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Designing Intergovernmental Grants to  
Facilitate Policy Reform

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# Designing Intergovernmental Grants to Facilitate Policy Reform

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## **Abstract**

Australia's current intergovernmental grant allocation framework fails to take a balanced approach when assessed against the criteria of efficiency, equity, transparency and accountability. Particularly compromised is the criteria of efficiency, resulting in states having little incentive to adopt policies in either their or the nation's interest. Current intergovernmental fiscal arrangements in Australia do little to ensure governments face the financial consequences of their decisions; do little to strengthen accountability; and often contradict performance standards attached to specific purpose grants. This paper proposes a holistic approach to the allocation of general purpose grants to States in the Australian federation. Central to the proposal is acknowledging the importance of the interactions general grants have with other sources of State funding (specific purpose grants and taxation) and with how those funds are expended. The benefit of the grant allocation framework proposed is how it puts control (and interest) back in intergovernmental grant allocation for the national government through its direct approach to addressing the disincentive effects of applying fiscal equalisation principles to general grant allocation. For subnational governments, its benefit is how it restores the fiscal incentive for them to embrace policy reform in the difficult areas of healthcare and taxation.

# DESIGNING INTERGOVERNMENTAL GRANTS TO FACILITATE POLICY REFORM

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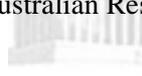
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*Keywords:* fiscal federalism, fiscal equalisation, intergovernmental grants, tax reform, state taxation, Australia

*JEL Classifications:* H2, H7

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### I INTRODUCTION

The challenge within federal systems is that the policy goals of national government are often in conflict with those of sub-national governments. For the national government, improving economic efficiency is a priority and this has become synonymous with uniformity and the need to harmonise policies across the federation. At the same time, its focus on equity has led to the funding of the federation in a way which addresses differences in revenue capacity and cost disability across sub-national governments. In most federations, what has resulted is not only a diminution of social and economic differences over time, but less tolerance for any diversity, including that arising from competition across the federation.

This trend is troubling since while uniformity can encourage free trade and labour and capital mobility both internally and internationally, it can also remove the incentive for sub-national governments to engage in innovation and experimentation. Optimally, the benefits of uniformity will be balanced against the benefits that diversity and competition bring to a federation.

This chapter makes two arguments: first, that Australia’s current grant allocation framework is in conflict with the general push for uniformity across states; and secondly, that it is possible to reform the existing grant allocation framework in a way that makes it better able to accommodate both uniformity *and* diversity within the federation. Such a framework would also have the advantage of ensuring that cooperative federalism does not remove the incentive structure for sub-national governments so necessary for positive benefits to arise from competitive federalism.

The chapter begins with an overview of the Australian federation’s performance against the criteria of efficiency, equity, accountability and transparency. It is argued that addressing these criteria need not be at the cost of diversity. Just why this is the case requires an understanding of the conceptual issues guiding intergovernmental grant structures designed to fund the fiscal imbalance (of expenditure over revenue) confronting most sub-national governments. Part II begins by detailing a hypothetical intergovernmental grant structure

capable of reconciling the potentially conflicting demands of national and sub-national governments in a federation.

Part III outlines how the complex grant model applied in Australia is essentially conflicted. It argues that, while specific purpose grants from the national government are assigned to achieve particular objectives, general purpose grants are allocated in such a way as to conflict with and undermine the objectives assigned to specific purpose grants. It is proposed that real benefits for both the Commonwealth and states would arise from rebalancing the various grant allocation criteria.

Part IV applies the proposed alternative grant allocation framework outlined in Parts II and III to the case of current healthcare grants and to the potential sharing by governments of the personal income tax base. It is found that such an approach could facilitate the Commonwealth objective of uniformity (and efficiency) as well as providing states with the incentive to build their economies. Part V reviews the issues which could arise from the implementation of the proposed reforms.

## II GRANT DESIGN AND FISCAL EQUALISATION

National governments have five basic objectives in providing grants to sub-national governments. The first is to fund services and investments<sup>1</sup> where there is a *vertical fiscal gap*: that is, a difference between the revenue raising capacity (or assessed revenue) and expenditure needs (assessed expenditure) of different levels of government. This gap arises where sub-national governments are ‘crowded out’ by the national government, as is the case often with some tax bases. In Australia, a large vertical fiscal gap exists and states fund only around half of their expenditure from own-revenue sources.

Secondly, grants can be used to reduce inequalities across jurisdictions. National governments will use grants for this purpose to ensure that all sub-national governments are able to provide a similar level of service, given a similar tax effort and efficiencies in service delivery. The principle of horizontal fiscal equalisation (‘HFE’) is designed to achieve this through redistributing fiscal resources between governments at the same level while vertical fiscal equalisation (‘VFE’) achieves it through the transfer of fiscal resources from the national to the sub-national government.

Thirdly, grants can be used to fund programs where the national government partly or wholly funds a service that is delivered by a sub-national government. This can be the case in priority areas such as healthcare and education and involves specific purpose grants being agreed through negotiations between the national and sub-national governments.

A fourth objective of grants is to avoid fiscal externalities that can arise from the misallocation of resources across sub-national governments. If taxes are low and services high, citizens will have an incentive to move location for reasons other than productivity (or economic) differences, and business activity and capital will also be misallocated between

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<sup>1</sup> See generally W E Oates, ‘Decentralization of the Public Sector: An Overview’, in Robert J Bennett (ed), *Decentralization, Local Governments, and Markets: Towards a Post-Welfare Agenda* (Oxford University Press, 1990) 43–58; Daniel Bergvall et al, ‘Intergovernmental Transfers and Decentralised Public Spending’ (2006) 5 *OECD Journal on Budgeting* 111, 126.

jurisdictions. To remove this inefficiency, either taxes on mobile bases should be assigned to the national government, or grants to sub-national governments should be designed to ensure that those governments operate at a level which is optimal nationwide.

Finally, grants can be used to address asymmetric shocks across sub-national governments that might occur as a result of their widely differing economic, social and demographic attributes. This is most evident in the case of sub-national economies heavily reliant on natural resource exports or on tourism.

Grants therefore are designed to achieve equity, efficiency and stabilisation objectives. Where complexity and confusion often arises is when grants focused on one objective come into conflict with a grant designed to achieve other objectives. As observed by Bergvall et al, 'an important cause of inefficiency in many countries is the use of the same grant for various purposes, for instance, subsidisation grants that simultaneously attempt to equalise, or financing grants that simultaneously attempt to subsidise'.<sup>2</sup>

Where the objectives of various grants become unclear as a result of their interactions, transparency and accountability, as well as efficiency and equity, are compromised. One solution would be to clarify each grant's underlying principles and objectives and to acknowledge and address how their interaction might undermine these. To better appreciate this approach, Figure 1 represents schematically a grant allocation framework based on the principle that a national government has available a 'pool' of resources to address sub-national government funding objectives and that this 'pool' is divided into general purpose grants and specific purpose grants.

While specific purpose grants<sup>3</sup> are designed to address issues such as spillovers, asymmetric shocks and national priorities, general purpose grants are most often focused on transferring a block of funds to sub-national governments based on fiscal equalisation principles. As shown in Table 1, across OECD countries general purpose grants are allocated to sub-national governments on either of two basic principles<sup>4</sup>: VFE or HFE. This gives rise to a second distinction in Figure 1.

VFE is designed to allocate general purpose grants between sub-national governments, on criteria such as disparities in expenditure needs or fiscal capacity, to achieve a national government objective, such as a minimum expenditure capability or a guaranteed average revenue capacity. In contrast, strict HFE is about having sub-national governments with higher-than-average tax capacity and lower cost structures contributing to an equalisation fund from which sub-national governments with lower-than-average tax capacity or higher cost structures can benefit.

