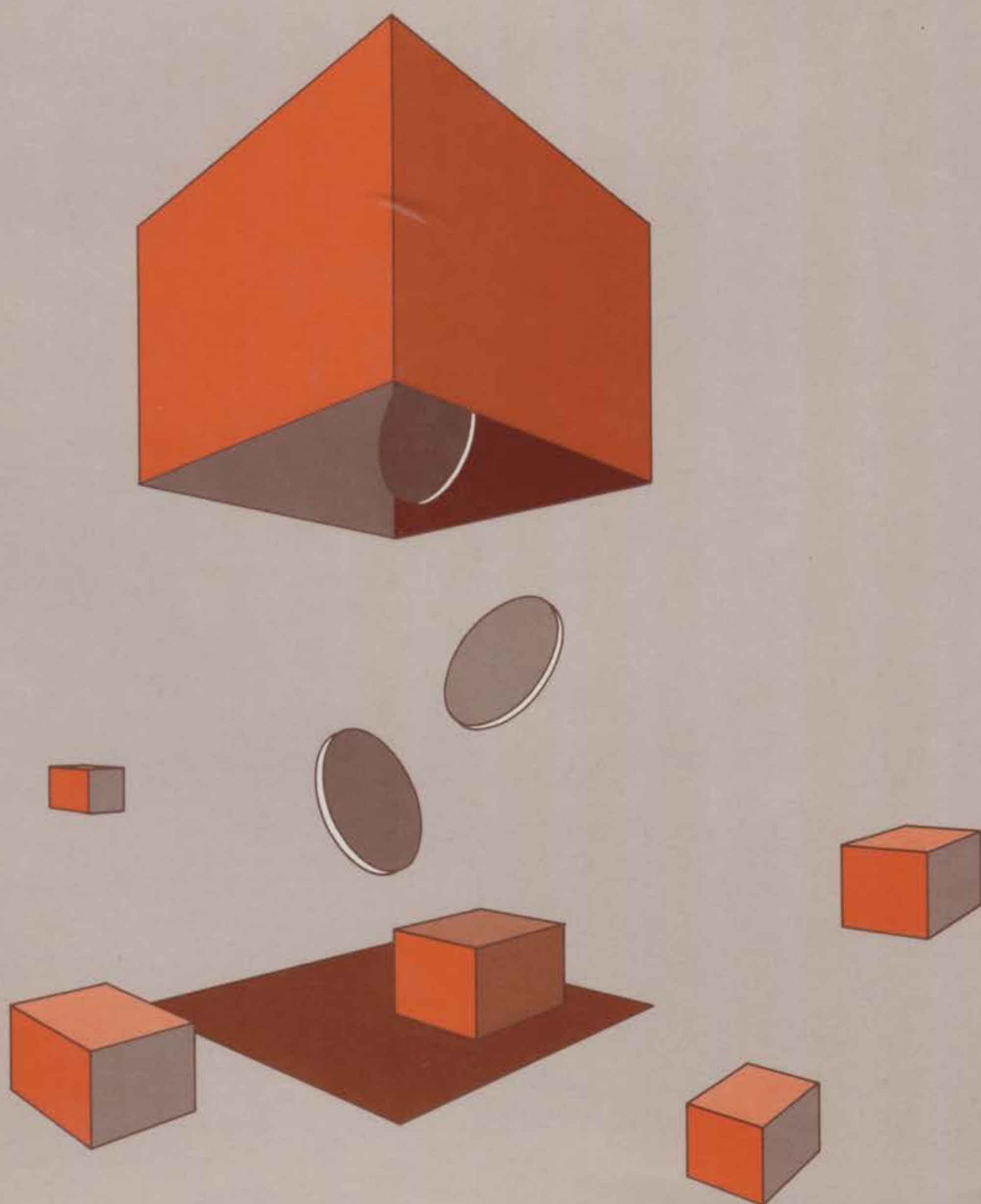
Federalism and fiscal balance

a comparative study

J.S.H. Hunter



Few topics in the world of public finance arouse more heat than the financial arrangements between the central government and the states or provinces of countries with federal systems of government.

In an attempt to shed some light on these sometimes complex arrangements, this book discusses financial relationships between central and state or provincial governments in four federal countries-Australia, Canada, the United States of America and West Germany. It covers the information on political organisation and constitutional requirements of each country, examination of relevant theories on fiscal federalism, and a survey of economic structure and developments in each country necessary to give the study a true perspective.

Dr Hunter faces up to the problems currently confronting federal countries and gives careful consideration to the advantages of fiscal decentralisation and the need for improved methods of inter-governmental co-operation. In an Australian context he suggests several ways in which improvements could be made in the functioning of the federation within a framework of medium and long range economic planning.

The problem of federal-state/provincial relationships admits of no easy answers; indeed, any answers will be open to challenge. Nonetheless this book will be essential reading for students of economics and government, in Australia and overseas, and for government officials and economists in many countries.

This book was published by ANU Press between 1965–1991.

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Australian National University Press and Centre for
Research on Federal Financial Relations
Canberra 1977

First published in Australia 1977

Printed in Hong Kong for the Australian National University
Press, Canberra

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National Library of Australia
Cataloguing-in-Publication entry

Hunter, James Stuart Hardy.
Federalism and fiscal balance.

Index.
Bibliography.
ISBN 0 7081 1337 0.

1. Intergovernmental fiscal relations. I. Title.

336.18

Southeast Asia: Angus & Robertson (S.E. Asia) Pty Ltd, Singapore
Japan: United Publishers Services Ltd, Tokyo

Preface

If recent studies can be taken as a guide, there seems little doubt that the federal solution holds a strong attraction for many newly independent and developing nations. Federalism in not a 'lost cause' as several writers believed some twenty-five to thirty years ago.[1] There has, in fact, been a resurgence of interest in it as the virtues of decentralised government have become more widely recognised. And with this renewed interest it is not surprising that many of the newer federations (e.g. India, Nigeria) have been modelled in several important respects on older established federations, such as Canada and Australia.

It is true that, in the sphere of intergovernmental relations, Australia has led the way with certain innovative features. The Loan Council and Grants Commission rank as outstanding examples of institutional arrangements for co-operative federalism. These bodies were designed to assist the central government in the pursuit of certain goals (e.g. economic stability and horizontal equity between states) and to provide adequate scope for independent decision-making by the states and freedom to allocate funds between differing resource uses in line with state priorities and community needs. Other countries have been inclined to view such developments favourably and there have even been attempts to emulate them.[2]

The story of the adoption of federal systems by many developing economies is a fascinating one which has received attention in recent literature.[3] Many countries with a unitary form of government (e.g. United Kingdom) have also taken steps to enlarge the scope for decentralised decision-making.

The pre-occupation of the present study does not, however, lie in either of these directions. In particular, the study has been prompted by growing signs that the federal structure in Australia is in jeopardy and that some fairly fundamental changes in fiscal arrangements are needed to retrieve the situation — assuming, of course, that retention of a federal form of government is desired. One of the newer federations — the Federal Republic of Germany — includes features which are of special interest. These features warrant close study in view of the great success of the German experiment with 'modern co-operative federalism'.

Each federal system is unique in several respects (partly because each federal constitution is unique). Arrangements which work well in one country will not necessarily prove successful in another country. The particular structure of federalism to emerge in any one country is, after all, the product of many forces — historical, geographical, cultural, political and sociological. For example large interregional income disparities which are quite acceptable in one federation may be intolerable in another.

But there are also certain basic conditions which must be satisfied if the federal form of government is to survive and have real meaning. The autonomy of states or regions is probably the most important, because once that autonomy is lost and states or regions, or both, become

little more than administrative offshoots of the central government, the federal system exists only in name. In fact if and when this occurs the costs of retaining the federal form are likely to appear as an unnecessary burden on the community. As Professor Sawer has aptly pointed out, a most important feature of federalism is 'the creation of an area of guaranteed autonomy for each unit of the system'.[4]

The present study will therefore seek to ascertain, firstly, whether Australia is approaching what Professor Sawer has called an 'organic' federalism[5] (i.e. where the 'centre' dominates every aspect of policy) and, secondly, whether recent experience in Canada (where provinces appear to have attained a relatively large degree of autonomy) or in the newer federation of West Germany (which occupies an intermediate position) can help to suggest a solution. Federal revenue sharing in the United States is also demanding of close study since it represents an attempt to re-vitalise the federal structure in accordance with modern needs.

In making these comparisons we should note that each of these countries has a high standard of living, a strong central government, and is modelled on capitalistic lines in the sense that there is in each country considerable stress on the need for private initiative and decision-making. Thus our task is not as formidable as it would be if an attempt were being made to compare countries which have reached quite different stages of development and which operate with differing ideological bias (e.g. consider Nigeria, Yugoslavia, the United States, Papua New Guinea and India).

While a good deal has been written on federalism in Australia,[6] the United States and Canada, comparatively little is known in Australia of the structure of the Federal Republic of Germany. A large part of what follows in relation to Germany will build on earlier studies by the author.[7]

The present study will concentrate on recent developments (i.e. since the mid 1950s) and will deal almost exclusively with four 'federal' countries — Australia, Canada, the United States and West Germany.

It is hoped that such a study will not only uncover some major differences in the federal structures of these countries (and, in so doing, contribute towards a better understanding of each of these structures), but will make possible some concrete suggestions for ways to overcome prevailing problems, once these have been identified.

The study was prompted mainly by a concern at the way in which federal-state financial relations are developing in Australia. This was coupled with an interest in emergent trends in other federal countries. A period of study leave at the University of Muenster opened up an opportunity to observe aspects of intergovernmental fiscal relations in West Germany, especially the recent focus on co-operative federalism.

While great care must be exercised in inter-country comparisons, it was felt that a study of four major federal countries could be useful in sorting out the main issues in federal-state finance and in suggesting possible solutions to the present problems facing the Australian federation. Considerable stress is placed on the need for reform in Australia especially in relation to tax sharing, horizontal fiscal equalisation, and machinery for intergovernmental co-operation and planning.

An attempt is made (in Parts II and III) to present a complete picture of both vertical (federal-state) and horizontal

(interstate) fiscal imbalance and adjustment in all four countries. This is followed by Part IV, which deals specifically with intergovernmental co-operation and planning. To give perspective to the study, Part I embodies relevant theoretical analysis as well as information on constitutional requirements in each country and differing economic structures.

The study could not have been completed without valuable assistance from many quarters. For providing detailed comments on a complete draft, special thanks are due to Professor R.L. Mathews, Director of the Centre for Research on Federal Financial Relations at the Australian National University and to Mr W.R.C. Jay, Deputy Director of the Centre. Special mention should also be made of those who encouraged me to proceed with the inquiry, in particular Professor R.L. Mathews, Professor R.C. Gates of the University of Queensland, Professor W. Prest of the Australian National University, and Professor P.J. Drake of the University of New England. Professor R.M. Burns (Director of the Institute of Intergovernmental Relations, Queen's University, Ontario). Professor R.H. Leach (of Duke University, North Carolina) and Dr P.B. Spahn (of the Centre for Research on Federal Financial Relations) provided invaluable assistance by commenting on portions of the text.

The author derived considerable benefit from discussions with Professor B.P. Herber of the University of Arizona, Mr W.R. Lane of the University of Queensland, Dr N. Davey of the Australian Treasury, Dr D.H. Murray of the University of New England and Ministerialrat Dr E. Neuthinger of the Federal Ministry of Finance in Bonn. Others were also helpful in correspondence, notably Professor R.M. Burns, Professor E.J. Hanson of the University of Alberta, Dr K.H. Neuhaus (of the Central Information Bureau for State Finance Ministers in Bonn-Bad Godesberg), Ministerialdirigent Kurt Stadler of the Bavarian State Treasury, and officers of the Ontario Ministry of Finance and the Federal- Provincial Relations Division of the Department of Finance in Ottawa.

The most important acknowledgement is, of course, to my wife, Friederike, whose enthusiasm for the project never wavered and who gave up a great deal of time to assist with both typing and translation. I am also grateful to Mrs C. Cuskelly (Secretary of the Department of Economics at the University of New England) for her valuable assistance with the typing of parts of earlier drafts in connection with this study.

J.S.H.H.

Armidale
February 1975

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Part I Background Survey

1 The Essence of Federalism and the Constitutional Division of Powers and Responsibilities

Federalism is the antithesis of a unitary state. In the latter, administration is decentralised through a network of local authorities, each of which is a creature of the central government. The activities of a local authority in such a state are wholly determined by the nature of legislation enacted at the centre; the powers and functions which regional or local authorities possess depend entirely on the powers and functions the central government decides to confer upon them. The essential feature of a unitary state is that powers are *delegated* from the centre. Local governments do not have any independent areas of legislative responsibility. In the Union of South Africa, for example, the regional governments are subordinate to the central government. While certain powers are delegated to the provinces, the Union Parliament has the power to overrule the provincial councils at any time and may even abolish them altogether. As Professor Wheare has stated: 'There is clearly no question ... of the regional governments being co-ordinate with the general government as in the United States.'[1] In a unitary system all sovereign powers are concentrated in the central government.

In a federal system, on the other hand, there are two levels of government which are legally independent of one another. In effect, the total government sector is divided into two independent parts, each of which has certain rights and responsibilities (or special fields of competence) as embodied in the Constitution. Each sector or tier is invested with sovereign powers.[2]

The contrast between a federal and unitary system has been explained clearly by Griffith:

> The federal principle rests on the Constitution. Constitutional law [in the United States] has divided the spheres of permitted governmental action into that permitted only to the nation, that permitted only to the states, and that shared by both. This is legally something quite different from a delegation of powers by Parliament to the local authorities in Britain, a delegation which may be revoked as easily as it is granted.[3]

In a federation, local or municipal authorities bear a similar relation to the state or regional governments (the second tier) as they do to the central administration in a unitary state. It is therefore more correct in a federation to speak of three levels of administration (federal, state and local) and two levels of government (federal and state).

We now turn from the general to the particular, to indicate the main constitutional powers in each of the four countries — powers which shape, but do not wholly determine, the division of responsibilities between each tier, and in particular the financial powers of the central government and degree of central control.

Australia[4]

Under the Australian Constitution, which became effective from 1 January 1901, the Federal Government was given certain enumerated powers while the states were

left with residual powers. The Commonwealth was given the sole responsibility for a group of activities in the international field (defence, overseas trade, immigration, external territories, for example) and, since 1946 (by constitutional amendment), it has also assumed responsibility for cash social service benefits, employment and repatriation.

The states, on the other hand, have the prime responsibility in several important areas such as education, transport, health and hospitals, law and order, agriculture and forestry. But over the years the Commonwealth, mainly by virtue of its power to grant financial assistance to the states (section 96), has been able to exercise an important influence on expenditure in many of these fields, especially roads, education, and welfare services. The same general power has enabled the Australian Government to assist states in financial need.[5]

The states have a direct responsibility for important business undertakings (the actual administration being delegated in most cases to special 'semi-governmental' authorities) such as railways, electricity, gas and water.

Section 51 of the Constitution gave the Commonwealth power to make laws with respect to taxation 'but so as not to discriminate between States or parts of States'. The states were given concurrent powers with the Commonwealth over all taxes except customs and excise duties which were reserved for the national government. Apart from the need to eschew discriminatory treatment between states, the Commonwealth had unlimited taxing powers.

The 'Braddon Clause' (section 87) should be mentioned as there is nothing quite like it in the other federations. This clause contained explicit provision for Commonwealth Government grants to the states, and with no strings attached. The clause provided that three-fourths of net revenue from customs and excise duties be distributed to the states for at least the first ten years of federation. After 1910 and in terms of the *Surplus Revenue Act* of that year, the Commonwealth paid per capita grants to the states, amounting (up to the 1927 Financial Agreement) to about one-half of what had been collected in customs and excise duties.[6]

Another section of the Constitution which has an important bearing on the present study is section 105 (and as amended by section 105A) under which the Commonwealth can make agreements with states pertaining to their public debts, including the takeover of such debts by the Commonwealth and regulations about future borrowing. This provision enabled the Commonwealth Government in 1927 to enter into the Financial Agreement with the States and to establish the Australian Loan Council for the purpose of co-ordinating Commonwealth and state borrowing. This development is described by Mathews and Jay as 'a most significant move in the direction of co-operative federalism.'[7]

Finally, the Senate structure was intended to provide a counterforce to centralised power by giving the states a voice at the centre. Although each state has an equal number of senators irrespective of population, the Senate has in practice developed more as a House of Review (in which party ideologies have overriding influence) than as a House of the States.[8]

Constitutional amendments have been relatively few in Australia. For example, all four questions put to the Australian people in conjunction with the 1974 federal elections were rejected. The same fate awaited the 1973 referenda on federal

prices and income powers. Constitutional amendment is more difficult in Australia than in other federations since a majority of voters in four out of six states must approve any change as well as a majority of voters in all states. (Further detail on this and other matters pertaining to the Australian Constitution can be obtained from various *Year Books* published by the Australian Bureau of Census and Statistics.)

Canada

The Canadian Constitution — the *British North America Act* of 1867 (BNA Act)[9] — divides powers between the provincial and Dominion legislatures in such a way that the provinces have exclusive legislative control over a list of fifteen enumerated subjects and the Dominion has exclusive legislative competence over the rest (which are also enumerated to a large extent).

