

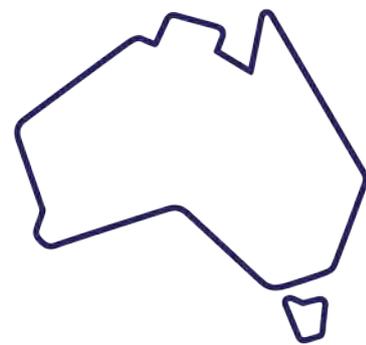


Australian Government
Department of the Prime Minister and Cabinet



Reform of the Federation

WHITE PAPER



COAG and Federal Financial Relations

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GETTING INVOLVED AND HAVING YOUR SAY

The Commonwealth Government would like as many people as possible to be thinking about how our federal system of government can be improved.

A Green Paper setting out options for reform will be published in the second half of 2015, ahead of the publication of the White Paper in 2016.

The Green Paper will allow the public to make written submissions on the proposals put forward.

For more information please visit the website www.federation.dpmc.gov.au.

INTRODUCTION

On 10 October 2014, the Council of Australian Governments (COAG):

... acknowledged the importance of the federal system to Australia's success as a nation. It supported a collegial approach to reviewing current arrangements with a view to reducing overlap and duplication in roles and responsibilities between governments and working together better in areas of shared responsibilities. COAG agreed that clearer lines of reporting and accountability to the public should result in better education, health and other social and economic outcomes for Australians and more efficient and lower cost service delivery ... whilst this could involve significant reform in some areas, it would ensure taxpayer funds are better targeted and they deliver better results for the Australian people.¹

For over a century Australia's Federation has worked well and delivered stability and economic prosperity. However, a significant proportion of Australians do not believe our current system of government works well. Increasing overlap between the roles and responsibilities of all levels of government over recent decades has undermined the efficiency and effectiveness of our Federation.² Hence, the Prime Minister and the Premiers and Chief Ministers have agreed that the Reform of the Federation White Paper should focus firmly on clarifying roles and responsibilities between different spheres of government and the need for all levels of government to coordinate action to ensure the best possible results for citizens.

Any reform in this area has to lead to an improvement in how governments perform for their citizens. A reallocation of roles and responsibilities that is no more than a bureaucratic tidy-up will be a waste of time, effort and resources. Reform of the Federation must deliver concrete improvements in the way services are delivered.

This issues paper examines two aspects of Australia's intergovernmental structure that are the essential building blocks of a Federation that delivers for citizens: the institutional framework in which intergovernmental relations are conducted; and the federal fiscal system supporting it.

In seeking to examine the effectiveness of current intergovernmental arrangements, it is important to first understand the constitutional context around intergovernmental relations. Section 51 of the Constitution gives the Commonwealth Parliament a specific and limited list of legislative powers. With a few exceptions (such as customs and defence), the Constitution does not limit the State's ability to make laws in any areas; however, section 109 makes it clear that the Commonwealth's laws (under section 51) will prevail over State laws in those areas to the extent there is any inconsistency between them. Further, section 96 allows the Commonwealth to provide financial assistance to the States on terms and conditions it thinks fit.³

The Constitution is almost completely silent on the formal mechanisms by which Commonwealth and State interaction might be facilitated.⁴ There was nothing formal set up that

¹ Council of Australian Governments, COAG Communique, 10 October 2014, <<https://www.coag.gov.au/node/521>>.

² A Brown, *Australian Constitutional Values Survey*, Griffith University, 2014.

³ The Constitution also makes provision, through section 94, for any surplus revenue of the Commonwealth to be distributed to the States. Section 94 was rendered largely ineffective by the High Court in *New South Wales v Commonwealth* (1908) 7 CLR 179.

⁴ P Kildea & A Lynch, 'Entrenching 'Cooperative Federalism': Is it time to formalise COAG's place in the Australian Federation?', *Federal Law Review*, vol. 39, no. 103, 2011, pp. 2-8.

brought the Commonwealth and the States together regularly to discuss matters of mutual interest and to thrash out agreements on how they would interact and cooperate on particular issues.⁵ It simply was not regarded as necessary.⁶

Since then, the world has changed, the Commonwealth has greatly expanded its role, and collaboration on issues has become more important.

To ensure Australia is able to adapt to changing economic and social conditions so as to deliver better public services and a more productive and competitive economy, the Commonwealth and States and Territories have made various attempts to establish an institutional architecture and policy framework for cooperation. For example, two Special Premiers' Conferences were convened in 1990-91 to discuss the relationship between the Commonwealth and the States and Territories. Topics included the duplication of services across governments, the tax system and the extent of Commonwealth conditions on funding transfers to States and Territories.

In May 1992, the Commonwealth and State and Territory governments agreed to establish COAG as the peak intergovernmental forum in Australia. It met for the first time in November that year. The current members of COAG include the Prime Minister, State and Territory Premiers and Chief Ministers, and the President of the Australian Local Government Association (ALGA).⁷

Since its establishment, COAG has promoted policy reforms of national significance requiring co-ordinated action by all governments. Arguably the most significant of these was the introduction in the 1990s of the National Competition Policy. This was recognised as being so important for the nation that support for it survived changes of political leadership at both levels of government.

COAG has also enabled cooperation in a number of important areas. Through COAG, the Commonwealth and States and Territories have reached agreement to progress joint reforms in key policy areas such as the Goods and Services Tax (GST), counter-terrorism, Seamless National Economy and the National Disability Insurance Scheme. The 1999 Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations enabled the full distribution of revenue raised through the GST to the States and Territories, in return for the abolition of some inefficient State and Territory taxes. It also enabled the replacement of previous financial assistance grants and provided growth revenues to better meet spending needs.

In 2008, COAG agreed to the Intergovernmental Agreement on Federal Financial Relations (IGAFFR). The purpose of the IGAFFR was to improve the quality and effectiveness of government services by reducing Commonwealth prescriptions on service delivery by the States and Territories, providing them with increased flexibility in the way they deliver services.

⁵ The framers did nevertheless include the establishment of a body called the Interstate Commission (now defunct, with residual functions resting with the Productivity Commission since 1989), with a remit to adjudicate disputes between States about cross-border trade and commerce.

⁶ M Keating & J Wanna, 'Remaking Federalism?' in *Institutions on the Edge? Capacity for Governance*, P Weller (ed), Allen and Unwin, Sydney, 2000, pp. 126-155.

⁷ ALGA joined COAG at its inception.

While COAG and the IGAFRR were important developments in supporting Commonwealth and State and Territory engagement on significant issues, they have arguably not yet lived up to their full potential. Critics of COAG point to the power imbalance between the Commonwealth and the States and Territories in terms of influence and agenda setting; and to the need for COAG to have a greater strategic focus on a small range of key issues of national significance. Likewise, annual reviews of the IGAFRR have identified several areas where implementation was compromised. For example, a 2012 review of National Partnerships⁸ under the IGAFRR found nearly half were of low or medium national significance.

Part 1 of this paper focuses on how COAG currently operates as a forum for high level discussion of matters of strategic national importance that can only be solved by cooperation and collaboration. We draw on examples of other federations, such as Canada and Germany, to explore the pros and cons of different types of institutional arrangements.

In Part 2 the paper assesses the effectiveness of the 2008 IGAFRR, and asks how the positive aspects of the arrangements it put in place can be embedded in future structures and practices, and how the downsides can be avoided.

A key focus of the discussion is the principle of democratic accountability. To what extent has the implementation of intergovernmental agreements increased the accountability of governments to voters? Implicit in this question is the understanding that the purpose of intergovernmental relations and arrangements, whatever their nature, is to improve results for citizens. The ability of citizens to assess the performance of governments remains integral to any new arrangements that the Reform of the Federation White Paper might propose.

Equally important is the issue of federal financial relations, which is why the Reform of the Federation White Paper is being developed in close alignment with the Tax White Paper. While the Tax White Paper will consider issues around how tax revenue is raised, the Reform of the Federation White Paper will consider the expenditure responsibilities of each level of government and how revenue collected by the Commonwealth is distributed to and among the States and Territories. The importance of federal financial relations is further highlighted by the need to ensure the fiscal sustainability of all levels of government, particularly as demographic change in Australia's population accelerates over the next decade.

The links between the two White Papers are a key element of the discussion in Part 3, which considers the consequences of the relatively high (compared with other federations) degree of vertical fiscal imbalance (VFI) in Australia. VFI refers to the mismatch between the expenditure responsibilities of the States and Territories relative to the revenue they raise, making them reliant on transfers from the Commonwealth to finance their activities. Around 45 per cent of total State and Territory revenue now comes from the Commonwealth (including the GST), although this varies across jurisdictions.

The existence of VFI is not necessarily a problem in itself, but a high degree of VFI creates perverse incentives for both levels of government. It allows the Commonwealth to act in ways which can compromise the autonomy of States and Territories in their own sphere, thus creating

⁸ National Partnership payments are provided to the States and Territories to: support the delivery of specified outputs or projects; facilitate reforms; or reward those jurisdictions that deliver on nationally significant reforms.

confusion about democratic accountability, just as Deakin predicted when he wrote in 1902 that States would become “bound to the chariot wheels of the Central Government”.⁹ A high degree of VFI also creates incentives for the States and Territories to blame the level of Commonwealth funding for problems in State-delivered services, rather than to make the case to their own electorates for raising more funding from their own revenue sources.¹⁰ At the same time, a high degree of VFI can leave State and Territory budgets heavily dependent on Commonwealth grants and therefore vulnerable to changes to the fiscal priorities of the Commonwealth.¹¹

A related aspect of our federal financial relations is examined in Part 4, namely the mechanism to reduce the fiscal disparities between States and Territories to allow for an equivalent level of public services to all Australians, no matter in which State or Territory they reside. This is known as ‘horizontal fiscal equalisation’ (HFE). While various forms of HFE have occurred since Federation, since 2000 a varying proportion of the revenue from the GST has been distributed to the States and Territories to achieve HFE. Recently, HFE has been brought into sharper focus as an increase in mining royalties in Western Australia has seen its share of GST funding fall to very low levels. The paper asks whether the Australian community still considers full equalisation of fiscal capacities a worthwhile goal, and if so, whether the current method of implementing HFE remains appropriate and what, if any, changes should be considered.

Any changes to the current GST arrangements will require consensus across all jurisdictions and acceptance by the broad community. As the Prime Minister has stated, the GST cannot and will not change unless all the States and Territories agree and there is general consensus across the political spectrum. This means — leaving aside any minor administrative changes — that the base and the rate of the GST will not change unless there is such agreement and consensus. Fundamentally, the Australian Government’s intention is to cut the overall tax burden, not increase it.

⁹ Anonymous column [written by Alfred Deakin] in the *London Morning Post*, 1902.

¹⁰ R Bird & M Smart (‘Assigning State Taxes in a Federal Country: the Case of Australia’, paper to the Melbourne Institute – Australia’s Future Tax and Transfer Policy Conference, Melbourne, 2008, p. 81): “Given the structure of federal transfers, state governments may behave opportunistically in order to extract more resources from the centre, reflecting the inherent externalities when some portion of the additional federal taxes needed to finance transfers may be exported to taxpayers in other regions.”

¹¹ A Fenna, *Commonwealth Fiscal Power and Australian Federalism*, *UNSW Law Journal*, 2008, p. 515.

PART 1: INSTITUTIONAL ARCHITECTURE

1.1 Context

Although the Constitution provides for a large number of powers and responsibilities within the Federation to be held concurrently by the Commonwealth and the States, it is largely silent on any formal intergovernmental machinery to facilitate interaction.¹² The High Court is there to resolve disputes between the Commonwealth and the States on constitutional matters, but there is no mechanism that would reduce the likelihood of disputes arising in the first place.

The absence of any formal constitutionally-defined mechanism or forum to manage intergovernmental relations has not limited the efforts of governments to support intergovernmental collaboration. These efforts have been driven by the common desire of all governments to work collaboratively to tackle complex challenges and harness emerging opportunities in a globalised world. Like other federations, Australia has a number of instruments to support intergovernmental cooperation including a peak forum, a network of ministerial councils, intergovernmental agreements and funding transfers in the form of grants from the Commonwealth to the States and Territories. The most significant and enduring organisational innovation in the area of intergovernmental relations in Australia was the establishment of the Council of Australian Governments (COAG) in 1992.

1.2 About COAG

The establishment of COAG occurred after two Special Premiers' Conferences which concluded in November 1991, where First Ministers adopted four principles to guide a review of Commonwealth and State and Territory roles and responsibilities.¹³ These recognised Australia's nationhood and emphasised subsidiarity (the principle that functions should be performed by the lowest level of government competent to do so effectively), the need for increased flexibility and competitiveness in the Australian economy, and the accountability of the government to the electorate.¹⁴ The current members of COAG include the Prime Minister, State and Territory Premiers and Chief Ministers, and the President of the Australian Local Government Association (ALGA).

COAG provides a crucial national platform for the initiation, development, implementation and monitoring of policy reforms that are of national significance, and which require cooperative action by Australian governments.¹⁵ Since its establishment, COAG has settled and signed a number of important intergovernmental agreements. The agreements have committed jurisdictions to implement decisions that have either been reached or confirmed by COAG. In many instances, agreements have been the precursor to the passage of legislation either solely by the Commonwealth or jointly by the Commonwealth and State and Territory governments.¹⁶

¹² Kildea & Lynch, pp. 2-8.

¹³ Premiers' Conferences had been held for many decades prior to COAG's establishment.

¹⁴ A Twomey & G Withers, 'Federalist Paper 1: Australia's Federal Future', Report for the Council for the Australian Federation, 2007, p. 28.

¹⁵ Council of Australian Governments, About COAG, 2010, <http://archive.coag.gov.au/about_coag/>.

¹⁶ Council of Australian Governments, Guide to Intergovernmental Agreements, 2012, <http://archive.coag.gov.au/intergov_agreements/index.cfm>.

Despite the inherent difficulties in maintaining cooperation across governments, COAG has been largely successful. The most notable COAG success has been the implementation of the National Competition Policy beginning in 1995.¹⁷ Since then, a range of agreements have been reached, including agreements on tax reform and counter-terrorism, among others. More recently, COAG has initiated reforms to promote a Seamless National Economy through the harmonisation of regulatory regimes across the country and to increase productivity, raise workforce participation and mobility, and improve the delivery of government services. A major reform to the structure of grants to the States and Territories was implemented through the Intergovernmental Agreement on Federal Financial Relations, agreed by COAG in 2008.¹⁸

1.2.1 Ministerial and COAG Councils

COAG is supported in its role by inter-jurisdictional, ministerial-level Councils that facilitate consultation and cooperation between the Commonwealth and the States and Territories in specific policy areas. Collectively, these Councils constitute the COAG Council system. When established, COAG Councils were expected to identify and prioritise for consideration issues of national significance, where joint action could be taken by governments. Councils were also expected to develop policy reforms for consideration by COAG, as well as oversee the implementation of policy reforms agreed by COAG.¹⁹

In 2011, following a streamlining effort undertaken after a review in 2009-10,²⁰ COAG's Council system comprised 22 ministerial-level Councils. The system consisted of three different types of Councils. Standing Councils were ongoing and addressed issues of national significance. Select Councils were time-limited and reform-focused. Legislative and Governance Forums oversaw responsibilities set out in legislation, intergovernmental agreements and treaties outside the scope of Standing Councils. The performance of Councils was beset by a number of challenges that included weak links to COAG, insufficient focus and planning around execution of the reform agenda and lack of clarity in the delegation of responsibilities and accountabilities between States and Territories and the Commonwealth. These factors eventually marred the effective implementation of COAG's ambitious reform agenda.²¹

In December 2013, COAG agreed to streamline the COAG Council system again. It reduced the number of COAG Councils to eight and made all of them time-limited. The streamlining was driven by the desire to cut down on bureaucracy and red-tape and to re-focus the work of the Councils on COAG priorities. This approach aligns with the Commonwealth's commitment to respect State and Territory sovereignty. The membership of the Councils continues to consist of the Commonwealth and State and Territory Ministers with responsibility for their respective subject matter and, where appropriate, the President of ALGA.²² COAG Councils are accountable through their Chair to COAG. New guidelines on COAG Councils, issued in May 2014, give Councils the freedom to make their own decisions and progress work within their remit. They

¹⁷ M Painter, *Collaborative Federalism: Economic Reform in Australia in the 1990s*, Cambridge University Press, Cambridge, 1998.

¹⁸ Council of Australian Governments, About COAG, <http://archive.coag.gov.au/about_coag/> .

¹⁹ Council of Australian Governments, About COAG, <http://archive.coag.gov.au/about_coag/> .

²⁰ Council of Australian Governments, *Handbook for COAG Councils*, 2011, p. 4.

²¹ COAG Reform Council, *Lessons for federal reform: COAG reform agenda 2008-13*, COAG Reform Council, Sydney, 2013, p. 59.

²² If a Council will work on matters affecting New Zealand, the Council may include a representative in its membership.

also give Councils the option to refer to COAG any major decisions and intergovernmental agreements.²³ In addition to these COAG Councils, Commonwealth and State and Territory Ministers also meet regularly to discuss areas of shared interest outside the formal COAG Council system.

This change reflects the changing nature of the role played by the Ministerial Councils based upon the approach of COAG. The role of Ministerial Councils has extended from being operationally focused to tackling a broader policy mandate. In considering the overall institutional architecture supporting intergovernmental arrangements in Australia, any adjustments to the effective functioning of COAG also need to take into account the role of the Ministerial and COAG Councils.

1.2.2 Process and governance

In considering the role of COAG, scholars such as Kildea and Lynch have observed that almost twenty years after its formation, COAG's basic structure and processes remain largely undefined and subject to the discretion of the Prime Minister.²⁴ The frequency, timing and duration of meetings are determined by the Commonwealth, as the COAG Secretariat is housed within the Department of the Prime Minister and Cabinet. As the Chair of COAG, the Prime Minister also finalises the agenda for COAG meetings.²⁵

Kildea and Lynch suggest that the influence exerted by the Commonwealth around the timing of meetings is significant because it allows the Commonwealth to consult the States and Territories at a time that suits its own policy timetable. Similarly, while the Prime Minister routinely invites the States and Territories to provide input into the agenda, the final decision on agenda items rests with the Prime Minister.²⁶

Embedding in practical ways a principle of respect for the roles and responsibilities of different levels of government is necessary for COAG's sound functioning and its ability to foster cooperation and collaboration across all governments in Australia. Recognising this and the need to address the challenges outlined above, on 13 December 2013 COAG agreed to meet twice a year, around April and November, providing more certainty around the timing of meetings. It also agreed to focus on "a few important national priorities, and on outcomes rather than process". The meeting also enabled the Commonwealth to reiterate its respect for the sovereignty of the States and Territories in their own sphere.²⁷ Arriving at a set of concrete arrangements that give effect to that commitment is an important goal for the White Paper.

In its 2011 report, the Senate Select Committee on the Reform of the Australian Federation noted there was a "need for greater transparency of COAG processes, particularly in areas such as the public availability of agendas prior to meetings and the publication of meeting schedules".²⁸ The Commonwealth's response to this report noted that the confidentiality of COAG proceedings promotes the open and frank exchange of ideas and ultimately enhances the ability

²³ Australian Government Department of the Prime Minister and Cabinet, *Guidance on COAG Councils*, 2014, p. 1.

²⁴ Kildea & Lynch, pp. 10-11.

²⁵ Kildea & Lynch, pp. 10-11.

²⁶ Kildea & Lynch, pp. 10-11.

²⁷ Council of Australian Governments, COAG Communique, 13 December 2013, <<http://www.coag.gov.au/node/516>>.

²⁸ Parliament of Australia, Senate Select Committee on the Reform of the Australian Federation, *Australia's Federation: an agenda for reform*, Canberra, 2011, p. 51.

of COAG members to reach agreement on issues of national significance.²⁹ As we consider governance arrangements around COAG operations, it will also be important to consider issues around transparency and accountability.

1.2.3 Engendering Collaboration

While COAG has no formal status under Australian law, it continues to be the key forum to drive national reform. The perceived tenuous nature of COAG, despite its critical significance to our Federation, has led to calls to formalise some of the COAG arrangements to give them greater resilience and durability.³⁰ As noted by Kildea and Lynch, none of these calls look

...exclusively to constitutional amendment as the silver bullet of reform. The notorious difficulty of attaining a successful referendum result particularly on federal issues which has traditionally been amongst most contentious proposals – as well as the difficulty of all that might be done in the way of federal reform within a single suite of proposed amendments, has ensured that sub-constitutional institutions and mechanisms have been looked to as a simpler and more effective way to achieve change.³¹

Another key forum to address national policy issues is the Council for the Australian Federation. The Council was formed voluntarily by Premiers and Chief Ministers in October 2006. It commissioned two discussion papers in 2007 and 2009, written by academics, that promoted the renewal of Australian federalism.³² The objectives of the Council are to:

- work towards a common understanding of the States' and Territories' positions in relation to policy issues involving the Commonwealth Government; and
- take a leadership role on key national policy issues, including the Federation, that are not addressed by the Commonwealth Government.³³

In relation to its first objective, the Council provides Premiers and Chief Ministers an opportunity to caucus ahead of COAG meetings. In relation to its second objective, there is great potential for national reforms to be advanced without the need for the Commonwealth to provide carrots and sticks. For example, the Council has taken on the task of “developing [occupational] licensing reform which enhances flexibility and mobility for Australian workers, but does not impose a top-down, national system which would increase costs for businesses and individuals”.³⁴ The Federation White Paper presents an opportunity for the Council to be reinvigorated as State and Territory First Ministers seek to collectively shape a reform agenda in partnership with the Commonwealth.

²⁹ L Blyden, ‘COAG’, NSW Parliamentary Research Service, Briefing Paper No. 6, 2013, pp. 56-58.

³⁰ John Brumby, Chair of the former COAG Reform Council, recently proposed improving governance standards for COAG by establishing an independent COAG Secretariat and the establishment of a Federation Reform Council to independently monitor the timetable, milestones and progress on new arrangements that may arise out of the Federation White Paper reforms. J Brumby, ‘Reforming the Federation’, in *A Federation for the 21st Century*, Committee for Economic Development of Australia, Melbourne, 2014, pp. 152-156. In the same report, Fenna also notes the various calls to institutionalise Commonwealth and State relations and how welcome such developments would be without specifically outlining what form they should take.