In some federations, the focus when determining grant distribution is not on the fiscal (or combined revenue and expenditure) position of a sub-national government but only on its

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<sup>2</sup> Bergvall et al, above n 1, 112–3.

<sup>3</sup> Such grants can be earmarked, mandatory, matching and/or closed ended, often with performance (benchmarking) criteria attached and related reward/penalty arrangements.

<sup>4</sup> See generally OECD, *Working Papers 1–12* (September 2006 – March 2011) OECD Fiscal Federalism Network, OECD Centre for Tax Policy and Administration  
<[http://www.oecd.org/findDocument/0,3770,en\\_2649\\_35929024\\_1\\_119684\\_1\\_1\\_1,00.html](http://www.oecd.org/findDocument/0,3770,en_2649_35929024_1_119684_1_1_1,00.html)>.

revenue raising capacity (or more precisely, its assessed revenue). In this case, either the principles of vertical revenue equalisation ('VRE') or horizontal revenue equalisation ('HRE') could be applied. In the case when VRE principles are applied, grants are allocated to sub-national governments sufficient to ensure they have total funding equal to a minimum defined as equal to the average national per capita assessed revenue from the own-revenue sources available to the sub-national governments.<sup>5</sup>

In contrast, HRE would guide a decision to fund those below the average national per capita assessed revenue through a redistribution from those sub-national governments with above the average national per capita assessed revenue. Similarly, a particular expenditure could be funded through applying vertical cost equalisation ('VCE') principle. Here, grants ensure sub-national governments have, at a minimum, funding equal to a minimum of the national average per capita assessed expenditure, estimated by taking into account cost disabilities in delivering services. In contrast, cost equalisation geared horizontally ('HCE') would focus on those sub-national governments with below national average per capita assessed expenditure contributing to those with above national average per capita assessed expenditure.

While Figure 1 is not definitive in terms of all the possibilities, it does represent the most common approaches to national government allocation of the total grant 'pool' to sub-national governments. Two facts are clear from this Figure: first, that specific purpose grants cannot be considered in isolation from general purpose grants and, secondly, that general purpose grants can be distributed according to a multiplicity of principles. The allocation of the 'pool' between those related or unrelated to equalisation (A:B) and those which relate to vertical as distinct from horizontal equalisation (X:Y) vary widely across federations and decentralised governments. In many cases, this allocation is not immediately apparent because of the myriad grants national governments typically make available to sub-national governments. In other cases, while the approach taken is similar in principle, in practice it can be applied with varying degrees of comprehensiveness and rigor. This is most apparent in the case of grants allocated on HFE principles.

The challenge for fiscal equalisation is achieving an equitable grant allocation without compromising economic efficiency or destabilising the economic and fiscal base of the sub-national government. Key to meeting this challenge is identifying the source of any conflicts and designing equalisation grants to either address or at least acknowledge these conflicting objectives.

The efficiency compromise arising from fiscal equalisation is well understood and the source of considerable debate. As shown in Table 1, 'the amount of equalisation grants a sub-national government loses if it increases its own tax revenue varies considerably across countries; however, on average sub-national jurisdictions have to dedicate more than 70 per cent of additional tax revenue to equalisation'.<sup>6</sup> Such high rates are a significant disincentive

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<sup>5</sup> Assessed revenue is defined as revenue from a Representative Tax System (or RTS) estimated as equal to the average national tax rate applied to a sub-national government's share of the base of a particular tax: see Expert Panel on Equalization and Territorial Formula Financing, *Annex 4: Representative Tax System Simplification* (May 2006) <<http://www.eqtf-pfft.ca/english/EQTreasury/annex04-1.asp>>.

<sup>6</sup> See Hansjörg Blöchliger and Claire Charbit, 'Fiscal Equalisation' (2008) 44 *OECD Economic Studies* 1, 9 <<http://www.oecd.org/dataoecd/59/35/42506135.pdf>>.

to government effort to increase their revenue base (and therefore to growth). In fact, assuming tax capitalisation<sup>7</sup>, there is an incentive for a sub-national government to increase its tax rates, resulting in a reduction in its tax base and consequently benefiting it through a higher equalisation grants.<sup>8</sup>

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<sup>7</sup> The capital value of any asset can be defined as the present value the market will pay for the rights to the future income flow from that asset. Changes to the income from that asset can change its capital value. Tax increases (decreases) impact on that income and can therefore potentially reduce (increase) the capital value of the asset – an effect which is called tax capitalization.

<sup>8</sup> For Australia, see generally Bev Dahlby and Neil Warren, 'Fiscal Incentive Effects of the Australian Equalisation System' (2003) 79 *Economic Record* 434; for Canada, see generally Michael Smart, 'Raising Taxes through Equalization' (2007) 40 *Canadian Journal of Economics* 1188; for Germany, see generally Thiess Büttner, 'The Incentive Effect of Fiscal Equalization Transfers on Tax Policy' (2006) 90 *Journal of Public Economics* 477.

