current spending at will, with possible consequences for HM Treasury's Golden Rule over which the Treasury has no control.
- Over the 12 standard regions of the UK, public expenditure per head has a zero statistical relationship with GDP per head, rather than the expected statistically significant inverse relationship (McLean and McMillan 2003).
- There is a particularly painful juxtaposition between Scotland and the North-East region of England. Scotland has substantially higher GDP per head but also substantially higher public expenditure per head. Lord Barnett has repeatedly called this juxtaposition 'terribly unfair' (see, for example, Barnett 2001, col. 226).

Does the CGC regime have any relevant lessons for the UK?

Features to copy

The CGC is a non-partisan agency immune from political manipulation. Although it reports to the Commonwealth Department of Finance, it is independent of both that and the Commonwealth Treasury. There are good grounds for saying that the UK arrangements for addressing VFI and HFE are too close to the centre of UK government, being integral functions of HM Treasury (for the DAs) and the Office of the Deputy Prime Minister (for

England). As financing the DAs is an intergovernmental concern, it should be a function of an intergovernmental body. A UK Territorial Grants Commission could be a non-departmental public body, not under the line management of any UK or DA department. The UK Government, the DAs, and the English regional chambers or assemblies could jointly appoint its Commissioners. Its staff could be seconded from the Treasury, ODPM, the Office for National Statistics, the DAs, universities, and other appropriate organizations (from both the public and the private sector).

To dislodge the CGC regime would require the unanimous support of all eight Australian States and Territories. A comparable body in the UK should also be constitutionally embedded as deeply as possible. If it distributes untied grant, the source of grant should be exogenous: that is, it should comprise the product of a robust tax base such as VAT, not be determined endogenously by any of the parties to the bargaining.

Features to discuss

Is equity between states an appropriate policy aim? In British terminology: should policy-makers care about equity among the four units of the United Kingdom? Should they care about equity among the 12 standard top-level statistical units (that is, the three DAs and the nine Government Office regions of England?) One powerful reason is that the people care (some of them, at least), and the people elect the UK government. Even Garnaut and FitzGerald (2002) concede that equity among States is policy-relevant when there is talk of secession. There has been talk of secession by Northern Ireland since it was created, and by Scotland since the 1960s. The greater transparency of UK fiscal federalism since devolution has meant that more people have noticed apparent inequity. Scotland has higher GDP per head than six of the English regions, and yet it also enjoys higher public spending per head than any of the six. As has been said, Joel Barnett himself has repeatedly called this 'terribly unfair': for instance, in a House of Lords debate that he initiated on his eponymous formula (Barnett 2001). The Barnett genie is out of the bottle.

Another reason, at least for a government of the (Centre-)Left, is that equity between regions may be a precondition for horizontal equity between people. It is reasonable to ask that the quality of treatment a citizen gets from a public service should not be significantly worse in one standard region than another. That is why the most egalitarian of Labour's great politicians, Aneurin Bevan, was the most bitterly opposed to devolution. Devolution is a fact. The challenge to policy-makers is therefore to placate the shade of Nye Bevan without dismantling devolution. This implies ensuring equity among the four units. In any case, even granted that horizontal equity is mostly a matter of equity between persons, it is between persons as consumers of private *and* public goods. Therefore there is a case in equity for ensuring that States or territories have a comparable capacity to provide public goods.

Although the regions of England do not (yet) have elected governments, the argument for equity among all 12 units is almost as strong as the argument for equity among 4. Both the 'popular demand' and the 'equal quality of service' arguments have some force here. This implies that it is reasonable for the UK to consider a strong HFE regime like the CGC's, which coexists with Australian federalism.

Should a UK grants commission go as far as the CGC does in equalizing away the effects of payments for special purposes? The largest special purpose payment to the UK regions and nations is agricultural support under the Common Agricultural Policy. There are good efficiency and equity grounds for equalizing that away. Other, one-off, examples include the additional support to Wales in respect of EU Objective One, and various peace-related programmes in Northern Ireland. There is a good public finance argument in favour of equalizing these away; but it would be politically unpopular. It would reignite a 25-year-old controversy between the UK government and the European Union as to whether the former annuls the regional policy of the latter by cutting its own support to the regions. If it were done, any equalizing away should be over a period of years, as it is in Australia.

Features to avoid

The CGC regime does no better, and arguably worse, than the English SSA regime in avoiding the problem of regression against past spending. Both regimes strive to condition grant on regressors whose values the beneficiaries cannot control, so as to avoid creating perverse incentives. Both have limited success.

The CGC's desire to be policy neutral takes it too far for the UK situation. In Australia, public funding of private (mostly religious) schools is embedded in the past politics of church and state there. Policy neutrality implies that the CGC can take no position on whether the States, or the Commonwealth, should subsidize private schools. Commonwealth grants to them are passed 'through' the States without stopping there. If (as is currently the case) it costs more to educate a pupil at a private than at a State school, then, *ceteris paribus*, the *fewer* pupils in a State are in its schools, the *more* it receives in grant from the CGC. This is unlikely to be acceptable in the UK, where details would in any case differ because some religious schools are fully state-funded and others are largely state-funded in the UK.

The call for a territorial grants board in the UK is gaining strength. This review has shown that the UK should not copy the CGC arrangements wholesale. It should adopt some with enthusiasm, think hard about some, and definitely reject others. The independence of the CGC is deeply embedded in the Australian constitution for reasons that go back to the creation of the Commonwealth. Although the Diceyan tradition of parliamentary sovereignty – allied to disdain for a written constitution – are both in decay in the UK, it is not certain whether UK politicians would agree to embed a non-partisan grant-making body in a place they cannot reach. But if they were to do this, the welfare of citizens of the UK would increase.

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APPENDIX

ACT	Australian Capital Territory
ATSIC	Aboriginal and Torres Strait Islander Council
EPC	equal per capita [expenditure]
CGC	Commonwealth Grants Commission
DA	devolved administration (i.e. any of Scotland, Wales or Northern Ireland)
GDP	gross domestic product
GSP	gross State product
GST	goods and services tax (=VAT)
HFE	horizontal fiscal equalization
NSW	New South Wales
NT	Northern Territory
ODPM	Office of the Deputy Prime Minister
PPP	purchasing power parity
Qld	Queensland
SA	South Australia
SPP	special purpose payments (from the Commonwealth to States)
Tas	Tasmania
VFI	vertical fiscal imbalance
Vic	Victoria
WA	Western Australia

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