³¹ Kildea & Lynch, p. 104.

³² These two papers are Twomey & Withers, and Wanna, Phillimore, Fenna & Harwood.

³³ Council for the Australian Federation, About the Council for the Australian Federation, <<http://www.caf.gov.au/default.aspx>>.

³⁴ Council for the Australian Federation, Occupational Licensing Reform, <<http://www.caf.gov.au/OccupationalLicensing.aspx>>.

1.2.4 Institutional Arrangements in Other Federations

It is useful to look at arrangements in other federations to see whether lessons can be learned from the way powers are constitutionally divided between the central government and sub-national governments; how other constitutions recognise intergovernmental relations and institutions; and how intergovernmental relations and practice are supported institutionally.

Germany

The structure of the German federation facilitates intergovernmental cooperation by requiring both the federal and provincial political representatives to be involved in the legislative process of the national government. Both levels of governments cooperate on policy development, while responsibility for implementation is separated and largely rests with the *Länder* (State) governments.

Intergovernmental cooperation is reinforced by the German Federal Constitutional Court, which officially recognises the 'comity' principle. The comity principle requires governments to take the legitimate concerns and interests of other governments within the federation into account in their decision-making, to negotiate in good faith and to engage in cooperation.³⁵

Germany has a two-level parliamentary system with an integrated style of federalism. The federal legislature, which is the main lawmaker, has two houses: a lower house (the *Bundestag*) elected directly by popular vote; and an upper house (the *Bundersrat*) representing the constituent units of the federation, the *Länder* governments. Members of the *Bundesrat* are delegates of the *Länder* governments. That is, the members of the *Bundesrat* are not elected, but are appointed by their respective *Länd* government.³⁶ This means that it functions as a true 'states' house', unlike our Senate.

Participation of the *Länder* governments in federal legislation prevents the *Länder* from becoming marginalised over time. It also provides *Länder* politicians with a voice in federal politics.³⁷ The federal government uses expertise from *Länder* administration when designing a law, and *Länder* governments have a veto over legislation that affects their administration.³⁸ Participation of the *Länder* governments in federal legislation also creates cooperation between *Länder* governments themselves when preparing decisions on federal bills.³⁹

Both the federal and provincial governments in Germany have distinctive and well respected roles within a clear constitutional framework. The clarity in roles is complemented by mechanisms that foster cooperation and input into policy design, all of which enhances transparency and accountability.⁴⁰

³⁵ J Wanna, J Phillimore, A Fenna & J Harwood, 'Common Cause: Strengthening Australia's Cooperative Federalism', Final Report to the Council for the Australian Federation, 2009, p. 11.

³⁶ S Oeter, *Federal Republic of Germany*, Forum of Federations, 2006, p. 6.

³⁷ Oeter, p. 7.

³⁸ A Benz, *Intergovernmental Relations in German Federalism-joint decision making and the dynamics of horizontal cooperation*, Forum of Federations, 2009, p. 1.

³⁹ Benz, p. 4.

⁴⁰ C Saunders, 'Cooperative arrangements in Comparative Perspective' in G Appleby, N Aroney & T John (eds), *The Future of Australian Federalism: Comparative and Interdisciplinary Perspectives*, Cambridge University Press, Cambridge, 2012, pp. 414-431.

When compared with the Australian system, German federalism gives a much stronger role to state governments in the formation of national policy. The *Bundestag* is not able to enact legislation that the *Länder* (through the *Bundesrat*) do not support. The veto power of the *Bundesrat* varies and depends upon the type of legislation. In the case of ordinary federal legislation, the *Bundestag* can overrule the objection from the *Bundesrat* by an absolute majority. On laws affecting the *Länder* (which account for almost fifty-percent of statutes adopted by the federal legislature), the *Bundesrat* cannot be overruled. This is an institutional expression of the comity principle.

It is worth noting that in Australia, the *Public Governance, Performance and Accountability Act 2013* requires Commonwealth officials to encourage cooperation with others to achieve common objectives (s. 17) and, “when imposing requirements on others in relation to the use or management of public resources”, to take into account the effects of imposing those requirements (s. 18). Applied to intergovernmental relations, these clauses could be seen as similar to the comity principle.

Canada

In contrast to Germany, and closer to the Australian experience, intergovernmental relations in Canada are supported by a variety of largely ad-hoc arrangements that have changed over time. The constitutional division of powers within the Canadian federation is fairly clear and dates back to 1867. In the Canadian model, constitutional powers of different levels of government are clearly separated. Unlike the Australian Constitution, which only enumerates the Commonwealth’s powers, the Canadian constitution has three lists of powers: one for the national government; one for the provinces (States); and one for concurrent or shared powers.

In seeking to understand Canadian federalism, it is important to note that Canada lacks a nationwide party system. Political parties that operate at the national level have no formal relationship to political parties that operate at the provincial level. As a result, it is not possible for an election result in Alberta or British Columbia to be interpreted as ‘sending a message to Ottawa’ when electors vote out a provincial government. Nor is it possible for the national government to rely on support for reforms to federal relations from provincial governments that are part of the same political organisation.

In attempting to deal with significant cultural and regional diversity, accompanied by a vast geographic spread, the Canadian federation has evolved and developed its own style of ‘treaty’ federalism.⁴¹ That is, Canadian federalism is heavily dependent upon intergovernmental bargaining. Policy-making is increasingly dependent upon negotiated agreement, which in turn involves working around the constitution without violating its fundamental stipulations. In other words:

⁴¹ T Hueglin, “The bargaining game: Canada as a new model of federal governance?” in G Appleby, N Aroney & T John (eds), *The Future of Australian Federalism: Comparative and Interdisciplinary Perspectives*, Cambridge University Press, Cambridge, 2012, pp. 182-196.

... negotiating non-constitutional agreements between the provinces and the federal government has become essential to the functioning of the Canadian federation in the absence of the possibility of constitutional change.⁴²

This is very similar to the situation in Australia, in more ways than one: overall responsibility for intergovernmental cooperation at the federal level in Canada is assumed by the Prime Minister, who is supported by a Minister for Intergovernmental Affairs and a secretariat,⁴³ and the mechanisms of intergovernmental relations are informal and have no constitutional basis.

For a long time the centrepiece of Canadian intergovernmental relations has been the First Ministers Conferences (FMCs). The meetings provide a forum for discussion on common policy areas and on the development of joint directions. They are convened by the Prime Minister and have no fixed procedures. Parts of conferences may be held in public, but most discussion takes place behind closed doors.⁴⁴ However, the frequency and regularity of these meetings has varied over time and in the last few years the group has rarely convened.

Much of the work of intergovernmental relations is undertaken by a growing number of Ministerial Councils that are composed of federal, provincial and territorial ministers. Some of these groups have been institutionalised and have regular meetings. In addition to these forums, senior officials and deputy ministers also meet informally to exchange information.

Organisational support for a majority of the intergovernmental conferences is provided by the Canadian Intergovernmental Secretariat, which does not have a policy advisory role. Finally, guidelines for Canadian Cabinet submissions highlight the need to report on the intergovernmental impact of new policy proposals, including information on the perspectives of provincial and territorial governments and their potential involvement in the proposed initiative.⁴⁵

While these examples can be instructive, care must be taken when seeking to apply arrangements from one setting to another, as noted by Saunders:

There is interaction between the spheres of government in every federation. In most federations such activity is increasing and generally is seen to be a boon. In many federations also, however, cooperation brings in its wake some of the problems that Australians experience. Intergovernmental arrangements are so deeply embedded in organic constitutional systems and local political practice that it is necessary to be particularly alert to the difficulty in this context.⁴⁶

It would be wrong to conclude that arrangements in other countries should be simply transported to Australia. However, the examples provide an opportunity for reflection on the experiences of others and the lessons that can be drawn.

⁴² J Simmons, 'Treaty federalism: the Canadian experience', paper to the 'Competitive Federalism – International Perspectives' International Colloquium, Liberal Institute, Potsdam, Germany, 2008, p. 5.

⁴³ Hueglin, pp. 182-196.

⁴⁴ Privy Council Office, Canada, 'Intergovernmental Relations in the Canadian Context', Federal-Provincial-Territorial Relations, <<http://www.pco-bcp.gc.ca/aia/index.asp?lang=eng&page=relations>>.

⁴⁵ Privy Council Office, Canada, 'A Drafter's Guide to Cabinet Documents', <<http://www.pco-bcp.gc.ca/index.asp?lang=eng&page=information&sub=publications&doc=mc/guide-eng.htm>>.

⁴⁶ Saunders, pp. 424-425.

Question 1.1: How do we ensure COAG's focus remains firmly on issues of national significance?

Question 1.2: Given COAG's lack of constitutional status, how can its role in the Federation be strengthened and made more durable?

Question 1.3: What improvements can be made to the governance arrangements surrounding COAG operations to embed the "comity" principle and build greater trust and confidence between levels of government?

Question 1.4: What other institutional arrangements, including examples from other federations, would further support our intergovernmental relations?

PART 2: INTERGOVERNMENTAL AGREEMENT ON FEDERAL FINANCIAL RELATIONS – ENHANCING ACCOUNTABILITY?

2.1 History and Context

Early in the Federation’s history, Commonwealth surplus revenue was transferred back to the States as general purpose payments. However, following the 1908 High Court decision in the ‘Surplus Revenue’ case,⁴⁷ with the passage of time a growing proportion of Commonwealth transfers began to be allocated to specified tasks. These transfers have taken the form of specific purpose payments (SPPs)⁴⁸ or ‘tied grants’, made under Section 96 of the Constitution, which allows the Commonwealth to “grant financial assistance to any State on such terms and conditions as the Parliament thinks fit”. This measure has been employed to support the transfer of funds in a wide range of policy areas, including those that are the sole jurisdiction of States and Territories.⁴⁹

By the mid-1970s the split between general purpose payments and SPPs was almost equal.⁵⁰ In mid-1999, the Commonwealth and the States and Territories signed the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations. This involved the introduction of a Commonwealth value-added tax - the Goods and Services Tax (GST). Under that agreement, the Commonwealth returned all the net revenue collected from the GST to the States and Territories as general revenue assistance,⁵¹ while abolishing untied financial assistance grants. However, the Commonwealth continued its commitment to SPPs.⁵² In exchange for the GST revenue, the States and Territories agreed to abolish a specified number of inefficient taxes, such as those on financial transactions. While the abolition of these taxes is largely complete, progress on the remaining taxes has been mixed to date.

In the years between the introduction of the GST and the 2008 signing of the Intergovernmental Agreement on Federal Financial Relations (IGAFFR), the number of SPPs grew rapidly and reached almost 100. SPPs also became increasingly prescriptive, with various input conditions attached. Often these conditions imposed Commonwealth priorities on State expenditure. However, as Keating and Wanna argue, the degree to which the Commonwealth bureaucracy has been able to ensure the various conditions were met in the manner they envisaged is open to question:

⁴⁷ *NSW v Commonwealth (Surplus Revenue Case)* (1908) 7 CLR 179

⁴⁸ Appendix C provides further information on SPPs.

⁴⁹ A key driver for the evolving nature of funding transfers between the Commonwealth and the States and Territories was a series of High Court decisions in relation to the revenue raising capacities of the Commonwealth and the States and Territories and the interpretation of their Constitutional powers. The *Surplus Revenue Case*, cited above, was the first of these. Further detail on the history of High Court decisions is provided in Chapter 3 and Appendix C.

⁵⁰ A Fenna & R Hollander, ‘Dilemmas of Federalism and the Dynamics of the Australian Case’, *Australian Journal of Public Administration*, vol. 72, no. 3, 2013, p. 224. The GST now comprises just over half of Commonwealth grants to the States and Territories.

⁵¹ The GST revenue that is transferred to the States and Territories is net of costs incurred by the Australian Taxation Office in administering the GST.

⁵² B Searle, ‘Federal Fiscal Relations in Australia – 2001’, Working Paper, International Centre for Economic Research, Torino, Italy, 2002, p. 9.

In these circumstances, if states feel arm-twisted, then they have ample scope to avoid honouring such agreements in the process of implementation. Indeed, there may be a tendency for the Commonwealth to underestimate the discretionary power of the states in this regard and possibly to overestimate Commonwealth powers to get its own way.⁵³

The expansion of the Commonwealth's role in areas of State and Territory responsibility and the weakening of desirable links between States' and Territories' taxation and expenditure decisions was criticised by many independent commentators.⁵⁴ It was against this backdrop that COAG agreed, in 2008, to sweeping reforms to the intergovernmental machinery governing the Federation and set about attempting to rejuvenate it.

The reforms proposed significant changes to the system of tied grants through which the Commonwealth set directions and shaped service delivery in a wide range of State policy domains.⁵⁵ It was hoped that the new approach would focus on improved service delivery, funding linked to the achievement of outcomes and outputs rather than inputs, and devolution of decision-making and service design to the frontline.⁵⁶ To facilitate this, the Commonwealth secured States and Territories' cooperation in a system of performance assessment. Centred on the COAG Reform Council (CRC), this enhanced the work already undertaken through the Report on Government Services (RoGS).⁵⁷ The new IGAFRR came into effect on 1 January 2009.

2.2 Objective of the IGAFRR

The Commonwealth sought to give effect to its vision of a new 'cooperative federalism' by agreeing to finalise the IGAFRR at the COAG meeting of 29 November 2008.⁵⁸ A key driver for the development of the IGAFRR was the identification of a wide ranging reform agenda, building on the National Reform Agenda that had begun in 2006 and which recognised the need for a new wave of productivity-enhancing reforms, particularly in relation to human capital and a skilled and mobile workforce. In 2011, this agenda was streamlined to focus on five themes: a long-term strategy for economic and social participation; a national economy driven by our competitive advantages; a more sustainable and liveable Australia; better health services and a more sustainable health system for all Australians; and closing the gap on Indigenous disadvantage. The signatories to the IGAFRR also recommitted to the elimination of specified inefficient State and Territory taxes as agreed in 1999.

The objective of the IGAFRR was to improve the well-being of all Australians by reducing Commonwealth prescriptions on service delivery by the States and Territories and replacing them with an emphasis on outcomes, thus providing them with increased flexibility in the way they deliver services. In addition, it aimed to provide a clearer specification of roles and responsibilities for each level of government and an improved focus on accountability for better outcomes and better service delivery.

⁵³ M Keating & J Wanna, 'Remaking Federalism?' in M Keating, J Wanna & P Weller (eds) *Institutions on the Edge? Capacity for Governance*, Allen and Unwin, Sydney, 2000, pp. 126-155.

⁵⁴ Keating & Wanna, pp. 126-155.

⁵⁵ A Fenna & G Anderson, 'The Rudd reforms and the future of Australian federalism' in G Appleby, N Aroney & T John (eds), *The Future of Australian Federalism: Comparative and Interdisciplinary Perspectives*, Cambridge University Press, Cambridge, 2012, p. 393.

⁵⁶ Productivity Commission, *Benchmarking in Federal Systems- Roundtable Proceedings*, Melbourne, 2010, p. 227.

⁵⁷ Further details on RoGS are outlined in Section 2.4.4.

⁵⁸ Note: The Australian Local Government Association, while a member of COAG, is not a signatory to IGAFRR.

The new agreement had two aspects: a new approach to financial transfers from the Commonwealth to the States and Territories, coupled with a new approach to public accountability for the outcomes that were delivered with that funding. We examine both these aspects in greater detail below.

2.3 Funding reform: paying the piper, calling the tune?

In the years preceding the signing of the IGAFRR the number of SPPs to the States and Territories had proliferated. In 2008, there were almost 100 SPPs. This led to the development of a complex administrative and financial landscape, characterised by strict input controls related to the transfer of funds.

The IGAFRR sought to streamline and simplify arrangements by subsuming a wide range of specific Commonwealth-State agreements into six National Agreements. The National Agreements focused on six key reform areas: healthcare; education; skills and workforce development; disability services; affordable housing; and Indigenous welfare. With the exception of Indigenous welfare, these agreements were complemented by ongoing funding streams that were untied, apart from the requirement for the funds to be spent in the relevant reform area.

Like most reforms that involve the cooperation of States and Territories, the IGAFRR came with a set of financial inducements.⁵⁹ This included financial assistance to support the States and Territories to undertake reforms which also advanced the Commonwealth's policy objectives. In this case, the IGAFRR came with a commitment from the Commonwealth to provide an additional \$7.1 billion in SPP funding over the following five years. The reforms also intended to allow the States greatly enhanced discretion and autonomy in how SPPs could be used. The focus was to be on the outcomes that could be achieved through this flexibility, rather than on compliance with input-focused terms and conditions, including financial reporting, which the Commonwealth imposed. As Anderson and Parkin noted:

The reforms spelt out in the agreement were quite fundamental. Alongside the formal confirmation of the dramatic reduction (via consolidation) in the number of SPPs was a system of reporting against mutually agreed outcomes and performance benchmarks by an independent COAG Reform Council in which the performance of both levels of government would be assessed.⁶⁰

However, in addition to this, there was an:

interesting and significant counterbalancing initiative from the Commonwealth that accompanied the consolidation and freeing up of the SPPs. A new category of commonwealth conditional payments to the states—badged as National Partnership Programs.⁶¹

In addition to the key National Agreements, a small number of separate agreements – National Partnership Agreements (National Partnerships) – were aimed at supporting delivery of specified programmes identified as having whole-of-nation implications.⁶² Linked to these was a system of payments termed National Partnership Payments (NPPs).

⁵⁹ Appendix C provides further details on the types of agreements and payments facilitated by the IGAFRR.

⁶⁰ G Anderson & A Parkin, 'Federalism: a fork in the road?' in C Aulich, M Evans (eds) *The Rudd Government Australian Commonwealth Administration 2007 – 2010*, ANU Press, Canberra, 2010, pp. 204-225.

⁶¹ Anderson & Parkin, pp. 204-225.

⁶² Commonwealth of Australia, *National Commission of Audit 2014*, Phase One, Canberra, 2014, p. 25.

The Commonwealth's intention was to drive nationally-significant reforms in areas that were Commonwealth priorities, through the provision of financial rewards to the States and Territories.

The IGAFRR emphasised the need for fair and sustainable financial arrangements to support reform. All payments to the States and Territories were simplified and centrally administered by the Commonwealth Treasury (previously they were administered by the relevant Commonwealth line departments), with one monthly payment made to each State and Territory Treasury. This arrangement provided both greater flexibility as well as funding certainty to the States.⁶³ However, States and Territories have argued there is little funding certainty as the renewal of funding for expiring National Partnerships is subject to the Commonwealth budget process.

2.4 Accountability reform: who does what and how well?

Democratic accountability requires those who govern to provide an adequate account of their performance to their citizens. It shapes the focus of policies so that they address public needs, drive effective public service delivery and provide a feedback loop to help guide reforms. Well-functioning accountability mechanisms ensure that governments continue to act in the best interests of their citizens.⁶⁴

The IGAFRR set out to enhance government accountability to the public through combining a focus on the achievement of outcomes, with a clearer specification of roles and responsibilities between the Commonwealth and the States and Territories, and enhanced performance reporting. An overview of the performance reporting and accountability arrangements within the IGAFRR is outlined in [Appendix C](#). The following section describes the institutional and design features supporting the accountability arrangements in the IGAFRR.

2.4.1 Roles and responsibilities

The IGAFRR emphasised the importance of clearly defined roles and responsibilities. COAG was keen to avoid any unnecessary and costly duplication of functions between different levels of government. It also wanted to strengthen public accountability by ensuring that the community was clear about who does what.

Based upon the above approach, the six National Agreements outlined the roles and responsibilities of each level of government. A number of shared responsibilities between Commonwealth and State and Territory governments were also identified.

In many instances these shared responsibilities resulted from the need for collaboration between governments. In 2011, there were 63 shared responsibilities across National Agreements. As most of the shared responsibilities were broadly defined, the potential for

⁶³ Deloitte Access Economics, *Assessment of progress under COAG Reform Agenda*, Report to the COAG Reform Council, 2013, p. 7.

⁶⁴ H Bjuremalm, A Gibaja, J Molleda, 'Democratic Accountability in Service Delivery: A practical guide to identify improvements through assessment', International Institute for Democracy and Electoral Assistance, Stockholm, 2014, p. 17.

National Agreements to support the objective of enhanced public accountability through clear allocation of roles and responsibilities was significantly reduced.⁶⁵

Roles and responsibilities in National Partnerships were generally clearer as, by definition, the agreements were narrower in scope and hence the roles were quite specific.

Question 2.1: How do we balance the need to foster collaboration across levels of government whilst retaining clarity around roles and responsibilities?

2.4.2 Institutional Arrangements

The IGAFRR had two institutional arrangements supporting its implementation: the Standing Council on Federal Financial Relations and the CRC.

Standing Council on Federal Financial Relations

The Standing Council on Federal Financial Relations⁶⁶ was part of the COAG Council system and had delegated responsibility from COAG for general oversight of the operations of the IGAFRR. Membership of the Standing Council consisted of the Treasurers of the Commonwealth and State and Territory governments. The Standing Council had an ongoing role in monitoring the maintenance of reforms in the IGAFRR and making associated recommendations to COAG. Further, it had primary responsibility for ensuring that National Agreements and National Partnerships adhered to the agreed design principles on 'national significance' outlined in Schedule E of the IGAFRR.⁶⁷ However, the Standing Council faced similar challenges to other COAG Councils as outlined in Part 1.

The COAG Reform Council (CRC)

The CRC was established by COAG in 2006 and operated until June 2014. Its initial role was to report to COAG annually on progress with implementation of the National Reform Agenda. In 2007, COAG clarified the role of the CRC to include a broad ex-post assessment of the costs and benefits of individual reform packages, giving consideration to the differences between jurisdictions.⁶⁸ In 2008, COAG expanded the role of the CRC as part of the arrangements for federal financial relations. Schedule A to the IGAFRR set out the CRC's role, and this is outlined in detail in [Appendix C](#).

In response to its expanded role, the CRC outlined its mission as assisting COAG to strengthen the performance and public accountability of governments. It also identified several objectives including:

- assisting governments to monitor and improve their performance in pursuit of the COAG reform agenda; and

⁶⁵ COAG Reform Council, *COAG reform agenda: Report on progress 2011*, COAG Reform Council, Sydney, 2011, p. 23.