The central government, as in the other three federal countries, is composed of two chambers — the House of Commons and the Senate. The latter has not been an effective institution. Unlike Australia and the United States, senators are appointed by the Governor-General on the advice of the Prime Minister. Moreover, each province does not have equal Senate representation, this being based on four major geographical areas in a manner which gives Ontario and Quebec twenty-four senators each, the Atlantic provinces thirty senators (New Brunswick and Nova Scotia ten each, Newfoundland six and Prince Edward Island four), and the Western provinces twenty-four sentators (six for each of the four provinces).[10]

The framers of the Canadian Constitution wanted to create a strong central government, partly because of a belief that the American states had retained too much power. To this end the Dominion Government was granted unlimited powers of taxation. In practice, however, such unlimited power has not prevented the provinces from imposing a wide range of taxes.[11] While there is no doubting the legal right of the Dominion Government to levy whatever taxes it desires at any rates, it is also true that the provinces have a constitutional right to share in direct taxation in order to raise revenue for provincial purposes. The proposal of the Rowell-Sirois Commission to give exclusive power over direct taxes to the Dominion Government[12] was rejected after World War II. In more recent years the provinces (with the active encouragement of the Dominion Government) have greatly enhanced their power in the income tax field. This theme is developed fully in chapter 7.

The 'power of disallowance', by which the Dominion Government (in terms of the BNA Act) has the legal right to reserve or disallow provincial legislation, is also evidence of the desire for a strong central government and led Professor Wheare to the conclusion that Canada has a quasi-federal constitution.[13] This power does not mean that the Dominion Parliament can legislate upon provincial subjects. The power can only be used as a constraint on provincial legislation. However, according to Wheare, this power means that the Dominion executive could, for example, prevent a province from raising revenue or spending money if it disapproved of its financial legislation. Although not a dead letter, the power of disallowance has been used sparingly since 1887. Legal powers which could turn Canada into a unitary state 'have been subordinate to the federal principle in practice'.[14]

Thus, despite the power of disallowance and the taxing powers, Canada has not drifted towards a unitary system. In fact

the trend, particularly since 1962, has been in the other direction — towards a strengthening of provincial financial autonomy. While the Dominion Government has wide-ranging powers it has not always chosen to exploit them in view of the popular desire in Canada for an extensive use of provincial powers. In this connection, the special position and influence of Quebec must be noted. According to one writer, Quebec has always had a special position, a special status. 'It is the citadel of French Canada'.[15] The vigour with which successive Premiers of Quebec, and to a lesser extent the Premiers of several other provinces, have pursued the cause of provincial autonomy is taken up again in chapter 7.

It should be added that the Privy Council and the courts have taken a broad view of provincial functions and the Dominion Government has on several occasions championed the cause of decentralised administration and decision-making. It is also significant that, since the residual powers reside with the national government (unlike the situation in the United States and Australia), new powers can usually be acquired by the Dominion Government without taking anything away from the provinces — and hence without the need for constitutional amendment. If the provinces are concerned with matters of purely regional or local importance (as encompassed by the enumerated powers) the acquisition of new power by the national parliament in matters of nationwide importance (i.e. not purely local or regional) is not likely to be a problem. When, for example, the Dominion Government took over responsibility for unemployment insurance in 1940, this was not a transfer of powers because it fell into the residual group and was obviously a subject of national rather than of local or regional importance.[16]

Central government intrusion into areas which constitutionally belong to the provinces has, however, been significant. This process in Canada, as in other federations, has been aided by the development of a system of grants to the provinces. These grants have sometimes taken the form of unconditional subsidies to poorer provinces to improve the general standard of public services, but more often than not the grants were designed to promote certain activities (in all provinces) such as education and health services, both of which come under provincial jurisdiction.[17] The justification, in theory, for these grants is covered in chapter 3. It is interesting to note that, unlike Australia, there is no specific provision in the Canadian Constitution for federal power to make such grants and 'apparently no constitutional question has ever been raised about it.'[18]

It was mentioned above that the provinces have a constitutional right to a share of direct taxation. The Constitution restricts provincial power in taxation to 'direct taxation within the province'. However, the provinces have been able to adhere to this condition and still impose retail sales taxes by framing their own tax laws so that the tax constitutes a direct levy on the purchaser at the time of the retail sale and not on transactions or the vendor (see chapter 7). Ever since the courts have upheld the right of the provinces to levy these 'direct' sales taxes, the tax powers of the provinces have been virtually equal to those of the Dominion Government.

Thus the Canadian provinces are clearly in a much stronger position to raise revenue than are their Australian counterparts.[19] They also have much greater freedom in the tax field than do the West German States (the *Laender*). However, most provinces have agreed to certain

limitations on their taxing powers. This they have done to qualify for federal grants, to meet emergency situations (such as war), to avoid unduly high taxes, and in the interest of overall fiscal uniformity.

United States of America

The form of government of the United States is based on the Constitution of 1788. The Constitution strengthened the position of the Federal Government compared with the original confederation, which was designed to protect the sovereignty of the states.

Under the Constitution the national government has authority in matters of general taxation, treaties with foreign powers, foreign and interstate commerce, the postal service, coinage, weights and measures, patents and copyright, the armed forces and crimes against the United States.[20]

Although the so-called 'residual' powers belong to the states (as in Australia) this has not enabled the states to enjoy anywhere near complete freedom of action with respect to the many fields of governmental activity not specifically earmarked as the exclusive province of the Federal Government. Thus, while there is a constitutional requirement for geographical tax uniformity (the so-called 'uniformity rule' which prohibits federal tax discrimination by state, region or area) there is nothing in the Constitution which requires geographical uniformity in public expenditures. The US Supreme Court in its twin decision of *Frothingham* v. *Mellon* and *Massachusetts* v. *Mellon* ruled, in effect, that Congressional majorities can spend public moneys in nearly any manner they choose.[21] This opened the way for an expansion of federal grants-in-aid programs, an expansion which has been especially marked since the 1920s.

Nevertheless it is true that the US Constitution has permitted a more decentralised fiscal structure than has been possible in other federations. There are several explanations for this, including the great diversity of American society, the relatively large number of states, and the particular structure of government, including the separation of powers between the executive and legislature. Such separation weakens the Federal Government internally and makes for less cohesion in any efforts to counter the power of the states. As one writer on American government has put it: 'The Constitution of 1789 represented a compromise between those who wished for a strong, almost unitary central government, and those who recognized the need for some central authority but wished to keep it as weak as possible, fearful of the consequences of such centralization.'[22]

While the states could not levy customs duties or impose taxes on exports or on federal instrumentalities (and the Federal Government is effectively precluded from direct property taxes), the Constitution gave broad taxing powers to both levels of government. However, the 'apportionment rule'[23] required that no direct tax could be levied unless in proportion to population and this meant, in effect, that all such taxes must be head taxes. Tax rates would therefore vary among states in inverse proportion to their per capita tax base. The rule effectively blocked the imposition of a national income tax (especially a progressive tax) since it would have involved a regressive structure of rates as between states, rates being higher for states with low per capita incomes than for states with high per capita incomes. This problem was overcome by the Sixteenth Amendment of 1913. This amendment gave Congress

power to levy and collect income taxes without apportionment among the states and without regard to any census or enumeration.[24]

The Constitution did not assign different taxes to different levels of government. This opened the way for tax competition, which persists to the present day. Thus all three levels of government use income taxes, taxes on motor fuels, alcoholic beverages and tobacco products. Only a few taxes are *not* imposed by both federal and state government.[25] However, the Federal Government depends heavily on income taxes, with almost two-thirds of its tax revenue being derived from that source. The states, on the other hand, rely more heavily on sales taxes than on income taxes. In the United States there has been no parallel to the Australian Uniform Tax Plan or the Canadian intergovernmental tax agreements which operated during World War II and early post-war periods.

Amendments to the Constitution can be made at the initiative of Congress by a two-thirds vote. Amendments, however, are not easy since they must be ratified by the legislatures of three-quarters of the states.[26] Since 1950 there have only been five amendments.

The Senate is a very powerful segment of the governmental structure in the United States. Each state, regardless of population, is represented in Washington by two senators. The election of senators was taken from the state legislatures and given to the voters by the seventeenth amendment of 1913.[27]

As in other federations, the fiscal powers of local government are determined by the states since local government has no sovereign powers of its own.

West Germany

The West German Constitution is set out in the Basic Law of 1949. As compared with the three countries discussed above, it is easier to amend the West German Constitution. An amendment is carried if approved by a two-thirds vote of both Houses of Parliament in Bonn.[28] Up to June 1968 (i.e. in less than twenty years) there had been seventeen amendments to the Basic Law.[29] There have been several important amendments since 1968, especially in relation to finance reform (for details, see chapters 9, 13 and 19).

Another major difference between the federal structure of West Germany and that of the other three countries relates to the particular role which the Constitution gives to the Council of States (*Bundesrat*). The latter serves as a permanent conference of state ministers (or their deputies) and is therefore a true House of the States. The Council of States has acquired a place of key importance in the Basic Law. The Council delegates (the representatives of the states) vote on instructions from their respective governments and are recallable at their discretion. In these and in other important respects, the Council differs from the Senate or Upper House at the national level in the United States or Australia.

The Council acts as a check on centralising tendencies which are, for the most part, a feature of the federal system in Germany. Laws which bear on state interests (and this includes laws regulating taxes where proceeds accrue entirely or in part so states or local authorities)[30] cannot be promulgated until the consent of the Council is secured.[31]

The division of powers as between central and regional governments is similar to the American and Australian system (but not the Canadian system) in so far as there are certain powers reserved exclusively for the national government. (In Germany these cover such matters as

defence, foreign affairs, immigration, railroads, air transportation and the post office.) But instead of residual powers being reserved for the states, the West German Constitution makes provision for concurrent federal and state legislation to cover fields not specifically assigned to the Federal Government (e.g. public welfare; regulation of commerce, industry, banking, insurance and labour relations; promotion of scientific research; public roads and shipping).

On the face of it the West German federation is strongly biased towards the centre. In the field of concurrent legislation, the states can legislate only if the central government decides *not* to do so. In fact the central government has made wide use of its concurrent legislative powers, especially in the tax field. The point is that the Federal Government can legislate in any field in which the need for federal legislation can be demonstrated. This places the Federal Constitutional Court in a key position to decide what activities should, in fact, be reserved for the states. Its decisions to reserve education and culture for the states suggest that it can serve as an effective buffer against centralising tendencies. In 1961 the court made it clear that the development of radio and television was a matter for the states and not the Federal Government. But a more important buffer, as we have seen, is the special position and authority of the Council of States.[32]

Germany did not follow the American pattern of giving both federal and state governments autonomy in finance. This is partly because the framers of the Constitution, with the considerable advantage of hindsight, wished to avoid the need for piecemeal 'patching-up' subsidies which, drawing on the experience of other federations, appeared to be the inevitable result of allowing competition between rival taxing authorities (the so-called 'tax jungle').[33] The supremacy of the national government in tax legislation was therefore firmly established from the outset. The national or central government was given 'exclusive' legislative competence over customs duties and federal monopolies (e.g. alcohol) and 'priority' legislative competence over all remaining taxes.[34] Despite opposition from the Allied authorities, it was decided to opt for fiscal uniformity[35] but with an important proviso, in terms of a constitutional guarantee, that revenues from certain taxes would be assigned to the states and that other revenues (income taxes and, more recently, the value-added tax) would be *shared* between federal and state governments. (For further details, see chapter 9.)

2 Economic Structure and the Role of Government

Area and Population

Australia's six states cover an area of 2·5 million sq miles, Canada's ten provinces cover an area of 2·1 million sq miles and the area of the United States (Alaska and Hawaii excluded) is almost 3 million sq miles. These three countries are therefore fairly comparable in area, although the number of states differs markedly. In this respect the Federal Republic of Germany presents a sharp contrast since the eleven states are compressed into an area of less than 96,000 sq miles, which is not much greater than the size of Victoria and less than half the size of Manitoba.

The Federal Republic of Germany has a population of approximately 62 million, compared with Australia's 13 million, Canada's 22 million and a population in the United States of more than 200 million.

As regards overall population density, there are considerable differences as between the countries. In Germany there are 640 persons per sq mile, compared with 60 in the USA, 10 in Canada and 5 in Australia. All four federations have considerable differences in population density as between states. Thus in Australia we find that Victoria has 40 persons per sq mile while Western Australia has only one. In Canada, Prince Edward Island has 50 people per sq mile while Saskatchewan and Newfoundland each has 4. In the United States, where there are many more states, the differences are even more pronounced. In Wyoming and Nevada there are fewer than 5 persons per sq mile while in states such as Massachusetts and New Jersey there are more than 700 people per sq mile; and in Maryland and New York there are more than 380 to the sq mile. The variations are far less in West Germany if the City States are excluded. Thus, North Rhine Westphalia has 1300 people per sq mile and Bavaria about 390.

City States and Territories

There are three City States in West Germany — Hamburg, Bremen and West Berlin. At the end of 1972 these states accounted for just over 7 per cent of the total population. There are no City States, or their equivalent, in the United States, Canada or Australia. In view of the heavy concentration of people in Australia who live in relatively few cities (more than 60 per cent live in the six state capitals), any proposal for the creation of City States (which is permissible under the Constitution) would warrant careful study. However, in the 1970s the more pressing need is to strengthen the basis of federalism for the six states, with emphasis on regional development and decentralisation within existing state boundaries.

There are federally controlled territories in the United States, Canada and Australia. (The United States and Australia also have external territories.) These territories have varying degrees of autonomy but are not part of a federation of states. The Constitutions do not provide them with specified spheres of influence in which they can pursue independent policies. The powers which the local legislative bodies possess are those conferred upon them by the central

Table 2-1

Growth or Prosperity Indicators, 1950-1970
Average annual rate of growth

	Real GDP per capita*		Real private consumption per capita	
	1950 to 1960	1960 to 1970	1950 to 1960	1960 to 1970
Australia	3.0	4.9	3.1	3.3
Canada	3.2	6.6	3.8	3.4
United States	2.6	3.9	2.0	3.6
West Germany	15.9	7.3	12.5	6.3

Source: IMF: *International Financial Statistics*, 1972 Supplement.

* Average annual rate of increase of GDP per capita, as adjusted for changes in consumer prices.

governments. In Canada, where the provinces and the Federal Government both have jurisdiction and powers allocated by the *British North America Act*, the authority of the territorial governments (Yukon and Northwest Territories) can only be determined by federal legislation. In Australia, the Australian Capital Territory (ACT) and the Northern Territory (which passed from South Australian to central government control in 1911) are territories of the Commonwealth. Although not forming part of the federation of states, their degree of autonomy and overall influence in relation to legislation of the Australian Government has tended to increase, especially since each territory now has the right to elect two senators and could therefore hold the balance of power where the number of government and opposition senators representing various states are approximately equal. These territories can therefore be expected to have a more powerful influence on federal legislation in Australia than does the District of Columbia (DC) in the United States (DC was ceded by the State of Maryland in 1791).

Economic Growth

As noted at the outset, all four countries rate as highly developed economies.

While there is no single measure of economic growth or performance, when allowance is made for population and price increases the Gross Domestic Product (GDP) is often considered as a useful broad indicator.

In terms of annual average rates of growth, real GDP per capita for the decade of the 1960s was considerably higher in Germany and Canada than it was in Australia and the United States. However, if one regards real private consumption per capita as a better index of economic prosperity, then Germany was clearly ahead as seen in table 2-1.

In absolute terms, comparisons are even more hazardous. Using 1970 data and employing the exchange rate relationships current at the time we reach, not unexpectedly, the conclusion that real income and consumption per capita are significantly higher in the United States and Canada than in Germany or Australia — although the gap is not as large as it used to be (see table 2-2):

Table 2-2

Growth or Prosperity Indicators
(1970)

	GDP per capita		Private consumption per capita	
	$A	Index Australia = 100	$A	Index Australia = 100
Australia	2400	100	1300	100
West Germany	2800	117	1500	115
USA	4200	175	2700	208
Canada	3500	146	2000	154

Source: 1970 national income statistics. Calculations have been made to the nearest $A100 and on the basis of $A1.0 = $US1.12, $C1.15, DM4.0.

Since exchange rates do not necessarily reflect relative price levels, great caution should be used in assessing the significance of absolute figures for any year. Real income per capita is, in any event, only one measure of a country's economic well-being. If we use that measure it is clear that all four countries are high on the international scale and that recent performance shows Germany gaining in relation to several other countries. It is also worth noting that gross fixed capital formation is more than 25 per cent of the national income in Australia and

Table 2-3

GDP at Factor Cost by Industry
(per cent of total)

	Rural, mining, power	Manufacturing	Construction	Other
Australia (1970-71)	13.2	26.7	8.3	51.8
Canada (1972)	10.7	23.1	6.3	59.9
United States (1971)	4.8*	26.6	6.1 †	62.5
West Germany (1972)	6.6	40.4	8.4	44.6

* Excludes mining.

† Mining and construction.

Source: Australia: Australian Bureau of Statistics, *Australian National Accounts, National Income and Expenditure 1971-72*, table 17, p. 37.
Canada: the 1974 *Corpus Almanac*.
United States: US Department of Commerce, *Survey of Current Business*, February 1972, p. 11.
West Germany: *Monthly Report of the Deutsche Bundesbank*, Vol. 25, No. 11, November 1973, p. 64.