Figure 1 Grant Allocation and Fiscal Equalisation

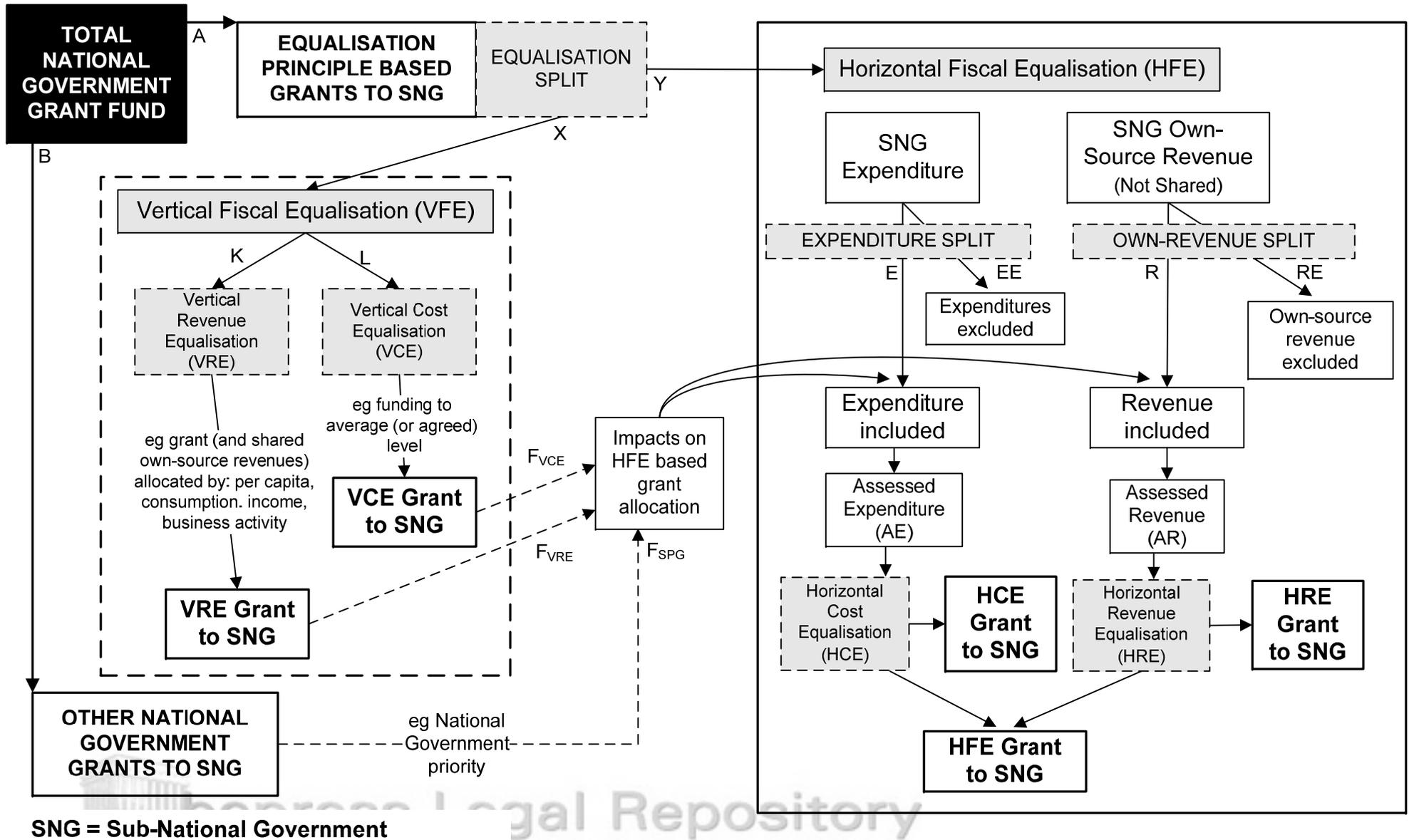


Table 1 Main features of fiscal equalisation in OECD Countries, 2004

	Cost and revenue equalisation	Subnational equalisation	Revenue equalisation				Cost equalisation		
			Direction	Revenue base	Frequency of changes to the distribution formula	Equalisation rate	Direction	Cost base	Frequency of changes to the distribution formula
<b>Federal/regional countries</b>									
Australia	Joint	Yes	Horizontal	Potential tax raising capacity, payroll, property sales, land values, mining activities	Every five years	n.a.	Horizontal	Average/Standard cost	Every five years
Austria	Separate	No	Horizontal	Tax sharing system, actual tax revenue collected	Every four years	0% for Länder above average fiscal capacity, 88% for Länder below	Vertical	Average/Standard cost, actual expenditure	Every four years
Canada	Separate	Yes	Vertical	Representative Tax System with 33 different taxes	Formerly every five years, currently more frequent	0% for provinces above average fiscal capacity, 70-100% for provinces below	Vertical	Average provincial expenditure growth	Formerly every five years, currently more frequent
Germany (2005)	Separate	Yes	Vertical	Tax sharing system, actual tax revenue collected, RTS	Less often than every five years	n.a.	Vertical	Global lump sum contributions, actual expenditures	Less often than every five years
Italy	Separate	No	Both horizontal and vertical	Representative Tax System	Less often than every five years	55% to 90%	Vertical	Actual expenditure	Less often than every five years
Mexico	Cost equalisation only	No		(No revenue equalisation)	n.a.		Vertical	Unit cost, historical expenditure	n.a.
Spain	Cost equalisation only	No		(No revenue equalisation)			Vertical	Historical expenditure	Between every two to five years
Switzerland	Separate	Yes	Both horizontal and vertical	Actual tax revenue, tax rates, household income	Less than every five years	n.a.	Vertical	Actual expenditure	Between every two to five years
<b>Unitary countries</b>									
Denmark	Separate	No	Horizontal	n.a.	Less often than every five years	85% for metropolitan municipalities, 90% for poor municipalities, 58% for others	Vertical	Average/Standard cost	Less than every five years
Finland	Separate	No	Horizontal	Representative Tax System (Personal Income Tax, Corporate Income Tax, Property Tax)	Minor changes every two to five years	40% for municipalities above 90% of average fiscal capacity, 100% for municipalities below	Vertical	Average/Standard cost, actual expenditure	Every two to five years
Greece	Separate	No	Vertical	Actual tax revenue		n.a.		(No cost equalisation)	
Japan	Cost equalisation only	No					Vertical	Average/Standard cost	Every year
Norway	Separate	No	Horizontal	Potential tax revenue (all local governments set the same tax rate)	Less often than every five years	55% for municipalities above 90% of average fiscal capacity, 90% for municipalities below	Horizontal	Average/Standard cost	Every two to five years
Poland	Separate	No	Vertical	Representative Tax System (Personal Income Tax, Corporate Income Tax, actual tax revenue)	Every two to five years	n.a.	Vertical	Per capita	n.a.
Portugal	Joint	No	Vertical	Actual tax revenue	Less often than every five years	0% for municipalities above average fiscal capacity, 100% for municipalities below	Vertical	Average/Standard cost	Less than every five years
Sweden	Separate	Yes	Horizontal	Potential tax revenue	Every two to five years	85% for municipalities above 115% of average fiscal capacity, 95% for municipalities below	Horizontal	Average/Standard cost	Every two to five years
Turkey	Revenue equalisation only	No	Vertical	Per capita	Nine changes in the last 20 years	n.a.		(No cost equalisation)	
United Kingdom (England)	only	Yes	Vertical	Actual tax revenue	Every two to five years	0-100% according to property tax brackets	Vertical	Average/Standard cost	Every year

Source: Hansjörg Blöchliger and Claire Charbit, 'Fiscal Equalisation' (2008) 44 *OECD Economic Studies* 1–22 <<http://www.oecd.org/dataoecd/59/35/42506135.pdf>> Tables 1, 3 and 4.

In the case of poor sub-national governments who are the recipient of a grant which puts a floor in their fiscal capacity (through a minimum entitlement), a development trap might arise as the marginal equalisation tax rate is 100 per cent until they pass the floor.<sup>9</sup> Fiscal equalisation can therefore widen disparities because of the asymmetric incentives. One solution is to include only some taxes in the equalisation formula (as with taxes on resources in Canada which are designed to encourage resource development in poorer (Atlantic) provinces). However, if the equalisation formula is not comprehensive, then a sub-national government could 'avoid taxes that enter the formula and select taxes that do not, resulting in a distorted sub-national tax structure. Lenient tax effort, especially if tax administration is under sub-national control, may also be a result of high equalisation rates'.<sup>10</sup> A solution to this strategic tax setting by sub-national governments is to make some grant entitlements related to policy results such as certain sectoral growth performance, rather than wealth creation. This is the case in Italy where some grants are provided for investment subject to performance in selected policy areas.<sup>11</sup>

These observations should be tempered though by the incentive a sub-national government has to grow its economy and to yield greater benefits to the state than what is lost through the equalisation tax.<sup>12</sup> Nonetheless, the benefits from (inefficient) sub-national government 'strategic behaviour' designed to maximise its grant share must be minimised when designing equalisation arrangements. Adopting comprehensive approaches to revenue and cost equalisation is important here as is adopting measures which are independent of sub-national government actions.<sup>13</sup> However, in practice a focus on having simple and transparent equalisation arrangements often results in measures which are not independent of sub-national government own tax and expenditure policies.

Disincentives can also arise when cost equalisation arrangements attempt to address unit cost and need differentials between sub-national governments. This is most often evident where there are major differences in social disabilities or delivery costs across regions. Fear of losing their equalisation grant is a disincentive to reducing their disadvantage and can result in a conflict between regional and national priorities, as well as conflict between regions who are, and those who are not addressing their disadvantage with grant funding. One approach to reducing the latter conflict is through vertical cost equalisation which involves funding only for those sub-national governments with a *below* average level of service provision given cost disabilities. This contrasts with horizontal cost equalisation which occurs when funding enables sub-national governments to achieve some average level of service provision given cost disabilities — even if in practice they opt to spend their general purpose grant

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<sup>9</sup> Christian Barette, Bernd Huber and Karl Lichtblau 'A Tax on Tax Revenue' (Working Paper No 333, CESifo, September 2000); Ross Garnaut and Vince FitzGerald, 'Issues in Commonwealth-State Funding' (2002) 35 *Australian Economic Review* 290.