⁶⁶ The Standing Council on Federal Financial Relations is now known as the Council on Federal Financial Relations.

⁶⁷ Further details on Schedule E of the IGAFRR is at Appendix B.

⁶⁸ COAG Reform Council, *Report to the Council of Australian Governments*, COAG Reform Council, Sydney, 2008, p. 2.

- equipping the public with information to interpret the relative performance of governments in order to hold them to account.⁶⁹

In accordance with these objectives, the CRC published a high-level annual report on progress under the COAG reform agenda. The CRC also produced more detailed reports on specific reform areas and agreements and made these publicly accessible on its website. Complementary to its reporting activities, the CRC also provided advice to COAG on options to improve performance reporting frameworks.⁷⁰ This involved the CRC working with the Commonwealth and the States and Territories to identify and implement data quality improvements.

Given the scope of its role, the success of the CRC depended heavily on its ability to access a strong service delivery evidence base. The CRC took a structured approach to collecting performance information by collecting baseline data in the first year, undertaking a comparative analysis of the performance of jurisdictions against each other and also against their own year-on-year performance.

2.4.3 Streamlining Reporting Requirements

Good and reliable public accountability arrangements are distinguished by key features including ‘full transparency’ and provision of ‘compact information’, which require all relevant performance information to be made public.⁷¹

The IGAFRR performance reporting framework acknowledged the importance of public reporting requirements, identified the need for an ongoing effort to streamline reporting requirements, and emphasised an increased focus on the achievement of ‘outcomes’ in key reform areas by all levels of government. It also provided greater transparency to the arrangements for financial transfers, by providing public access to the funding agreements, through the Standing Council on Federal Financial Relations website.

With the signing of the IGAFRR, the reporting burden on jurisdictions was significantly reduced as COAG rationalised 92 Specific Purpose Payment agreements into six National Agreements and 16 National Partnerships.⁷² The Commonwealth and States and Territories also worked together to identify and pursue improvements to other aspects of performance reporting.

This included the development of a ‘Conceptual Framework for Performance Reporting’ in 2010. The framework was developed by the Heads of Treasuries and endorsed by COAG in 2011. The ‘conceptual framework’ provided general guidance on the number and nature of performance indicators for different types of agreements. It also provided useful guidance on the selection of performance indicators based upon their appropriateness to a particular reform area.⁷³ The conceptual framework informed the subsequent review of the six National Agreements, which were revised in 2012.

⁶⁹ Deloitte Access Economics, *Assessment of progress under COAG Reform Agenda*, p. 11.

⁷⁰ Deloitte Access Economics, *Assessment of progress under COAG Reform Agenda*, p. 12.

⁷¹ T Willems, ‘Public Accountability and Public-Private Partnerships: How to obtain good public accountability in complex settings?’, paper to the Political Research Standing Group conference on regulatory governance, Dublin, 2010, pp. 18-19.

⁷² COAG Reform Council, *COAG reform agenda: Report on progress 2012*, COAG Reform Council, Sydney, p. 24.

⁷³ Council of Australian Governments, *Conceptual Framework for Performance Reporting*, Canberra, 2011, p. 1-2.

2.4.4 Performance management using performance information

The IGAFRR's accountability framework was intended to provide useful information to assess government performance, as well as to help governments make policy and programme adjustments. The CRC worked with a number of other organisations to access performance data and information. Principal amongst these were: the Steering Committee for Review of Government Service Provision; the Productivity Commission; the Australian Bureau of Statistics (ABS); and the Australian Institute of Health and Welfare (AIHW).

As the Commonwealth's research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians, the Productivity Commission was tasked with assisting the CRC in its reporting role. The Commission reported to COAG on the economic impacts and benefits of COAG's reform agenda every two to three years. The Commission also provides the secretariat to the Steering Committee for the Review of Government Service Provision, which oversees the production of the annual RoGS.

RoGS provides information on the equity, efficiency and effectiveness of government services in Australia.⁷⁴ Currently RoGS is published annually and contains performance information on 16 broad service areas. The scope of RoGS extends well beyond the reform areas identified in the IGAFRR.

Two other agencies that play an important role in data collection and performance reporting are the AIHW and the ABS. The AIHW collects and reports information on the health, housing and community services sectors, including data on Commonwealth, and State and Territory government service delivery. The ABS provides key statistics on a wide range of economic, environmental and social issues. These reports and statistics are expected to be utilised by all levels of government to inform policy decisions on health, housing and community service matters. The ABS also provides data on government expenditure, including Government Financial Statistics.

As we move towards a data-rich world and increased digitalisation, the pressure on governments to account for their conduct and share and utilise performance information will continue to grow. A response to these demands should be based upon careful analysis of existing data provision and its potential to support a performance management system that enables governments to improve service delivery.

Question 2.2: Given the focus on improving government service delivery through better use of performance information, how do we extract best value from the plethora of performance information currently collected by multiple entities nationally?

2.5 The IGAFRR: good in theory, but did it work in practice?

Any evaluation of the success or failure of the IGAFRR needs to be based upon whether it achieved its core objective of improving the well-being of all Australians. Performance reporting

⁷⁴ Productivity Commission, *Report on Government Services 2014*, Volume A: Approach to performance reporting, Canberra, 2014, p. iii. G Banks & L McDonald, 'Benchmarking and Australia's Report on Government Services', in A Fenna & F Knüpling (eds), *Benchmarking in Federal Systems*, Productivity Commission and Forum of Federations, Melbourne, 2010, p.199-226.

is crucial to providing an understanding of the success or otherwise of COAG in selecting reform priorities and of the IGAFRR in setting out the implementation of these reforms.

In 2013, the CRC evaluated the effectiveness of the IGAFRR in driving reform. The CRC confirmed that substantial progress had been achieved in each of the six policy areas identified by COAG. The CRC acknowledged the vital role played by COAG in gaining agreement on actions at head of government level and its contribution in progressing the reform agenda. There was also general support for the IGAFRR framework and its principles, and for it serving as the basis for reinvigoration of Commonwealth-State relations. However, it also noted that the pace of reform had slowed as governments focused on tackling the global financial crisis. The review also found that the Commonwealth had departed from the IGAFRR framework in developing new reforms (for example in health and education). Outside the IGAFRR framework, the focus on collaborative policy development was less pronounced.⁷⁵

A consistent criticism of the IGAFRR has been the lack of attention given to its implementation. In its final report, the CRC noted the failure to embed the key principles of the agreement into intergovernmental processes following the IGAFRR's negotiation in 2008. The CRC argued that this problem was further compounded by a lack of established processes for ensuring adherence to the IGAFRR framework, and indeed for responding when there were departures from it. The CRC identified that, in part, this was because line Ministers and their agencies did not buy into the reforms and did not have clear responsibilities and accountabilities for its implementation.⁷⁶

2.5.1 Shared Responsibilities and Accountability

The CRC's views on the effectiveness of the IGAFRR need to be balanced by taking into consideration other external perspectives. For example, Anderson and Parkin argue that:

The consolidation and re-conceptualisation of SPPs formed a remarkable breakthrough. This was, however, tempered by the creation of the NPPs ... and it is also the case that even COAG—however strong the voices of the states within it—is itself an instrument of cooperative centralism that, in the end, reinforces the dominant role of the Commonwealth at least as an instigator and coordinator and frequently as a policy driver.⁷⁷

Hence, Anderson and Parkin suggest that the IGAFRR (through the creation of new NPPs) provided the opportunity for COAG's tendency towards cooperative centralism to be reinforced. This contrasts with the original intent of the IGAFRR, which acknowledged the need for shared responsibilities recognising that major reform required collaboration between governments.

However, shared responsibilities within the National Agreements eventually led to confusion around accountability of governments. For example, under skills and workforce development reform, one of the shared responsibilities was to 'be accountable to the community for achieving outcomes'. This was a vague responsibility which provided no clarity on which level of government was responsible for the achievement of the outcome.⁷⁸

⁷⁵ Deloitte Access Economics, *Assessment of progress under COAG Reform Agenda*, p. i.

⁷⁶ COAG Reform Council, *Lessons for federal reform: COAG reform agenda 2008-13*, p. 10.

⁷⁷ Anderson & Parkin, p. 111.

⁷⁸ COAG Reform Council, *COAG Reform Agenda: Report on progress 2011*, p. 23.

2.5.2 Proliferation in Agreements and Increased Reporting Burden

As noted earlier, COAG had initially successfully streamlined the number of agreements. However, over time there was a proliferation in the number of National Partnership agreements. This was a departure from the IGAFRR's intention of greater untied funding to the States and Territories to enable more innovation in service delivery. A number of reasons have been cited for this departure, including impatience with obtaining results under the new system and the desire to deliver on election promises.⁷⁹ Additionally, all payments under the IGAFRR framework, no matter how small, require a written agreement between the Commonwealth and the relevant States.⁸⁰

The proliferation in National Partnerships also increased the administrative burden on jurisdictions. By the end of 2010, there was a catalogue of over 300 documents, including six National Agreements, 51 National Partnerships and 230 Implementation Plans.⁸¹ The administrative burden and costs for States and Territories increased as they had to allocate more resources to both negotiating and managing the agreements. The increase in the reporting burden was linked to increases in the number of agreements, changes in the level of detail required, reporting frequency and new reporting requirements around Implementation Plans. Project Agreements, a simplified form of National Partnership with less detail and lower reporting requirements, were introduced for low-cost and low-risk projects. Since 2013, governments have made further progress in rationalising agreements and reducing their reporting burden.

On balance, it is difficult to assess the extent to which the additional costs and administrative burden associated with the reporting requirements strengthened public accountability.

Question 2.3: How do we best strike a balance between collecting and disseminating performance information to improve public accountability, and minimising the administrative and reporting burden?

2.5.3 Assessing National Significance

A key objective of the IGAFRR was to strengthen the ability of States and Territories to deliver quality services in agreed areas of national reform with support from the Commonwealth. National Agreements and National Partnership agreements were expected to assist with the realisation of this aspiration, with each agreement being linked to a reform area of particular national significance. Schedule E of the IGAFRR (details in [Appendix B](#)) set out the principles to guide the selection of areas for which the Commonwealth could provide support, thus enabling national reforms or service delivery improvements through National Partnerships. However, the CRC's assessment of National Partnerships in 2012 revealed that of the 59 active National Partnerships approximately half were of low or medium 'national significance'.⁸²

⁷⁹ A Lynch, 'Commonwealth financial powers - taxation, direct spending and grants - scope and limitations', *Public Policy*, vol. 6, no. 1-2, 2011, p. 29.

⁸⁰ *COAG Reform Fund Act 2008* (Cth), section 7(2). Most payments to the States and Territories fall under the IGAFRR framework (see IGAFRR, clause 23).

⁸¹ Commonwealth of Australia, *National Commission of Audit 2014*, Phase One, p. 26.

⁸² COAG Reform Council, *COAG Reform Agenda: Report on progress 2012*, p. 10.

While a number of factors led to the above problem, the CRC suggested that a key factor was the lack of buy-in from line Ministers and agencies of the principles and intent of intergovernmental agreements, including the IGAFRR. In 2013, the CRC noted that the COAG reform agenda was largely driven by First Ministers, with strong involvement of central agencies. Collectively they were undertaking most of the work in relation to design and negotiation of policies. Line agencies with primary responsibility for implementation of the reform agenda were not always involved from the outset in COAG processes. Hence they had limited appreciation of the IGAFRR's basic philosophy around service delivery.⁸³ Without clear articulation of responsibilities and accountabilities of line Ministers for implementing the IGAFRR, and little enforcement of the IGAFRR's principles, the reforms were hard to sustain.

2.5.4 Reporting on Outcomes

Under the IGAFRR, reporting on National Agreements and National Partnerships was expected to be outcomes focused. Outcomes can be described as the results of government policy measures on the Australian community. COAG's development of six National Agreements largely embedded the focus on the measurement of outcomes.

To further improve accountability, performance benchmarks were also introduced for National Agreements. It was expected that the development of performance benchmarks would help the community to assess the progress governments were making towards outcomes. However, this approach encountered practical difficulties in implementation. Sometimes there were no performance indicators in the National Agreements to measure certain outcomes. In other instances, there was a lack of alignment between performance indicators and outcomes.⁸⁴

In its 2011 report, the CRC noted that some performance indicators were conceptually underdeveloped. The National Healthcare Agreement provided an example where not all indicators were meaningful, that is, it was not clear whether an increase or decrease in the value of an indicator was the desired outcome.⁸⁵ Based upon such evidence, in its final report, the CRC argued for the development of a 'programme logic framework' to guide the selection of interim outcomes for each area of reform. As there are long timeframes for the achievement of outcomes, the CRC felt that it would be useful to identify interim outcomes or outputs that could be expected along the way.⁸⁶

A number of inconsistencies emerged in relation to the overall approach to performance measurement, particularly in relation to National Partnerships. Performance measurement for National Partnerships with linked reward payments was undertaken by the CRC in its capacity as an independent assessor. For reward agreements, the CRC reported on the achievement of pre-determined performance benchmarks. This assessment informed the decision by the Commonwealth to make a payment to reward nationally significant reform initiatives.

However, for 'non-reward' National Partnerships, performance reporting remained linked to the achievement of *outcomes*. The absence of reward payments meant there were no intermediate reporting points for these agreements. As result, in 2011 the CRC was able to report on

⁸³ COAG Reform Council, *Lessons for federal reform: COAG reform agenda 2008-13*, p. 43.

⁸⁴ COAG Reform Council, *COAG Reform Agenda: Report on progress 2011*, p. 16.

⁸⁵ COAG Reform Council, *COAG Reform Agenda: Report on progress 2011*, p. 19.

⁸⁶ Appendix C includes further information on Outcomes and Outputs.

performance for only three out of six National Partnerships associated with the National Education Agreement.⁸⁷

This experience highlights the challenges of designing a single outcomes-based accountability framework that can be applied equally to different policy areas. Identifying appropriate performance targets for each policy area may be problematic due to the lack of an existing data set to form the evidence base. Also, there may be a long lead time between service interventions and expected outcomes. More importantly, there may be other contributing factors that have an impact on the progress of reform and therefore the achievement of outcomes. These and other challenges highlighted above collectively compromised the usefulness of the IGAFRR public accountability framework.

Question 2.4: Given the focus on public accountability, what type of performance information (outcomes and/or outputs) is most useful in assisting citizens to assess the performance of governments?

2.5.6 Data Access and Usability

The performance reporting and accountability framework for the IGAFRR identified key characteristics for performance reporting data as well as the need for a national performance reporting system. The intent was to reduce the confusion in interpreting performance information by ensuring consistency in data provision. Consistent data were expected to enable the CRC to equip COAG and the public with information that enabled comparative analysis of performance across jurisdictions.

Although the CRC developed a structured approach to achieve this objective, it struggled to conduct a comparative analysis of performance across jurisdictions. This was due to a number of factors – gaps in the availability of baseline data across particular reform areas, lack of agreed standard data definitions, difficulties in timely availability of data, lack of qualitative supporting information around quantitative data, and lack of data for key areas, such as regional and remote service delivery.⁸⁸

2.5.7 Accountability Arrangements

Consideration of the effectiveness of the IGAFRR also needs to look at the effectiveness of its accountability framework: whether citizens found the performance information useful when assessing government performance; and how different parties within the system used the performance information for positive outcomes. The benefit of collecting performance information is only fully realised if it is used in future decision making. Paul McClintock AO (former Chairman of the CRC) has commented in this regard that “use of performance information from National Agreements is poorly understood – there is not a lot of evidence that governments are improving their performance in response to the findings”.⁸⁹ The IGAFRR lacked an agreed performance management system which would have enabled the parties to

⁸⁷ COAG Reform Council, *COAG Reform Agenda: Report on progress 2011*, p. 37.

⁸⁸ Parliament of Australia, Joint Committee of Public Accounts and Audit, *Report 427 – Inquiry into National Funding Agreements*, Canberra, 2011, p. 19.

⁸⁹ P McClintock, *Accountability for Outcomes: Facing the Challenges*, address to the COAG Reform Council Centre of Excellence, 1 August 2012.

understand how performance information was being utilised to inform decisions around allocation of resources, budgeting, planning and the design of new programmes.

Had the IGAFRR taken a more comprehensive approach to accountability, it might have enabled governments to better determine what service improvements could improve efficiency in outcomes. COAG members could have outlined their proposed course of action in response to specific performance information. Such a system would have made visible the decisions taken by States and Territories to enhance service delivery based upon performance information. In turn this would have strengthened public accountability as citizens would have been able to understand how governments were tackling emerging challenges in key reform areas.

Since the abolition of the CRC in 2014, the responsibility for monitoring performance under the IGAFRR has been transferred to the Department of the Prime Minister and Cabinet. Additionally, the Productivity Commission has been given funding for a year to develop transitional reporting arrangements with the Department retaining ongoing responsibility for monitoring of State and Territory performance.⁹⁰

A crucial consideration in relation to accountability arrangements is also the provision for public and parliamentary scrutiny of intergovernmental transfers. The Inquiry into National Funding Agreements, conducted by the Joint Committee of Public Accounts and Audit in November 2011, noted a submission by the Victorian Government stating that:

... while it is appropriate that the Commonwealth government, through the Commonwealth Parliament is accountable for areas it is directly responsible for ... Commonwealth Ministers and officials should not however be asked to answer for the performance of State and Territory governments.⁹¹

Question 2.5: As effective public accountability relies heavily on the provision of performance information, how do we ensure that citizens have confidence in such information?

The possibility that the IGAFRR might not live up to its promise was foreseen by some. In 2008, Fenna noted that there were three ‘hitches’:

One is the ‘rigorous focus on outcomes’ ... In a relatively benign version, this would be a form of centrally facilitated yardstick competition. In a less benign form, the Commonwealth would assume responsibility for rewarding or punishing States on their performances. The second hitch is that the old SPPs do not disappear; rather they are reduced to an estimated 30 per cent of the total tied funding and are re-styled ‘National Performance [sic] Payments’. The third is that if fully implemented, the reforms impose little restraint on the future use of the Commonwealth’s spending power. Tied grants may be pared back, but there is little to stop them sprouting up afresh and little to arrest a return to the old ways.⁹²

⁹⁰ Australian Government Department of the Prime Minister and Cabinet, *Portfolio Budget Statements 2014-15*, Prime Minister and Cabinet portfolio, 2014, p. 25.

⁹¹ The new *Public Governance, Performance and Accountability Act 2013* does not impose performance reporting requirements for Commonwealth funding given to the States under Section 96.

⁹² Fenna, pp. 509-529.

Question 2.6: What, if any, mechanisms should be put in place to ensure that reforms to federal financial relations that allow States and Territories to be more 'sovereign in their own sphere' are not easily wound back?

PART 3: REVENUE AND EXPENDITURE MISMATCH

3.1 Context

In 1902 Alfred Deakin said that the “the power of the purse” would lead to the States being “financially bound to the chariot wheels of the Central Government”.⁹³ What starts with good intentions towards cooperation can morph into something more coercive if the Commonwealth considers its own reform objectives are being compromised.

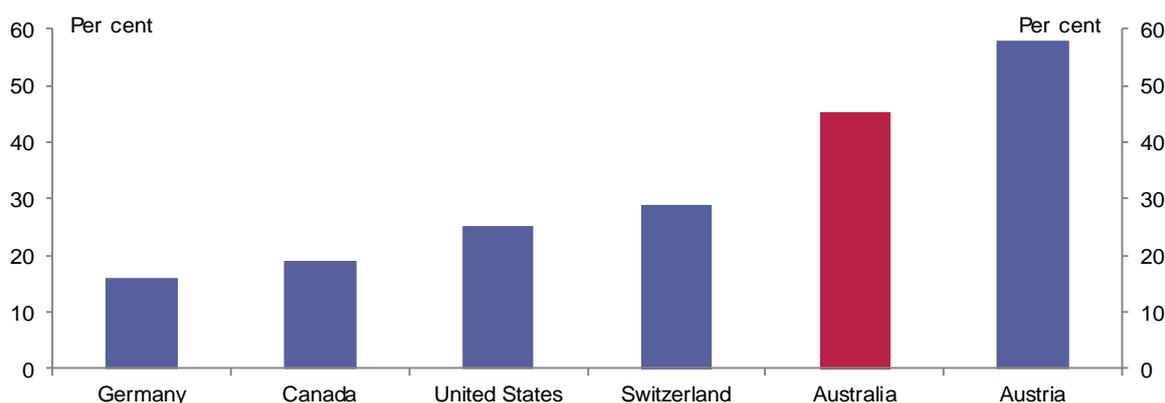
Cooperative federalism has the potential to turn into ‘coercive federalism’ (see Issues Paper 1, *A Federation for Our Future*) because of our Federation’s fiscal arrangements. Appleby, Aroney and John identify that:

The fiscal relationship between the central government and sub-national government units is one of the most challenging facets of any federal system. With fiscal power comes policy power, particularly in the negotiation of intergovernmental agreements. Thus fiscal dominance within a federal system brings with it the ability to skew the federal balance.⁹⁴

Almost from the very outset Australia’s Federation has been characterised by a significant degree of vertical fiscal imbalance (VFI). While the States’ revenue is insufficient to meet their extensive responsibilities, the Commonwealth’s revenue exceeds its spending requirements. Over time this disparity has continued to grow. As a consequence of this disparity, the States and Territories have increasingly depended on grants from the Commonwealth to meet their expenditure obligations. These grants have become an abiding feature of an extensive system of intergovernmental transfers.⁹⁵

While VFI is a feature of most federations, Australia has a high level of VFI when compared with other federations, as illustrated in Figure 3.1. Further information on the drivers of VFI in some of these federations is at [Appendix A](#).

Figure 3.1: Vertical fiscal imbalance in selected federations



Note: VFI is defined as central government grants as a per cent of total sub-national government revenue.

Source: IMF Government Finance Statistics Yearbook 2008, United States Census Bureau State and Local Government Finance, 2011.

⁹³ Anonymous column [written by Alfred Deakin] in the *London Morning Post*, 1902.

⁹⁴ G Appleby, N Aroney & T John, *The Future of Australian Federalism*, Cambridge University Press, Cambridge, 2012, p. 17.