Germany. This is a high ratio by world standards. Ratios in the United States and Canada are closer to 20 per cent.

Industry Structure

A notable feature of the West German federation is its relatively heavy involvement in manufacturing. In Germany more than 40 per cent of GDP is accounted for by the manufacturing sector. By contrast, we find that rural and mining activity and the service industries (including government) are relatively more important in Australia, Canada and the United States (see table 2-3). A similar pattern prevails with regard to the distribution of the work force.

Foreign Trade and the Balance of Payments

Of the four countries, Canada appears to depend most heavily on foreign trade, but is closely followed in this respect by Germany. Australia's dependence has lessened over the years. As table 2-4 shows, exports are of far less importance in the United States since they constitute only 5 per cent of GDP.

Table 2-4

Exports as a Per Cent of GDP
(average 1966 to 1970)

	%
Australia	15
Canada	23
United States	5
West Germany	21

Source: Data from IMF: *International Financial Statistics*, 1972 Supplement.

For most of the period since World War II, both Australia and Canada were large net importers of capital. Much of this capital was geared to economic growth in those countries. Large net capital inflow made it possible for both countries to acquire real resources from abroad and hence to sustain large balance of payments deficits on current account without a large fall in monetary reserves or the imposition of controls on imports (import controls were lifted in Australia in 1960).

As is well known, the United States emerged from World War II with a strong currency. As a large net capital exporter, the United States was able, in effect, to transfer resources to the rest of the world (including Germany for part of the period and Canada and Australia for most of the period). From the early 1960s until late in 1973, these capital exports had to be controlled in view of diminishing current account surpluses and a declining confidence in the US dollar.

In Canada, economic prosperity continues to depend heavily on its close economic ties with the United States, including a large inflow of capital and know-how.

A unique characteristic of Australia is its geographic isolation. Nevertheless the growth of the Australian economy since World War II has also been associated with very substantial inward capital movements. The source of these capital movements has been predominantly the US and UK, but with the accent turning more in recent years to trade and capital flows with Asia, especially Japan. Between 1969 and 1973 the Australian dollar gained in strength (*vis-à-vis* most other currencies). Successive balance of payments surpluses prompted a 16·7 per cent revaluation of the Australian dollar (in relation to the US dollar) in 1973, making a total revaluation of almost 33 per cent since the end of 1970. However, during 1974 the favourable trend in the balance of payments was reversed, and the Australian Government's response to

this situation included the elimination, in two steps, of the Variable Deposit Requirement (VDR) applicable to overseas borrowing for terms in excess of two years and a devaluation (in September) of the Australian dollar by 12 per cent. In the final quarter of 1974 the Australian dollar weakened in relation to several key currencies, including the West German mark. For the whole of 1974 the value of the Australian dollar in terms of the mark fell by approximately 20 per cent.

Economic growth in the Federal Republic of Germany was greatly enhanced in the early years of the Republic (1949-57) by the US foreign aid program and, after 1957, by its membership in the EEC. The latter has brought many benefits but most significant has been a widening economic area free of trade barriers and with opportunities for a high degree of mobility with respect to capital, enterprise and labour. West Germany managed to generate large current account surpluses in its balance of payments for most of the 1950s and a large part of the 1960s and early 1970s. These surpluses, which were associated for much of the period with an undervalued currency, contributed importantly to a steep rise in official monetary reserves as well as to an increase in net long-term capital outflow (especially between 1966 and 1969).

The sharp deterioration in the US balance of payments position in the 1960s, and especially between 1968-72, has been widely discussed. Such deterioration was a product of several forces, notably a large capital outflow, the impact of the Vietnam war, foreign aid programs, and a worsening competitive position. The last was associated with an overvalued currency but the problem was also exacerbated by a sharp increase in the rate of inflation in the US economy during 1972-4.

Interstate Income Differences

Table 2-5 illustrates that income differences as between states are far less marked in Australia than in the other three federal countries. Per capita income in Connecticut and New York, for example, is more than 60 per cent greater than in Arkansas and Mississippi. However, the recent trend in the United States has been for per capita incomes to grow faster in states with below-average incomes than in states with above-average incomes. In Canada, Ontario's personal income per capita is almost twice as large as Newfoundland's. By contrast, in Australia, Victoria and New South Wales at the top of the scale had an average personal income per capita in 1972-3 which was only 19 per cent greater than Tasmania, the state with the lowest per capita income. Comparisons with Germany are less straightforward because of the high income per capita of the City States (West Berlin and the *Hansastädte* Hamburg and Bremen). However, if the latter are grouped together (as in table 2-5), income disparities between the remaining states are seen to be much narrower than in the United States or Canada.

Role of Government

Each country has a strong central government which can exercise a decisive influence in fiscal and monetary affairs. The overall goals from the standpoint of economic stabilisation and growth are similar in each country. Germany, however, has had more success in reaching those goals than have the other countries.

In the 1960s the public sector in all four countries (but to a lesser extent in Germany) grew in relative as well as in absolute terms, thus conforming to the

celebrated hypothesis advanced by Adolph Wagner.[1] The relative importance of the public sector in each country for selected years since 1960 is shown in table 2-6.

Table 2-5

Income Disparities Between States
(Per capita income in each state, or group of states, as per cent of national average)

	Australia (1971-72)
New South Wales (and Australian Capital Territory)	104.8
Victoria	103.7
Queensland	91.5
South Australia (and Northern Territory)	91.7
Western Australia	95.2
Tasmania	87.2
	Canada (1970)
Ontario	115.2
British Columbia	107.5
Manitoba	99.2
Alberta	99.0
Quebec	90.4
Saskatchewan	84.8
Nova Scotia	81.3
New Brunswick	73.1
Prince Edward Island	64.7
Newfoundland	56.9
	United States (1971)
Average first five states	118.8
Average next five states	112.9
Average second last five states	80.4
Average last five states	73.7
	West Germany (1970)
Average — City states	152.9
Hessen	106.5
North Rhine-Westphalia	103.5
Baden-Württemberg	100.2
Bavaria	93.5
Rhineland-Palatinate	87.4
Saarland	86.6
Lower Saxony	86.1
Schleswig-Holstein	81.8

Source: Australia: Commonwealth Grants Commission, *40th Report* (*1973*), p. 122
Canada: Advisory Commission on Intergovernmental Relations 'In Search of Balance — Canada's Intergovernmental Experience' *Report M-68*, Washington, Sept. 1971, p. 14.
United States: US Department of Commerce, *Statistical Abstract of the United States 1972*, p. 319 and *Survey of Current Business*, August 1973, pp. 39-43.
West Germany: Statistisches Jahrbuch 1971, *Statistisches Bundesamt*, pp. 25, 509.

A breakdown of the government sector shows that local authorities (by virtue of powers delegated through state legislatures) occupy a much more important position in the United States, Canada and Germany than they do in Australia. However, what is perhaps more interesting is the division of expenditures between the Federal Government on the one hand, and state and local government on the other; and in this respect we find that the central governments in Australia and the United States account for a larger share of public sector outlays than in the other two countries. Even if defence expenditure is

Table 2-6

Public Expenditure as Per Cent of GDP†*

	Australia ‡	Canada	USA §	West Germany ‖
1960	27.9	29.7	30.0	27.5
1965	32.3	29.9	30.0	30.2
1968	31.9	33.7	31.7	29.4
1969	32.3	34.1	31.5	28.8
1970	32.0	36.3	32.5	28.7
1971	33.0	37.7	32.6	30.0
1972	32.7	38.4	32.5	30.2
1973	32.0	37.6	32.0	30.1

*Excludes intergovernmental transfers and debt transactions but includes cash social service benefits and other payments to persons.

†At market prices

‡ On a financial year basis, starting with 1960-61.

§ Of which defence expenditures varied from 7-9 per cent of GDP over the period.

‖ Including West Berlin.

Source:

Australia: Australian Bureau of Statistics, *National Accounting Estimates of Public Authority Receipts and Expenditure*, Supplement to the Treasury Information Bulletin, December 1972, March 1974; and *National Income and Expenditure* 1972-73 and December quarter 1974.

Canada: Canadian Tax Foundation, *The National Finances*, 1974-75, table 2-12, p. 19.

United States: US Department of Commerce, *Statistical Abstract of the United States*, 1972, p. 406, and *Survey of Current Business*, February 1973 and March 1975.

West Germany: Federal Ministry of Finance, *Finanzbericht*, Bonn, 1975, p. 32.

excluded, public expenditure at the federal level is still relatively more important in the United States and Australia.

The distribution of total public sector outlay by level of government is shown in table 2-7. This table excludes intergovernmental transfers but includes transfers to persons and businesses as well as direct expenditure on goods and services. On this basis, expenditure at the federal level in relation to expenditure at other levels is significantly lower in Canada than in the other countries. In Canada the local tier is much more important than in Australia, because about one-third of all government expenditure on education (which is to a large extent undertaken at the state level in Australia) and nearly one-half of all expenditure on police and other protection (also largely a state function in Australia) are carried out at the local level. Moreover, in some provinces health services are operated locally. A similar pattern is evident in the United States, where local schools in 1971 accounted for 27·7 per cent of total general expenditure by state and local authorities.[2]

In Germany, municipal authorities are

Table 2-7

*Distribution of Total Public Sector Outlay by Level of Government**

(per cent)

	Australia (1971-72)	Canada (1971)	United States‡ (1970)	West Germany (1971)
Federal	48	37	56 (42)	44
State	45	30	17 (22)	34
Local	7	33†	27 (36)	22
	100	100	100 (100)	100

*Excludes intergovernmental transfers.

†Includes hospitals and pension plans.

‡Percentages in brackets refer to public expenditure, other than on defence.

Source: Calculations are based on the following source material:

Australia: See table 2-6 above.

Canada: Canadian Tax Foundation, *The National Finances, 1973-74,* table 2-11, p. 20.

United States: See table 2-6 (p. 412 of *Statistical Abstract*).

West Germany: See table 2-6 (p. 39 of *Finanzbericht,* 1974).

particularly important as far as capital expenditure is concerned, financing about two-thirds of all fixed investment in the public sector[3] (compared with 40 per cent in Canada and 17 per cent in Australia). In comparing Australia with Germany, however, it should be noted that the Australian states (and their semi-governmental authorities) perform many of the functions which in Germany are undertaken by municipalities or municipal corporations.[4] Examples are: adult education; extension of water, gas and electricity mains; development of local transport services; local welfare services; hospitals; and housing.

Summary

The foregoing survey is far from exhaustive. Differences in political institutions are not featured. There are, moreover, obviously important philosophical differences in the approach to federalism in these countries, differences which have not been highlighted in this chapter.

Australia is fairly unusual among the four federations in that there is an absence of major language and ethnic or cultural differences between states. In Australia there is nothing comparable with the 'Deep South', Quebec, or even Bavaria. This almost certainly provides one plausible and perhaps overriding reason why the drive for state fiscal autonomy and decentralised decision-making has been much less pronounced in Australia than in the United States or Canada, and to a lesser extent in Germany as well.

In Canada, and even more so in Australia, the number of state governments is small in relation to total area, although not in relation to total population. City states are peculiar to Germany. City states could, logically, have a place in Australia since nearly two-thirds of the population live in the six capital cities and nearly 40 per cent in the

two major cities, Sydney and Melbourne.

In relation to higher levels of government, local authorities in Australia are much less important than their counterparts in other federations. However, this is explained to some extent by the development of semi-government authorities in Australia — authorities which operate under state law and which perform many of the functions which in other countries fall within the jurisdiction of municipal administration.

All four countries have high living standards but the economic structures differ in several important respects: the manufacturing sector is relatively more important in Germany, governmental activity as a whole is somewhat less important (but not appreciably so), production is geared to export markets and, for a variety of reasons (including significant gains in productivity), large and persistent current account surpluses have been recorded on external account. Moreover, the mobility of factors of production (including the dissemination of knowledge) beyond national boundaries is aided not only by a stable political environment in the country itself but also by the common market structure and the greater ease of access to other markets. Comparative industrial harmony has also been of great assistance in enabling the West German federation to forge ahead in economic terms.

Canada does, of course, have close economic and other ties with the United States and therefore occupies an intermediate position; but growth in recent years has been less spectacular than in Germany. Factor mobility is much less in Australia but one does not have the impression that this has been a major barrier to economic progress (partly, one could argue, because of offsetting developments which have been favourable, notably new mineral discoveries in the mid 1960s, a stable political environment, large capital inflow and immigration and closer ties with Asian countries). Australia is generally thought of as a dependent economy but its dependence on external trade, while much greater than the United States, is markedly less than in either Canada or Germany.

Income disparities between states are much greater in the United States and Canada (and the same could be said about income/wealth disparities between persons for the whole community). The same is true of cultural and/or ethnic differences.

A final, but most important point, relates to judicial interpretations of the Constitution. It seems clear that the courts in Canada and Germany have adopted a much more liberal stance in interpreting the powers of provincial or *Laender* legislatures *vis-à-vis* the powers of the national parliament than has been the case in the United States and Australia, where judicial decisions have, for the most part, had the effect of strengthening centralist tendencies. In this connection, the Federal Constitutional Court in Germany has, as noted earlier, ruled in favour of the *Laender* with respect to the broad functional areas of education and culture and more specifically on the question of radio and television. In Canada, according to Corry,[5] the Supreme Court adheres closely to the notion of exclusive and rigidly separated spheres of power, and the Judicial Committee of the Privy Council has given a wide interpretation to the powers of the provincial legislatures. Other writers arrive at a similar conclusion. Thus Fletcher states that the legal framework has operated as a centrifugal force in the Canadian federation, 'dividing jurisdiction and thwarting attempts to centralize control in im-

portant areas of economic and social concern. There can be little doubt that for much of its history, the judicial Committee brought a "states' rights" bias to its interpretative task.'[6]

By contrast the US Supreme Court has brought down judgments which underscore the extent of the spending power of the Federal Government. According to Corry, 'the Court has come very close to holding that Congress can direct the economic life of the country — and influence its social and political structure ... as it sees fit.'[7] One consequence has been a very extensive use in the United States of federal grants-in-aid as a tool of intergovernmental fiscal adjustment.

Federal grants-in-aid have also been used in the other three federations as a means for securing greater central control and influence over state spending patterns. In Australia and Germany the Constitutions are quite explicit on this matter (section 96 and articles 91 and 104 in the respective Constitutions). In Australia, the High Court has in several instances effectively ruled in favour of an extension of control by the central government. This can be seen in relation to federal legislation which has come before the court, such as the *Land Tax Act* of 1910, *Federal Aid Roads Act* of 1926 (which had important implications for other section 96 grants), and the *Uniform Tax Legislation* of 1942, which was validated in 1942 and again in 1957 against challenges by state governments.[8] Most important also were various court decisions relating to the interpretation of section 90, which (until 1974) effectively excluded the states from imposing sales taxes.[9] A High Court decision of 1971 also has important implications for Commonwealth control of companies.[10]

This brief survey illustrates, above all, that each federal country has special characteristics of its own. We should therefore not be surprised to discover major differences in fiscal institutions and decision-making machinery as between these countries.

3 Theoretical Aspects of Fiscal Federalism

Unity and Diversity in a Federal System

A logical step in approaching the theoretical aspects of fiscal federalism is to consider unity and diversity in a federal system.

Federalism permits a strong central government to exist alongside several regional (state) governments. States which opt for a federal form of government do so in the knowledge that they will retain sovereignty in some areas and lose it in others. The federating states can see the advantage of national unity with respect to a range of governmental functions — relations with other countries is an obvious example, regulation of interstate commerce is another. A federal structure is therefore a symbol of diversity as well as unity.

While recognising the need for national policies in certain key areas, the states or regions will want to retain a measure of autonomy with respect to matters which are primarily of regional or local concern. Regions will differ in area, population, climate, resource endowment and perhaps culture and language.

Unity at the national level and diversity at state and local levels is therefore the foremost characteristic of the federal form of government. In short, we might have very little difficulty in agreeing with Golay when he states: 'Any federal system is a practical solution to the problem of government when unity and diversity are to be combined.'[1]

Diverse Preferences and Decentralised Government

An important facet of federalism is that states are left free over a fairly wide range of activities (i.e. those designated as falling within their jurisdiction) to go their own way and allocate expenditures in accordance with their own priorities, and largely in response to consumer preferences. To some extent differences in economic development and in standards of public services (between states) are inevitable since one of the political reasons for establishing a federation is to permit regional diversity.[2]

This point is often overlooked in popular discussions on the subject, and particularly by those who argue for uniformity in public services throughout the federation. In a federation it is *not* axiomatic that economic conditions should be the same everywhere.[3] According to Mushkin and Adams[4] the preference of the consumer voter is an important aspect of the federal structure which is often overlooked.

It should be possible for people to select an area or jurisdiction which best approximates their preference pattern for public and private goods. The standard and range of public services provided by each jurisdiction need only be similar if preference patterns do not diverge in any marked degree. If they do so diverge then state and, better still, local jurisdictions can best respond to such diversity because state and local decisions are 'nearer the people'; and these decisions will be more responsive to the desires of the people if there is an efficient and equitable voting mechanism.