<sup>10</sup> Blöchliger and Charbit, above n 6, 9.

<sup>11</sup> Frederica Busillo, 'Interaction between Regional Development Policies and Fiscal Equalisation in Italy' (Paper presented at OECD Workshop 'Fiscal Equalisation, Impact of Design on Effectiveness', Zaragoza, 1–2 June 2006).

<sup>12</sup> Martin Schneider, 'Local Fiscal Equalisation Based on Fiscal Capacity: The Case of Austria' (2002) 23 *Fiscal Studies* 105.

<sup>13</sup> See generally Blöchliger and Charbit, above n 6; Bergvall et al, above n 1, 111–58.

differently to how their share of general purpose grant is estimated. Vertical cost equalisation can therefore be more efficient and less divisive than horizontal cost equalisation when allocating grants to support sub-national expenditures. As is evident from Table 1, in most OECD countries expenditure equalisation is vertical, which contrasts with revenue equalisation which is horizontal (except in Canada).

While fiscal equalisation will reduce sub-national government inequity by reducing regional disparities, it is clearly not without its limitations. An adverse effect, not well understood, arises from the interaction between general purpose grants and the specific purpose grants (Figure 1). If specific purpose grants are treated as just another revenue source for sub-national governments, then the objective attributed to it may be undermined and even overridden by the fiscal equalisation objective attached to the general purpose grant allocation. This can have important consequences for efficiency as well as potentially worsen transparency and accountability. It can also discourage sub-national governments from undertaking change and accepting the related economic and political risk.

To better understand this issue and its possible resolution, we now turn to grant design in Australia. In particular, I look at how limiting the fiscal equalisation induced pooling of general purpose grants and specific purpose grants can assist in encouraging various tax and expenditure reforms by states in the Australian federation.

### III FISCAL EQUALISATION AND INCENTIVES

The Intergovernmental Agreement on Federal Financial Relations<sup>14</sup> is the current core funding agreement negotiated through the Council of Australian Governments ('COAG') between the Commonwealth and the states.<sup>15</sup> It makes direct reference to general purpose grants which are distributed between states based on the principle of horizontal fiscal equalisation and to specific purpose grants which arise from various National Agreements (and involve National Specific Purpose Payments ('NSPP') and National Partnership Payments ('NPP')).

In December 2010 the Productivity Commission, as part of its regular reporting requirement to COAG, catalogued all COAG agreements and initiatives between the federal and state governments, finding 325 related documents, six National Agreements, 51 National Partnerships, 230 Implementation Plans and 27 intergovernmental agreements and other initiatives.<sup>16</sup> Of the 51 National Partnerships, 24 are monitored by the COAG Reform Council and eight have reform performance reward payments attached. In 2008–09, all these

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<sup>14</sup> COAG, *Intergovernmental Agreement on Federal Financial Relations* (2008)

<[http://www.coag.gov.au/intergov\\_agreements/federal\\_financial\\_relations/docs/IGA\\_federal\\_financial\\_relations.pdf](http://www.coag.gov.au/intergov_agreements/federal_financial_relations/docs/IGA_federal_financial_relations.pdf)> 4.

<sup>15</sup> See Mary-Ann McQuestin, 'Federalism Under the Rudd and Gillard Governments', chapter # in this volume.

<sup>16</sup> See Productivity Commission, *Catalogue of COAG Reforms and Initiatives: Impacts and Benefits of COAG Reforms, Reporting Framework – Annex to the Research Report* (December 2010), 2  
<<http://www.pc.gov.au/projects/study/coag-reporting/report/annex>>.

agreements and resulting Commonwealth grants combined to contribute \$84 006 million<sup>17</sup> towards the \$173 876 million of the total expenditure by states. Of these total grants, \$41 189 million (or 49 per cent) were specific purpose grants and \$42 817 million (or 51 per cent) general purpose grants arising from the sharing amongst states of the GST revenue.

The Intergovernmental Agreement on Federal Financial Relations is explicit in its requirement that general purpose grants be allocated to ensure ‘equalisation of fiscal capacities between states and territories’.<sup>18</sup> To this end, the Commonwealth requests advice from the Commonwealth Grants Commission (‘CGC’) — a statutory authority under the *Commonwealth Grants Commission Act 1973* (Cth)<sup>19</sup> — whose primary responsibility is to advise the Commonwealth Treasurer in response to an annual Terms of Reference for an ‘Update of State Revenue Sharing Relativities’. This typically requests that the ‘Commission’s assessments should reflect the underlying principle of horizontal fiscal equalisation’.<sup>20</sup> Neither the legislation nor the Treasurer’s Terms of Reference, defines HFE. Instead, the legislation only outlines the framework in which the CGC operates, leaving it to define, in consultation with the states and Commonwealth, how it will interpret HFE as an ‘underlying principle’.

This contrasts with the legislation which forms the basis of the distribution of Commonwealth general purpose grants to local government through states: *Local Government (Financial Assistance) Act 1995* (Cth). Here, section 5 is far more prescriptive, defining precisely the actual ‘equalisation’ approach to be adopted by each state<sup>21</sup> when establishing their own State Grants Commission to advise them on the allocation of Commonwealth grants to local governments. Interestingly, the CGC disputes the methodology adopted by State Grants Commissions and as outlined in Commonwealth legislation.<sup>22</sup> However, there is a considerable difference of opinion amongst the states about the CGC’s own approach to interpreting HFE. This chapter argues that a key source of this dissent is the CGC approach to *re-pooling* all general and specific purpose grants and that *de-pooling* these grants in a way which is more balanced in approach would better address the

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<sup>17</sup> See Commonwealth, *2010–11 Australian Government Budget — Australia’s Federal Relations*, Budget Paper No 3 (2010) 20, Table 1.2. The grants to states as reported in the *2010-11 Budget* do not include the changes to the health specific purpose grant proposed at the 13 February 2011 COAG meeting.

<sup>18</sup> COAG, above n 14, 4.

<sup>19</sup> While the CGC was constituted in 1933 as an independent statutory authority, its role has changed with the passage of time. For an outline of changes since Federation, see Jim Hancock and Julie Smith, *Financing the Federation* (South Australian Centre for Economic Studies, 2001) <<http://www.adelaide.edu.au/saces/publications/reports/consultancy/FinancingtheFederation.pdf>>. The CGC also publishes its own historical document: CGC, *The Commonwealth Grants Commission: The Last 25 Years* (Commonwealth, 2008)

<[http://www.cgc.gov.au/\\_data/assets/file/0008/12995/75\\_Anniversary\\_Report\\_Website.pdf](http://www.cgc.gov.au/_data/assets/file/0008/12995/75_Anniversary_Report_Website.pdf)>.

<sup>20</sup> See, eg, the Terms of Reference from the Treasurer in CGC, *Report on State Revenue Sharing Relativities 2009 Update* (Commonwealth, 2009) vi

<[http://www.cgc.gov.au/\\_data/assets/file/0017/15560/FINAL\\_REPORT.pdf](http://www.cgc.gov.au/_data/assets/file/0017/15560/FINAL_REPORT.pdf)>.

<sup>21</sup> The Australian Capital Territory is excluded from this requirement, being a city state. For links to the seven State Grants Commissions, see Department of Local Government, Government of Western Australia, *Useful Links* <<http://dlg.wa.gov.au/Content/LG/GrantsCommission/UsefulLinks.aspx>>.