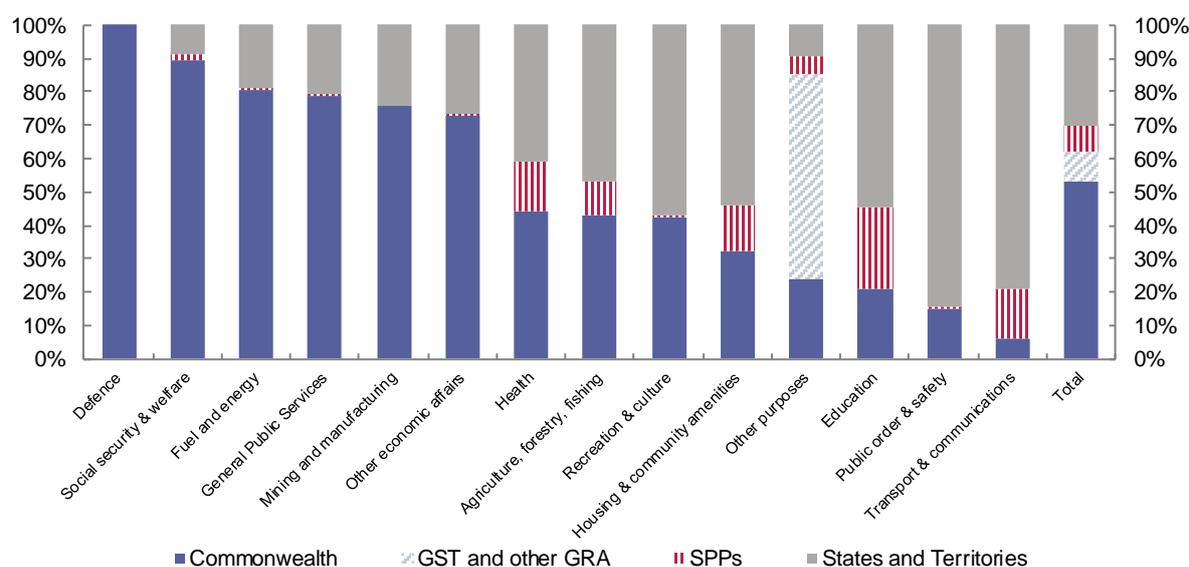
⁹⁵ G Banks, A Fenna, & L McDonald, ‘Australia’s federal context’, in A Fenna & F Knüpling (eds), *Benchmarking in Federal Systems*, Productivity Commission and Forum of Federations, Melbourne, 2010, p. 187-189.

Commonwealth grants comprise a large proportion of State and Territory budgets. Total Commonwealth grants to the States and Territories (including grants to local government) were \$92.3 billion in 2012-13, or around 45 per cent of total State and Territory revenue. The Goods and Services Tax (GST) comprises just over half of these Commonwealth grants. Excluding the GST, the rest of the Commonwealth grants (which are mostly specific purpose grants) comprise 21.5 per cent of total State and Territory revenue. Commonwealth grants to the States, Territories and local government are also a substantial part of the Commonwealth Budget: estimated to be 24.2 per cent in 2012-13⁹⁶, or about 6.1 per cent of Gross Domestic Product (GDP).

A number of effects can result from significant levels of VFI. It can create opportunities for the Commonwealth to step into areas that are traditionally the responsibility of States and Territories. It can result in an expectation by the public (and in some cases by States and Territories) that the Commonwealth will fill fiscal and policy gaps, including in areas of State and Territory responsibility.⁹⁷ It can also reduce pressure on States and Territories to rely on their own revenue sources. At the same time, it can leave State and Territory budgets heavily dependent on Commonwealth grants that may be unilaterally reduced at any time to meet the evolving fiscal priorities of the national government.⁹⁸ All of these effects can result in reduced transparency and accountability.

Figure 3.2 shows the high level of State and Territory reliance on Commonwealth funding across a range of functional areas of expenditure.

Figure 3.2: Commonwealth and State and Territory expenditure by function



2012-13 data. Source: Commonwealth Treasury, 2013.

Note: these functions are drawn from the Government Purpose Classifications used under the ABS Government Finance Statistics dataset. Under these classifications, mining and manufacturing also includes construction; and agriculture, forestry and fishing also includes hunting.

⁹⁶ Commonwealth of Australia, *Final Budget Outcome 2012-13*, Canberra, 2013, p. 67

⁹⁷ Bird & Smart: "Given the structure of federal transfers, state governments may behave opportunistically in order to extract more resources from the centre, reflecting the inherent externalities when some portion of the additional federal taxes needed to finance transfers may be exported to taxpayers in other regions."

⁹⁸ Fenna, p. 515.

On the revenue side of the ledger, the Constitution provides the Commonwealth with the ability to impose any kind of tax, while the States and Territories also have a general power to levy taxes, with the exception of tariffs, customs and excise.⁹⁹

The most significant change to the taxation arrangements in the Federation came in the Second World War, when the Commonwealth made the receipt of general revenue assistance through section 96 payments conditional on the States not levying separate income taxes. Since then, the amount of revenue raised by the Commonwealth has increased, with most of the major taxes (personal and corporate income tax and the GST) now imposed under Commonwealth legislation. Further information on the history of our VFI is at [Appendix D](#).¹⁰⁰

The States and Territories have a range of taxes on payrolls (following a referral of Commonwealth power in 1971), land, certain transactions (such as stamp duty on conveyances) and gambling¹⁰¹. They also charge users directly for goods and services and impose royalties on minerals extracted in their jurisdiction, while royalties on most offshore resources accrue to the Commonwealth.

While the interpretation of the Constitution taken by the High Court in successive cases has prevented the States and Territories from imposing taxes on the production, manufacture, sale or distribution of goods, they continue to have access to two very efficient taxes, a broad-based payroll tax and land tax.¹⁰² However, interstate tax competition has led to some State and Territory taxes being partially competed away, as well as the abolition of estate taxes by all States and the Commonwealth by the early 1980s.¹⁰³

Of total Australian tax revenue in 2012-13, the Commonwealth raised 81.5 per cent and the States and Territories raised 15.1 per cent, with local governments raising the remainder.¹⁰⁴ The GST, which accounted for 12.1 per cent of total Australian tax revenue, is raised by the Commonwealth; however, all net GST revenue is transferred to the States and Territories on an untied basis.

⁹⁹ Section 90 of the Australian Constitution.

¹⁰⁰ Australian Bureau of Statistics *Taxation Revenue*, cat. no. 5506.0, indicates that personal and corporate income tax, and GST together comprised 67.2 per cent of total taxation in Australia in 2012-13.

¹⁰¹ Western Australia does not levy a tax on gambling machines (including poker machines) because they do not allow them outside the casino.

¹⁰² The *Australia's Future Tax System* 'Report to the Treasurer' also states that "to the extent that the burden of a broad-based payroll tax will fall on workers and a broad-based land tax on landowners, the immobility of these resources (relative to capital) make them good taxes for the States" (Commonwealth of Australia, Canberra, 2010, p. 679).

¹⁰³ Commonwealth of Australia, *Australia's Future Tax System*, 'Architecture of Australia's Tax and Transfer System', Canberra, 2008, p. 292 and p.301.

¹⁰⁴ Australian Bureau of Statistics, *Taxation Revenue 2012-13*, cat. no. 5506.0 and Secretariat calculations. State tax revenue excludes mineral royalties and user charging.

Box 3.1: A summary of High Court decisions that have affected the financial arrangements of the Federation

Section 94 of the Constitution was designed to give reassurance that States would continue to receive Commonwealth payments ‘of all surplus revenue of the Commonwealth’¹ at regular (monthly) intervals. The meaning of ‘surplus revenue’ was tested within a decade of Federation in *NSW v Commonwealth (Surplus Revenue Case)* (1908) 7 CLR 179, when the High Court found there was no Constitutional impediment to the Commonwealth paying unused revenue into trust accounts, to be used in future years. This effectively denied the States access to a stream of revenue thought protected by section 94.

The landmark *First Uniform Tax Case* (1942) 65 CLR 373 enabled the Commonwealth to increase its tax raising capacity by offering financially attractive arrangements to the States.² After failing to reach a political solution at the Premiers’ Conference in April 1942, the Curtin Government introduced legislation the following month to achieve its goal.³ Victoria, South Australia, Queensland and Western Australia immediately challenged the scheme. The High Court found that States could continue to impose income taxes; rather it was the political decision by States to accept conditions on section 96 grants that resulted in their effective ceding of income tax raising capacity. The decision was upheld in a subsequent challenge by the States in 1957.

A series of High Court decisions on the meaning of ‘excise’ further narrowed the possible revenue bases of States and Territories.⁴ The most significant of these (in terms of State and Territory revenue foregone) was in 1997. In *Ha v New South Wales* (1997) 189 CLR 465 the High Court decided that State business franchise fees on tobacco, alcohol and petrol were in fact excises. Under section 90 of the Constitution it is illegal for States and Territories to charge excises, so this decision meant a significant and unexpected loss of revenue for the States and Territories. This decision left the Commonwealth with more revenue than it needed; the 1999 Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations was hurriedly drawn up to distribute the revenue back to States and Territories.

Recent High Court cases have articulated limitations on the Commonwealth’s direct spending power. In *Pape v Commissioner of Taxation* [2009] HCA 23, the High Court rejected the proposition that the appropriation of moneys in accordance with sections 81 and 83 of the Constitution conferred a substantive spending power on the Commonwealth, holding instead that the power to spend appropriated moneys must be found elsewhere in the Constitution or in statutes made under it.⁵ Where the Commonwealth does not have legislative or executive power under the Constitution to support direct spending, it can grant Commonwealth raised funds to the States under section 96. This was the approach ultimately taken with school chaplaincy funding after *Williams v Commonwealth of Australia* [2014] HCA 23 (Williams No 2). In this way, the grants power might be seen to entrench VFI by allowing revenue raised by the Commonwealth to be used for State and Territory responsibilities.

¹ Section 94 of the Australian Constitution.

² *South Australia and Ors. v the Commonwealth* [The First Uniform Tax Case] (1942) 65 CLR 373, 417, Latham CJ.

³ C Saunders, ‘The Uniform Income Tax Cases’, in HP Lee & G Winterton (eds) *Australian Constitutional Landmarks*, Cambridge University Press, Cambridge, 2010, p. 67.

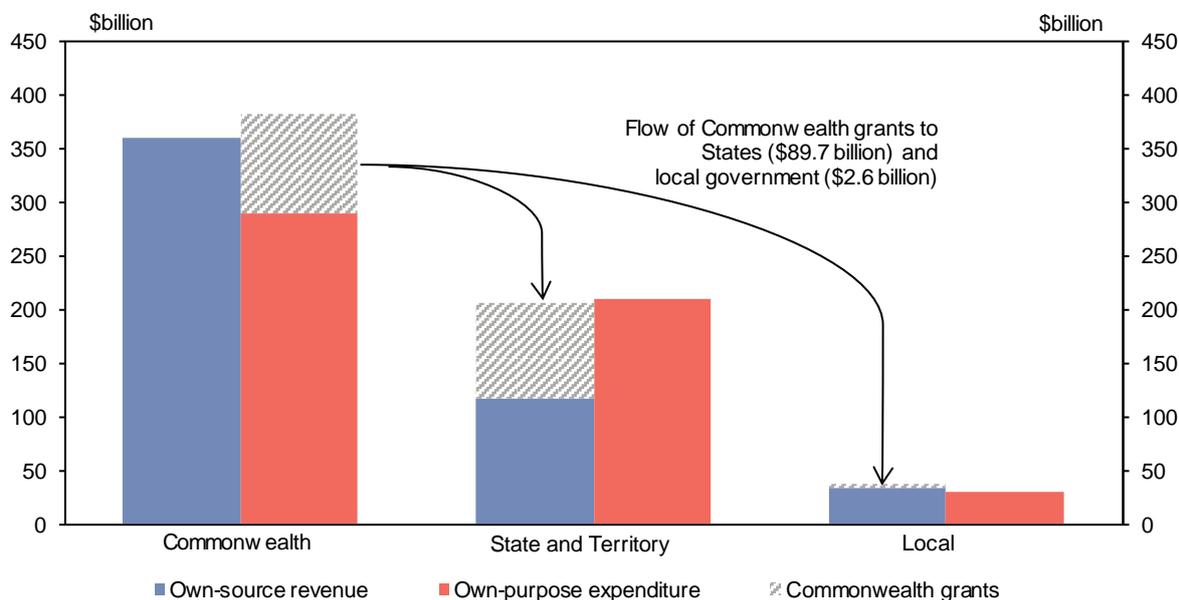
⁴ *Ha v New South Wales* (1997) 189 CLR 465; *Western Australia v Hamersley Iron Pty Limited (No 1)* (1969) 120 CLR 42; *Western Australia v Chamberlain Industries Pty Ltd* (1970) 121 CLR 1 (19 February 1970).

⁵ [at 111-113, 210, 320 & 606-607]

Figure 3.3 illustrates the quantum of total revenue and total expenditure for each level of government in 2012-13. It is evident from this figure that Commonwealth grants to other levels of government are a significant part of the Commonwealth Budget, as well as a significant part of

State and Territory and local government revenue. The arrows illustrate how much of the Commonwealth Budget is distributed to the States and Territories and to local government. In the State and Territory column, the shaded area, Commonwealth grants (comprising both GST and specific purpose grants), represents the extent of VFI.

Figure 3.3: Impact of Commonwealth grants on different levels of government, 2012-13



Notes: Commonwealth payments comprise general revenue assistance (including GST) and specific purpose payments. Commonwealth financial assistance grants to local government are paid through States and Territories; however, this has not been included in State and Territory revenue or expenditure in the graph. State and Territory expenditure and local government revenue also include State and Territory grants to local government.

Source: ABS Government Finance Statistics Cat. No. 5512.0 and Commonwealth 2012-13 Final Budget Outcome.

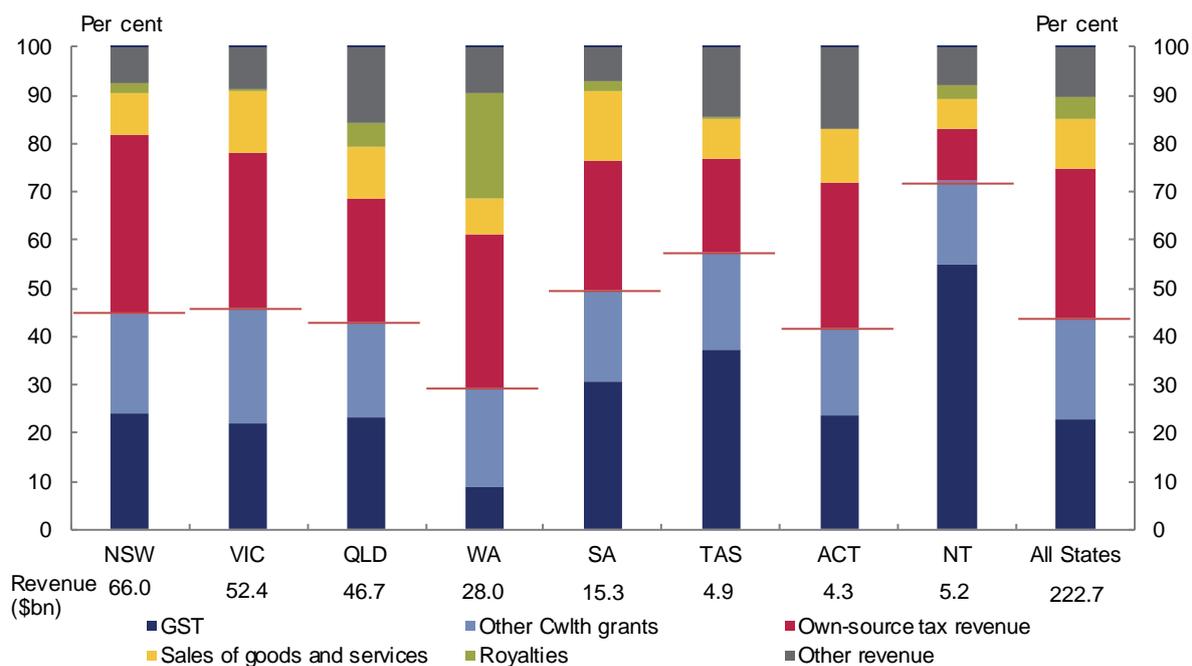
While overall Commonwealth grants have remained fairly stable as a proportion of total Commonwealth spending over the 10 years to 2012-13, specific purpose grants grew by 64.8 per cent over this period, while general revenue assistance (of which the vast majority is the GST) grew by 14.4 per cent.¹⁰⁵ States and Territories are able to allocate general revenue assistance grants for any purpose, while specific purpose grants have varying conditions attached to them. Hence, this trend has reduced the proportion of more flexible funding available to the States and Territories. This trend has been partly driven by reduced growth in GST receipts.¹⁰⁶

Figure 3.4 summarises the key revenue sources of each State and Territory in 2013-14, with the degree of VFI shown by the horizontal red line. The degree of VFI varies by State and Territory. Western Australia receives 29.6 per cent of its revenue from Commonwealth grants (the least of any State or Territory), while the Northern Territory receives 72.2 per cent of its revenue from Commonwealth grants (the most of any State or Territory). Variations in the share of GST allocated to each State and Territory are driven by the principle of horizontal fiscal equalisation (more detail on this is at Part 4).

¹⁰⁵ Parliamentary Budget Office, *Australian Government spending, Part 1: Historical trends from 2002-03 to 2012-13*, Canberra, February 2013, p. 55.

¹⁰⁶ Parliamentary Budget Office, *Australian Government spending, Part 1: Historical trends from 2002-03 to 2012-13*, p.55.

Figure 3.4: Revenue source by State and Territory; the level of VFI is beneath the red line

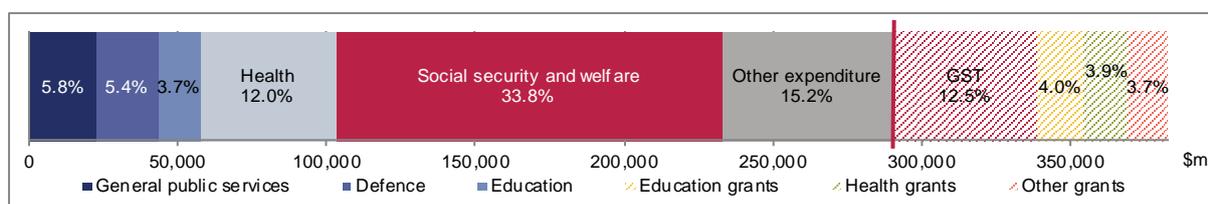


2013-14 data. Source: State budgets, ABS. cat. no. 5512.0 and Commonwealth Final Budget Outcome 2013-14.

3.2 What is the impact of the current structure of VFI?

A key objective of the White Paper will be to ensure that our federal system has a clearer allocation of roles and responsibilities between different levels of government, not for its own sake, but to improve services for citizens. Australia’s level of VFI is a function of the revenue sources and expenditure responsibilities of the Commonwealth and the States and Territories. Figures 3.5 and 3.6 show Commonwealth and State and Territory expenditure by function. These figures illustrate the potential that a substantial level of VFI brings for increased overlap and duplication in key areas, such as health and education, particularly through the use of specific purpose grants, which can significantly influence State and Territory policies and programmes.

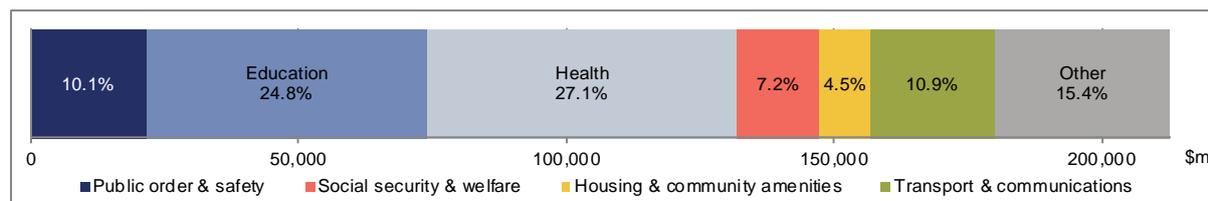
Figure 3.5: Commonwealth expenditure by function, 2012-13



Note: VFI is shown to the right of the vertical red line. Striped boxes indicate grants to States. All the bars to the left of the vertical red line are Commonwealth own-purpose expenditure.

Source: ABS Cat. No. 5512.0, Commonwealth Final Budget Outcome 2012-13.

Figure 3.6: State and Territory expenditure by function, 2012-13



Source: ABS Cat. No. 5512.0.

3.2.1 Benefits of VFI

Having the national government collect the majority of taxes reduces the administrative cost of taxation through economies of scale generally, and, for businesses that operate across sub-national jurisdictions, lowers compliance costs as they need to deal with only one set of rules and one tax collection agency for any particular tax.¹⁰⁷ The benefits of reduced administrative costs can also apply to both national and sub-national taxes where they are collected by the national tax collection agency.

Allowing room for intergovernmental transfers provides scope to help sub-national governments adjust to major changes in economic circumstances if necessary, as participation in a common national currency means sub-national governments do not have access to macroeconomic levers such as monetary and exchange rate policy.¹⁰⁸

VFI provides the national government with the scope to fiscally equalise between sub-national governments, so that they have a similar fiscal capacity to provide similar levels of services across the country. This currently occurs in Australia through the distribution of the GST.

When externalities, spill-overs across borders or strong equity considerations merit an initiative by the national government to act in areas of sub-national government responsibility, the additional revenue available to a national government allows it to do so. A national approach to the Murray-Darling Basin is one example of this. However, this resort to the 'national interest' argument to justify Commonwealth intervention in many areas can be overdone, especially in the face of community concern over some issue, when the idea of 'a national approach' as the only legitimate response gains some traction in the media.

3.2.2 Disadvantages of VFI

Many commentators consider the extent of VFI in Australia to be undesirably large and, in several important respects, leads to the imposition of constraints on the autonomy (or sovereignty) of States and Territories.¹⁰⁹ This occurs when the national government uses its fiscal influence to shape sub-national government policies and programmes, through the use of tied grants. This can impose a 'one-size-fits-all' approach which may not be in the best interests of all citizens, as it can undermine innovation, and the ability to tailor programme design and delivery to local circumstances.