The spatial scope of benefits would seem to be the most important single criterion in determining what level of government should assume responsibility for particular functions. Whether a particular service, for example a local bus service, should be introduced is a decision which is best made at the local community level since it is the local community which benefits from the service, and as long as the main benefits are internal it would seem unreasonable to call on other communities to assist in financing the service (this does not, of course, preclude intercommunity loans, or even loans from the state and/or central government to meet capital costs).

A related point is that a more efficient allocation of resources is likely to the extent that decentralised government facilitates a balancing of cost and benefit at the margin for differing public sector activities. Economic theory places great stress on the ability of economic units to make optimising decisions which increase total output or welfare. Such ability is clearly enhanced when people are better informed about the costs and benefits of additional expenditures, are directly affected by the extension of the public activities in question and are able to evaluate the costs and benefits without the aid of a costly bureaucracy. These requirements are likely to be more compatible with a small than with a large governmental unit (although there may, of course, be offsetting inefficiencies if the unit is not large enough to be able to take advantage of economies of scale).

The greater the diversity in the preference pattern the stronger the argument for decentralised government. This argument may also be linked with (i) the need to preserve and encourage individualism and experimentation; (ii) the inherent political dangers of centralisation; and (iii) the political case for the separation of powers in a democracy.[5]

Financial Autonomy

Considerable freedom of action at the regional and local levels is therefore crucial. In a federation the states must be able to act independently within their own sphere of competence; and they must be responsible for their actions. This does not preclude co-operation with the national government where functions overlap, but there must be ample room for freedom of initiative and operation by each level of government if a viable federal system is to be preserved. This is only possible when each level has adequate financial resources for the tasks assigned to it. The financial resources available to it must, in each case, be sufficiently elastic to meet the need for additional public services which a growing economy will foster.

Layer-Cake Model

This view of federalism, stressing both unity at the national level and diversity at the regional or local level, has a strong theoretical underpinning in terms of the Musgrave-Tiebout layer-cake model of public sector activity[6] and the related doctrine or principle of fiscal equivalence.[7]

Under the Musgrave tripartite view of the public sector, government activity is split between the Allocation, Distribution and Stabilisation branches, with each branch acting on the assumption that both of the others are doing their jobs. In this arrangement the Stabilisation and Distribution branches come under the jurisdiction of the central government but the Allocation Branch is shared between each level of government (central and state/local) and can differ between states or regions — depending on the preferences of their citizens. The national government is involved in the Allocation Branch to the

extent that benefits are nationwide. In the knowledge that the central government is acting through the Distribution Branch to secure an equitable distribution of income between persons for the nation as a whole and is taking appropriate action to influence total expenditures (public and private) for counter-cyclical purposes, the states are seen to respond to regional preferences and allocate expenditures accordingly with the use of benefit taxes for the various activities.

By stressing unity and diversity the layer-cake model can, therefore, be seen to have some relevance to a federal system in the sense that distributional and stabilisation policy can both be regarded as functions of the central government, while allocation policy is shared between the central government and the states depending on the spatial scope of the benefits and costs of providing services.

However, such a simple model tends to conceal many pressing problems which face federal systems in practice. In the first place, state and local governments will not be prepared to place extensive reliance on benefit taxation. Acceptance of this form of regressive taxation would require major tax reforms at the federal level (e.g. the introduction of a negative income tax). But the more formidable difficulty is to assess the value which individuals place on different government services.[8] Moreover, as noted above, states and local authorities will want to have an elastic revenue base so that revenues expand in harmony with the growth of incomes and the increasing demands for government services. This arrangement will have more appeal to state and local authorities than an extensive reliance on benefit taxation, which is hardly calculated to win votes since it imposes burdens on those least able to pay. Exclusive use of ability-to-pay taxation (e.g. income taxes) by the central governemnt is unlikely to be acceptable to state and local authorities. Even if the central government itself levies the taxes, a portion of the revenue yield can be, and usually is, diverted for use by states and local authorities.

The theory also has to be modified or extended to allow for intervention by the central government in the affairs of states or regions in order to: (i) secure a more equitable distribution of (tax) revenues as between states; and (ii) promote particular activities which are undertaken by the states or authorities under their control.

On point (i), central government transfers to persons as part of the policy of the Distribution Branch are used to finance private goods — they do not even out differences in fiscal capacity and expenditure needs as between states. A negative income tax would assist persons on low incomes but it would clearly do nothing to offset differences as between states or regions in the cost of providing public goods. To meet this problem, equalisation grants have an important role to play in a federation, especially where there are large discrepancies in interstate fiscal capacity and in the relative costs between states of providing government services. The grants should make it possible for low income (or high cost) areas to provide services comparable in range and quality to those available in high income (or low cost) areas without the need to impose unduly high taxes. On resource allocation (point (ii)), intervention from the centre may be needed even for those activities which are normally regarded as state or local functions. For example, the latter authorities may fail to take adequate account of external benefits and therefore not extend investment in these activities to the optimum point (see below under

'Theory of Federal Grants').

Thus, as with all theoretical models ever invented, the layer-cake model, while useful as a first approximation to what would seem to be a desirable division of functions in a federation, requires substantial modification in order to accord with reality. Apart from difficulties of states relying extensively on benefit taxation, central intervention will be required to narrow differences in taxable capacity between states. Such intervention, via federal equalisation grants, is based predominantly on grounds of equity although the grants have been defended on economic grounds as well.[9] The Federal Government, whatever success it may have with a program of low income relief (e.g. through a negative income tax) is unlikely to allow standards of public services in any state to fall below certain minimum levels. It is also unlikely to ignore significant differences in taxable capacities and expenditure needs as between states. Allowance also has to be made for economies of scale and spillover benefits between regions. The aim is to secure the most efficient use of resources in the federation and although it involves intervention by the central government via grants-in-aid programs and hence an incursion into state autonomy, this can be justified on economic grounds. The existence of economies of scale and of spillovers between regions has in any event often been cited as a foremost reason for states wanting to form a federation in the first place.[10] Federal intervention designed to lower the cost of public services and correct for spillovers should not therefore meet with violent opposition from the states.

A more fundamental reason why the layer-cake model is unacceptable and could, with advantage, be discarded springs from a growing realisation that in practice it is neither feasible nor desirable to establish rigid divisions of functions between different levels of government. If this is true, then the major problem becomes one of co-ordinating decisions of each level. How can differing priorities (federal and state) be reconciled and decisions implemented which reflect preferences of local communities and national aspirations in areas where federal and state functions overlap (e.g. education, highways, housing)? This theme will be developed further. At this point, however, it seems essential to note that a scheme of co-operative government in which the emphasis is on interdependence and sharing of functions between different levels of government takes us some considerable distance from a layer-cake model with its rigid division of functions.

Overall Fiscal Equalisation

We now consider the theoretical basis for equalisation grants and attempts to adapt public finance theory, as applicable to a unitary system, to a federal system.

From the standpoint of conventional public finance theory (of the Pigovian type) expenditure (and hence taxation) should be carried to the point where the marginal social cost of each unit of expenditure is equated with the marginal social benefit of each unit. When there are many different types of expenditure, the equilibrium requirement is that the ratio of marginal social benefits and costs must be equal for all types of expenditure (A, B, . . . X). Thus:

$$\frac{MSB_A}{MSC_A} = \frac{MSB_B}{MSC_B} = \ldots \frac{MSB_X}{MSC_X}$$

If these ratios are not equal, then a reallocation of units of expenditure as between different categories (A, B, . . . X) can be shown to increase total utility or welfare. Thus in table 3-1 (which assumes an

Table 3-1

Optimum Allocation of Public Expenditures in a Unitary System

Units of expenditure type A & B (re-allocation of units from A to B) A	B	($) MSB (=MSC) A	B	($) Differences in MSB (=MSC)
11	9	15	36	+ 21
10	10	20	30	+ 10
9	11	23	28	+ 5
8	12	25	27	+ 2
7	13	25.5	26.5	+ 1
6	14	26	26	....
5	15	29	25	− 4
4	16	35	22	− 13
3	17	45	18	− 27
2	18	60	10	− 50

equality of marginal social cost and marginal social benefit for all units of expenditure) a reallocation of expenditures between expenditure types A and B (i.e. more of B and less of A) will increase total utility up to the point at which the benefit at the margin for each expenditure type is equal. Beyond that point any further reallocation will cause a fall in total utility. This assumes, of course, the operation of the Law of Diminishing Marginal Utility — the more units of a given expenditure type that are available the less the value at the margin of each succeeding unit. In this example, it has also been assumed that additional social costs at the margin diminish to the same extent (*pari passu*) as the marginal social benefits, as expenditure on a particular activity increases.

Assuming that agreement could be reached on the social values or utilities at the margin for additional public expenditures, the application of the Pigovian principle could be followed in a unitary state. The central government, if it had complete discretion, could at least use the principle as a guide in regulating taxes and expenditures.

A difficulty arises in a federation, where the states have jurisdiction and freedom of action over a certain range of activities. Thus while the central government may pursue the above principle in its own sphere and each of the states do the same in their respective spheres, there is no guarantee — in fact it is very unlikely — that the position of equilibrium or maximum benefit could be attained for the nation as a whole.[11]

The reason is not hard to find. When states differ in incomes (and hence taxable capacities) and in standards or levels of public services, the benefits and sacrifices resulting from the application of additional units of public expenditure and taxes will not be identical. The taxes will involve less of a sacrifice and the expenditures less of a benefit at the margin in the rich states as compared with the poorer states. In wealthy states with high income levels the need for additional state

Table 3-2

Re-allocation of Expenditure Between States to Secure Equilibrium in a Federation

	Units of Expenditure on public goods in state R	Units of Expenditure on public goods in state P	Additional expenditure in state P MSB (=MSC) $	Taxes in state R MSC (=MSB) $	Net change in MSB $
Initially	40	20	50	10	—
	39	21	48	12	+ 36
	38	22	45	15	+ 30
	37	23	40	20	+ 20
Equilibrium	36	24	30	30	—
	35	25	15	45	− 30
	34	26	5	60	− 55

services is relatively low and the real cost of financing such an addition will also be relatively low (in fact in equilibrium for that state the marginal social cost of the additional taxes will equal the marginal social benefit of the new expenditures). Interstate discrepancies between marginal social benefits (and costs) suggest that the welfare of the nation as a whole might be enhanced if relatively heavy taxes were imposed in the wealthy states and the proceeds used for spending on public services in less affluent states. Hence the need for federal intervention, via equalisation machinery, to redistribute tax revenues between states.

How far should such redistribution be carried? In theory, and in the absence of resource-distorting effects or a 'second-best' solution in terms of the attainment of minimum standards of public services, and assuming that each state is allocating expenditures between categories according to Pigovian principles, then the redistribution of revenue between states should continue until an equality of social benefit at the margin for all public expenditures is attained. This is illustrated in table 3-2 on the basis of just two states (R = rich; P = poor).

Thus, beginning initially with 40 units of expenditure on public goods in state R and 20 units of expenditure in state P, a net gain in utility for the federation can be secured by allowing relatively more expenditure on public goods in state P than in state R up to the point at which, in this hypothetical example, there are 36 units of expenditure in state R and 24 units of expenditure in state P. Beyond that point any further reallocation will only reduce total utility.

The assumptions built into this table are as follows:

(i) There are initially large discrepancies between MSB (and hence MSC) of expenditure on public goods as between poor and rich states. As noted this seems reasonable and provides the essential rationale for federal intervention. Whatever the allocation (in each state) between expenditure types, the benefits and the costs at the margin of expenditure on *all* public goods can be expected to be con-

siderably larger in poor than in rich states.

(ii) The allocation of expenditures within each state is consistent with the Pigovian principle enumerated above, that is

$$\frac{MSB_A}{MSC_A} = \frac{MSB_B}{MSC_B} \ldots = \frac{MSB_X}{MSC_X}$$

(iii) The Law of Diminishing Marginal Utility operates. Thus, even though marginal social benefits will initially be relatively high in poorer states, they will fall as more public facilities become available and of course they will rise in richer states as these facilities are scaled down.

(iv) Since our main purpose is to demonstrate that there is a *prima facie* case for revenue redistribution between states which are heterogeneous and differ in fiscal need, it has been assumed in the foregoing table that real costs at the margin fall *pari passu* with the marginal social benefits as public facilities are expanded in state P (taxes impose increasing sacrifice at the margin and subsidies decreasing sacrifice). In practice this assumption may require substantial modification.

(v) Total expenditure on public goods is constant for purposes of the illustration. Thus, the additional taxes imposed in state R (or a reduction in federal grants to that state which necessitates an increase in state taxes or curtailment of expenditure) are assumed to reduce purchasing power in the state and hence the demand for public and private goods. The higher taxes increase the real cost of expenditure on public goods in state R while the subsidies lower the real cost of such expenditure in state P.

(vi) The analysis is simple and is entirely static. While the approach does help to establish, *prima facie*, a case for interstate fiscal equalisation on broad welfare grounds, it makes no allowance for differing growth potentials as between states. Pouring funds into a relatively poor state, which has very limited prospects for growth, does not seem to be a sensible policy. Thus it may be that this basic theory requires substantial modification. It is possible that policies which raise the standard of public services in poorer areas may interfere with the efficient allocation of resources — for example by reducing the mobility of factors of production and hence lowering the growth rate for the nation as a whole. In relation to assumption (iv), it may well be that the expansion of public facilities in state P is possible only at great cost to the federation as a whole. While the citizens of state P may place great value (high marginal social benefits) on these additional facilities, the cost in terms of alternatives forgone (namely, the transfer of resources from state R where marginal productivities are relatively high to state P where these marginal productivities are relatively low) may exceed the benefits. This may cause a loss of investment opportunities in state R and thereby adversely affect the level of private activity in that state (a state in which opportunities for investment at relatively low cost would otherwise be considerable). Resource-distorting effects then occur. A full discussion of this issue, largely in terms of the Buchanan-Scott exchange, is reserved for chapter 11.

Despite these qualifications, the foregoing analysis provides a basis in theory for federal intervention designed to secure an increase in welfare for the nation as a whole. Thus, despite Scott's assertion that this type of analysis is somewhat empty 'and gives absolutely no guidance to particular problems',[12] it does seem to highlight two general points which are

essential to an understanding of modern federalism:

(i) The autonomy of a state or region cannot be absolute. Unless regions are very homogeneous and similar in resource use and income levels, federal intervention to secure a redistribution of income between states will be required.

(ii) The autonomy of the central government is also limited in some degree. This is because agreement on an acceptable redistribution formula is likely to require co-operation and compromise (give and take) by both levels of government. This is especially true in a federal country such as Germany, where the more affluent states with greater voting powers in the Upper House in Bonn may be able to block an equalisation law which is designed to transfer income to one or two states with the lowest per capita incomes (see chapter 13).

A final point is that federal intervention for purposes of overall fiscal equalisation must be carefully distinguished from specific action to expand certain types of activities — whether in poor or affluent states — on the basis of the existence of externalities or benefit spillovers between regions. The latter are taken care of by means of categorical or tied grants, to which we now turn.

Theory of Federal Grants

Professor Wheare's 'ideal' federation is one in which there would be no federal-state fiscal problems since 'both central and state governments should be politically and financially independent within their own spheres.'[13]

While our concept of federalism is such as to indicate that *legally* each tier (central and regional) has independent powers, we know that in practice such a pure federalistic ideal is hardly likely to be reached.[14] A case has already been made for federal intervention for purposes of interstate fiscal equalisation. Such intervention will not greatly inhibit state freedom of action in allocating funds between alternative uses, especially if the federal grants are unconditional, which is usually the case.

Federal intervention does, however, extend much further than that. In practice we find not the 'ideal' federation but a sort of 'quasi' federalism, to borrow another phrase from Professor Wheare. The main difference is that in a quasi federalism the central government interferes to promote the national interest, not by a direct takeover of state functions (although this does happen on occasions), but by using the vehicle of federal grants to promote particular activities. In some federations, as noted earlier, the Constitution provides explicit authority for such interference (e.g. in Australia and Germany) while in others the central government has successfully extended grants-in-aid without such explicit authority but with the backing of the courts (e.g. Canada and the United States).