<sup>22</sup> See CGC, *Review of the Operation of the Local Government (Financial Assistance) Act 1995* (Commonwealth, 2001)

<[http://www.cgc.gov.au/publications/other\\_inquiries2/report\\_of\\_the\\_operation\\_of\\_the\\_local\\_government\\_financial\\_assistance\\_act\\_1996](http://www.cgc.gov.au/publications/other_inquiries2/report_of_the_operation_of_the_local_government_financial_assistance_act_1996)>.

grant allocation criteria of equity, efficiency, transparency and accountability. Understanding why requires an understanding of the current CGC approach.

### A *Understanding the CGC Approach*

The CGC approach to HFE is effectively based on ‘five pillars’:<sup>23</sup>

- Pillar 1 a state’s financial capacities, not its performance or outcomes;
- Pillar 2 what states collectively do (on average);
- Pillar 3 policy neutrality, or a view that a state’s own policies or choices should not directly influence its grant;
- Pillar 4 practicality; and
- Pillar 5 contemporaneity, or delivering grants most appropriate to the application year.

Historically, the Commonwealth has shown little interest in the CGC approach to equalisation, leaving it to the states, whose self-interest was relied upon to ensure the CGC achieves an outcome which was broadly acceptable to all.<sup>24</sup> However, the ‘five pillars’ approach is neither definitive nor uncontroversial. This is particularly the case where major state policy reforms are proposed. Pillar 1 is at odds with the growth of performance conditions attached to a large proportion of the specific purpose grants to states which are around half of total grants received by states.

Pillar 2 forms the basis on which differences in a state’s tax capacities and cost disabilities are assessed when determining their assessed tax and assessed expenditure. However, the principle of ‘what states do on average’ can come into direct conflict with the objectives of specific purpose grants which are determined through direct agreement between the states and the Commonwealth. At its simplest, specific purpose grants are based on ‘what individual states ought to do’ (as implied in performance and earmarking conditions). However, if specific purpose grants are treated as just another revenue source ( $F_{SPG} > 0$  in Figure 1), they will directly interact with general purpose grants and potentially conflict. Understanding this interaction is crucial to ensuring the objectives set for each type of grant is achieved (and if not why not).

In relation to the policy neutrality assumption in Pillar 3, this is only true in a policy and economic steady-state environment;<sup>25</sup> and Pillar 4, practicality, is only effective if it does not compromise the integrity of the principles being applied. In the latter case, the *2010 CGC Review’s* simplification of its methodology saw a number of taxes assumed to exhibit immaterial capacity differences across the states. This resulted in assessed revenue from these taxes being allocated between states on an equal per capita basis with a state’s share of

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<sup>23</sup> Neil Warren, ‘Intergovernmental Fiscal Arrangements as a Constraint on State Tax Reform under Henry’ in Chris Evans, Richard Kreyer and Peter Mellor (eds), *Australia’s Future Tax System: A Post-Henry Review*, (Thompson-Reuter, 2010) ch 14, 305–363.

<sup>24</sup> See various state submissions to the CGC questioning almost every aspect of its methodology in both its major and annual reviews of its approach to HFE <<http://www.cgc.gov.au>>.

<sup>25</sup> See, eg, CGC, *Report on GST Revenue Sharing Relativities — 2010 Review* (Commonwealth, 2010) 34; for in detail discussion of the CGC methodology, see especially Neil Warren, ‘Tax Devolution and Intergovernmental Transfer Policy Options in a Budgetary Crisis: UK Lessons from Australia’ (2010) 8 *eJournal of Taxation Research* 215–255.

assessed revenue being equal to its share of the national population. The result was that 43 per cent of all state own-source revenue<sup>26</sup> was excluded from the equalisation process, having no implications for general purpose grant allocation amongst the states. The implied tradeoff between practicality and integrity could obviously be an important issue for some States.

Pillar 5, contemporaneity, is only achievable when the economy is cyclically stable and structurally unchanging.<sup>27</sup> Since grant entitlements estimated for the current year are derived from data for the most recent three years for which it is available,<sup>28</sup> precise equalisation will not be achieved in the year in which it is applied. The result is that general purpose grant allocation can be pro-cyclical and potentially destabilising for state budgets.

For this study, of particular importance is the treatment of NSPPs and NPPs. Essentially, any payment which has an influence on a state's fiscal capacity will be treated by the CGC as providing budget support to a state and therefore as impacting on general purpose grant entitlements.<sup>29</sup> With most Commonwealth specific purpose grants to states assumed to influence a state's fiscal capacity, they are therefore assumed to impact general purpose grant entitlements. If all specific purpose grants were allocated on an equal per capita basis, this might not be an issue.<sup>30</sup> In fact, NSPPs are actually allocated to states 'on the basis of their population share' in six broad categories (healthcare, schools, skills and workforce development, disabilities services, affordable housing, and Indigenous reforms).<sup>31</sup> With NSPPs allocated by the CGC on an actual per capita basis, these grants will not impact general grant entitlements. However, NPPs are not allocated to states on an equal per capita basis and therefore this methodology will see NPPs impact entitlements. This is despite NPPs being provided to states 'to support the delivery of specified outputs or projects, to facilitate reforms or to reward those jurisdictions that deliver on nationally significant reforms'.<sup>32</sup>

As the CGC has acknowledged: 'This treatment of SPPs effectively means that the fiscal equalisation objective has primacy over other objectives of government. Over time, this issue has been raised with successive Commonwealth Governments, with no change to the existing approach.'<sup>33</sup>

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<sup>26</sup> Ibid.

<sup>27</sup> See John Spasojevic, 'Fiscal Equalisation in Australia: Some Technical Issues', in Junghun Kim and Jorgen Lotz (eds), *Measuring Local Government Expenditure Needs (The Copenhagen Workshop 2007)*, (Korea Institute of Public Finance and Danish Ministry of Social Welfare, 2008) 270–292. <[http://www.sm.dk/data/Lists/Publikationer/Attachments/311/Measuring\\_LocalGov\\_Expen\\_WEB%20\(2\)%20171008%20pdf.pdf](http://www.sm.dk/data/Lists/Publikationer/Attachments/311/Measuring_LocalGov_Expen_WEB%20(2)%20171008%20pdf.pdf)>.

<sup>28</sup> For example, the 2011–12 relativities relate to the average of relativities estimated for 2007–08, 2008–09 and 2009–10.

<sup>29</sup> See CGC, 'New Issues for the 2011 Update' (Staff Discussion Paper CGC 2010-02-S, July 2010) 7, Figure A-1 <[http://www.cgc.gov.au/\\_data/assets/pdf\\_file/0003/18984/2011\\_Update\\_2010-02-S\\_New\\_issues\\_for\\_the\\_2011\\_Update.pdf](http://www.cgc.gov.au/_data/assets/pdf_file/0003/18984/2011_Update_2010-02-S_New_issues_for_the_2011_Update.pdf)>.

<sup>30</sup> This will be discussed further in Part III and demonstrated in Table 3.

<sup>31</sup> COAG, above n 14, [D26].

<sup>32</sup> Ibid [D29]; see also Ministerial Council for Federal Financial Relations, *Schedule D — Payment Arrangements* (25 March 2009) <[http://www.federalfinancialrelations.gov.au/content/intergovernmental\\_agreements.aspx](http://www.federalfinancialrelations.gov.au/content/intergovernmental_agreements.aspx)>.

<sup>33</sup> Alan Morris, 'The Commonwealth Grants Commission and Horizontal Fiscal Equalisation' (2002) 35 *Australian Economic Review* 318, 322–3.