¹⁰⁷ Commonwealth of Australia, *Australia's Future Tax System*, 'Architecture of Australia's Tax and Transfer System', p. 303.

¹⁰⁸ R Boadway, *International Lessons in Fiscal Federalism Design*, eJournal of Tax Research, UNSW, Sydney, 2012, p. 25.

¹⁰⁹ A Morris, 'Commonwealth of Australia', in A Shah (ed), *The Practice of Fiscal Federalism: Comparative Perspectives*, McGill-Queen's University Press, Montreal & Kingston, 2007, p. 55.

The imposition of conditions through tied grants can also reduce accountability, particularly where these conditions do not align with the policies of the sub-national government responding to community preferences. Citizens may hold sub-national governments responsible for not meeting service delivery expectations, even though the choices of sub-national governments were constrained.

A high degree of VFI arguably increases the risk of blame shifting between levels of governments. The sub-national government can blame inadequacies in service provision on inadequate funding from the national government. Equally, the national government can blame poor outcomes on inadequacies in administration or implementation by the sub-national government,¹¹⁰ thus justifying further intervention in the sub-national government's business and exacerbating the risk of overlap.

When a government does not have to raise the revenue it spends, a 'fiscal illusion'¹¹¹ may result. This potentially leads to an over-provision of services, as governments which receive grants obtain a political benefit from providing services without the political cost of raising revenue.¹¹² Conversely, when a national government chooses to spend its excess revenue, this can lead to an over-provision of services in areas of national government responsibility.

The International Monetary Fund (IMF) argues that there is merit in optimising the degree of revenue autonomy of sub-national governments, citing empirical evidence showing that giving sufficient revenue autonomy to sub-national governments is a critical condition for success in containing expenditure.¹¹³ Sub-national governments are encouraged to spend and reform efficiently when they have to tax their citizens and be accountable to them. The IMF cites Eyraud and Lusinyan, who showed that in OECD countries, the general government fiscal balance improves, on average by 1 per cent of GDP, when financing equivalent to one-tenth of sub-national expenditure shifts from grants or borrowing to sub-national taxes.

The misalignment between expenditure and taxation may also lead to a moral hazard problem, whereby the national government is pressured to transfer extra funds to sub-national governments that are facing difficult fiscal circumstances, softening the sub-national government's budget constraint and leading to an inefficient allocation of resources.¹¹⁴ Conversely, the misalignment can compromise sub-national government finances if national government grants can be unilaterally reduced at any time to meet the national government's evolving fiscal priorities.¹¹⁵

¹¹⁰ Commonwealth of Australia, *Australia's Future Tax System*, 'Architecture of Australia's Tax and Transfer System', p. 303.

¹¹¹ A fiscal illusion refers to the possibility that citizens may not appreciate the actual cost of the services they receive due to the tax raised to fund the services not being fully visible to them. In relation to intergovernmental grants, this illusion may occur if citizens do not link their payment of tax to one level of government with the provision of services by another level of government (*Australia's Future Tax System*, 'Architecture of Australia's Tax and Transfer System', p.302).

¹¹² Commonwealth of Australia, *Australia's Future Tax System*, 'Architecture of Australia's Tax and Transfer System', p. 303.

¹¹³ International Monetary Fund, *Fiscal Monitor – Public Expenditure Reform: Making Difficult Choices*, Washington, April 2014, p. 42.

¹¹⁴ Bird & Smart, p. 81.

¹¹⁵ Fenna, p. 515.

A reliance on grants by the sub-national government reduces revenue certainty, since the recurrent funding from the national government is not a guaranteed income stream, but rather funding that is at risk of being turned off or reduced. This uncertainty is not conducive to good policy.¹¹⁶ The provision of grants also results in administration costs which might otherwise be avoided if revenue and expenditure responsibilities were better aligned. For example, grants often create a desire or need by the national government to negotiate and monitor conditions on grant payments.¹¹⁷

Together, these issues highlight the importance of governments raising their own marginal revenue to fund their marginal expenditure, thereby making government financing more transparent and governments more accountable to the electorate for their additional spending and the revenue raised for it.

Question 3.1: Is the current level of Australia's VFI a problem? If so, how much of a problem does this pose for Australia's Federation?

Question 3.2: What are the advantages and disadvantages of moving closer towards vertical fiscal balance?

Box 3.2: Role of the Federation and Tax White Papers

The Federation White Paper will consider the issues of vertical fiscal imbalance and horizontal fiscal equalisation. However, the focus of this attention will be on how revenue collected by the Commonwealth is distributed to and among the States and Territories, so as to ensure fiscal sustainability for both levels of government, for a given set of re-allocated expenditure responsibilities.

The Tax White Paper will consider the bases and rates of taxes levied at the Commonwealth and State and Territory levels.

It is difficult to separate these issues completely, because the question of how much revenue each level of government should raise in the future is closely related to what expenditure responsibilities each level of government will have. Conversely, the question of which expenditure responsibilities each level of government should assume is influenced by the revenue-raising capacities of each level of government.

Examination of revenue-raising responsibilities and expenditure responsibilities will need to occur in lock-step, to assess the overall impact of individual changes on VFI, and to consider trade-offs and options for alleviating any undesirable impacts. This is why the Federation White Paper will be closely aligned with the Tax White Paper, so that proposals may be developed and considered together.

¹¹⁶ B Hinz, 'Hands off, Canberra: education is better off with the States', *The Conversation*, 14 July 2014.

¹¹⁷ Commonwealth of Australia, *Australia's Future Tax System*, 'Architecture of Australia's Tax and Transfer System', p. 303.

3.3 Opportunities for reform

Given the current fiscal pressures facing all levels of government, which will increase as population ageing creates greater demand for services, we need to consider opportunities for reform that are fiscally sustainable. To the extent that Australia's high level of VFI adds to the fiscal pressures facing governments, we need to consider how VFI could be reduced, without losing the benefits described in the previous section.

In practice, reducing VFI may be challenging, as it requires either:

- changes to spending responsibilities (with the Commonwealth increasing its spending responsibilities to more closely match its revenue);
- expansion of existing State and Territory taxes or charges, or sharing of the Commonwealth tax base (such as income tax),¹¹⁸ together with commensurate reductions in Commonwealth taxes so there is no net increase in the tax burden; or
- some combination of the above.

In the absence of any changes to the overall level of VFI, it may still be possible to shift the balance between specific purpose grants and general revenue assistance, and to consider how far that could go to addressing concerns around efficiency and accountability. Issues around minimising administration and compliance overheads, as well as the durability of such arrangements, would need to be considered, while also maintaining incentives for sub-national governments to spend efficiently and rely on their own taxes to finance their marginal expenditure decisions.

Previous attempts to consider substantial reform on the allocation of roles and responsibilities have often come to little. The financial transfers involved from one level of government to another to support changes to expenditure responsibilities have been too big to contemplate in the absence of a simultaneous reform in other areas of spending or in revenue-raising responsibilities. This time around; however, there is a good opportunity to effect change as revenue issues are 'on the table' and will also be considered in the Tax White Paper.

Question 3.3: To what extent do questions regarding Commonwealth and State and Territory revenue raising and expenditure responsibilities need to be considered simultaneously?

Question 3.4: Should governments wish to reduce the level of VFI, what is the best way of achieving this?

Question 3.5: Should some level of VFI remain, how do we ensure a high level of public accountability, and what governance arrangements are needed for long term durability?

¹¹⁸ With regard to sharing the Commonwealth tax base, there would be a reduction in VFI only if the Commonwealth reduced its income tax rates to allow the States to raise their own rates. An arrangement where the Commonwealth simply transferred taxes that it raises to the States (such as with the GST) would not technically reduce VFI.

3.4 The situation for local governments

Australia's Federation today comprises 566 local governing bodies.¹¹⁹ The States and the Northern Territory¹²⁰ provide the legislative framework in which local government operates, and oversee its operations in their respective jurisdictions.

While local governments differ in many ways — such as the scope and scale of their functions, as well as their size, economic and geographic characteristics — they face similar problems to State and Territory governments in terms of having own-source revenue that does not fully meet their expenditure needs.

Local governments across Australia have a variety of roles and functions and deliver a wide range of services. They have legislative and regulatory functions that are defined in State and Northern Territory statutes, enabling them to make and enforce local laws. They are also responsible for land-use, town planning, environmental planning and development approvals within their jurisdiction.

The four largest shares of local government expenditure are in the following areas:

- transport and communication (including road construction and maintenance, parking, rail and air transport, community transport and communication technology);
- housing and community amenities (including housing and community development, water supply, household garbage and sanitation, sewerage and street lighting);
- general public services (including administrative functions such as executive, legislative and financial affairs); and
- recreation and culture (including public halls, swimming pools, national parks and wildlife, libraries, museums and art galleries).¹²¹

There is considerable variability among States and Territories in the roles and responsibilities of local governments. For example:

- sewerage and water supply services are a local government function in Tasmania, rural New South Wales and outside south-east Queensland, but a State responsibility elsewhere;
- a large number of local governments in Victoria provide some welfare services, especially aged care, on behalf of the Commonwealth and Victorian Governments;
- local governments in Western Australia and Queensland are required to maintain a larger network of local roads than other States and Territories; and

¹¹⁹ According to the *2010-11 Local Government National Report* (Commonwealth of Australia, Canberra, 2013, p. 3), there were 566 local governing bodies in 2010-11, including 556 local governments and 10 declared local governing bodies (which includes five Indigenous local governing bodies, and other bodies such as Lord Howe Island).

¹²⁰ There are no local governments in the Australian Capital Territory.

¹²¹ Productivity Commission, *Assessing Local Government Revenue Raising Capacity*, Research Report, Canberra, 2008, p. 18.

- the Brisbane City Council provides urban public transport services, which are a State responsibility elsewhere.¹²²

Local government revenue comes from three main sources. The first two sources - taxation (property rates) and user charges - represent own-source revenue. The third source is grants from other levels of government. A fourth source, categorised as 'miscellaneous' by the ABS, consists of revenue raised through the likes of investment interest, dividend interest, income from public enterprises and fines.

Local government own-source revenue represents about 85 per cent of total local government revenue, aggregated at the national level.¹²³ Property rates, and fees and charges account for the majority of own-source revenue, with property rates the only source of tax available to local governments. However, their combined share has decreased over time, reflecting growth in other own-source revenues, such as developer charges and fines.

Grants represent about 15 per cent of total local government revenue, although the level of grants differs significantly across councils. A quarter of councils receive 44 per cent or more of their revenue from grants, while ten per cent of councils receive at least 58 per cent of their revenue from grants.¹²⁴ The Commonwealth and the States and Territories each contribute roughly half of all intergovernmental grants to local governments. Total grants per capita in rural areas are usually significantly higher than in urban areas.¹²⁵

The Commonwealth provides two types of grant to local government: financial assistance grants and specific purpose payments. In 1974, the Commonwealth began providing untied financial assistance grants to local government, paid through the States and Territories under section 96 of the Constitution. Since the first *Local Government (Financial Assistance) Act* was passed in 1987, these grants have been referred to as financial assistance grants to local government. These grants are paid to local government through the States and Territories and are distributed among the States and Territories on the basis of population. The amount of the grants was increased after 1992 when separate tied Commonwealth funding for local roads, distributed among the States and Territories in shares reflecting their local roads task, was rolled into the financial assistance grants. Local government grants commissions in each State and the Northern Territory determine the distribution of these funds amongst their local governments in accordance with the *Local Government (Financial Assistance) Act 1995*.

The Commonwealth uses specific purpose payments to provide direct funding to local governments for local roads and infrastructure (for example, the Roads to Recovery programme), child care programmes, and disability and other services administered by local governments. As local governments are not a signatory to the IGAFRR, Commonwealth financial assistance to local governments is provided outside of the IGAFRR framework.

The States and Territories provide grants to local governments for specific purposes or services, including reimbursements for rate concessions. States and Territories also provide contract

¹²² Productivity Commission, *Assessing Local Government Revenue Raising Capacity*, p. 19.

¹²³ Australian Bureau of Statistics, *Government Finance Statistics 2012-13*, cat. no. 5512.0 and Secretariat calculations.

¹²⁴ Productivity Commission, *Assessing Local Government Revenue Raising Capacity*, p. XXIII.

¹²⁵ Commonwealth of Australia, *2010-11 Local Government National Report*, p. 6.

payments to local governments to carry out some State and Territory functions, which is a form of user charging for local government.

As local governments are creatures of State and Territory governments and deliver services that would otherwise be delivered by them, the *Australia's Future Tax System* Review stated that:

It may be more appropriate for State governments, rather than the Australian Government, to be responsible for ensuring that local governments have access to enough revenue – including through untied financial assistance – to provide local services. The ability of the States to fund untied financial assistance is contingent on the States themselves having access to sustainable tax revenue.¹²⁶

As the Federation and Tax White Papers concurrently consider the expenditure responsibilities and revenue raising of each level of government, the revenue and expenditure base of local government will need to be considered in light of any wider changes to federal financial arrangements.

Question 3.6: What, if any, unnecessary duplication and overlap occurs in roles and responsibilities between local governments and other levels of government?

Question 3.7: What should be the division of roles and responsibilities between local governments and other levels of government? In what areas is a shared role warranted?

Question 3.8: What, if any, reforms are required to the revenue-raising powers and other revenue sources of local government?

¹²⁶ Commonwealth of Australia, *Australia's Future Tax System*, 'Report to the Treasurer', p. 696.

PART 4: INTERSTATE FISCAL EQUITY

4.1 Context: horizontal fiscal equalisation

In all federations, different States or sub-national governments have different capacities to raise revenue or deliver services due to factors largely beyond their control, such as population size, demography and distribution, socio-economic status of citizens, geography and natural resources. Almost all federations have some mechanism for redistributing financial resources in order to reduce these disparities and ensure all jurisdictions are able to deliver services to their population at a comparable standard. This process is known as horizontal fiscal equalisation (HFE).

The necessity of HFE becomes clear when comparing the situation of federations with nations that have a unitary system of government, where the national government is wholly responsible for revenue raising and service delivery to all citizens. It has been argued that “HFE provides a similar outcome to what would happen if Australia were a unitary system”, by using the revenue it collects from across the country to deliver a comparable standard of services to all citizens regardless of where they lived.¹²⁷ Additionally, if there were no system of HFE, “fiscal inefficiency can arise as households and business have an incentive to locate in regions of greater fiscal capacity simply to take advantage of lower tax rates and/or higher public service levels”,¹²⁸ rather than on the basis of economic opportunities.

4.2 HFE in Australia

In Australia, special grants to assist States with a lower fiscal capacity had been made since at least 1910. A greater desire for independent advice on how to assist these States resulted in the establishment of the Commonwealth Grants Commission (CGC) in 1933. From 1981, a system of full multi-state equalisation was progressively introduced, whereby the relative needs of each State and Territory are assessed against the average fiscal capacity of *all* States and Territories: an increased share of the equalisation pool for one State or Territory reduces the share of other States and Territories (a ‘zero-sum game’). Prior to the Goods and Services Tax (GST), the equalisation pool was a sum of money that had been determined historically, and was paid out to States and Territories in the form of untied financial assistance grants.

Since the introduction of the GST in 2000, the practice of HFE is mainly performed through adjustments to the quantum of the revenue from the GST provided to each State and Territory.¹²⁹ All GST revenue raised by the Commonwealth is then passed onto the States and Territories according to the principle of full equalisation.¹³⁰

¹²⁷ Commonwealth of Australia, *GST Distribution Review*, Interim Report, Canberra, 2012, p. 147.

¹²⁸ R Boadway, ‘International Lessons in Fiscal Federalism Design’, *eJournal of Tax Research*, vol. 10, no. 1, 2012, p. 23.

¹²⁹ Apart from the GST distribution, there are other funding mechanisms that contain an implicit fiscal equalisation element. For example, many specific purpose grants are distributed to the States on the basis of need in a particular policy area.

¹³⁰ ‘Full’ equalisation means that, once fiscal capacities are assessed, the system aims to bring all States to the average fiscal level, in order for them to have the capacity to provide services and infrastructure to citizens at the same standard.

HFE is administered in Australia by the Commonwealth based on advice from the CGC. The CGC's current definition of HFE is as follows:

State governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.¹³¹

The definition has evolved over time. The original 1936 definition was:

Special grants are justified when a state through financial stress from any cause is unable efficiently to discharge its functions as a member of the federation and should be determined as the amount of help found necessary to make it possible for that state by reasonable effort to function at a standard not appreciably below that of other states.¹³²

The key difference to be noted is that in the early definition, the intention was to ensure that States can provide services “not appreciably below that of other States”, whereas the modern version aims to ensure provision “at the same standard”.

In addition to changing the definition of HFE over time, the CGC makes changes to its method of assessments through regular five-yearly reviews. Detail on the latest review is at section 4.3.

It is worth noting that HFE does not guarantee that the States and Territories will actually provide a uniform standard of service across the country; its aim is to equalise the *fiscal capacity* of each State and Territory to do so, while leaving each State and Territory free to determine their standard and level of service provision. Additionally, while *full* equalisation is the objective in Australia, the CGC does not aim to achieve *precise* equalisation, since not all revenue and expenditure factors will be included, either because they cannot be reliably measured or have an immaterial impact.¹³³

The CGC recommends to the Treasurer the GST revenue sharing ‘relativities’, which reflect how much GST revenue each State or Territory receives compared with what it would receive based on its population share (or ‘equal per capita’ share). The relativities are assessed in respect of each jurisdiction’s revenue and expenditure capacities, which are driven by innate factors largely beyond the control of each State or Territory.

The use of relativities means States and Territories that have a fiscal capacity above the national average will receive a share of the GST pool that is *less* than their equal per capita share (making them ‘donor’ States or Territories), while States and Territories that have a fiscal capacity below the average will receive a GST share that is *more* than their equal per capita share (making them ‘recipient’ States or Territories).

Table 4.1 provides a breakdown of State and Territory relativities for 2014-15, and the GST distribution that is expected to result from these relativities. The table shows that currently New

¹³¹ Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities – 2010 Review*, Vol. 1, Canberra, 2010, p. 34.

¹³² Commonwealth Grants Commission, *The Commonwealth Grants Commission: The Last 25 Years*, Canberra, 2008, p. 107.

¹³³ Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities – 2015 Review*, Draft Report, Canberra, 2014, pp. 12-13.

South Wales, Victoria and Western Australia are the donor States while the other jurisdictions are the recipient States and Territories.

The States and Territories that are donors and recipients also change over time as their economies and demographic profiles evolve – the States and Territories that will be donors in the future may not be the same as the donors today, or today’s donors may have been recipients in the past.

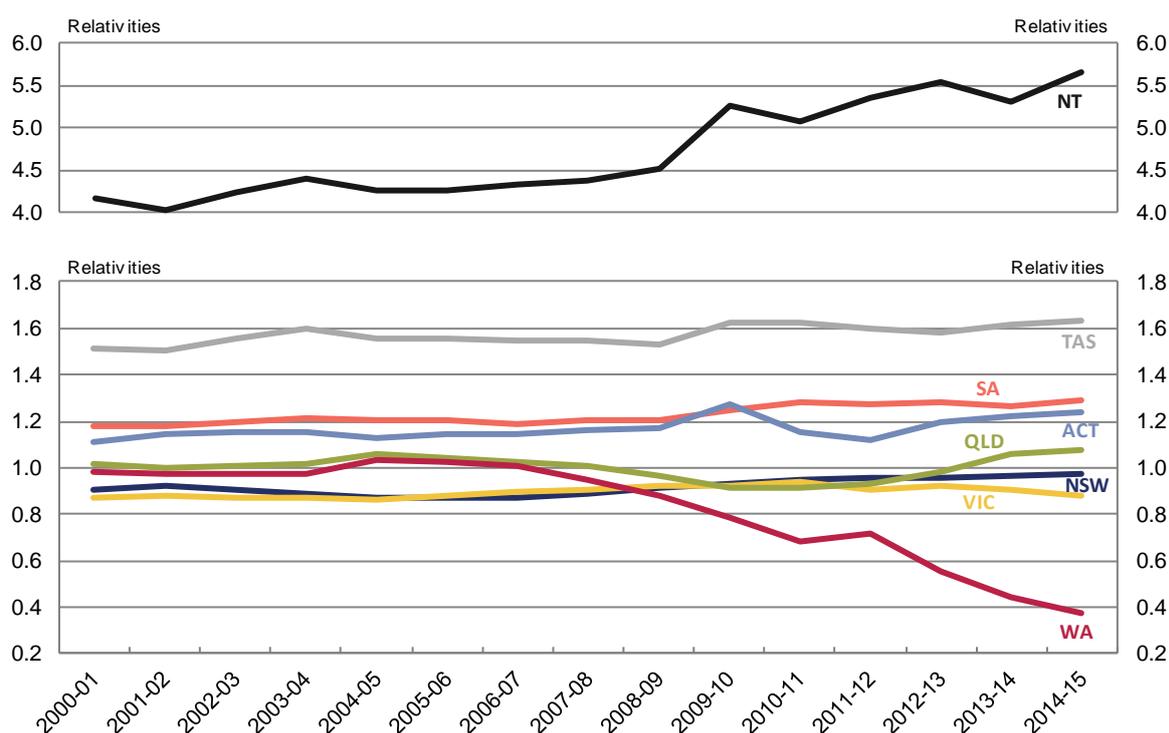
Table 4.1: Difference from equal per capita distribution, 2014-15

	GST relativity	GST distribution \$million	Equal per capita distribution of GST \$million	Redistribution(a) \$million	Projected population ('000)	Per capita redistribution \$
NSW	0.97500	16,758.1	17,119.5	-361.5	7,567	-47.8
VIC	0.88282	11,828.4	13,345.2	-1,516.8	5,899	-257.2
QLD	1.07876	11,735.7	10,835.6	900.0	4,789	187.9
WA	0.37627	2,255.3	5,970.0	-3,714.7	2,639	-1,407.8
SA	1.28803	4,956.3	3,832.7	1,123.6	1,694	663.3
TAS	1.63485	1,911.4	1,164.5	746.9	515	1,451.1
ACT	1.23600	1,098.6	885.3	213.3	391	545.1
NT	5.66061	3,166.4	557.1	2,609.2	246	10,595.4
Total	n/a	53,710.0	53,710.0	5,593.0	23,740	n/a

(a) The total redistribution of \$5593.0 million is the sum of the positive items in that column.