What is the theoretical basis for such interference? In this instance the main justification is in terms of spillover benefits between regions. Here it is argued that the independent action of various states may tend to leave public services under-provided, since each government can be expected to take little account of the benefits it provides to non-residents. Benefits of many governmental activities accrue mainly to one group but also spillover into other groups. Education and highways are the classic examples. To meet this situation — to ensure that the public activity is extended so that a large part of the external benefits are, in fact, 'internalised' — the appropriate instrument is the specific purpose matching grant.[15]

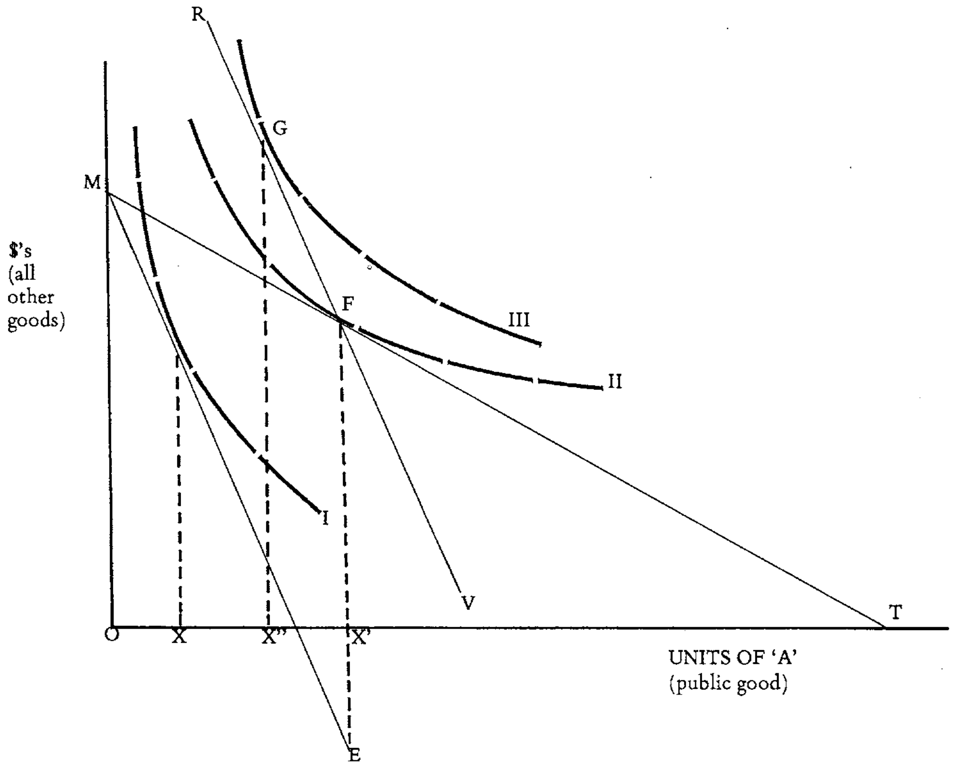

Fig. 3-1 Effect of a Specific Purpose grant: matching and non-matching. Reproduced from Wallace E. Oates, *Fiscal Federalism*, Harcourt Brace Jovanovich, New York.

There are, of course, spill-ins as well as spill-outs. In so far as investment in public activity 'A' is not carried far enough in region r^1 for benefits to be reaped by the residents of region r^2 and if, by the same token, there is an under-investment in 'A' in region r^2 so that residents of r^1 are excluded from the benefits, there is of course a double loss for the nation as a whole, assuming that the investment in question has a high national priority and does not squeeze out other activities which are also high on the scale of national priorities.

The following outline of the theory of intergovernmental grants draws heavily on the work of Oates and Wilde.[16]

An application of Pigovian theory to governmental activity suggests that higher levels of government have the responsibility for compensating lower levels of government for the benefit spillovers so that the marginal cost of the public services can be equated with the marginal social utilities created.

Wilde demonstrates that a matching grant is the appropriate instrument for dealing with benefit spillovers.[17] If 'A' is the specific public good which the upper level of government wishes to promote, then a specific non-matching grant will ensure that those grant funds are used for 'A' but cannot prevent the recipient government from devoting fewer of its own resources for the provision of 'A'. A matching grant, by contrast, provides a seepage of resources into 'A' from other uses. This can be illustrated with the aid

of figure 3-1.[18]

With budget constraint MN there is initially OX of 'A' consumed. But if a subsidy is provided such that the price of 'A' falls, the budget constraint moves to, say, MT. The consumption of 'A' therefore rises to OX', which is assumed to be the socially desirable level. The total grant is then EF.

Now suppose that, instead of this unit subsidy, the recipient government were to be given a lump sum grant of EF, with the stipulation that the grant moneys must be used in the provision of 'A'. The budget line then changes from MN to RV. If the highest indifference curve attainable is III and this indifference curve is tangential with the new budget line at G, then OX" of 'A' would be provided which is greater than OX but less than OX'.

This illustrates the point that lump sum non-matching grants (whether specific purpose or not) only have an income effect since the recipient government can divert a portion of its own resources from 'A' and may even reduce taxes. Thus in figure 3-1 there would be no net additional output of 'A' if G were to lie along the vertical path from X (instead of to the right of X). In that event, all the grant moneys which are spent on 'A' are exactly compensated by additional spending from own resources on all public goods except 'A' and/or by an increase in the consumption of private goods via tax reduction. This cannot happen when the higher level of government insists on a maintenance of effort on the part of the recipient government with respect to the provision of 'A'. This can be done through matching arrangements.

Only if the governmental unit did not use any of its own income in the provision of 'A' would the above argument not apply. It follows that the more self-reliant the recipient government is with respect to revenue raising, the greater the possible leakage or diversion of resources from 'A' to other goods as a result of the receipt of grant moneys earmarked for the provision of 'A'. Thus the matching grant is clearly the best policy instrument to use in order to correct for distortions which stem from externalities in the provision of public goods. (In the United States in 1971 more than 80 per cent of grant funds required matching.)

It is worth noting the conflict of priorities as between higher and lower levels of government inherent in this example. Thus the matching grant will ensure a provision of OX' units of 'A' which is judged to be the socially desired output. However, such an output will place the recipient government on a lower indifference curve (i.e. at F) than it would be (i.e. at G) if there had been no matching requirement. There is therefore an obvious clash between priorities of the lower and higher levels of government.

Fiscal Decentralisation — Some Limiting Factors

Our survey of theory so far has suggested that there is a presumption in favour of fiscal decentralisation as far as the Allocation Branch is concerned. The gains from such decentralisation must, however, be weighed against the costs (or the gains from greater centralisation).

On economic grounds the presumption in favour of decentralised decision-making springs from the assertion that when the number of persons involved is smaller, knowledge of costs and benefits may be greater and there is a more direct link between benefits and real resource costs. This bears closely on the doctrine of financial responsibility. If a community is required to finance its own public program through local taxation, residents are more likely to weigh the benefits of the program

against the costs. If funds come mainly from the centre, residents will want to go on expanding the program since they bear only a small part of the costs.[19]

The splitting up of a large group into several smaller groups is also likely to increase welfare in the sense that, when opinions differ about the desirability of alternative public programs, more people can have the program they prefer. This point can be illustrated by building on an example cited by Tulloch.[20] Suppose the original unit of government had a voting population of 10,000 with 6000 favouring policy A and 4000 favouring policy $\bar{A}$. If policy A is adopted, 6000 people get their way and 4000 are disappointed. But if this unit is broken down into two smaller units, each of equal size with 5000 voters, a greater number of voters can now get their way — in fact 7000 or 9000 in the examples below. (In both examples, policy $\bar{A}$ is adopted by unit 1 and policy A is adopted by unit 2.)

		No. in Favour of:	
		Policy A	*Policy* $\bar{A}$
Example 1	Unit 1	2000	3000
	Unit 2	4000	1000
		6000	4000
Example 2	Unit 1	1000	4000
	Unit 2	5000	–
		6000	4000

All people cannot get their own way if there are only two units, assuming groups of equal size. All people could, however, get their way if there were, for example, five units, each with 2000 people.

		No. in Favour of	
		Policy A	*Policy* $\bar{A}$
Example 3	Unit 1	2000	
	Unit 2	2000	
	Unit 3	2000	
	Unit 4		2000
	Unit 5		2000
		6000	4000

If the assumption of groups of equal size were dropped there could be simply two groups — one of 6000 and the other of 4000 people. But the choice is not likely to be just between policies A and $\bar{A}$. A larger number of relatively small groups could be envisaged to cater for a variety of public expenditure mixes. Such extension does, however, presuppose that people can move freely between units; and this brings us to a 'Tiebout world' in which people can move into the area which best suits their

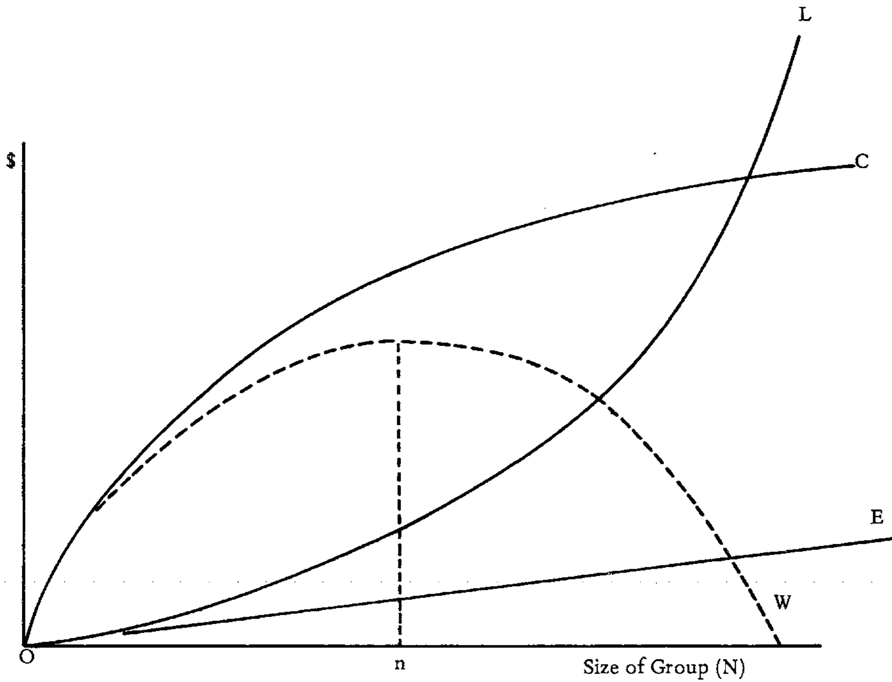

Fig. 3.2 Determining the optimum sized group. Reproduced from Wallace B. Oates, *Fiscal Federalism*, Harcourt Brace, Jovanovich, New York.

preferences. Welfare gains are larger when individuals with similar tastes locate together geographically. This result is also consistent with the principle of fiscal equivalence since those who expect to benefit (from either policy) are the ones who pay.

But if there are benefits from greater fiscal decentralisation along the lines indicated (each individual has greater freedom to choose, the larger the number of units), there are also costs.

If there are too many units of government the costs of decision-making will be high, and if too many people move into particular areas, there will be costs associated with congestion, noise, traffic and crime. The quality of life can suffer. Account must also be taken of economies of scale — an amalgamation of units may be needed to reduce the costs of a service to the community.[21] Equally important is the likelihood that smaller units will take insufficient account of the benefits which spill over into other jurisdictions. To correct for these various distortions will require intervention by higher levels of government, as already indicated.

For these reasons there are clear limitations on how far fiscal decentralisation can be carried. An attempt has to be made to weigh the costs and benefits associated with decentralised decision-making. If individuals possess similar preferences, the benefits of greater centralisation (larger units) are likely to outweigh the costs. To gauge the optimum sized group we can use a diagram from Oates: (figure 3-2).[22]

As people become part of a larger group, they consume jointly and there is a welfare cost (OL) because the influence of any one individual diminishes as N

increases. Therefore, the more diverse the preferences, the steeper the slope of OL which, given OC (which measures the gain, in terms of lower cost, from a larger group), reduces the optimum size of the group.

OC depicts the aggregate gain in welfare (because of a lower unit cost of services) as the group size increases. OE is the potential gain from 'internalising' the external effects, a gain which increases as the size of the group increases. Thus, the optimal sized group in this example is O_n, since at this point OW (= OC — OL + OE) is at a maximum.

Summary: Policy Instruments and Goals

The foregoing survey of theory relevant to a study of fiscal balance in a federal system suggests that state and local authorities should have a major role in terms of resource allocation. Fiscal decentralisation offers maximum benefits when there are significant differences in consumer preferences. As these differences narrow, other considerations such as economies of scale become more important and suggest the need for larger units. Up to a point the larger units can be expected to lower unit costs by virtue of economies of scale and to save on administrative costs as well. Each consumer may not get exactly what he wants — if, indeed, he ever seriously thinks about it — but what he does get is made available at a lower unit cost. In practice there is clearly a trade-off between the costs associated with restrictions on individual choice, as the size of the group expands, and the above-mentioned cost savings.

Beyond such broad generalities, allowance has to be made for: (i) federal grants to correct for vertical imbalance; (ii) horizontal equalisation transfers at the state and local levels; and (iii) federal transfers needed to provide for inter-jurisdictional spillovers and to promote certain national goals. Transfers under (ii) and (iii) involve central intervention in one form or another and will, in all probability, cause some distortion of priorities at the state and local levels of government.

The need for central intervention can be looked at in terms of financial autonomy of state and local units, equity as between units at each level, and resource allocation. Alternatively, intergovernmental fiscal adjustment can be viewed in terms of instruments and targets — involving an eclectic approach.[23]

The most appropriate intergovernmental fiscal instrument for spillover correction is the matching grant.

The most appropriate instrument for interstate fiscal equalisation is the unconditional grant if the aim is simply to put the recipient state in a position where it can spend more on public services (without imposing additional taxes) if it wishes to do so. Depending on the specific aims of the central government, other instruments may be used. Thus, if minimum standards are not particularly important but there are certain areas of public spending which the Federal Government wishes to promote, the bloc grant is a suitable technique for intergovernmental fiscal adjustment. Bloc grants from the centre (as under US revenue sharing) enable state and local authorities to spend freely within certain broad functional categories. This instrument has the great advantage that it can be used to correct for both vertical and horizontal fiscal imbalance.

If the Federal Government desires to conserve its funds, maintain a tight control over the direction of spending and at the same time help the most needy states it can, perhaps, obtain the best results through a system of variable matching

grants, whereby the amount contributed by the Federal Government bears an inverse relation to per capita incomes of the recipient states (the same principle can be used at the local level).

In any event it is clear that at least two policy instruments are necessary to achieve the goals implicit in a system of federal grants.[24] An ideal assignment might, therefore, be as follows:

Instrument	Goal
Bloc grant	I Correction for vertical inter-governmental fiscal imbalance[25]
Unconditional grant and/or bloc grant and variable matching grant	II Correction for horizontal fiscal imbalance
Matching grant	III Correction for intergovernmental externalities

Some of these grants will inhibit independent action by the states. In any event there is inevitably an overlapping of functions between the two main levels of government. This calls for intergovernmental consultation so that a costly duplication of their efforts can be averted. Because of this and because forward planning in the public sector will necessitate intergovernmental cooperation in various forms, neither level of government can have absolute autonomy.

This analysis does therefore lead us to question the appropriateness of a rigid division of functions of different jurisdictions. Once we have finished amending the layer-cake model to accord with various aims of government, taking particular account of financial autonomy, horizontal equalisation, political constraints and the desire to minimise cost, we end up with a sort of marble-cake arrangement in which an essential ingredient is intergovernmental cooperation. This point has been brought out forcibly by Reagan who describes the new style federalism, which is very much alive, as a political and pragmatic concept stressing actual interdependence and sharing of functions between the central government and the states.[26] The new style replaces the old style, or conventional, federalism which tended to give undue emphasis to legal and rigid divisions of functions and responsibilities. Important developments in the sharing of decision-making between the Federal Government and the states with respect to various governmental functions in each of the four federal countries are considered fully in Part IV.

Part II Fiscal Federalism: Vertical Balance

4 General Principles and Relevant Criteria

Non-Correspondence of Revenue Resources and Expenditure Functions

In a federation it is unlikely that revenues of each level of government will match expenditures at each level. Few would suggest that states should spend only what they raise from their own revenue sources. Some degree of vertical intergovernmental fiscal imbalance is therefore to be expected. Such imbalance is usually a reflection of the superior revenue-raising potential of the central government and the fact that the states have jurisdiction in areas where expenditure demands are heavy and increase automatically as the economy expands.

Thus at the federal level R > E while at the state level E > R, where R = revenue from 'own' sources (excluding borrowing and intergovernmental transfers) and E = expenditure. This is the conventional approach put in the simplest possible terms. If the vertical imbalance is large this means that the division of revenue between central and state governments (as a whole) does not correspond closely with the distribution of expenditure functions between the two levels of government.

If the gap between state expenditures and own tax revenues is large, the states will be obliged to lean heavily on federal grants and/or on debt financing.

Vertical and Horizontal Imbalance

While there are advantages in distinguishing between two major issues — (i) the amount of the vertical transfer; (ii) the mode of its distribution between the states — it is often difficult in practice to keep them apart; for grants which are designed to ease the financial burden for all states may, at the same time, be distributed in a way which assists some states more than others (this depends on the distributional criteria employed, such as per capita income, population density, area, paucity of resources, etc.). There is thus a double-barrelled problem: first to determine the size of the financial transfer and second to decide how the transfer should be allocated among the states.

When economists, politicians and other interested parties refer to a 'crisis' in federal-state financial relations what they usually have primarily in mind is the extent of the vertical fiscal imbalance, and the associated problems of closing the 'gap'; and the latter is largely a measure of the difficulty which the states have, compared with the central government, in raising revenues to match growing expenditure commitments.

This problem is linked with the observed tendency for the public sector to grow faster than the private sector (a product of urbanisation, population growth, increased population density, not to mention government policy and the fact that prosperity itself generates a spiralling demand for public services). But of particular relevance (in the context of federal-state financial relations) is the tendency for the revenue requirements of state and local governments as a whole to grow faster than the national product (partly because demands for services are highly responsive to growth in income)

while taxes traditionally used by these governments are such that revenues grow at a slower rate than the national product.[1]

Horizontal fiscal adjustment is of an essentially different character since there are some states which benefit greatly, others which, in effect, bear the brunt of the cost of transfer, while some states may be at the margin or in the middle of the spectrum in the sense that they are not greatly affected one way or the other (e.g. Bavaria in Germany and Manitoba in Canada).