The CGC approach to the treatment of NSPP–NPPs clearly calls into question the merits of having complex arrangements underpinning the distribution of these payments to states. If the objective is to achieve certain performance criteria, then this could be achieved through general purpose grants and related performance conditions. In practice, specific purpose grants have the attraction of attaching relevance and meaning to the national government performance criteria — but this should not require a complex allocation framework. It is probably for this reason that NSPPs are formally allocated on an equal per capita basis — but it does raise the issue as to why NPPs are not also allocated on a similar basis.

### B CGC Induced ‘Re-Pooling’

The CGC is clearly aware<sup>34</sup> that by offsetting Commonwealth specific purpose grants received by each state against that state’s ‘Total Requirement for Financial Assistance’, its methodology effectively undoes the intended specific purpose grant distribution arising from any special negotiations between the Commonwealth and the states. In effect, what the CGC does is add back (or *re-pool*) specific purpose grants into the general purpose grant ‘pool’. As a general rule, only quarantining a specific purpose grant and related expenditure will maintain the original distribution of the specific purpose grant. The CGC recognised this outcome when it asserted that:

To whatever extent our stakeholders believe other objectives should prevail, the remedy is simple. All that is required is that the terms of reference given to the Commission instruct it to treat particular SPPs — or indeed all SPPs — in some other way. Judgements about the priorities to be accorded to different national objectives is for governments, not the Commission.<sup>35</sup>

An alternative to quarantining would be to require the CGC to replace its input-focused approach to specific purpose grants (‘what is’) with a focus on outcomes/outputs performance conditions (or ‘what ought to be’). In the latter case, states would be indirectly forced to match specific purpose grants so as to achieve national government specified outcomes/outputs and benefit from any reward regimes (or not be impacted adversely by penalties for non-performance). For example, in the case of a healthcare grant, this would force actual and assessed sub-national government healthcare expenditure to become aligned since ‘what sub-national governments do’ would become ‘what sub-national governments ought to do’ according to their agreement with the national government. However, if states were to opt to fund healthcare at levels above ‘what ought to be’, then the general purpose grant allocation methodology based on ‘what is’ could not align with ‘what ought to be’ and would act to redistribute the healthcare specific purpose grants. In practice, the simplest and least controversial approach is to quarantine the healthcare specific purpose grant from the HFE principles-based allocation of general-purpose grants (as when  $F_{VCE}=0$  and  $F_{SPG}=0$  in Figure 1).

<sup>34</sup> Ibid.

<sup>35</sup> Ibid.

## IV DE-POOLING TO FACILITATE STATE POLICY REFORM

The effective pooling of specific purpose grants and general purpose grants through the CGC methodology means the fiscal equalisation principles are applied to the total grant ‘pool’ in Australia (except to the extent that some specific purpose grants are quarantined). The equitable allocation of the ‘pool’ of all grants therefore takes precedence over issues such as efficiency, revenue stability, regional asymmetric shocks, accountability, transparency and the particular objectives of specific purpose grants. As noted earlier, the Commonwealth has historically shown only marginal interest in the methodology and left the CGC to define its own approach to fiscal equalisation.<sup>36</sup> However, when announcing its *Review of GST Distribution* on 30 March 2011, Prime Minister Gillard acknowledged what had been long argued by states, that instead of ‘states facing penalties for economic growth and rewards for economic underperformance, the GST distribution process should encourage economic reform and better delivery of services, and provide states with certainty.’<sup>37</sup> She also expressed the hope that the review ‘will lead to a simpler, fairer, more predictable and more efficient distribution of the GST to states and territories.’<sup>38</sup>

The all-important question which will no doubt confront the *Review* is how to achieve cooperative federalism in a way which does not hinder competitive federalism. In effect, how to ensure states have the incentive to reform their economies (and address inefficiencies) while distributing general purpose grants in a way which addresses state disabilities (or inequities).

This Part examines an alternative to the current grant allocation model which meets these objectives. First, the approach proposed builds on the observation in Part III that when the CGC applies equalisation principles to the allocation of general purpose grants, it effectively ‘re-pools’ all general purpose and specific purpose grants. If this ‘re-pooling’ is not acceptable or intended, then there is merit in ‘de-pooling’ (or reallocating) the effectively ‘re-pooled’ grants.

Secondly, the grant model proposed will ‘de-pool’ the ‘re-pooled’ grants according to the principles outlined in Figure 1 but where VFE and SPG grants are excluded when determining HFE based general grant allocation (by assuming  $F_{SPG}$ ,  $F_{VCE}$ ,  $F_{VRE} = 0$  and related expenditure (EE) is excluded). The advantage of this approach is that it is conceptually similar to the most recent healthcare proposal by the Commonwealth to COAG (on 13 February 2011) but complements it with an approach which maintains the original intent of the healthcare specific purpose grant allocation and matching state funding. With this would come greater transparency and accountability.

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<sup>36</sup>This is evident both through its unwillingness to use its TOR to the CGC to assert its position and through its unquestioning acceptance of the CGC advice. It is also evident through the CGC’s confidence in releasing media statements with its advice to the Government outlining what this will mean for different states when all that is required of the CGC is the eight per capita relativities — leaving the government to report what this will mean for individual states.

<sup>37</sup> Wayne Swan and Julia Gillard, ‘Review of GST Distribution’ (Joint Media Release, No 28, 30 March 2011) <<http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/028.htm&pageID=003&min=wms&Year=&DocType=>>.

<sup>38</sup> Ibid.

More generally, in the model proposed in Figure 1, the grant ‘pool’ can be ‘de-pooled’ into five separate grant ‘pools’:

1. Vertical cost equalisation principles could be applied to shared (national government/sub-national government) spending responsibilities (for example, healthcare and education) with an allocation of grants applied assuming VCE grants are excluded ( $F_{VCE}=0$ ) along with related expenditure (EE), resulting in grants being assessed against output/outcome (‘what ought to be’) rather than inputs (‘what is’);
2. Vertical revenue equalisation principles could be applied to shared revenue and shared tax bases to encourage efficient state tax design (‘what ought to be’) while assuming VRE grants are excluded ( $F_{VRE}=0$ ) along with related expenditure (EE);
3. National government priorities should determine specific purpose grant allocation with SPG grants excluded ( $F_{SPG}=0$ ) along with related expenditure (EE);
4. Horizontal fiscal equalisation should guide the allocation (given 1-3 above) to fund any *residual* fiscal imbalance for states where attention is on inputs (‘what is’);
5. Vertical fiscal equalisation determining allocations (given 1-3 above) to fund any *residual* fiscal imbalance for states where attention is on inputs (‘what is’).

In the remainder of this Part, two policy reforms will be examined for how they might be better facilitated as a result of adopting the above approach to ‘de-pooling’ the current CGC ‘re-pooling’ of Commonwealth grants to states.

#### A *Applying Outcome-Based VCE to Healthcare Funding*

VCE is the most common approach across OECD countries for allocating national government grants to fund sub-national government expenditure. This approach will not be that dissimilar from that proposed by the Commonwealth to the states on 13 February 2011 where the specific purpose grant ‘pool’ for healthcare would be defined as including all healthcare funding whether from specific purpose grants, general purpose grants or state own-revenue.<sup>39</sup> Under the proposed new model, this ‘Healthcare Pool’ is to be distributed to hospitals on the basis of an agreed volume of activity and an efficient price. If a state’s cost of delivery is below the efficient price, the state can retain the savings. If it is above, they can either increase their funding of healthcare from own-sources or provide less service. An incentive therefore exists to deliver services at the efficient price. Equally, a state could choose to increase the volume of services above some agreed level but this would be at their direct expense, although if they could supply services efficiently at below the national efficient price, more services could be provided for the same overall level of healthcare funding.