Source: 2014-15 Commonwealth Budget Paper No. 3.

Figure 4.1: GST relativities 2000-01 to 2014-15



Source: Commonwealth Grants Commission Report on GST Revenue Sharing Relativities, 2014 Update.

Note: Prior to 2009-10, the relativities reflected a combined pool of GST and health care grants. Since 2009-10, the relativities have been applied to a pool of GST revenue only. With a smaller pool, the relative fiscal capacities of the States and Territories play a bigger role in determining the measured relativities, accentuating the differences between them.

Figure 4.1 shows how GST relativities have changed since the introduction of the GST in 2000-01. Most notable is the substantial decrease in Western Australia’s relativity, which is

largely a result of its improved revenue-raising capacity from increased mining royalties. Northern Territory's relativity has also increased since the mid-2000s, with the higher level of need required for its significant Indigenous and remote population continuing to reinforce its high relativity, while Queensland has shown a trend reversal, with increasing relativities since 2011-12. The other States and Territories had relatively stable GST relativities over this period.

Prior to 2000, New South Wales and Victoria were consistently the two principal donor States, while the others tended to be recipient States and Territories, although Queensland and Western Australia were closer to a per capita share than the smaller States and Territories.

Australia has a long history of applying equalisation. Its system is more comprehensive than those in other federations (with the possible exception of Germany), and it aims to achieve a high degree of equality in State and Territory fiscal capacities.¹³⁴ By contrast, while HFE is a feature of fiscal arrangements in other federations, most only provide some form of partial equalisation (for example, raising poorer jurisdictions up to an average but not necessarily pulling richer jurisdictions down to the average). Further background on the CGC's methods in determining the distribution of GST, and the history of HFE in Australia is at [Appendix E](#). Background on international approaches to HFE is at [Appendix A](#).

4.3 Recent and parallel processes

A major review of HFE occurred with the release of the GST Distribution Review by the Hon John Brumby, Mr Bruce Carter and the Hon Nick Greiner AC in late 2012. The Review considered whether the current form of HFE will ensure that Australia is best placed to respond to its long-term economic, demographic and social challenges, while guided by the principle that the GST would continue to be distributed to the States and Territories on the basis of equalisation payments.

The GST Distribution Review did not recommend fundamental change to the HFE system in the short to medium term. Its recommendations focused on improving the system's governance, transparency, stability and simplicity, but with only relatively minor effects on any State's GST share. However, it did put forward a longer-term reform vision of an equal per capita distribution of the GST, with the Commonwealth providing equalisation funding to the smaller States and Territories to ensure they continue to have the capacity to provide comparable services to those of the larger States. The Review suggests that this could be based on a guaranteed proportion of GDP.¹³⁵ The Review noted that this could be feasible in a scenario where there is better alignment of national tax bases and service responsibilities, resulting in a reduced level of VFI.

The 2014 National Commission of Audit recommended new arrangements to address HFE, while also recommending an approach to reducing the level of VFI.¹³⁶ The Commission of Audit recommended sharing all GST revenue on an equal per capita basis, with the Commonwealth providing an additional grant to current recipient States and Territories to ensure that no State

¹³⁴ J Spasovejic & M Nicholas, 'Fiscal Equalisation in Australia', *Australian Journal of Public Administration*, vol. 72, no. 3, 2013, p. 326.

¹³⁵ Commonwealth of Australia, *GST Distribution Review*, Final Report, Canberra, 2012, pp. 20-21.

¹³⁶ Commonwealth of Australia, *National Commission of Audit 2014*, Phase One, p. 74.

or Territory is worse off compared with the existing equalisation process. In the Commission of Audit's model, the CGC would determine the distribution of additional equalisation grants.

The CGC is currently undertaking its 2015 Methodology Review, due to report in February 2015. This is a comprehensive review of the system for determining relativities and grant shares under HFE which occurs around every five years. These reviews have been limited to the equalisation methodology rather than the principles and objectives of equalisation. The Methodology Review's Terms of Reference incorporate a number of recommendations of the GST Distribution Review relating to the operation of the current HFE system.¹³⁷ Outcomes of the Methodology Review will apply to GST distribution from 2015-16.

4.4 Assessment of horizontal fiscal equalisation

4.4.1 Balancing comprehensiveness and simplicity

Critics argue that the current equalisation methodology is very comprehensive, but too complex. Submissions to the 2012 GST Distribution Review raised the need for further simplification, despite previous efforts by the CGC to simplify the process through their Methodology Reviews.¹³⁸

Critics also note the system's reliance on judgment and potential unpredictability which affects the budget planning of States and Territories. Despite years of close examination by the CGC and the States and Territories, there continues to be intense debate and analysis about the correct quantification of expenditure and revenue needs.¹³⁹ The current methodology is also criticised for using internal standards (i.e. what States and Territories do) rather than 'best practice' standards (i.e. what States and Territories should do) to determine appropriate benchmarks for revenue capacity and expenditure need, although it is difficult to reach agreement about 'best practice' standards.

The 2012 GST Distribution Review was tasked with considering changes to the form of equalisation, and whether alternative approaches would provide reduced complexity and increased transparency, while also considering equity, predictability and stability in the determination of GST distributions.

The Review concluded that, in general, simplified methodologies tended to reduce the degree of equalisation and result in greater differences in redistribution. For example, an equal per capita allocation of GST would result in a significant redistribution away from recipient States and Territories, while smaller moves to simplification (such as increasing materiality thresholds) would result in a much smaller redistribution away from recipient States and Territories. In short, the Review concluded that "it is not possible to closely replicate the outcomes of the current system in a dramatically simpler way".¹⁴⁰ The Review concluded that "we can neither recommend very small changes that would deliver only symbolic benefits to the large States ...

¹³⁷ Commonwealth Grants Commission, *Report on State Revenue Sharing Relativities – 2015 Review*, Draft Report. The Terms of Reference may be found here:

<<https://www.cgc.gov.au/attachments/article/156/Terms%20of%20reference.pdf>>.

¹³⁸ Commonwealth of Australia, *GST Distribution Review*, Interim Report, p. 43.

¹³⁹ For example, see R Garnaut & V FitzGerald, *Review of Commonwealth-State Funding*, Final Report, Melbourne, 2002, p. 55, and the submissions made to the *GST Distribution Review* regarding simplicity.

¹⁴⁰ Commonwealth of Australia, *GST Distribution Review*, Final Report, p. 6.

nor are we prepared to recommend larger changes that would have major negative impacts on small States”.¹⁴¹

The GST Distribution Review recommended only marginal changes to the HFE system in order to ensure that the system is not driven to appear falsely precise. These recommendations relate to the materiality thresholds around revenue and expense assessments, and the number of decimal places in the GST relativities, with these to be considered in the 2015 Methodology Review. The GST Distribution Review stated that any reform proposals to simplify HFE would lead to either *less equalisation* than under the present model or *less precision* through a more general form of equalisation.¹⁴²

Question 4.1: Does fairness for all citizens require the differences in the fiscal capacities of the States and Territories to be fully eliminated? If not, what degree of difference is tolerable and still consistent with fairness?

Question 4.2: What is the best approach for re-distributing financial resources between States and Territories to reduce disparities in fiscal capacity to deliver public services and infrastructure at a comparable standard?

4.4.2 Treatment of Commonwealth grants to the States and Territories

Commonwealth specific purpose grants are a significant source of State and Territory revenue and act as a supplement to fund services. As these grants are effectively another source of revenue for the States and Territories, they are generally taken into account in determining the distribution of the GST. The GST Distribution Review noted that should these revenue sources not be included in the calculation, a State or Territory that received more than their population share of Commonwealth grants would end up with an above average fiscal capacity, thus undermining the intent of the HFE process.¹⁴³

The inclusion of specific purpose grants in the calculation of GST relativities effectively means that HFE redistributes these grants, albeit with a time lag due to the redistribution methodology. For example, if NSW receives a \$100 million grant, all else being equal, its GST funding would be reduced by about \$70 million over time (reflecting its population share of about 30 per cent). The \$70 million would be redistributed to other States and Territories to equalise fiscal capacity. This methodology can create problems with one-off Commonwealth grants, such as infrastructure grants,¹⁴⁴ as the States and Territories generally require the full amount of Commonwealth funding under the grant to complete specific projects; however, this comes at the cost of reduced GST revenue to fund other ongoing and emerging budget priorities.¹⁴⁵ The

¹⁴¹ Commonwealth of Australia, *GST Distribution Review*, Final Report, p. 56.

¹⁴² Commonwealth of Australia, *GST Distribution Review*, Final Report, p. 47.

¹⁴³ Commonwealth of Australia, *GST Distribution Review*, Interim Report, p. 83.

¹⁴⁴ Parallel to the White Paper process, the CGC Methodology Review is developing a new transport infrastructure assessment, to include, if appropriate, a framework to identify which transport infrastructure project grants are nationally significant and should therefore be partly excluded from HFE consideration.

¹⁴⁵ Commonwealth of Australia, *GST Distribution Review*, Interim Report, p. 85.

lumpiness of infrastructure grants across States and Territories over time can also be a major cause of volatility in GST relativities.¹⁴⁶

There is discretion for the Commonwealth Treasurer to quarantine Commonwealth grants from the calculation of the GST distribution, allowing States and Territories to retain the full amount of the Commonwealth grant without any subsequent reduction in GST funding. However, a decision to quarantine a large grant to one State or Territory can have significant ripple effects on the quantum of funding going to all other States and Territories, who sometimes view Commonwealth decisions to quarantine grants as arbitrary and unpredictable.¹⁴⁷

Question 4.3: What is the most appropriate way of treating Commonwealth grants, in regard to their impact on the distribution of the GST?

4.4.3 Does horizontal fiscal equalisation create disincentives for improving revenue generation or reforms to promote economic development?

In light of concerns that HFE led to various inefficient outcomes, the GST Distribution Review considered whether HFE:

- encouraged States to change tax or spending policies to maximise their GST share;
- discouraged tax reform;
- encouraged higher taxes;
- discouraged policies to promote economic development;
- discouraged efficient service delivery;
- discouraged efficient migration;
- created grant dependency; or
- led to excessive provision of public services.

With regard to the efficiency of service delivery, the CGC states that its methodology:

does not penalise efficient States nor reward inefficient ones. States are funded on the assumption that they can deliver services at the average observed level of efficiency. If a State is more efficient than the average, it retains the benefit. If it has below average efficiency it bears the cost.¹⁴⁸

The GST Distribution Review's finding in relation to the above concerns was that while the current system of HFE creates perverse theoretical incentives in some instances, there was little evidence of any effect in the real world. The Review concluded that there was little or no evidence that HFE acts as a material disincentive to State tax reform.¹⁴⁹ Even while there may be some merit in addressing perverse incentives on principle alone, the Review concluded that these cannot be meaningfully reduced without significant reductions in equalisation outcomes.

¹⁴⁶ Commonwealth of Australia, *GST Distribution Review*, Interim Report, p. 85.

¹⁴⁷ Commonwealth of Australia, *GST Distribution Review*, Final Report, p. 70.

¹⁴⁸ Commonwealth Grants Commission, *Report on GST Revenue Sharing Relativities – 2014 Update*, Canberra, 2014, p.32.

¹⁴⁹ It is notable that the ACT have recently embarked on major tax reform, by phasing out stamp duty on conveyances and replacing it with a broad-based land tax.

Given the lack of evidence of efficiency losses in practice, the Review was not convinced this would be a worthwhile trade-off.¹⁵⁰

In relation to tax reform, while this is likely to result in gains and losses in the distribution of funding for different States and Territories, the Review asserted that a number of other factors would primarily drive State and Territory tax policy decisions, such as political considerations associated with large changes in the gross incidence of taxation. The Review doubted that effects on GST distribution were a key factor in influencing policy decisions around tax reform.¹⁵¹

However, Warren states that:

the case may be different with major reforms, such as a major restructuring of State taxation. It has been shown that the CGC HFE methodology, which is based on the principle of “what States do”, is influenced by major reforms and can therefore impact directly and significantly on a State’s GST grant share during a period of major change. This is not a criticism of the CGC or the HFE methodology, which is well suited to a steady-state environment. Rather, it is an acknowledgement that there is a sound case for focusing on policy options to complement the current CGC methodology ... to ensure that the benefits of reform are retained and built upon by the States.¹⁵²

Question 4.4: Does the current system of HFE create disincentives for jurisdictions to improve their own revenue generation or to make reforms necessary to improve their economies? If so, how can this be addressed? Should it be addressed through HFE?

¹⁵⁰ Commonwealth of Australia, *GST Distribution Review*, Final Report, p. 140.

¹⁵¹ Commonwealth of Australia, *GST Distribution Review*, Final Report, p. 136-137

¹⁵² N Warren, ‘Intergovernmental Fiscal Arrangements as a Constraint on State Tax Reform under Henry’, in C Evans, R Krever & P Mellor (eds), *Australia’s Future Tax System: The Prospects under Henry*, Thomson Reuters, Sydney, 2010, p. 350.

APPENDIX A: FISCAL ARRANGEMENTS IN OTHER FEDERATIONS

Canada

The drivers of vertical fiscal imbalance

Canada's federal government has the constitutional right to raise revenues through any mode of taxation. However, its three largest tax sources – personal income tax, sales tax and payroll tax – are shared with Canada's provincial governments. In the case of personal income tax, the provinces must abide by the federal tax base but are allowed discretion with respect to choosing their tax rates and rate structures, including both the size of tax brackets and the use of tax credits. The provinces must also abide by a common allocation formula for personal income tax, which allocates income to the provinces on the basis of a taxpayer's province of residence on 31 December of each tax year. The provinces also own the natural resources within their borders and can manage and tax them as they see fit, although, like Australia, there is significant disparity in the ability of provinces to raise revenue from natural resources.¹⁵³

The Canadian Constitution assigns exclusive legislative authority to the provinces in areas such as health, education, social services and highways. Exclusive federal powers are limited to defence, international trade, criminal justice and unemployment insurance, while shared areas include immigration, agriculture and pensions.

The proportion of provincial expenditure financed by own-source revenues has been gradually increasing for several decades, both because provinces have been levying a greater proportion of the overall tax base and because their expenditure responsibilities have been rising more rapidly than has the level of federal-provincial transfers.¹⁵⁴ Despite the theoretical possibilities of tax competition arising between provinces, there seems to have been little competition to date on corporate and personal income tax.¹⁵⁵

There remains some level of vertical fiscal imbalance (VFI) in the Canadian federation, with federal grants comprising approximately 19 per cent of total province revenue.

Framework for intergovernmental transfers

The federal government transfers funds to the provinces and territories through four main intergovernmental agreements: the Canada Health Transfer, the Canada Social Transfer, transfers for equalisation and the Territorial Formula Financing scheme. The health and social transfers are allocated on an equal per capita basis amongst all provinces and territories, with the social transfer encompassing welfare and postsecondary education. These transfers have minimal conditions attached.¹⁵⁶

¹⁵³ R Boadway, 'Canada', in A Shah (ed), *The Practice of Fiscal Federalism: Comparative Perspectives*, McGill-Queen's University Press, Montreal & Kingston, 2007, p.116.

¹⁵⁴ Boadway, 2007, p.111.

¹⁵⁵ Boadway, 2007, p.113.

¹⁵⁶ Boadway, 2007, p.119.

The federal government is committed to providing equalisation payments to address fiscal disparities between the provinces. The fiscal transfer arrangements for Canada's First Nations territories also differ considerably from those applying to the provinces, due to their sparse populations and harsh northern conditions.¹⁵⁷ Apart from the four main block grants, the federal government also provides much smaller transfers to the provinces for specific purposes, such as cost-sharing for national highway funding. These are typically highly conditional and may have matching arrangements.¹⁵⁸

Arrangements for fiscal equalisation

The purpose of Canada's equalisation programme was enshrined in the Canadian Constitution in 1982, which defines the principle of equalisation as ensuring that "provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation".¹⁵⁹ Canada's system aims to achieve this by equalising the revenue-raising capacity of provinces to the national average, known in Canada as the 'ten-province standard'.¹⁶⁰ However, unlike Australia, while Canada's system aims to allow a reasonably comparable level of public service across provinces, it does not actually take into account any actual differences in the costs of providing these services. Further, mining revenue, which is a major source of revenue for some provinces, is subject to a discount of 50 per cent from revenue assessment calculations.

Like Australia, equalisation grants to provinces are untied, and paid from the national government's consolidated revenue. However, in Australia, the equalisation grants comprise a proportion of the GST revenue, which is a Commonwealth tax that is fully assigned to the States and Territories. This gives rise to the GST often being referred to in the public debate as a State tax, and to debates about States' relative 'shares' of the GST. The nature of the debates about fiscal equalisation are different in Canada, where only provinces with below-average capacity receive equalisation payments, while provinces with above-average capacity are able to retain the extra revenue that made them above-average fiscally. Therefore, provinces are not equalised to the same capacity.

While Australia uses an independent expert commission to determine the distribution of equalisation payments to the sub-national governments, equalisation transfers are determined by the federal government in Canada.¹⁶¹ Funding for the First Nations territories is also provided separately from the equalisation programme for the provinces.

¹⁵⁷ Boadway, 2007, p. 108.

¹⁵⁸ Boadway, 2007, p. 119.

¹⁵⁹ Subsection 36(2) of the *Canadian Constitution Act 1982*.

¹⁶⁰ H Blochliger & C Vammalle, 'Canada: The equalisation reform', in *Reforming Fiscal Federalism and Local Government: Beyond the Zero-Sum Game*, OECD Publishing, 2012, p. 65.

¹⁶¹ R Watts, 'Processes for Adjusting Federal Financial Relations: Examples from Australia and Canada', in P Boothe (ed), *Fiscal Relations in Four Countries*, Forum of Federations, Ottawa, 2003, p. 5.

Germany

The drivers of vertical fiscal imbalance

The federal government and *Länder*¹⁶² share all the major tax bases and they are distributed according to a constitutionally-enshrined formula that divides revenue relatively evenly. Neither the federal government nor the *Länder* can decide unilaterally the rate or base of the most important taxes.¹⁶³ Political accountability for tax rates is not clearly defined in Germany. By comparison, Australia has very clear lines of responsibility for tax collection.

Expenditure responsibilities are rarely exclusive to a single sphere of government in Germany and there is a high degree of cooperation between the federal government and the *Länder*. The fact that the *Bundesrat* ('Federal Council') is directly appointed by the *Länder* guarantees that they have direct input in federal government policy settings. Federal grants comprise approximately 16 per cent of total *Länder* revenue.

Framework for intergovernmental transfers

Major cooperative endeavours are enshrined in national or constitutional law and are not left to intergovernmental agreements.¹⁶⁴ The *Länder* have strong input through national processes on the nature and level of intergovernmental transfers.

Legislation that imposes spending responsibilities on the *Länder* governments requires the approval of the *Länder* through the *Bundesrat*. The process of inclusion and cooperation is known as the 'comity' principle, which is a strong design feature that flows through all aspects of German federalism.

Arrangements for fiscal equalisation

Germany has a formal transfer system based on a methodology determined partly by the constitution's requirement of an 'equality of living conditions' across the country, and partly by the federal parliament, including the *Bundesrat*.

Germany's fiscal equalisation system is mainly concerned with equalising the revenue capacities of the *Länder*, with only small adjustments for expenditure needs. Equalisation in Germany is achieved through various means.

Firstly, the value-added tax (VAT) revenue base is shared amongst all levels of government, with the *Länder's* share allocated on an equalising basis. The *Länder's* share of the VAT is about 45 per cent, although this share has varied over time. Of this share, 75 per cent is allocated on an equal per capita basis, while the other 25 per cent is paid to *Länder* with below average revenue-raising capacity.

Secondly, there are direct transfers between the richer *Länder* and the poorer *Länder*, depending on relative financial capacity.

¹⁶² Equivalent to Australia's States and Territories.

¹⁶³ L Feld & J von Hagen, 'Federal Republic of Germany', in A Shah (ed.), *The Practice of Fiscal Federalism: Comparative Perspectives*, McGill-Queen's University Press, Montreal & Kingston, 2007, p. 146.

¹⁶⁴ T Hueglin & A Fenna, *Comparative Federalism: A Systematic Inquiry*, Broadview Press, Ontario, 2006, p. 236.

Lastly, for *Länder* whose financial capacities are still below the average after the distribution of VAT and transfers between *Länder*, the federal government provides supplementary grants.

Switzerland

The drivers of vertical fiscal imbalance

A key feature of the Swiss federation is the substantial autonomy enjoyed by the Swiss cantons (States) in relation to their ability to raise revenue and in relation to their policy and expenditure responsibilities. The cantons have the basic power to tax income, wealth and capital. The federal government relies mainly on indirect taxes and a value-added tax. Additionally, 30 per cent of a federal direct tax on personal and corporate income is shared with the cantons, while cantons and local governments also levy their own personal and corporate income tax. However, the small size of the country leads to intense tax competition, which results in large differences in the tax load. There is a tendency for the wealthy in Switzerland to live in low-tax cantons, although the federal direct tax is highly progressive to partially offset this effect.¹⁶⁵

The federal government has responsibility for areas specified under the Swiss Constitution, such as foreign affairs, defence, customs and monetary policy. All other matters are the responsibility of the cantons. The possibilities for the national government to interfere with canton or local policies are quite limited, while cantons also do not have much say in national politics.¹⁶⁶ However, there remain some shared responsibilities. For example, motorways are built by the cantons as directed and financed by the federal government.

Federal grants and shared taxes comprise approximately 29 per cent of total canton revenue.

Framework for intergovernmental transfers

The federal government provides specific grants, which comprise a basic rate to ensure minimum standard requirements for public services, and an equalisation component (summarised below). While the Swiss constitution does not permit federal conditional grants, in practice certain grants are made for particular programmes, though largely with the consent of the cantons (which could challenge such conditions through a referendum).¹⁶⁷

Intergovernmental transfers to the cantons also include shared revenue, including the proceeds from the federal direct tax on income, as well as customs duties.