Equalisation transfers are based on suppositions concerning equity or justice, usually in terms of an appeal to the 'rights' of residents of less affluent states to enjoy a comparable standard of services and face a comparable tax burden as citizens in similar circumstances residing in the more affluent states. A theoretical basis for these transfers was set out in the previous chapter and will be considered further in chapter 11.

For reasons set out in chapter 3, it seems unlikely that rationalisation of fiscal federalism in accordance with the layer-cake model could be carried to the point where vertical fiscal imbalance was eliminated. It is most unlikely that states would be able or willing to act as envisaged in the model and use benefit taxes on the scale necessary to eliminate vertical imbalance. Thus even the most ardent supporters of the model concede the need for vertical adjustment via some sort of revenue or tax sharing arrangement. But they prefer to consider such adjustment as being 'not the essence of rational fiscal federalism but as one of several means of filling any gap remaining after fiscal federalism has been rationalized along the lines of the layer-cake model'.[2]

Federal payments to adjust for vertical and horizontal fiscal imbalance are conceptually distinguishable, even though in practice it has often proved difficult to keep them apart. In what follows, horizontal fiscal equalisation will, where possible, be separated; and comment on rationale and mode of operation in each country is reserved for Part III.

The Problem of Vertical Imbalance

While there is evidence that the problems associated with horizontal fiscal imbalance are being tackled systematically in several federal countries, and apparently with a good measure of success, the elimination of large vertical fiscal imbalances is proving to be a much more difficult assignment. This is especially true of Australia.

The persistence of these large imbalances in some federations can, in part, be put down to sheer inertia, allied with a feeling that it is not really a problem anyway. But a full explanation is much more complex and would go to the very heart of intergovernmental relations, and in particular the following:

- (i) the nature and extent of state fiscal autonomy;
- (ii) impact of greater state autonomy on federal powers to achieve stability and growth objectives;
- (iii) clash of federal and state priorities (e.g. housing, social welfare, infra-structure expenditures);
- (iv) the absence of, or defects in, existing revenue sharing arrangements;
- (v) failure of the central government to contain inflation and its effect on state budgets;
- (vi) constitutional barriers on the use by the states of certain taxes (coupled, perhaps, with a refusal of the central government to

collect taxes on behalf of the states);

(vii) shortcomings in machinery for intergovernmental co-ordination;

(viii) pursuit of centralist policies by some national governments;

(ix) power conflicts between politicians.

If there is a continuing gap between expenditure and revenue at the state level it must be closed somehow. Given that states within a nation do not have the power to draw cheques on the central bank to meet cash deficits, then the gap can only be closed in one or several of the following ways:

(i) efforts by states to exploit existing tax resources more fully;

(ii) transfer of taxes from the federal to the state level (e.g. succession duties in Canada);

(iii) revenue sharing arrangements;

(iv) federal grants;

(v) debt financing;

(vi) direct centre intervention and/or a federal takeover of state functions (such takeover may be achieved by intergovernmental agreement — state railways in Australia, for example — or by constitutional amendment);

(vii) expenditure reduction.

But why does it matter if the vertical financial imbalance is large? What *is* the problem? There are four reasons why a large imbalance does constitute a problem:

(i) The close bearing which vertical imbalance has on state financial autonomy. According to the doctrine of financial responsibility (or principle of fiscal equivalence), each unit of government should have independent revenues sufficient to meet the costs of functions assigned to it. Such financial autonomy is essential for independent and decentralised decision-making. Governments do not act responsibly, according to this argument, unless they have financial autonomy.

(ii) A large vertical imbalance means an excessive reliance by the states on federal grants or borrowing; and this means (particularly if the states do not have independent borrowing powers) that states are obliged, in response to rising expenditure needs, to put pressure on the Federal Government for grants or loans without any serious attempt being made either to effect economies in the use of resources under their direct control or to match costs and benefits at the margin in relation to expenditures financed by federal grants. The expansion of public sector programs therefore has a tendency to be unduly influenced by short-term political considerations and to be susceptible to short-term political bargaining, with the result that cost-benefit calculations essential to efficiency in resource allocation tend to be pushed into the background. Moreover, efficiency in resource allocation may suffer, as Mathews and Jay point out, 'because the Commonwealth makes expenditure decisions in areas where it lacks information needed to make effective choices and where it does not have political responsibility for those decisions'.[3]

(iii) States and local authorities usually account for more than 50 per cent of public spending and

often more than 75 per cent of public capital expenditure. As long as this situation prevails, it can be argued that forward planning is more difficult when states do not have elastic revenue sources; and the gap (vertical imbalance) will widen over time if states and local authorities have to rely on taxes the yields from which are not very responsive to growth impulses (especially since the public sector has tended to grow faster than the private sector).

(iv) A large vertical imbalance is likely to reflect the absence of, or defects in, revenue sharing arrangements. These arrangements have some appeal in terms of co-operative federalism, greater state self-reliance and fiscal psychology.

Coefficient of Vertical Balance

The conventional approach to vertical balance is, as noted, in terms of broad aggregates. At the state level, $V_b = R_s - E_s = O$

where V_b = vertical balance
R_s = state revenues from own resources
E_s = state expenditure

Thus if $E_s > R_s$, then $E_s - R_s = G + B$
where G = federal grants
B = borrowing (net)

This approach is, however, far too simple because all items lumped together under (G + B) are, in effect, treated the same, whereas in reality they may differ considerably with respect to the extent, if any, of state 'control' involved.

A more comprehensive approach would be to distinguish between those income items which are largely determined or 'controlled' by the Federal Government and those which are influenced by the states. The real question is this: to what extent do states have autonomy with respect to the size, not only of T_o (own taxes), but also of each of the other income components? If their influence or ability to 'control' is slight, the vertical fiscal imbalance will obviously be very large. When we examine our four federal countries we find that state influence with respect to these income components can differ markedly.

A more systematic and comprehensive approach to this question might therefore proceed as follows:[4]

For any period, state income from taxes and other sources, including federal grants and net borrowing, must equal total outlay.

Thus,

$$T_o + T_s + R + G_o + G_c + B = E \quad (1)$$

Where: T_o = Tax revenues received from taxes levied exclusively by the states
T_s = Tax revenues received from taxes, the proceeds of which are shared between the two levels of government (Fedral Government and the states)
R = Non-tax receipts
G_o = Open-ended (unconditional) grants received from the Federal Government
G_c = Conditional grants received from the Federal Government
B = Net borrowing by states
E = Total state outlay

Where G_o is given to the states essentially as a substitute for T_s (as in Australia), then equation or identity (1) can be re-arranged to incorporate the idea of above- and below-the-line items, the

former being items which make up the basic deficit and the latter those which finance that deficit.

Thus,

$E - T_o - T_s - R - G_o = G_c + B$ (2)

When the equation is put in this form, G_o is assumed to be the equivalent of T_s from the standpoint of state fiscal autonomy. This might be a legitimate procedure when comparing Australia with Germany since in neither country can the states vary income tax rates, although they receive what amounts to a share of growth taxes. In each case (and unlike G_c) the states are free to spend the proceeds in any way they please.

The regrouping in equation (2) is not, however, a very happy one. This is because: (i) G_c and B are not necessarily financing items; and (ii) T_o, T_s, R and G_o are unlikely to be entirely determined by state initiatives. G_c may, as in Australia for example, be partly a response to federal initiatives and partly a response to state initiatives. A rise in G_c is likely to be associated with a rise in E, and possibly also by a rise in T_o and R (especially if matching conditions apply).

Assuming E to be given in the short run, we can specify 'above-the-line' income items at the state level as:

$T_o' + T_s' + R' + G_o' + G_c' + B'$,

and 'below-the-line' income items as:

$T_o'' + T_s'' + R'' + G_o'' + G_c'' + B''$.

The above-the-line items are those which are influenced primarily by state initiatives and bargaining power while the below-the-line items are purely financing or residual items from the standpoint of the states, being determined by the Federal Government.

At the state level (where stabilisation and distributional policy is assumed to be entirely absent), the above-the-line items $T_o' + T_s' + R' + G_o' + G_c' + B'$ are taken to be guided wholly by expenditure needs in accordance with the Allocation Branch. The below-the-line items $T_o'' + T_s'' + R'' + G_o'' + G_c'' + B''$ are then simply the difference between E and $(T_o' + \ldots\ldots B')$. Once the size of E is determined, any gap remaining after the states have imposed their own taxes, borrowed funds on their own initiatives, and bargained successfully for larger grants or a share of pooled taxes, is filled by various transfers from the centre.

Focusing on the income components (E being partly a function of the latter and partly a function of exogenous forces), the *coefficient of vertical balance* (v) can be adduced as follows:

$$T_o' + T_s' + R + G_o' + G_c' + B' = vE \quad (3)$$

And since

$(T_o'' + \ldots B'') = E - (T_o' + \ldots B')$,

Then $T_o'' + \ldots B'' = E - vE$

Therefore (4)

$$v = 1 - \frac{T_o'' + T_s'' + R'' + G_o'' + G_c'' + B''}{E}$$

Putting the expression in this form has the advantage of showing that as E rises (from whatever cause) the degree of vertical imbalance will increase if the financing items rise more than proportionately. The greater the financing items in relation to E (i.e. the less the scope for state initiatives or state 'control'), the closer v will approach to zero (i.e. the greater the extent of vertical imbalance), and vice versa.

It is therefore apparent that v can have a range of values from zero to unity. At one extreme, when $T_o'' + \ldots\ldots B'' = E$, $v = O$. At the other extreme, $T_o'' + \ldots\ldots B'' = O$, and $v = 1$. Put in more familiar terms, if the 'above-the-line' income items $(T_o' + \ldots. B')$ sum to zero, the states do not have any financial

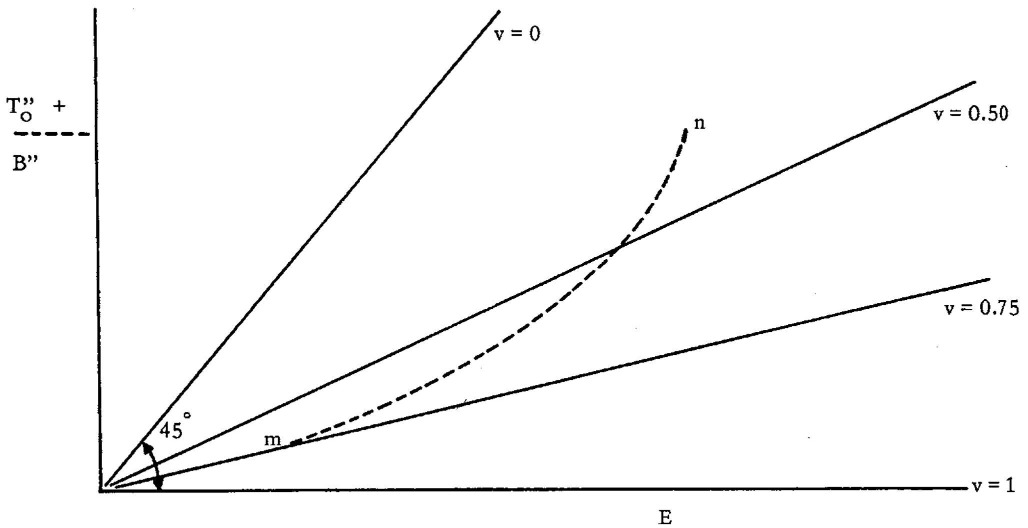

Fig. 4-1 Coefficient of Vertical Balance

autonomy. This would indicate a total dependence by the states on federally controlled grants-in-aid programs and/or on residual borrowing to meet expenditure commitments. In that event vertical imbalance would be absolute and in reality the federation would cease to have meaning. The states would be unable to vary revenue in response to voter preferences at the state or regional level in accordance with the layer-cake-model. On the other hand, as the 'above-the-line' revenue items come closer to E, independent decision-making on the part of the states and state financial autonomy become more marked, and v then comes closer to unity.

Figure 4.1 can be used to illustrate this. The 45° line in figure 4-1 would indicate an extreme position of absolute vertical imbalance (v = 0), while the horizontal line would indicate the other extreme position of absolute vertical balance (v = 1). In the second case, for example, each additional dollar of state expenditure is matched by state decisions to increase revenue (either tax or loan finance) by a dollar; and these decisions are assumed to be free of intervention from the central government.

In reality, of course, v will be somewhere between these extreme positions. If, as state expenditure commitments rise, the states find it more difficult to increase their own revenues and are obliged to rely increasingly on categorical grants-in-aid and/or on borrowing from the central government, the v line might be expected to trace out a path such as m......n. As m approaches n, a growing proportion of expenditure has to be financed by federal grants and loans (and perhaps state taxes as well, i.e. by $T_o'' + T_s''$) merely to fill the gap between E and the 'above-the-line' revenue components ($T_o' + \ldots B'$).

A reduced dependence on federal grants and borrowing is not necessarily the preferred position of the states. But the states cannot have it both ways. They cannot argue for greater control over tax and spending policies on the one hand and be content to rely heavily on federal transfers — unless they are able to exert considerable influence over both the size and composition of these transfers.

Vertical Balance: Inter-Country Comparisons

In theory, many additional amendments could be made to this broad framework. For example, it might be argued that T_o' is essentially different from T_s' since T_o' represents revenue from taxes imposed by the states which are, by and large, free to vary tax rates. T_s', however, does not mean the same thing in each federal country.

There are no shared taxes of any consequence in Australia. In Germany, T_s represents the state share of tax yields where tax rates are uniform throughout the country and are set by federal law. The German states are, however, in a strong bargaining position to determine the size of T_s.[5]

In Canada, the provinces are legally free to set their own income tax rates.[6] In reality, however, independence of action by the provinces is constrained in several ways. After 1966 the Dominion Government resisted further increases in the general abatement for the personal income tax to make greater tax room for the provinces. In 1972, the abatement system (with respect to the personal income tax) was abandoned, with the Dominion Government no longer providing, in any formal sense, tax room for the provinces. Under the new piggy-back arrangements the Federal Government now imposes only federal taxes, to which are added provincial taxes as a percentage of the federal rates. Federal revenue guarantees to the provinces associated with federal tax reform were subject to conditions which have impaired to some extent the freedom of action which provinces have in the tax field. Since there was considerable uncertainty as to how provincial revenues (which were linked to federal revenues by the new piggy-back arrangements) would be affected by the federal tax reform of 1971-72, the Dominion Government offered to guarantee provincial revenue for five years on the basis of 1971 tax rates as applied to personal and corporation income. Under Part IV of the *Federal-Provincial Fiscal Arrangements Act* 1972 there was, in effect, a federal guarantee that for five years the provinces would not suffer a loss of tax revenue by adopting income tax Acts modelled on the new Federal Act, provided that the rates were equivalent to those levied under the old Act.[7]

In the United States, where there is a high degree of state fiscal autonomy, many states have responded to fiscal pressures by raising tax rates or adopting new taxes.[8]

It would therefore be clearly inappropriate to include only T_o (and R) in the 'above-the-line' category. To do so would be to adhere to a particularly narrow version of state fiscal autonomy. Some part of T_s — and probably a large proportion — must also be included.

Another important question is whether G_o should be placed above- or below-the-line. Should open-ended grants be regarded as a source of revenue which the states can influence as easily as they can their share of earmarked taxes (T_s)? This will depend on the nature of these revenue sources — especially the degree of state control over the total — in particular federations. A sharp distinction between G_o and T_s would seem appropriate where states are in a position to influence the amounts they receive under a tax sharing arrangement (i.e. are *not* dominated by federal policy) and have a guaranteed source of revenue which grows broadly in harmony with GNP. This is, broadly speaking, the position in West Germany. On the other hand, where states depend importantly on G_o (as in Australia) and

their bargaining position (*vis-à-vis* the centre) is relatively weak, there would seem to be a strong case for a differing treatment of G_o and T . One might therefore expect that a large part of G_o should be excluded from the 'above-the-line' income components and be regarded as a means of correcting for vertical intergovernmental fiscal imbalance. Such exclusion would, of course, increase the basic deficit unless compensatory changes could be made in T and R.

At the same time it would not be sensible to suppose that all taxes are regarded as equally advantageous from the standpoint of state fiscal autonomy. Ideally, each income component should be weighted to reflect the degree of state autonomy or strength of state bargaining power involved.

Equation (4) might, therefore, be put in a slightly different form, viz:

$$v = \frac{1 - aT_o + bT_s + cR + dG_o + eG_c + fB}{E} \qquad (5)$$

The weights a... f could each vary from zero to unity depending on assessments made regarding the extent to which the states are able to influence each revenue component in question. The greater the influence — a matter of judgment — the lower the weight. A zero weight would effectively remove an income component from equation (4), implying that the item is entirely 'above-the-line' from the standpoint of vertical balance. Thus in Canada, T_s would be almost equivalent, dollar for dollar, to T_o (and R) since at the margin a province is free to vary revenue of either type (compare sales taxes with income taxes). The weights a, b and c would therefore be close to zero. If states are unable to exert much influence over G_o (i.e. their bargaining power *vis-a-vis* the Federal Government is deemed to be weak), then d would be close to unity. Where states possess independent borrowing powers and are not subject to stringent central limitations on their ability to borrow, the value of f would be close to zero. If states borrowed only to finance revenue-producing assets (and the central government did likewise but with some variation in accordance with stabilisation objectives) there is no vertical imbalance and the B term would drop out of equation (5). However, in most federations some part of borrowing (perhaps a small part) will be involuntary in a sense and needed purely to finance revenue deficits. Likewise, if it could be established that a significant proportion of G_c was made in response to state initiatives or after due consultation with the states, then e would be appreciably less than unity. In Canada, the 'opting out' procedures in respect of shared-cost programs would also tend to reduce the value of e; if provinces wish to take advantage of the federal offer (so far only Quebec has done so) they obtain in return a special abatement of the federal personal income tax.