Broadly, there is reason to expect that such a new funding model should result in an alignment of assessed and actual healthcare expenditure since ‘what states ought to do’ is ‘what states do’. However, if individual states opt to deliver services above agreed activity

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<sup>39</sup> See COAG, *Heads of Agreement — National Health Reform* (13 February 2011) <[http://www.coag.gov.au/coag\\_meeting\\_outcomes/2011-02-13/docs/communique\\_attachmentA-heads\\_of\\_agreement-national\\_health\\_reform.pdf](http://www.coag.gov.au/coag_meeting_outcomes/2011-02-13/docs/communique_attachmentA-heads_of_agreement-national_health_reform.pdf)>.

levels and/or at efficiency levels different from that agreed, then divergence could occur between CGC assessed and actual healthcare expenditure.

Overcoming any inefficiencies, inequities or complexities arising from applying CGC HFE methodology to the proposed healthcare grant allocation model could be achieved through quarantining only the 'Healthcare Pool' ( $F_{SPG}=0$ ) and excluding related expenditure (EE in Figure 1). This way the CGC methodology will not undo the original intent of the proposed COAG healthcare agreement due to 'what ought to be' being different from 'what is' (Pillar 2). This also has the added benefit of retaining the focus evident in the COAG agreement on outcomes and outputs (through performance requirements) rather than the CGC approach where the focus is on expenditure (costs and needs) and therefore inputs.

Quarantining would also need to extend to any rewards or penalties relating to performance. Failure to do so would work to remove any desired behavioural response by individual states (which explains why current performance payments under current healthcare NPPs are quarantined). The VCE-based approach to healthcare has another advantage — addressing an ongoing criticism of the CGC's equalisation methodology that Pillar 2 rewards disability, doing nothing to encourage states to reduce it — an accusation most commonly made of states with large Indigenous populations.<sup>40</sup> If VCE grants fund 'what states ought to do' rather than 'what states do on average', and have attached performance conditions, then quarantining these grants from consideration when allocating general purpose grants ensures the objective set for the specific purpose grants is uncompromised.

In the *2010–11 Australian Government Budget*, the Commonwealth acknowledged the limitations of equalisation when it stated that '[h]orizontal fiscal equalisation does not guarantee that the states will provide a uniform standard of service — its aim is to equalise the capacity of each state to do so, while leaving each state free to determine the standard of service provision'.<sup>41</sup> If this means that the approach to fiscal equalisation as applied by the CGC compromises the Australian Government objective for a specific purpose grant, then, as I have observed elsewhere, this will:

- (1) frustrate attempts by the Commonwealth to achieve national standards ('what states ought to do') in areas where states deliver public services (as with healthcare, education and Indigenous housing);
- (2) work against reward/penalty arrangements linked to NPPs;<sup>42</sup>
- (3) not reflect that state preferences as to 'what states do' can vary widely; and

<sup>40</sup> For comments on NT policy on Indigenous housing expenditure, see Government of NSW, *Architecture of Horizontal Fiscal Equalisation: Principles and Interpretation* (June 2006) CGC <[http://www.cgc.gov.au/data/assets/pdf\\_file/0020/5870/NSW\\_Submission\\_on\\_HFE.pdf](http://www.cgc.gov.au/data/assets/pdf_file/0020/5870/NSW_Submission_on_HFE.pdf)>; Department of Treasury and Finance, Government of Victoria, *Submission on Architecture of HFE and Contemporaneity to the Commonwealth Grants Commission as Part of the 2010 Review* (June 2006) CGC <[http://www.cgc.gov.au/data/assets/pdf\\_file/0003/5889/VIC\\_Submission\\_on\\_HFE.pdf](http://www.cgc.gov.au/data/assets/pdf_file/0003/5889/VIC_Submission_on_HFE.pdf)>.

<sup>41</sup> Commonwealth, above n 16, 7.

<sup>42</sup> The CGC methodology is best suited to a steady-state evaluation and not well suited to periods of major reform because the fiscal equalisation mechanism can work against change and only with direct Commonwealth involvement (through changing the CGC Terms of Reference and supplemental funding for states) can these limitations of fiscal equalisation be overcome: see Warren, above n 23.

(4) create disincentives for individual states to undertake major efficiency-improving reforms<sup>43</sup> (as the CGC HFE approach to grant allocation is not independent of actual state policies, being based on ‘what states do’).

It is to (4) and its implication in the case of major state tax reform that we now turn.

### B *VRE and Income Tax Base Sharing*

Despite Australian states having the power to impose taxes on income, such taxes have not been imposed since the Commonwealth introduced the uniform income tax legislation in 1942 as a war measure. Post-war, states proposed reintroducing such taxes but have been threatened with the loss of their grants on a dollar-for-dollar basis equal to any tax revenue raised. Despite states being given the opportunity to impose surcharges on the Commonwealth personal income tax in the late 1970s and 1980s, this did not occur because the Commonwealth was not prepared to ‘make room’ for the states.

In the recent Henry Review,<sup>44</sup> support was given for states sharing the personal income tax base with the Commonwealth on the condition that the Commonwealth ‘make room’ (in preference to sharing the revenue from the Commonwealth personal income tax). However, the application of HFE principles by the CGC to the allocation of the general purpose grant (or GST revenue) to states removes any incentive the latter might have to countenance such a proposal.<sup>45</sup> In fact, there is no incentive for states to embark individually or collectively on such a tax reform due to the marginal equalisation rate being excessively high.<sup>46</sup> In response, I have proposed five options to remove this HFE ‘trip’ to economically efficient state tax reforms:

- (1) Quarantine additional revenue from selected State tax reforms;
- (2) Quarantine any Australian government tax reform incentive grants;
- (3) Limit CGC redistribution of any agreed fiscal dividend through backcasting;
- (4) Institutionalise compensation; and
- (5) Adopt a flexible Pillar 2 through a partial move to ‘what states ought to do’ rather than ‘what states do’ on taxation.<sup>47</sup>

It is step (5) that the United Kingdom government is soon to introduce as part of its recently revised funding arrangements with Scotland. Here, 10 percentage points of both the UK Personal Income Tax basic and higher marginal tax rates on the Scots is assigned as a grant to Scotland, whether or not Scotland decides to set that rate above or below the 10 percentage points.<sup>48</sup> In effect, this is an application of VRE principles with the ‘average’ imputed with

<sup>43</sup> See CGC, above n 18; Warren, above n 23.

<sup>44</sup> Commonwealth of Australia, *Australia’s Future Tax System – Final Report: Part 2* (Commonwealth, 2010) vol 2, 675 (‘Henry Review’)  
<[http://www.taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs\\_reports.htm](http://www.taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm)>.

<sup>45</sup> See Warren, above n 23.

<sup>46</sup> This position is restated by Victoria in a recent submission to the Commonwealth: Department of Treasury and Finance, Government of Victoria, *Victoria’s Response to the CGC 2011 Update of GST Relativities* (2011) <[http://www.dtf.vic.gov.au/CA25713E0002EF43/WebObj/ResponsetoCGCGST2011/\\$File/ResponsetoCGCGST2011.pdf](http://www.dtf.vic.gov.au/CA25713E0002EF43/WebObj/ResponsetoCGCGST2011/$File/ResponsetoCGCGST2011.pdf)>.

<sup>47</sup> See Warren, above n 23.