Arrangements for fiscal equalisation

There are large differences between the Swiss cantons in regard to land area, population and economic strength. The tax competition outlined above also leads to large differences in the tax burden between different cantons.¹⁶⁸ To address the differences in fiscal capacities between cantons, the cantons receive a constitutionally fixed amount of federal revenue paid into an equalisation fund. An average financial capacity is assessed, whereby cantons with below-

¹⁶⁵ G Kirchgassner & P Gupta, *Sustainable Public Finances with Sub-Federal Fiscal Autonomy: The Case of Switzerland*, Forum of Federations, Ottawa, 2006.

¹⁶⁶ G Kirchgassner, 'Swiss Confederation', in A Shah (ed), *The Practice of Fiscal Federalism: Comparative Perspectives*, McGill-Queen's University Press, Montreal & Kingston, 2007, p. 322.

¹⁶⁷ G Anderson, *Fiscal Federalism: A Comparative Introduction*, Oxford University Press, Ontario, 2010, p. 60.

¹⁶⁸ Kirchgassner, p. 320, 333.

average financial capacities are financed by richer cantons and the federal government, with the federal government providing about 70 per cent of the equalisation funds.¹⁶⁹ Like the Canadian system, the Swiss system seeks only to ensure partial equalisation: ensuring that poorer cantons do not go below 85 per cent of the national average and doing little to equalise the richer cantons down to that average.

United States

The drivers of vertical fiscal imbalance

There is a significant degree of overlap in revenue-raising responsibilities, with the federal government and most states both taxing personal and corporate income, while states and local governments both charge sales tax in most states. There is also considerable variety in tax settings and service levels across the states.

While the United States constitution leaves most internal governance tasks to the states, over the years the federal government has greatly expanded its role through a combination of broad interpretation of certain key powers and conditional grants. Although VFI is lower than in Australia, with federal grants comprising approximately 25 per cent of total state revenue, those grants typically involve a high degree of conditionality.

More than 80 per cent of transfers in the United States are conditional. These grants include conditions such as ‘cross-cutting sanctions’, whereby one grant imposes conditions on other programmes, or ‘unfunded mandates’, which require states to undertake certain actions without financial assistance.¹⁷⁰

Frameworks for intergovernmental transfers

Intergovernmental payments are determined by Congress in an ad hoc manner.¹⁷¹ There is no process of formal engagement between the federal government and the states, with relatively underdeveloped networks for intergovernmental meetings or agreed processes for determining how to distribute revenue from the federal government. States typically promote their interests through bilateral meetings or through lobbyists.¹⁷² US Senators also play a role in promoting the interest of their states.¹⁷³

Arrangements for fiscal equalisation

While the level of economic disparity between states is greater in the United States than in Australia, the US does not have a formal equalisation system.¹⁷⁴ The Congressional Budget Office, similar to Australia’s Parliamentary Budget Office, does undertake occasional analysis of the effects of grants to the states and intergovernmental relations more broadly.

¹⁶⁹ Kirchgassner, p. 335.

¹⁷⁰ Fenna, p. 520.

¹⁷¹ The US Congress is the legislature of the federal government consisting of two houses: the House of Representatives (lower house) and the Senate (upper house).

¹⁷² G Anderson, *Fiscal Federalism: A Comparative Introduction*, Oxford University Press, Ontario, 2010, p. 82.

¹⁷³ Senators are members of the US Senate, with each state represented by two senators, regardless of population.

¹⁷⁴ Anderson, p. 61.

Some of these grants are distributed through an equal per capita system and some on the basis of need. Grants distributed on the basis of need could have an equalisation effect as states with lower fiscal capacities could be disproportionately eligible for such funding. The intent of grants distributed on the basis of need is generally to equalise between people, rather than between the states.¹⁷⁵

¹⁷⁵ W Fox, 'United States of America', in A Shah (ed), *The Practice of Fiscal Federalism: Comparative Perspectives*, McGill-Queen's University Press, Montreal & Kingston, 2007, p. 361.

APPENDIX B: SUPPLEMENTARY INFORMATION ON INSTITUTIONAL ARCHITECTURE

National Partnership Principles

Extract from Schedule E - National Policy and Reform Objectives of the Intergovernmental Agreement on Federal Financial Relations

- E21 The following principles guide the basis of Commonwealth support for a national reform or service delivery improvement in areas of state or territory responsibility, where it:
- (a) is closely linked to a current or emerging national objective or expenditure priority of the Commonwealth — for example, addressing Indigenous disadvantage and social inclusion;
 - (b) has ‘national public good’ characteristics — where the benefits of the involvement extend nationwide;
 - (c) has ‘spill over’ benefits that extend beyond the boundaries of a single State or Territory;
 - (d) has a particularly strong impact on aggregate demand or sensitivity to the economic cycle, consistent with the Commonwealth’s macro-economic management responsibilities; or
 - (e) addresses a need for harmonisation of policy between the States and Territories to reduce barriers to the movement of capital and labour.
- E22 To the fullest extent possible, the structure and design of National Partnership agreements, including the administration and reporting arrangements, will be aligned with the principles for designing National Agreements.
- E23 National Partnerships are generally expected to have limited time horizons. On delivery of the particular initiative which is subject to a National Partnership payment:
- (a) funding would cease because the project, output or reform has been delivered; or
 - (b) where on-going funding is required to maintain a new level of output, such funding may more appropriately be provided through the relevant National SPP Agreement or general revenue assistance.
- E24 National Partnership reward payments would not be paid to a State or Territory until an independent assessment by the CRC demonstrates that performance benchmarks have been achieved.
- E25 National Partnership agreements in areas within the scope of any National Agreement should link directly to the objectives, outcomes and outputs in the relevant National Agreement.
- E26 Commonwealth and State officials will reach prior agreement on the nature and content of any events, announcements, promotional material or publicity relating to National

Partnerships or activity under them. The cooperative nature of National Partnerships, and the roles and contributions of both the Commonwealth and the States and Territories, will be acknowledged and recognised appropriately in any announcement or other promotional material or publicity relating to approved project or programme activity, outputs or outcomes, including on signs, through the use of coats of arms or logos and on plaques affixed to new and refurbished buildings. Appropriate Commonwealth and State Government representatives will be invited to participate in opening ceremonies, product launches or similar events.¹⁷⁶

¹⁷⁶ Council on Federal Financial Relations, *Intergovernmental Agreement on Federal Financial Relations*, Schedule E - National Policy and Reform Objectives, 2009, viewed August 2014, <http://www.federalfinancialrelations.gov.au/content/intergovernmental_agreements.aspx>.

APPENDIX C: SUPPLEMENTARY INFORMATION ON THE INTERGOVERNMENTAL AGREEMENT ON FEDERAL FINANCIAL RELATIONS

Agreement Types

National Agreements and National Partnerships form the two main types of agreements within the Intergovernmental Agreement on Federal Financial Relations (IGAFFR). National Agreements define the objectives, outcomes, outputs and performance indicators, and clarify the roles and responsibilities of the Commonwealth and the States and Territories in the delivery of services across a particular sector. National Partnerships define the mutually agreed objectives, outcomes, outputs and performance benchmarks or milestones related to the delivery of specific projects linked to improvements in service delivery or reform.¹⁷⁷

The IGAFFR has four broad types of payments made by the Commonwealth to the States and Territories to deliver reform:

- *National Specific Purpose Payments (NSPPs)* are ongoing financial contributions to support State and Territory delivery of services in particular sectors (healthcare, schools, skills and workforce development, disability and affordable housing). While these must be expended in the relevant sector, governments retain full budget flexibility to allocate funds within each sector as they see fit to achieve any mutually agreed objectives.
- *National Health Reform (NHR) Funding* –was introduced in July 2011 and differs significantly from NSPPs in areas such as frequency of payments, indexation arrangements, review arrangements and basis for calculation of payments.
- *National Partnership Payments (NPPs)* support the delivery of specified outputs or projects (project payments), to facilitate reforms (facilitation payments) or to reward those jurisdictions that deliver on nationally significant reforms (reward payments). NPPs are time limited.
- *General revenue assistance (GRA)* includes the ongoing provision of GST payments, to be used by the States and Territories for any purpose.¹⁷⁸

Table C.1 below highlights the links between different National Agreements focused on different reform areas and the associated National Specific Purpose Payment. The NSPPs are the funding mechanism to the States and Territories to meet the mutually agreed objectives of the National Agreements. There is no NSPP for the National Indigenous Reform Agreement as its objectives are embedded in other National Agreements and National Partnerships, which have associated funding.

¹⁷⁷ Council of Australian Governments, *The Federal Financial Relations Framework*, 2009, viewed August 2014, <https://www.coag.gov.au/the_federal_financial_relations_framework>.

¹⁷⁸ COAG Reform Council, *COAG reform agenda: Report on progress 2011*, p. 24.

Table C.1: National Agreements and their associated National Specific Purpose Payment

National Agreements	National Specific Purpose Payment
National Healthcare Agreement	The NSPP was replaced by the National Health Reform Payments from 2011. It will be replaced by Public Hospital Funding from 2017-18.
National Education Agreement	The NSPP was replaced by Student First Payments from January 2014.
National Agreement for Skills and Workforce Development	National Skills and Workforce Development SPP.
National Disability Agreement	National Disability Services SPP. This will be replaced by the National Disability Insurance Scheme.
National Affordable Housing Agreement	National Affordable Housing SPP.
National Indigenous Reform Agreement	No NSPP.

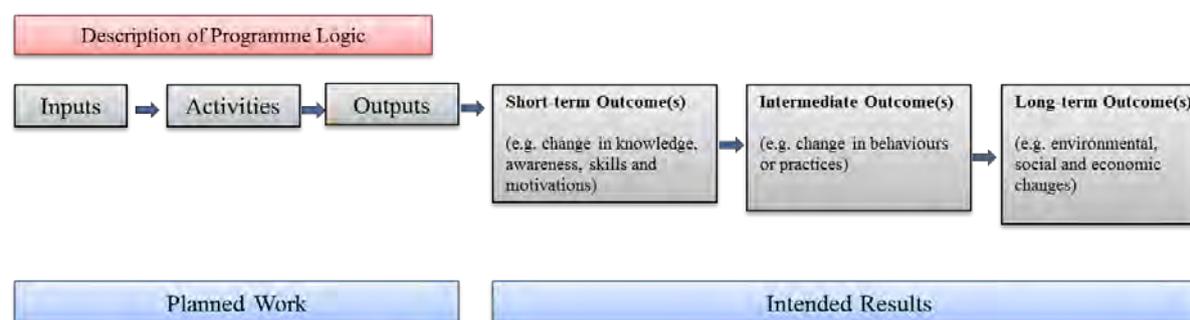
Note: From 1 January 2014, National Education Reform Agreement (NERA) funding replaced the National Schools Specific Purpose Payment for States and Territories that had signed the NERA. The NERA was outside the IGAFRR framework. The National Health Reform Agreement was also signed outside the IGAFRR framework. The National Healthcare SPP was replaced by National Health Reform Payments in 2011 and will be replaced by Public Hospital Funding from 2017-18.

Outcomes and Outputs and Programme Logic Framework

The Australian Government’s outcomes and outputs framework places a strong emphasis on outcomes as the foundation for performance information. Outcomes are the results or consequences of government actions for the community or a specific target group. Outputs on the other hand are an explicit measure of service delivery to people outside an agency.¹⁷⁹

The COAG Reform Council (CRC), in its final report, identified the need for a ‘programme logic framework’ for each reform area when developing an agreement. A programme logic framework would have helped explain the links between inputs, activities, outputs, interim outcomes, and long-term outcomes. The CRC noted that articulation of a programme logic would provide greater confidence that inputs and activities were likely to lead to desired outcomes and a stronger basis for the development of performance frameworks. The schematic below helps illustrate the programme logic framework.¹⁸⁰

Figure C.1: Programme logic framework for outcomes and outputs



¹⁷⁹ I McPhee, *Outcomes and Outputs: Are we managing better as a result*, Australian National Audit Office paper to the CPA National Public Sector Convention, 2005, p. 2.

¹⁸⁰ COAG Reform Council, *Lessons for federal reform: COAG reform agenda 2008-13*, p. 45.

Overview of performance reporting and accountability under the IGAFRR

The IGAFRR framework outlined a distinct approach to enhancing public accountability through a performance reporting framework. This was based upon the following key components:

Enhancing public accountability: The key objective of the performance reporting and accountability framework was to enhance the accountability of governments to the public through simpler, standardised and more transparent public performance reporting for all jurisdictions, underpinned by clearer roles and responsibilities.

Focusing on outcomes: In addition, it sought to replace Commonwealth prescriptions on State and Territory service delivery with a new focus on the achievement by all levels of government of mutually agreed objectives and outcomes.

Developing a reporting framework: The reporting framework focused on the achievement of results, efficient service delivery and timely provision of publicly available performance information.

Reporting under the framework related to:

- the comparative performance of government achievement against objectives, outcomes, outputs and performance benchmarks in areas covered by National Agreements; and
- the achievement by governments of objectives, outcomes, outputs and performance benchmarks in National Partnerships.

Identifying reporting data characteristics: The IGAFRR noted that the effectiveness of the reporting framework depended upon the quality of data underpinning each indicator. The signatories to the IGAFRR agreed that performance data should have a number of characteristics. These included that data should be *meaningful and understandable*, allowing the community to form its own judgement regarding the performance of governments in delivering services. Data was also expected to be *timely and comparable*, thus allowing for the comparison of relative performance across jurisdictions. The agreement also emphasised that data should be *administratively simple and cost effective to collect*. Finally, it highlighted the need for data to be *accurate* in order to allow the community to have confidence in the validity of the performance information being shared with them.

Performance reporting on National Agreements was based upon high level performance indicators for each agreement. Performance reporting on National Partnerships related to the achievement of pre-determined milestones and benchmarks and was linked to the delivery of incentive payments.

Data collection and collation for National Agreement performance data was largely undertaken by the Steering Committee for the Review of Government Service Provision. The Committee also assisted with data collection and collation for a number of National Agreements. The Steering Committee was expected to provide this information to the CRC in a timely manner. It was also expected to comment upon the quality of the performance indicators using quality statements

prepared by various collection agencies and the Australian Bureau of Statistics' Quality Framework.

Role of COAG Reform Council: Until its abolition in 2014, the CRC was the key accountability body for the IGAFRR, and was tasked with providing annual reports to COAG containing performance data on National Agreements and some National Partnerships. The annual reports were expected to highlight examples of good practice and performance across jurisdictions. The CRC was also expected to share its own comparative analysis of the performance of governments in meeting the objectives of the National Agreements.

The signatories to the IGAFRR agreed to provide the CRC with copies of performance reports on National Partnerships that supported the objectives of National Agreements. As an independent assessor, the CRC assessed the achievement of performance benchmarks linked to incentive payments under select National Partnerships. However, the authority to approve National Partnership reward payments rested with the Commonwealth.

National performance reporting system: The IGAFRR advocated the development of a new national performance reporting system. The intent was to reduce data collection costs and confusion in interpreting performance information. Consistent with the move to a single, integrated national reporting system, the signatories to the IGAFRR also agreed to improve Commonwealth and State and Territory data collection processes. They also agreed to develop standard data definitions, data reporting benchmarks and to improve performance indicators.

Commitment to continuous improvement: The IGAFRR committed all signatories to continually improve performance reporting. The task of coordinating such improvement efforts was given to the Standing Council for Federal Financial Relations working in consultation with COAG Councils, the Australian Statistician and other data collection agencies.¹⁸¹

The CRC's mission was to assist COAG to strengthen the performance and public accountability of governments and did so under its four objectives:

1. Enable governments to monitor and improve their performance in the pursuit of COAG reform agenda outcomes;
2. Equip the public with the information they need to interpret performance and hold governments to account;
3. Engage COAG and interested public in strengthening COAG governance and federal relations; and
4. Develop a culture of performance, accountability and innovation.¹⁸²

¹⁸¹ Council on Federal Financial Relations, *Intergovernmental Agreement on Federal Financial Relations*, Schedule C: Public Accountability and Performance Reporting, 2009, viewed August 2014, <http://www.federalfinancialrelations.gov.au/content/intergovernmental_agreements.aspx>.

¹⁸² Deloitte Access Economics, *Assessment of progress under COAG Reform Agenda*, COAG Reform Council, November 2013, p. 11.

Schedule A of the IGAFRR describing the role of the COAG Reform Council

A11 As set out in this Agreement, or otherwise requested by COAG, the Council will report to the Prime Minister, as Chair of COAG, on:

- (a) the publication of performance information for all jurisdictions against National Agreement outcomes and performance benchmarks;
- (b) production of an analytical overview of performance information for each National Agreement, and National Partnership to the extent it supports the objectives in a National Agreement, noting that the Council would draw on a range of sources, including existing subject experts;
- (c) independent assessment of whether predetermined performance benchmarks have been achieved before an incentive payment to reward nationally significant reforms under National Partnerships is made;
- (d) monitoring the aggregate pace of activity in progressing COAG's agreed reform agenda; and
- (e) other matters referred by COAG.

A12 Through the assessment and reporting process, the Council will highlight examples of good practice and performance, but will not have a policy-advising role.

APPENDIX D: BRIEF HISTORY OF THE DRIVERS OF VERTICAL FISCAL IMBALANCE

How did we get to this point?

At Federation, the Constitution limited the responsibilities of the Commonwealth but gave it the important revenue source of customs and excise duties, which had formed around three-quarters of the colonies' revenues. The States, with extensive responsibilities in education, health and law and order, were therefore partially dependent on fiscal transfers from the national government, while also deriving revenue from sources such as income tax, estate and stamp duties, railway profits and royalties.

Over the first decade of Federation, Commonwealth funding to the States initially reflected sections 87 and 94 of the Constitution. The Commonwealth returned to the States their entitlement to three-quarters of all customs and excise duty, as well as all surplus revenue.¹⁸³ However, the return of all surplus revenue ended in 1908, when the High Court's interpretation of 'surplus revenue' effectively denied the States access to a stream of revenue originally thought to be protected by section 94.

The States retained income tax as a major source of revenue. However, in 1915, the Commonwealth started to levy income taxes as a means of raising sufficient funds for its war-related expenditure. As a result, income taxes were levied by the Commonwealth and the States between 1915 and 1942.¹⁸⁴

Two years after the end of World War I, the High Court decided in the *Engineers* case that Commonwealth powers should be interpreted as broadly as their language allowed, ignoring any conventions that may have been supposed about presuming States' responsibilities or any notion of 'Constitutional balance'. In 1926 the High Court also upheld the Commonwealth's ability under section 96 to make conditional funding grants to States.¹⁸⁵ This form of funding became increasingly used by the Commonwealth over the century, and expanded significantly under the Whitlam Government.

The level of vertical fiscal imbalance (VFI) increased markedly following the complete takeover of income tax by the Commonwealth in 1942. This happened after the Commonwealth made the receipt of general revenue assistance through section 96 payments conditional on the States not levying separate income taxes. The High Court upheld this position in the *First Uniform Tax Case*,¹⁸⁶ although it did not find that States could not continue to impose income taxes. Rather, it was the political decision by States to accept conditions on section 96 grants that resulted in their effective ceding of income tax raising capacity.

¹⁸³ D James, 'Federal-State Financial Relations: The Deakin Prophecy', Department of the Parliamentary Library, Research Paper No. 17, 2001, p. 4.

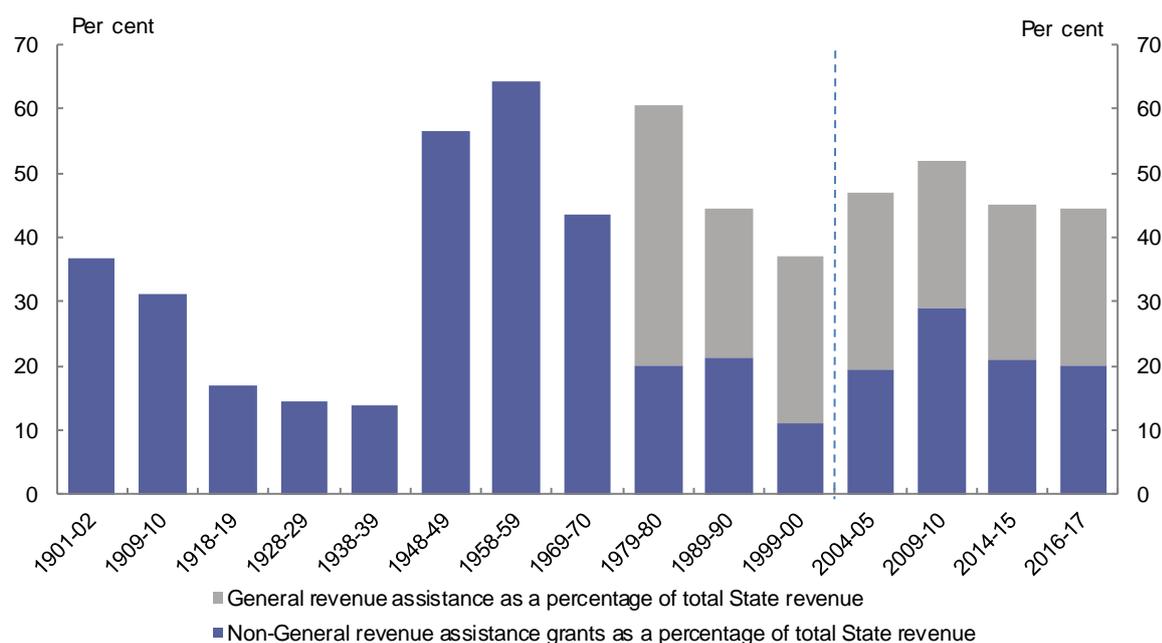
¹⁸⁴ At a Constitutional Conference in Melbourne in 1934, some States proposed that the Commonwealth 'could vacate the field of income tax'. However, when the Commonwealth made a serious offer to withdraw from income taxing arrangements, the States rejected it (R Garran, *Prosper the Commonwealth*, Angus and Robertson, Sydney, 1958, pp. 207-208).

¹⁸⁵ *Victoria v Commonwealth (Federal Roads Case)* (1926) 38 CLR 399.

¹⁸⁶ *First Uniform Tax Case* (1942) 65 CLR 373.