The important question which therefore emerges is this: To what extent can states influence each of the income components, T_o ... B? This is a question of fact and sensible answers cannot be forthcoming without extensive knowledge of the federal-state decision-making process in each country. If states cannot influence any of the components, v will be zero. The federation then exists only in name since decisions are, in effect, handed down from the centre. If, on the other hand, states can act in unison to bring pressure on the central government with respect to various grants (total and composition), then v is likely to be close to unity even

though reliance on state taxes is relatively modest.

This chapter is concerned only with establishing criteria which are relevant to vertical fiscal imbalance. Further attempts at gauging the degree of vertical fiscal imbalance in each country must await the detailed analysis which is carried out for each country in chapters 6-9.

Concluding Observations

Both the degree of vertical fiscal imbalance and the way in which such imbalance is regulated vary considerably from country to country. Subsequent chapters will bring out these differences more clearly. The Australian states rely heavily on unconditional federal grants, because they do not impose income or sales taxes and there is no tax sharing agreement as such. The German *Laender* do not receive large unconditional grants because they participate in revenue growth via tax sharing. In the United States and Canada the extent of vertical imbalance is small and reliance on conditional grants relatively large.

While the relative weight of expenditure functions assigned to each level of government is by no means uniform in those countries (see table 2-7), the greatest differences are to be found on the revenue side. In making inter-country comparisons it will therefore be of special importance to study: (i) the revenue sources available to each tier of government; (ii) the degree of state dependence on federal grants; (iii) the method or methods by which the total grants are calculated; (iv) the form which the grants take (e.g. purpose or non-purpose binding); (v) the extent of state and local debt financing; and (vi) the method of distributing revenue (and loan) funds between the states.

A coefficient of vertical balance can be postulated. But a classification of income items or some appropriate weighting system which measures such a coefficient is not an easy task. The scope for broad judgment is considerable. To make a meaningful classification of income components (above- and below-the-line) it is absolutely essential to have an adequate appreciation of what state fiscal autonomy really entails — a task which demands information that will throw light on the strength of state bargaining in each country and on the ability of the states to influence each of the income components.

The essence of state fiscal autonomy is that states, within their sphere of competence (as determined by the Constitution and legal interpretations thereof), must be reasonably free to vary expenditures and taxes, or at least be in a strong bargaining position to be able to increase their share of pooled revenues should state spending commitments rise faster than those at the national level. One version of state fiscal autonomy, which has been cogently advanced by the Rowell-Sirois Commission, is as follows:

> If a province chooses to provide inferior services and impose lower taxation it is free to do so, or it may provide better services than the average if its people are willing to be taxed accordingly, or it may, for example, starve its roads and improve its education, or starve its education and improve its roads.[9]

The Commission's version of state financial autonomy may still be useful in a Canadian — or American — context, but it does not appeal as providing a sufficient basis for gauging the degree of state financial autonomy in many other federations. The ability of states to vary

tax rates and expenditures is only part of the story. If states can act in unison to enhance their financial position *vis-à-vis* the centre — i.e., if their bargaining position is strong — then their financial autonomy is strengthened as a consequence.[10]

In particular, and by way of conclusion, it is possible to distinguish the following facets of state fiscal autonomy:

(i) The ability to change tax rates and hence influence T_0 or T_s.

(ii) The extent of participation in high yielding growth taxes (i.e. income and value-added taxes) either directly through tax sharing (T_s) or indirectly via unconditional grants (G_0), the size of which is geared to growth indicators.

(iii) Ability to change the state participation ratio where tax sharing exists or to exert pressure on the central government for larger untied grants. This will depend very largely on constitutional and other arrangements designed to ensure that states can influence the relevant decisions.

(iv) The extent to which the states can influence the size and composition of grants-in-aid programs (G_c), and especially in relation to the nature of projects, priorities, special conditions and central financial participation. This is likely to affect directly both E and B and will depend importantly on the machinery which exists for intergovernmental planning and co-operation. This machinery is well developed in the Federal Republic of Germany by comparison with other federations. Discussions with Treasury officials in Canberra suggest that in Australia state initiatives have been of some importance in this area, especially in relation to infrastructure expenditure.

(v) Dependence on borrowing. In a sense this is a residual, but allowance has to be made for independence of action on the part of the states. In the United States and Canada the states have independent borrowing powers and, while borrowing is not without cost, neither are taxes. The German states can borrow freely except at times when there is a threat to overall economic equilibrium. The Australian states have very little opportunity for initiatives on borrowing. For this and other reasons noted above, vertical fiscal imbalance (between federal and state governments) is much greater in Australia than in the other three federations.

5 Revenue or Tax Sharing Methods

Revenue or tax sharing arrangements provide one important method of dealing with the problem of vertical intergovernmental fiscal imbalance.

First it is necessary to define what we mean by revenue or tax sharing arrangements. It seems that a clear distinction should be made between tax sharing arrangements and the joint occupancy of tax fields. The latter may not involve tax sharing arrangements.[1] An example is the general sales tax field which in Canada is occupied jointly by the Federal Government and nine of the ten provinces. The federal manufacturers' sales tax is completely independent of the provincial retail sales taxes.[2]

Revenue or tax sharing arrangements must also be clearly differentiated from grants. Thus Australia has no revenue sharing arrangements as such but it does have a system of unconditional federal transfers (financial assistance grants) which to a large extent compensate the states for their meagre revenue sources and therefore constitute the principal method of regulating the vertical fiscal imbalance (especially since in Australia the states do not have independent borrowing powers). These grants must be distinguished from revenue sharing arrangements since the grants do not merely involve a sharing of taxes (income taxes) on the basis of derivation or source of revenue[3] but are distributed on a needs basis, more favoured treatment being accorded those states with relatively low tax capacity and above-average expenditure need. (These grants are discussed fully in chapter 6.) Likewise, the recent implementation of 'Federal Revenue Sharing' in the United States, although constituting an important method of regulating vertical imbalance, also contains an equalisation element and is not therefore part of tax or revenue sharing as defined in this chapter. ('Federal Revenue Sharing' is discussed fully in chapter 8.)

With these preliminary observations we can now distinguish between the main methods of tax or revenue sharing:

(i) *A rigid separation of revenue sources*. The Constitution could specify that the Federal Government would control income tax, the states would control sales taxes while property taxes would be left to local authorities. There is no particular logic in this method and it lacks the flexibility needed to adapt to changing circumstances.[4] Thus if state expenditures were rising faster than federal expenditures, the vertical imbalance would widen under this method.

(ii) *Concurrent powers over taxes*. Each level of government has roughly equal autonomy and each can levy virtually any tax it pleases. The United States has such a system, the only real constraints being that the states cannot levy customs duties and that the Federal Government is effectively excluded from the property tax field. Where income and sales taxes are imposed by federal, state and local authorities, there is the strong probability of a considerable degree of tax competition developing between units of government. If there is no attempt at tax co-ordination there is what has been referred to as a 'tax jungle'[5] with a con-

sequent duplication of administrative effort and every possibility of high tax rates. On the other hand, governments may elect to co-operate. Thus under a 'piggy-back' arrangement (one version of a tax supplement) units at one level of government may add an additional percentage point or two to a sales tax which is imposed by a higher level of government. The latter then collects the tax and remits the appropriate share to the lower units of government.

(iii) *Sharing of tax proceeds.* Assignment of the proceeds of particular taxes to each level of government can be combined with a sharing of the proceeds of the remaining taxes (usually the high yielding taxes) among those levels. Tax rates are uniform under federal law. This is the method adopted in Germany and, to a lesser extent, in India. The major advantages are simplicity and flexibility. Once an estimate is made of the total yield from the assigned taxes, it is a matter of deciding how the remaining taxes (in Germany these are income taxes and, more recently, the value-added tax) will be apportioned between each level of government. The arrangement is set out in the West German Constitution which, as noted earlier, is not difficult to change.[6]

The basis of apportionment — the percentage share of tax yields going to each level of government — can be adjusted every two years to take account of divergent revenue-expenditure patterns between each level. In Germany this arrangement has been extended to the local authorities, who derive a certain percentage (14 per cent between 1970 and 1975) of personal income tax receipts, distributed on an origin basis.

The important point is that the states have no say in tax rates or structures but can use their bargaining power to gain a larger share of tax revenue. The states have a guaranteed access to revenue.

In India, company taxes are levied and retained by the Federal Government but the latter, although it levies personal income taxes, is required by the Constitution to distribute a certain percentage of the yield from the personal income tax to the states.[7] The state share can be changed periodically in accordance with recommendations of the Finance Commission, which reports every five years. After much debate the Commission opted for a distribution of the state share largely on a population basis.[8]

(iv) *Tax credit* (*or abatement*). This is an example of tax co-ordination but differs from the above in that each level of government is concerned with tax rates and not just yields — and tax rates vary between provinces, as in Canada. The provinces can add a percentage to the central tax (income taxes) for their own purposes. If no ceiling is set under the agreements, which was broadly speaking the situation in Canada after 1966, provinces can impose additional taxes on their own citizens to meet additional expenditure needs at the margin. With the exception of Quebec for the personal income tax and Quebec, Ontario and (since 1972) Alberta for the corporation income tax, the Federal Government collects the taxes and remits relevant amounts to the provinces.

Between 1962 and 1967 a federal abatement or credit (raised from 24 to 28 per cent in 1967) applied to basic personal income tax rates.[9] After 1967 the Canadian provinces exercised their right to fix rates in excess of the federal abatement (the latter being the extent to which the Dominion Government had been prepared to provide tax room for the provinces). The abatement arrangement was replaced by a piggy-back arrangement in 1972, whereby the provinces may

add percentages to federal rates. In 1972 Nova Scotia increased its personal income tax rate from 30·5 to 38·5 per cent of the federal tax.[10] The ten provinces occupy about one-third of the combined personal and corporation income tax fields in Canada.

This method is said to limit flexibility for purposes of overall fiscal control since one level of government may, for example, increase rates while the other level reduces them.[11] There are, however, several advantages: greater self-reliance by provinces (cost-benefit matching at the margin); public awareness of the rates being levied by each level of government;[12] central assessment and collection for those provinces who want it; and a uniform tax structure (with respect to progression, rebates, etc.) with the exception of Quebec. The Canadian system eliminates a good deal of the tax competition found in the United States.[13] (In fact there was no competition under the abatement method since a province, by imposing a tax within the ceiling, did not change the total tax burden on its citizens. If a province chose not to tax up to the ceiling, the total tax burden would not change since the citizens in that province would pay less provincial tax and more federal tax.)[14] The abatement system was, of course, the result of agreement between the two levels of government. It was, for the most part, a case of tax co-ordination rather than tax competition.

(v) *Tax supplements*. A variant on the above is the so-called surtax method which allows states to add a percentage to the national levy for their own use. This method also has the advantage that assessment and collection are responsibilities of the national government. States are free to choose their own rates of tax (up to the ceiling) but must follow national policy with regard to progression, rebates, etc.[15] It differs from the method now used in Canada where the provinces are not constrained by a ceiling or by uniform assessment or collection (although most provinces have, in fact, accepted the Dominion Government's offer of central collection and assessment).

It is interesting to learn that four states in America (Alaska, Nebraska, Rhode Island and Vermont) use a 'piggy-back' arrangement whereby the state personal income tax is calculated as a fixed percentage of the taxpayer's federal personal income tax liability.[16] The state tax is an addition to the federal tax.

There have been several proposals for the introduction of a marginal state income tax in Australia.[17] A proposal which might be expected to have good support is one in which a reduction in financial assistance grants roughly matches the expected yield of the state tax with a corresponding reduction in federal tax. The state tax would be imposed as a certain percentage of the reduced federal personal income tax scale. This proposal has merit as an alternative to the system which operated before uniform taxation (i.e. before 1942) when the states imposed varying rates of income tax. There is force in the argument that states should be able to tax at the margin, that such a tax should be proportional and that there should be some upper limit (say 10 per cent) on the state tax. As with the pay-roll tax, which was transferred to the states in 1971, the states could, as Professor Gates has suggested, 'co-operate in avoiding large differences in the rates of tax which they levied'.[18] The state income tax could also, as with the pay-roll tax arrangement, allow a corresponding reduction in financial assistance grants.

The adoption of such a proposal would

have obvious advantages in Australia where the vertical fiscal imbalance is large and states do not have flexible or elastic revenue sources.[19] Even a quite modest tax which accounted for 5 per cent of personal income tax collections would raise more than $A250m for the states (1972-73 figures); and this amount would grow at a rate in excess of the GDP rate. Such a tax could lessen vertical fiscal imbalance by reducing reliance on federal grants and/or on borrowing. However, since the proceeds of the tax would be distributed to states on the basis of the source of the revenue — a basis which would be to the advantage of affluent states and to the disadvantage of the less affluent ones — larger equalisation grants would be needed by way of compensation.[20]

The question of a possible resumption of state income tax came up in 1952. However, the talks broke down when the Commonwealth and the states were unable to agree on the extent to which the Commonwealth should vacate the income tax field.[21]

(vi) *Sharing of income tax.* The personal and corporation income tax could be divided into two layers, one for the states (or local authorities) and the other for the national government. This method of tax sharing has been employed in Scandinavian countries. Under this approach, the local authorities assess the first layer, which consists of a proportional tax on the first X per cent of taxable incomes, and then use the proceeds as they please. The central government collects the tax and pays each municipality its share. The second layer is a tax imposed by the national government at progressive rates on incomes above the ceiling for the local tax. (This system was changed in Sweden in 1971, and incomes are no longer divided into layers for purposes of local and national taxes. But the local tax is still proportional and the national tax progressive.)[22]

According to U.K. Hicks[23] this method has several advantages: it effectively preserves local autonomy throughout the range up to the ceiling, because each municipality can choose both its own exemption limit and the rates and terms which apply. Rates do, in fact, vary considerably as between municipalities.[24] Such autonomy is achieved without any encroachment on the right of the central government to tax higher incomes at progressive rates.

Local authorities are at liberty to fix their own income tax rates, but the tax base is defined by law. In Sweden, the local tax is levied at a flat rate but, taking into account deductions, it tends to become progressive.[25]

Under the income layer approach, the income ceiling for the local tax needs to be raised at frequent intervals to counter the effect of inflation in bringing people into higher income tax brackets. The exemption limit needs to be adjusted upwards for the same reason. The exemption limit may be fixed by the local authorities but the ceiling must be fixed by the central government or by intergovernmental agreement.

As applied to a federal system, this approach would mean that the states would obtain independent tax powers and receive a steady income via a proportional tax. States could therefore operate the Allocation Branch without undue interference and the Federal Government could do the same with the Distribution and Stabilisation Branches.

The proposal would seem to have considerable merit in an Australian context. If all states imposed a rate of, say, 12 per cent on the first 60 per cent of personal income for tax purposes (rates

could, of course, differ as between states), the net yield to the states would be about $1150m, or 22 per cent of total personal income tax collections.[26] Such an arrangement would be of value in Australia from the standpoint of lessening vertical fiscal imbalance. Flexibility would be ensured since fairly frequent changes could be made to both the exemption limit (here assumed to be $2000) and the ceiling for the state tax (assumed to be $6000). However, because of constitutional problems such an arrangement would not be workable in practice unless the Federal Government agreed to collect the taxes on behalf of the states.

6 Vertical Intergovernmental Financial Imbalance in Australia

Extent of Fiscal Imbalance

The vertical fiscal imbalance in Australia is very large. While states and local authorities are responsible for more than 50 per cent of total government outlay, they raise less than 17 per cent of total taxation revenue. This means that while the Federal Government can easily cover outlays from its own revenue sources, states and local authorities are obliged to rely heavily on various federal grants and on borrowing (the latter also comes under central control and supervision).

Grants from the Australian Government accounted for more than 40 per cent of total receipts of state and local authorities in the 1960s, and in the early 1970s the proportion was even higher if interest-free capital grants, instituted in 1970-71, were included. Moreover, during a period in which federal debt has been falling, net borrowing on behalf of the states has continued to be large. For most of the 1960s debt financing was used for about one-fifth of total outlays of state and local authorities (see table 6-2), which represents a much heavier dependence on borrowing than in other federations.

Heavy dependence on federal grants and on borrowing reflect the magnitude of vertical fiscal imbalance. Whatever set of statistics is used, the dependence of the states on federal grants is very great, and certainly more pronounced than in most federations.[1] In 1973-74 these grants provided about 58 per cent of total state income, compared with 40 per cent in 1950-51.