<sup>48</sup> See Warren, above n 25.

the above (or below) actual ‘average’ rate effectively being ignored to the benefit (or cost) of Scotland in the above case. In Canada, VRE is applied through a province’s per capita equalisation entitlement being equal to the amount by which their fiscal capacity is below the average fiscal capacity of all provinces — known as the ‘10 province standard’. Those provinces with above average fiscal capacity receive no equalisation entitlement.<sup>49</sup>

At present in Australia, states with a tax capacity (or tax base) below the per capita national average receive transfers from states with an average per capita above the national average. States are therefore assumed to impose the tax at the national average tax rate. If a state increases its rate above the average, the CGC assumes in Pillar 3 that it will benefit wholly from any revenue above the average. In practice, however, Pillar 3 is not independent of ‘what states do’. While small changes in rates will only marginally impact grant entitlements, this is not so with substantial rate increases or major tax reforms.

If, instead, an approach was taken which operated on the VRE principle with the average set at ‘what ought to be’, then a state would have no reason not to impose the minimum and every reason to increase their rate above the average — since this would not be subject to equalisation. This is because the actual average (or ‘what is’) is no longer relevant to determining the equalisation grants. In Canada, such an arrangement effectively applies to natural resource revenues. Provinces receive a grant equal to the greater of either the amount they would otherwise receive by fully excluding natural resource revenues, or by excluding 50 per cent of natural resource revenues. This adjustment to equalisation ensures that provinces receiving revenue from natural resources receive a net fiscal benefit from their resources equivalent to half the per capita resource revenues of the receiving provinces.<sup>50</sup> This is a conceptual approach similar to that which Western Australia has long argued for to the CGC in relation to its resource royalties revenue.

With VRE, each state has a clear incentive both to grow its economy (due to a potentially zero marginal equalisation tax rate) and to impose rates greater than ‘what ought to be’. States would then have real and significant discretionary fiscal powers through their access to substantial revenue sources (such as through access to a broad based personal income tax). A significant benefit also would be the attention such an approach would give to the benefits of reform and the scope to reduce vertical fiscal gap while minimising the inefficiencies arising from the redistributive effects of addressing horizontal fiscal gap.

However, if this new substantial tax and related VRE grant pool was treated as just another revenue source when determining any general purpose grant shares using HFE principles, then this could undo any incentives for states to adopt major tax reforms. For this reason, the VRE grant pool and related tax would need to be quarantined ( $F_{VRE} = 0$  and related expenditure excluded (through EE) in Figure 1) when determining any general grant allocation.

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<sup>49</sup> See Department of Finance, Government of Canada, *Equalization Program* (15 February 2010) <<http://www.fin.gc.ca/fedprov/eqp-eng.asp>>; Expert Panel on Equalization and Territorial Formula Financing, above n 5.

<sup>50</sup> Ibid.

## V PROGRESSING CHANGE

'De-pooling' the CGC 're-pooled' Commonwealth grants and allocating them according to various differing principles (and quarantining where appropriate), has the virtue of simplicity and transparency which, combined, does much to ensure accountability. The attributes of equity and efficiency can also be achieved through ensuring the five grant 'pools' are designed around well-defined objectives and monitored through outcome/output performance conditions.

A particular strength of the proposed intergovernmental grant allocation framework (in Figure 1) is the incentive it offers for constructive (as distinct from destructive) competitive federalism. For example, using VRE or VCE principles and quarantining such grants can, as noted, ensure maintenance of the original objective of the grant as well as reduce marginal equalisation rates (potentially to zero), so enabling states to be rewarded for taking on the political risk associated with major policy reform.

However, such changes to grant allocation might not be enough.<sup>51</sup> An important complement is cooperative federalism where the Commonwealth is prepared to share the benefits it gains (through personal and income taxes) with those states implementing reforms in the national interest.

Implementing the proposed new grant allocation framework could involve little more than a series of independently negotiated agreements — much like that recently proposed in relation to healthcare. Complexity would be minimal as a result of quarantining each grant arrangement from other intergovernmental fiscal arrangements, thus reducing interaction between grants in different policy areas and the potential for unintended efficiency and equity consequences.

If history is any lesson, introducing the arrangements proposed in Parts II and III could confront political resistance across the states. However, the inertia against change can be overstated. When the Commonwealth Treasury provided its incoming government briefs to the Gillard Labor government in September 2010, it stated that '[t]he fiscal equalisation process does not promote reform'.<sup>52</sup> On 9 February 2011, the House of Representatives Joint Committee of Public Accounts and Audit announced an *Inquiry into National Funding Agreements* and in June 2011. Further, on 1 July 2011 a Senate Select Committee on the *Reform of the Australian Federation* reported on key issues and priorities for the reform of relations between the three levels of government within the Australian federation, including financial relations.<sup>53</sup>

States, too, are increasingly questioning current intergovernmental fiscal arrangements. On 24 March 2011, the Victorian Treasurer made a direct appeal to the Federal Treasurer for changes to current arrangements, arguing that '[w]e see the dramatic cuts to Victoria's GST revenue outlined in the 2011 update as undermining the credibility of the HFE principle and

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<sup>51</sup> See Warren, above n 23.

<sup>52</sup> Department of Treasury, Commonwealth, *Treasury Incoming Government Brief – Part 1 Overview* (24 September 2010) 21 <[http://www.treasury.gov.au/documents/1875/PDF/01\\_Overview.pdf](http://www.treasury.gov.au/documents/1875/PDF/01_Overview.pdf)>.

<sup>53</sup> Australian Senate, *Select Committee on the Reform of the Australian Federation* (2011) Parliament of Australia <[http://www.aph.gov.au/Senate/committee/reffed\\_ctte/reffed/index.htm](http://www.aph.gov.au/Senate/committee/reffed_ctte/reffed/index.htm)>.

its practical application through the CGC formula'. In support of their case, the Victorian Treasury prepared a report which argues, amongst other things, that 'states that provide services more efficiently and have a more efficient taxation regime may end up being penalised through the CGC assessment process'.<sup>54</sup> Western Australia also contests the current grant arrangements, asserting that it should be guaranteed a minimum 75 per cent of the average per capita GST collected in Australia, rather than the 71.7 per cent to be received in 2011–12 and 68.3 per cent received in 2010–11.

On 30 March 2011, the Commonwealth responded by announcing a *Review of GST Distribution*<sup>55</sup> with a preliminary report due in February 2012 and the final report in September 2012. Clearly, current intergovernmental financial arrangements are under challenge.

What this chapter has sought to demonstrate is that Australia's current intergovernmental grant allocation framework does fail to take a balanced approach when assessed against the criteria of efficiency, equity, transparency and accountability. Particularly compromised is the criteria of efficiency, resulting in states having little incentive to adopt policies in either their or the nation's interest. Current arrangements also do little to ensure governments face the financial consequences of their decisions; do little to strengthen accountability; and often contradict performance standards attached to specific purpose grants. Most importantly, the key benefit of the design proposed in this chapter is how it puts control (and interest) back in intergovernmental grants for the Commonwealth (by removing the effective veto by the CGC) while also restoring incentives for the states to reform the difficult policy areas of healthcare and taxation.

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<sup>54</sup> Department of Treasury and Finance, Government of Victoria, above n 46; Ted Baillieu, 'Commonwealth Slashes Victoria's GST Share — Victoria to Oppose Federal Cuts' (Media Release, 25 February 2011) <<http://premier.vic.gov.au/wp-content/uploads/2011/02/110225-Baillieu-Commonwealth-slashes-Victorias-GST-share-Victoria-to-oppose-federal-cuts-PDF-36KB.pdf>>.

<sup>55</sup> Swan and Gillard, above n 39.