Since then, there have been attempts at amelioration, such as the transfer of the payroll tax to the States in 1971. Later, in 1976, Prime Minister Fraser offered to return income taxing powers to the States by allowing them to enact a surcharge on the Commonwealth personal income tax, although no State took up the opportunity. Thus, a high level of VFI remains a defining feature of Australia's Federation. One intention of the GST, introduced in 2000, was to provide the States and Territories with more secure funding that would grow in line with the economy. In exchange for GST revenue, the States and Territories agreed to abolish inefficient financial transactions taxes (including, amongst others, the financial institution duty, marketable securities duty and debits tax), although not all of these taxes have been abolished in all States and Territories.

Figure D.1: VFI since Federation: Commonwealth grants as a proportion of State revenue



*Prior to 1979-80, this represents all Commonwealth grants as a percentage of total State revenue.

Note: The broken vertical line indicates the introduction of the GST in 2000. GST is now the major component of general revenue assistance.

Source: To 1969-70 – Mathews and Jay (1997) *Federal Finance: Australian fiscal federalism from Federation to McMahon*; 1979-80 onwards – ABS Cat. No 1301.0, Cat. No. 5512.0, *Commonwealth and State Budgets*.

Figure D.1 shows grants from the Commonwealth as a proportion of total State and Territory revenue over time. The changing level of VFI has been driven mainly by changes in taxation responsibilities, rather than changes in expenditure responsibilities.¹⁸⁷ The use of conditional grants under section 96 of the Constitution to pursue Commonwealth policy objectives has also contributed to this trend. The introduction of the GST and the associated abolition of a number of State and Territory taxes resulted in a further increase in the level of VFI.

Table D.1 shows the contributions of State and Territory own-source revenue and Commonwealth grants to State and Territory budgets in 2013-14. More than half of the grants from the Commonwealth come from GST revenue.

¹⁸⁷ Commonwealth of Australia, *Australia's Future Tax System*, Architecture of Australia's Tax and Transfer System, p. 301.

Table D.1: Total State and Territory revenue by source (illustrating VFI), 2013-14

	NSW	VIC	QLD	WA	SA	TAS	ACT	NT	Total
Revenue (\$m)									
Own-source revenue									
Taxation revenue	24,295	16,901	11,845	8,849	4,121	957	1,296	566	68,830
Sales of goods and services	5,677	6,725	5,048	2,078	2,199	395	500	307	22,928
Royalties	1,338	52	2,378	6,025	295	36	0	154	10,279
Other revenue(a)	5,075	4,676	7,338	2,719	1,089	703	729	404	22,731
Total	36,385	28,354	26,609	19,671	7,704	2,091	2,526	1,432	124,768
Commonwealth grants									
GST	15,850	11,508	10,892	2,500	4,652	1,824	1,031	2,834	51,090
Other general revenue assistance(b)	51	25	0	1,182	0	0	37	5	1,300
Specific purpose payments	13,720	12,478	9,233	4,603	2,898	995	748	881	45,557
Total	29,620	24,011	20,125	8,285	7,550	2,819	1,816	3,720	97,948
Total revenue	66,005	52,365	46,734	27,956	15,254	4,910	4,342	5,152	222,716
Proportions (per cent)									
Own-source revenue									
Taxation revenue	36.8	32.3	25.3	31.7	27.0	19.5	29.8	11.0	30.9
Sales of goods and services	8.6	12.8	10.8	7.4	14.4	8.0	11.5	6.0	10.3
Royalties	2.0	0.1	5.1	21.6	1.9	0.7	0.0	3.0	4.6
Other revenue(a)	7.7	8.9	15.7	9.7	7.1	14.3	16.8	7.8	10.2
Total	55.1	54.1	56.9	70.4	50.5	42.6	58.2	27.8	56.0
Commonwealth grants									
GST	24.0	22.0	23.3	8.9	30.5	37.1	23.7	55.0	22.9
Other general revenue assistance(b)	0.1	0.0	0.0	4.2	0.0	0.0	0.9	0.1	0.6
Specific purpose payments	20.8	23.8	19.8	16.5	19.0	20.3	17.2	17.1	20.5
Total (VFI)	44.9	45.9	43.1	29.6	49.5	57.4	41.8	72.2	44.0
Total proportions	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

(a) Other State revenue includes dividend income, income from public trading enterprises, fines and assets acquired below fair value.

(b) Other general revenue assistance includes Snowy Hydro Ltd tax compensation to NSW and Victoria; royalty payments from the North West Shelf oil and gas project and Ranger Project to WA and NT respectively; and municipal services assistance to the ACT.

Note: Totals may not sum exactly due to rounding. Source: Commonwealth Final Budget Outcome 2013-14, State 2014-15 budgets.

APPENDIX E: SUPPLEMENTARY INFORMATION ON INTERSTATE FISCAL EQUITY

History of horizontal fiscal equalisation in Australia

The provision of basic support to States with a lower fiscal capacity than others was a key issue in the lead up to the Federation of Australia in 1901 and led to formal arrangements for ongoing assistance to States through the establishment of the Commonwealth Grants Commission (CGC) in 1933.

Early discussion of equalisation transfers in Australia focused on practical and political issues, such as the continued financial viability of all States, supporting a minimum standard of services and compensating for any losses in revenue associated with joining the Federation. The debate centred on assisting States rather than on delivering equity for their citizens.

Following the establishment of the CGC, the needs of the States with less fiscal capacity ('claimant' States) were assessed against the average fiscal capacity of the more populous States, usually New South Wales and Victoria. Where a claimant State was assessed by the CGC as being fiscally disadvantaged, a special grant for that State was recommended. Up until 1974, special grants recommended by the CGC were basically concerned with assessing a claimant State's minimum financial needs, in order to make it possible for that State by reasonable effort to function at a standard not appreciably below that of other States.¹⁸⁸ Claimant States were generally required to make an above-average effort to raise own-source revenue before being eligible for special assistance.

In 1974, the CGC adopted a methodology whereby special grants were determined to assist claimant States in providing services comparable with that of the more populous States, while leaving States to choose the actual level and range of services provided to its citizens. In assessing the level of the special grant, the CGC considered the potential revenue-raising capacity of the claimant State by comparing revenue bases among States, and assessing the extent to which a claimant State experienced particular expenditure factors in the provision of goods and services. This consideration of both revenue capacities and expenditure barriers is one factor that made the Australian approach to fiscal equalisation unique.

Two key issues were identified with this approach. Firstly, because special grants were only assessed by the CGC when requested by the State, the distribution of the bulk of Commonwealth general revenue assistance was considered to be somewhat ad hoc, and by the 1970s, it was widely felt that a number of smaller States were receiving quite generous funding.¹⁸⁹ Secondly, because special grants were paid by the Commonwealth as additional assistance to the States concerned, it was seen purely as a Commonwealth expense. This situation was seen as

¹⁸⁸ J Hancock & J Smith, *Financing the Federation*, The South Australian Centre for Economic Studies, Adelaide, 2001, p. 45.

¹⁸⁹ D James, 'Federal-State Financial Relations: The Deakin Prophecy', Department of the Parliamentary Library, Research Paper No. 17, 2001, p.28.

unsustainable, given the Commonwealth's concern about its budgetary position during the late 1970s.¹⁹⁰

In order to address these issues, a system of full equalisation was introduced progressively from 1981, emerging from Prime Minister Fraser's New Federalism Policy. Under full equalisation, the relative needs of each State were assessed against the average fiscal capacity of *all* States: an increased share for one State reduced the share of other States. This principle of fiscal equalisation continues to be the approach for carrying out HFE to this day. In 2000, revenue from the GST became the pool by which the principle of HFE would be applied for distributing general revenue assistance among the States, with this approach upheld in an intergovernmental agreement signed in 1999 and renewed in the current Inter-governmental Agreement on Federal Financial Relations which came into effect in 2009.

The current principle of fiscal equalisation

The current principle of full equalisation, as defined by the CGC, focuses on equalising the fiscal capacity of all States and Territories to provide services and infrastructure at the same standard. This differs to the earlier objective of equalisation, which was to ensure the financial viability of the less populous States in the decades that followed Federation, and to enable those States to seek financial support for a standard of service not 'appreciably different' to that of the larger States.

Horizontal fiscal equalisation (HFE) is designed to equalise the capacity of States and Territories to provide services at the same standard. However, since the general revenue grants are untied and States are free to determine their own budget priorities and revenue policies, HFE is *not* designed to equalise the *actual* standard of services provided in each particular area.

A number of commentators, including Walsh, have argued that HFE at the State level provides a similar outcome to what would happen if Australia were a unitary system. HFE could be described as recognising the arbitrary nature of State and Territory borders and factors beyond the control of governments.¹⁹¹

To calculate the distribution of GST revenue using HFE, the CGC uses a total of the actual revenue and expenses of all States and Territories to construct an 'average' State budget, which includes the costs to provide the average level of services and the average revenue raised by State and Territory taxes. It then considers the extent to which States and Territories may be able to raise more or less than the average level of revenue (e.g., due to strong mineral royalty revenues or a buoyant property market), and what factors beyond a State or Territory's control (such as demographic or geographic features) may require it to spend more or less than the average level of expenditure to provide the same standard of services.

¹⁹⁰ R Mathews & B Grewal, *The Public Sector in Jeopardy: Australian Fiscal Federalism from Whitlam to Keating*, Centre for Strategic Economic Studies, Victoria University, Melbourne, 1997, p. 184.

¹⁹¹ As stated in Walsh: "if there are differences between States in the standard of services they provide to their citizens, it should be the result of differences in decisions by democratically elected governments, not the result of differences in their fiscal capacity to provide services of similar standard". C Walsh, *The equity case for equalising fiscal capacities: rationales, value judgments and their implications*, University of Adelaide School of Economics, prepared for the Department of Treasury and Finance, Victoria, 2011.

States and Territories with below average capacity to raise revenue, and/or above average costs to provide services, will receive more than their per capita share of GST revenue. States and Territories with above average capacity to raise revenue, and/or below average costs to provide services, will receive less than their per capita share of GST revenue.

To determine the distribution of GST revenue, each State and Territory will have an assessed revenue level (i.e. the own-source revenue it would raise if it applied the average policies), an assessed level of Commonwealth grants, and an assessed expenditure level (i.e. the funding it would need to provide the average level of services and infrastructure, given its demographic and geographic features). The differences among States and Territories that arise from applying these three assessments is then equalised using the GST grant, thus meeting the requirement that States have the same fiscal capacity to fund their individual needs.

As equalising fiscal capacities is not designed to equalise actual outputs, the GST distribution process will not necessarily result in the same level of services or taxes in all States and Territories, nor direct States and Territories to achieve any specified level of service in any area, nor impose actual budget outcomes in accordance with the CGC's calculations.

When the CGC determines how much GST a State or Territory needs, it divides the required amount by the average GST per capita to produce a 'relativity' for each State and Territory. The relativity is a per capita weight assessed by the CGC for use in calculating the share of the GST revenue a State or Territory requires to achieve HFE. These relativities are recommended to the Commonwealth Treasurer to determine each State and Territory's share of GST, with the Treasurer responsible for making a formal determination of each State and Territory's share. The relativities show how much GST each State and Territory receives as a proportion of its equal per capita share.

This calculation is undertaken for an inquiry period that spans three years (the assessment or reference years). For example, the relativities recommended to distribute GST in 2014-15 are the average of the annual relativities for the three assessment years 2010-11 to 2012-13.

Table E.1 sets out the revenue and expenditure categories that the CGC uses in its assessment.

Table E.1: Categories of State and Territory revenue and expenditure

Revenue	Expenditure (b)
Payroll tax	Schools education
Land tax	Post-secondary education
Stamp duty on conveyances	Admitted patients
Insurance taxes	Community and other health
Motor vehicle taxes	Welfare and housing
Mining revenue	Services to communities
Other revenue (a)	Justice services
	Road maintenance and repairs
	Transport services
	Services to industry
	Depreciation expenses
	Investment in infrastructure (c)
	Net borrowing/lending

Revenue from Commonwealth grants

Other expenses (d)

(a) Includes gambling taxes, emergency levies, user charges and any other revenue in Government Finance Statistics.

(b) Includes expenditure funded by State and Territory revenue, the GST and Commonwealth grants.

(c) Investment on new infrastructure and equipment only. Replacement of existing assets is assumed to be funded by depreciation expenses.

(d) Includes State and Territory legislatures, central administrative agencies, national parks and cultural services and a balancing item to ensure the expenses equal those in Government Finance Statistics .

Table E.2 summarises the factors that are taken into account by the CGC. There are general or ‘use’ factors, (which may be economic, geographic or demographic), expenditure factors and revenue factors.

Table E.2: Major factors, and indicators of revenue

Use factors (indicators of demand)

Population size and growth

Population age and sex structure [also an indicator of cost] (e.g. a higher demand for hospital services by the elderly)

Income (e.g. a greater demand for health and welfare services from low income earners)

Indigenous population [also an indicator of cost]

Number of welfare recipients (e.g. as recipients of concessions for State and Territory services)

Use of public versus private services (e.g. government and non-government schools)

Industry size (e.g. affects need for industry regulation)

Cost factors (indicators of expenditure)

Degree of low English fluency (e.g. greater need for interpreters)

Community size and remoteness (e.g. smaller schools must be provided in remote locations)

Isolation from other States and Territories (e.g. interstate freight costs)

Wage, rental and electricity costs (which forms a part of service delivery costs)

Road length (which affects road maintenance costs)

Indicators of revenue

Wages and salaries (impact on payroll tax)

Land values (impact on land tax and conveyance duty)

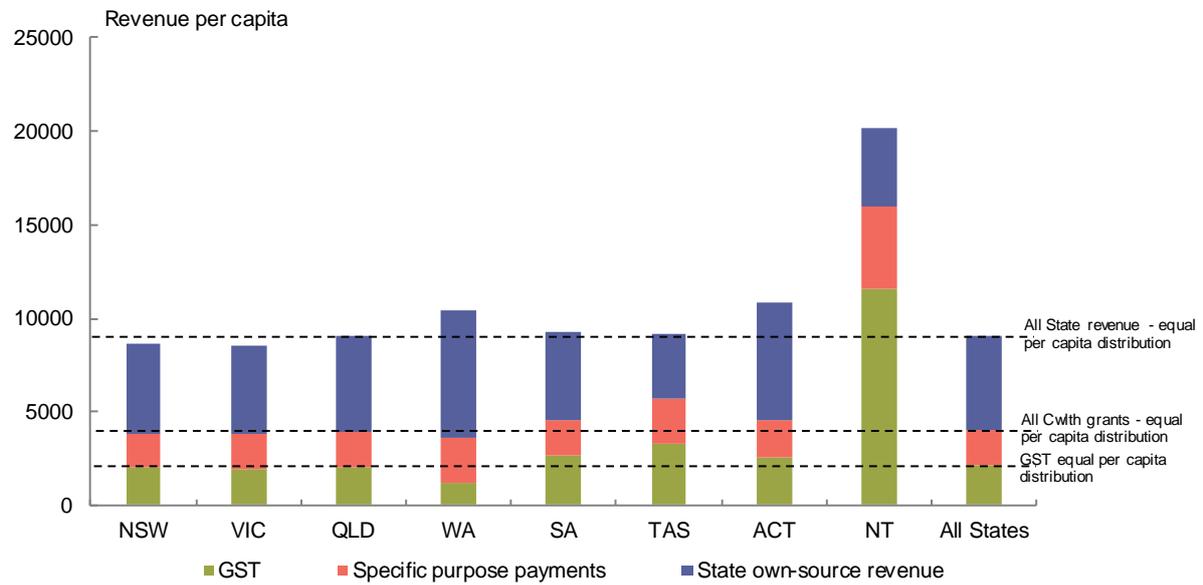
Resource endowments (impact on mining royalty revenues)

While the distribution of the GST reflects the funding necessary to achieve fiscal equalisation, other Commonwealth grants are distributed on a basis that is often closer to equal per capita. As a result, total Commonwealth grants to the States and Territories are generally closer to an equal per capita share than GST payments alone.

Figure E.1 shows State-by-State revenue per capita, split between revenue from the GST, revenue from other Commonwealth grants and revenue from State and Territory own-sources. With revenue from the GST, New South Wales, Victoria and Western Australia receive less than an equal per capita share of the GST, and other jurisdictions receive more than an equal per capita share. However, when other Commonwealth grants and State and Territory revenue are taken

into account as well, New South Wales, Victoria and Queensland are the only States that receive less than an equal per capita share of all revenue.

Figure E.1: State-by-State GST revenue, other Commonwealth grants and own-source revenue per capita, 2012-13



Source: Commonwealth Grants Commission Report on GST Revenue Sharing Relativities, 2014 Update, p. 27.

GLOSSARY

Australian Bureau of Statistics (ABS)

The ABS is Australia's official national statistical agency, established over 100 years ago as the Commonwealth Bureau of Census and Statistics, following enactment of the *Census and Statistics Act 1905*. The agency became the Australian Bureau of Statistics in 1975, with the passing of the *Australian Bureau of Statistics Act 1975*. The ABS provides statistics on a wide range of economic, social, population and environmental matters, covering government, business and the community.

Australian Institute of Health and Welfare (AIHW)

The AIHW produces reports on key health and welfare issues in Australia. One of its primary roles is to collect, analyse and report information drawn from health services, community services and housing assistance services.

COAG Council on Federal Financial Relations

The COAG Council on Federal Financial Relations (formerly the Standing Council on Federal Financial Relations) oversees the operation of the Intergovernmental Agreement on Federal Financial Relations, which provides the overarching framework for the Commonwealth's financial relations with the States and Territories. Membership of the Council consists of the Commonwealth Treasurer and the Treasurers of each State and Territory.

Commonwealth Grants Commission (CGC)

The CGC is a statutory body whose main function is to inquire into the relative fiscal capacities of the States and Territories and to make recommendations on the distribution of Goods and Services Tax revenue. Under the Intergovernmental Agreement on Federal Financial Relations, signed by the Commonwealth and State and Territory governments in 2008, the recommended distribution of the GST should achieve horizontal fiscal equalisation.

Council of Australian Governments (COAG)

COAG is the peak intergovernmental forum in Australia. The members of COAG are the Prime Minister, State and Territory Premiers and Chief Ministers and the President of the Australian Local Government Association.

General Revenue Assistance

General revenue assistance is a broad category of payments from the Commonwealth to the States and Territories. This assistance is provided to the States and Territories without conditions, to spend according to their own budget priorities. The main form of general revenue assistance is the Goods and Services Tax.

Goods and Services Tax (GST)

The GST is a broad-based tax currently set at 10 per cent on most goods, services and other items sold or consumed in Australia. The Commonwealth and the States and Territories have

agreed that all revenue collected from the GST will be returned to the States and Territories in accordance with the principle of horizontal fiscal equalisation.

Gross Domestic Product (GDP)

The market value of all officially recognised final goods and services produced within a year, or over a given period of time.

Heads of Treasuries (HoTs)

HoTs meetings are convened three to four times a year to discuss current federal financial relations issues, and are attended by the heads of Commonwealth, State and Territory Treasury and Finance departments. HoTs also provide advice to the Council on Federal Financial Relations as required.

Horizontal Fiscal Equalisation (HFE)

The process whereby disparities in the ability of sub-national governments to raise revenue or deliver services, often due to factors beyond their control, are equalised. This may occur through the central government in a federation making payments to the sub-national governments to equalise their abilities to provide services at a similar standard.

Intergovernmental Agreement (IGA)

An agreement between two or more governments.

Interstate Commission

Section 101 of the Constitution discusses the provision of an 'Interstate Commission'. The Constitution describes the Commission as an entity with "such powers as Parliament deems necessary" to "administer and adjudicate on matters primarily relating to interstate trade". The Interstate Commission has twice been established and abolished. In 1990, the functions of the Interstate Commission were transferred to the Industry Commission, which was subsequently amalgamated into the Productivity Commission in 1998.

Intergovernmental Agreement on Federal Financial Relations (IGAFFR)

Signed in 2008, the IGAFFR establishes the overarching framework for the Commonwealth's financial relations with the States and Territories. It is intended to establish a foundation for the Commonwealth and the States and Territories to collaborate on policy development and service delivery and facilitate the implementation of economic and social reforms in areas of national importance.

Implementation Plans

Implementation Plans are subsidiary documents to some National Partnership agreements that outline how an individual State or Territory intends to achieve the outcomes and outputs specified in the overarching National Partnership.

National Agreements

Under the Intergovernmental Agreement on Federal Financial Relations, there are two main types of agreements: National Agreements and National Partnerships. National Agreements define the objectives, outcomes, outputs and performance indicators, and clarify the roles and responsibilities that will guide the Commonwealth and the States and Territories in the delivery of services across a particular sector.

National Competition Policy

The Council of Australian Governments established and implemented the National Competition Policy following a report by the Independent (Hilmer) Committee. It included incentive payments to States and Territories for meeting their reform commitments.

National Partnerships

Under the Intergovernmental Agreement on Federal Financial Relations, there are two main types of agreements: National Agreements and National Partnership agreements. National Partnerships define the mutually agreed objectives, outcomes, outputs and performance benchmarks or milestones related to the delivery of specific projects, improvements in service delivery or reform.

National Partnership Payments (NPPs)

Commonwealth payments to the States or Territories that support the delivery of specified projects, facilitate reforms, or reward those jurisdictions that deliver on nationally significant reforms.

National Specific Purpose Payments (NSPPs)

A Commonwealth financial contribution to support State and Territory delivery of services across a particular sector.

Productivity Commission

The Productivity Commission is the Australian Government's independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians.

Project Agreements

A type of National Partnership used to implement projects that are considered low-value and/or low-risk. Project Agreements are simple, standalone, output-focused documents that are generally bilateral, although they may be multilateral in certain limited circumstances.

Relativity

A per capita weight assessed by the Commonwealth Grants Commission for use by Treasury in calculating the share of the Goods and Services Tax revenue a State or Territory requires to achieve horizontal fiscal equalisation.

Report on Government Services (RoGs)

The annual Report on Government Services provides information on the equity, effectiveness and efficiency of government services in Australia.

Vertical Fiscal Imbalance (VFI)

The mismatch between the expenditure responsibilities of subnational governments relative to their revenue-raising capacities. As a result, sub-national governments are reliant on transfers from the central government to finance their activities, as the central government's revenue sources exceed its own expenditure responsibilities.

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