Reasons for Fiscal Imbalance

The major reason for this imbalance is the Federal Government's control of major tax sources. Dependence on borrowing is a direct consequence of such control. The uniform tax legislation of 1942, although it did not expunge the constitutional power of the states to impose income taxes, has had the effect (for reasons set out below) of excluding the states from this lucrative source of revenue. High Court rulings over a long period to the effect that sales taxes are in the nature of excise duties have also excluded the states from the sales tax field.[2] However, the High Court's decision of April 1974 in *Dickenson's Arcade Pty Ltd* v. *Tasmania* would seem to have established that states can, in principle, impose consumption taxes. This decision, the implications of which are discussed at the end of this chapter, has already enhanced state bargaining power. Thus, following the Premiers' Conference in June 1974, Tasmania secured an additional grant from the Australian Government in return for an undertaking to abandon the tobacco tax. As part of the arrangement, Tasmania also ceased to be a claimant state in respect of financial assistance recommended by the Grants Commision.[3]

In view of the continuance of uniform taxation and the extent of federal excise and sales taxes, it is not surprising to discover that the central government itself collects more than 80 per cent of total taxation revenue.

A related point is that, since state taxes

are mostly regressive and their yields are not highly responsive to income growth, the states have experienced great difficulty in keeping up with expenditure commitments (which have expanded faster than those of the Australian Government) in an inflationary environment. The 'gap' has, of course, been plugged mainly by federal grants and borrowing.

Income Tax Power

It is timely, by way of explanation, to say something about the control of income taxes in Australia, since it is naturally puzzling on the face of it to find that the states have the power but cannot or will not use it.

Under the uniform taxation legislation introduced in the Commonwealth Parliament in May 1942, the Federal Government became the sole authority to impose taxes on income, such authority being operative for the duration of the war and one year afterwards. The states were compensated by tax reimbursement grants distributed on the basis of average tax collections in the two preceding years. A legal challenge by the states was unsuccessful in the High Court.[4]

After the war the Federal Labor Government under J.B. Chifley declared its intention to continue indefinitely with the uniform taxation system and, despite debate and legal challenge since then, the system has continued to operate and seems destined to remain a permanent feature of the Australian financial structure.

The states, although legally entitled to impose income taxes, have not been able to exercise this right. The failure to do this can be put down to several factors, including inertia by the states, the failure of states to agree among themselves, fear of Commonwealth reprisals, and High Court decisions.

The states have never surrendered their income tax powers but have had to face the reality that, in the absence of state agreement, the Federal Government would continue with its existing rates and withhold grants from the 'offending' state or states. According to Professor Richardson, no single state can afford to withdraw from the uniform tax scheme because federal tax rates must be uniform.[5] Therefore no allowance can be made in the imposition of federal tax rates for the fact that a state does not participate in the scheme. *All* states must agree either to withdraw from the scheme or remain parties to the scheme. There is apparently no middle ground, as there is in Canada where federal tax rates do not have to be uniform. As pointed out by Mathews and Jay, the uniform tax legislation did not impose any legal prohibition on the levying of income tax by the states. Each state had the choice of accepting the grant (with the condition that it did not impose income tax) or of refusing the grant and levying its own tax. The latter course would have meant that the citizens of the state in question would pay considerably higher income taxation than the citizens of other states. 'Legally, the states had a choice. Politically, they had no choice.'[6]

In the early 1950s the Federal Government under R.G. Menzies took the initiative in suggesting the possiblity of a resumption of income taxes by the states. The Prime Minister considered that the existing system was unsatisfactory and argued that states should be 'masters of their own budgets'.[7] This initiative, however, came to nothing, mainly, it seems, because the Commonwealth and several states raised technical problems[8] and because the proposal did not have the full backing of all states. The Federal

Government was able to 'bow out' gracefully when agreement could not be reached on the extent to which the income tax field should be vacated by the Commonwealth.[9]

Further legal challenges were proceeded with by Victoria and New South Wales in 1955-56 but the High Court, ruling in favour of the Commonwealth, asserted that the condition attaching to tax reimbursement grants, namely that states should not levy income taxes, was valid.[10] This put the matter to rest for some time because several states were benefiting greatly from the grants and were not prepared to give them up without an assurance that a return of income tax powers would substantially improve their position. As it was clear that the less affluent states would lose greatly from such a move, there was little enthusiasm for a policy which would 'rock the boat' and cause the grants to be withdrawn. It was, of course, argued that the Grants Commission would have taken this into account and recommended larger grants to the claimant states so as to offset any financial loss from the change. But these states and Queensland (which was not a claimant state at the time) were disenchanted with the prospect. What they pressed for instead was a revised financial assistance arrangement which would leave all states better off. Such an opportunity presented itself in 1959 after some ingenious back-stage manoeuvring by the Victorian Premier (Henry Bolte),[11] including application by Victoria (the wealthiest state at the time) and Queensland to the Grants Commission for special assistance. Rather than risk a complete breakdown in federal-state financial arrangements, the Commonwealth proposed a revised scheme of financial assistance which, as it turned out, was beneficial to all the states.

In September 1964 the Victoria Government announced its intention of introducing a marginal state income tax for individuals living in Victoria and requested the Federal Government to collect the tax on its behalf. This the Federal Government refused to do, its main argument being that any modification of uniform taxation required the support of all the states. Victoria failed to elicit support from other states and did not pursue the idea of setting up its own machinery for assessment and collection of its own income tax.[12]

At the Premiers' Conference in February 1970, all states pressed for an arrangment similar to that operating at the time in Canada, involving a partial withdrawal of the Commonwealth from income taxes so as to make room for the states.[13] It was argued that the states should assume direct responsibility for raising a substantial proportion of their revenue requirements by means of the income tax. It was recognised that adoption of a scheme similar to that operating in Canada would probably eliminate general purpose grants — at least for the more populous states.[14] Prime Minister John Gorton firmly rejected this proposal on the following grounds: (i) allowing the states access to income taxation could make the Federal Government's task of economic management more difficult (it could result in different tax rates being applied in various states); (ii) uniform taxation was beneficial and the public had come to accept it; (iii) the states would face budgetary problems because of marked fluctuations in income tax collections; and (iv) because the per capita yield of income tax varied markedly between states it would be difficult to work out equalisation grants satisfactory to the less populous states.[15]

Although the states' proposal was

rejected, the Commonwealth agreed to amendments in the financial assistance arrangements which greatly improved the financial position of all states.

Borrowing Power

Another important reason for a large vertical fiscal imbalance is that the states do not have independent powers of borrowing. The Loan Council procedures,[16] while having important advantages from the standpoint of co-ordinated borrowing and control over aggregate spending in the public sector, have forced the states into a position of subservience and increasing reliance on *ad hoc* federal assistance. The states do not have much say in the total loan program despite the greater number of votes which the states can command compared with the Commonwealth.

This apparent paradox is better understood when account is taken of the fact that, in all except two years between 1951 and 1973, the borrowing programs set by the Loan Council exceeded the amount the loan market would yield at prevailing interest rates. The gap was, for the most part, met by Commonwealth payments to the states in the form of special loans. The funds for these loans were obtained mainly from Commonwealth taxation but involved the states in a continuing cost in the form of debt servicing. Between 1952 and 1971 Commonwealth internal debt fell by 24 per cent, while state debt increased more than four-fold. In the ten years up to 30 June 1972 Commonwealth debt rose by only 2·4 per cent but state debt rose by 93·1 per cent.[17] However, the point should be made that the Federal Government, in agreeing since World War II to finance a significant part of its own capital works from revenue sources, was indirectly assisting the states by virtue of the fact that this policy enabled interest rates to be lower than would otherwise have been possible.

Despite this and other instances of federal policy which were intended to ameliorate the position of the states (the 1970 arrangements helped to alleviate state debt burdens, as noted below), it is clear that a sizable part of state income (about 10 per cent if federal grants are included and allowance is made for recouped debt charges)[18] must be earmarked for debt servicing. This puts added strain on the states and accentuates vertical intergovernmental fiscal imbalance. As one expert has put it:

> Although the [Loan] Council is in form a joint Commonwealth-State body, in practice the Commonwealth has acquired a predominant voice in its proceedings and so has effective control over State loan raisings. Despite [these] restrictions on their borrowing activities the Australian States and their authorities rely much more heavily on public borrowing than similar bodies in the United States or Canada where no such restrictions exist.[19]

Thus, a feature of vertical fiscal imbalance in Australia is that while the states do not have independent borrowing powers, they find it necessary to lean heavily on public borrowing. This stems partly from the fact that the states do not have control over elastic revenue sources and partly from steep rises in expenditures which are mainly the product of expanded welfare programs, economic growth and inflationary pressures.

Correcting for Vertical Intergovernmental Fiscal Imbalance

Having examined the extent of vertical intergovernmental fiscal imbalance and the main reasons why a large imbalance has persisted, we now turn to a con-

sideration of the methods that have been used to correct or regulate this imbalance.

Before World War II, financial transfers from the Commonwealth to the states (other than for horizontal fiscal equalisation, grants for special purposes such as roads[20] and to meet special difficulties) were on quite a meagre scale. States levied income taxes at various rates and the financial resources available to the states were, for the most part, sufficient to enable them to meet their own expenditures principally from funds which they themselves were responsible for raising. By the end of the 1930s income taxes accounted for almost 60 per cent of total state taxation revenue, and rates were still at relatively low levels.[21] There was no significant degree of vertical fiscal imbalance in evidence immediately prior to 1939. This does not mean that states were never in financial difficulties. All states suffered budget deficits throughout most of the 1930s, but these deficits were caused by the economic depression rather than by any limitations placed on state taxing powers (although the greater use of direct taxes by the Commonwealth after World War I was resisted by the states).[22]

When the uniform taxation legislation came into effect in 1942, grants — known as tax reimbursement grants — were made to the states as compensation for their loss of income tax revenue as a result of the Commonwealth becoming the sole income taxing authority. The grants were distributed initially to the states on a simple origin or derivation basis — each state received an amount equal to its own average tax collections for the two years prior to the introduction of uniform taxation.

At that early stage the grants could therefore be regarded as being tantamount to a tax sharing arrangement. However, between 1946 and 1958 there was a gradual shift of emphasis from a compensation to a needs basis of distribution. By 1958 neither the total nor the distribution of the grants bore any direct relation to tax collections in Australia as a whole or in each of the states. The tax reimbursement grant arrangements as they evolved should not, for reasons given at the beginning of the previous chapter, be categorised as tax sharing.[23] Successive Australian governments up to 1975 have not displayed any enthusiasm for using tax or revenue sharing as an instrument of intergovernmental fiscal adjustment, as have central governments in other federal countries, notably in West Germany, Canada and India.[24]

The shift of emphasis in the interstate distribution of grants from compensation to need has come under criticism from several quarters, notably from Professor Maxwell who observed: 'surely the title, tax re-imbursement, implied that each State should receive, on a uniform basis, the relevant revenues collected within its borders. And yet these revenues were, through the formula, distributed according to a crude measure of need.'[25]

Tax reimbursement grants in 1946-47 amounted to \$80m. This amount was raised to \$90m the next year and there was agreement that for subsequent years the aggregate grant payable to the states should be determined by a formula which took account of changes in the population of all the states and increases in average wages per person employed for Australia as a whole. With regard to the interstate distribution of grants the *States Grants (Tax Reimbursement) Act* 1946 provided that in successive years an increasing proportion of the grant (and by 1957-58, all the grant) was to be distributed in proportion to the populations of the states as adjusted for density and for numbers of children between 5 and 15 years of age.[26]

By 1957-58 interstate differences in per capita payments built into the formula were not very large.[27]

In addition to the tax reimbursement formula grants, the Commonwealth, starting in 1949-50, paid supplementary grants to the states — largely, it seems, on an *ad hoc* basis.[28] Although these supplementary grants were much smaller in absolute terms and although they grew erratically, they assumed considerable importance in most years. In no year between 1949-50 and 1958-59 did the supplementary portion account for less than 10 per cent of total tax reimbursement grants and in 1951-52 the proportion went as high as 28 per cent.

It is therefore clear that the formula did not serve, as was presumably its intention, as an accurate guide to what the states would actually receive by way of general revenue grants (other than special grants). As one writer has put it: 'these supplementary payments were the product of annual wrangles at premiers' conferences. They bore no consistent relation to the formula payments, being distributed according to short-term needs and political bargaining power'.[29] One is tempted to add that in conditions where states have access to limited revenue sources (in relation to expenditure commitments), *ad hoc* grants to meet circumstances not covered by the formula are inevitable. No rigid formula based on population and wages can be expected to cater automatically for the financial needs of the states. But the real weakness sprang from the absence of a tax or revenue sharing arrangement which over a period could be expected to have achieved a closer correspondence of revenue sources and expenditure functions at each level of government.[30]

The Commonwealth soon became conscious of certain inherent weaknesses in the formula and was particularly unhappy with the growth of the supplementary portion. Action was therefore taken in 1959 to correct the situation.[31] However, instead of moving in the direction of a broad-based revenue sharing arrangement and/or a clear separation of the tax reimbursement element from the needs element of the grants, the Commonwealth decided on an arrangement which in a short time was to perpetuate several existing weaknesses. It was decided to dispense with the name tax reimbursement grant and to substitute instead financial assistance grants — the purpose being to make it clear once and for all that the grants were paid from the general 'pooled' revenue of the Commonwealth and not from the proceeds of income taxes.

The intention was to devise a grant which was ostensibly for needs but was, in reality, a composite reflecting compensation to the states for loss of income tax revenue and payments which took account of relative state needs.

The new grant was designed, therefore, to serve the dual purpose of correcting for both vertical and horizontal fiscal imbalance. Moreover, as the large vertical imbalance could be attributed mainly to the federal 'take-over' of income taxes, it seemed to be shallow thinking on the part of the Federal Government to attempt to conceal and even deny the connection between the grants and the tax collections which would have accrued to the states (but which would have been distributed differently) if the states had levied the taxes themselves. The link is not severed merely by devising a distributional arrangement which favours the less affluent states. As Professor Maxwell has pointed out: 'resting upon no explicit principle, they [the financial assistance grants] were an imperfect amalgam of

payments as reimbursement and for needs'.[32] A mere change of label and in the distribution of the total grants does not change the fundamental purpose for which the grants are given. States will not forget the association of the grants with reimbursement 'because continued receipt of the grants requires that a State continue to refrain from income taxation'.[33]

The new system used a formula under which subsequent payments to each state were geared to increases in population in that state, increases in wages for the Commonwealth as a whole and a 'betterment' factor designed to assist the states in improving the standard and range of their services.[34]

From the standpoint of regulating vertical intergovernmental fiscal imbalance, the financial assistance grants formula was superior in several respects to the previous arrangement: the formula afforded the states better protection against cost inflation (over which they had little control) and gave them somewhat more leeway (through the betterment factor) in financing infrastructure expenditures which were the product of a growing economy.

While improving the lot of the states as a whole and several of the financially weaker states in particular (through a built-in bias in the base amounts which favoured those states), the new system did not, as was envisaged, dispense with supplementary payments (although these went under different name tags).[35] It also did nothing to overcome the debt burdens bearing heavily on state budgets, and it did not produce as much revenue as the states as a whole would have received had the rate of growth of income tax revenue been the main yardstick.

The formula yielded an average increase in revenue of about 8 per cent p.a. in the 1960s; this compares with an average increase of about 12 per cent p.a. in the personal income tax yield at constant rates. This discrepancy was the underlying reason for disenchantment on the part of the states.[36] However, allowance has to be made for *ad hoc* additions to base grants (to which the formula was applied) and special revenue and other financial assistance provided outside the formula. It must also be said that the formula avoided problems which may have arisen had state revenues been subjected to large yearly fluctuations (as would have been the case had grants been geared to income tax receipts).[37] Also, as it turned out, the financial assistance grants were administered (or manipulated?) in a way which proved highly advantageous to the less affluent states.

The tax reimbursement and financial assistance grants had one thing in common: the grants were unconditional in the sense that once the funds were received, no restrictions were placed on the way they were used. The tax reimbursement grants were, however, given on the understanding that the states would leave the income tax field to the Commonwealth and continue to pay pay-roll tax to the Commonwealth. These implied conditions also applied to the financial assistance grants, but in June 1971 the Commonwealth agreed to transfer pay-roll tax to the states and to reduce financial assistance grants. The reduction in the latter was, however, less than the additional revenue gained by the states from imposition of the pay-roll tax (at the existing rate of 2·5 per cent). This lesser amount reflected a variety of decisions relating to:

(i) an additional amount of $20m to be made available for states and local authorities;[38]
(ii) assistance for the less populous states (to the extent of $2·7m) in

order to offset the relative disadvantage to those states of the distribution on the basis of pay-roll tax collections of the additional grant under (i);

(iii) the costs to the states of administering the tax; and

(iv) the loss of revenue from pay-roll tax imposed on the non-business activities of local authorities which were to be exempted from the tax.[39]

Commonwealth and state legislation to transfer pay-roll tax was passed and the transfer took effect as from 1 September 1971.

Growth of Specific Purpose Payments

Specific purpose payments (grants and advances) accounted for more than 41 per cent of all Commonwealth payments to the states in 1973-74 and an estimated 50 per cent in 1974-75. This compares with only 25 per cent in 1963-64. State dependence on specific purpose payments has increased markedly since 1970-71, as shown in table 6-1.

Specific purpose payments cover a great range of public activities and are not motivated by any single all-pervading purpose. Indeed, the criteria for determining the grants are not readily apparent[40] — especially as it is not at all clear what goes on behind the closed (and perhaps locked) doors of senior Treasury offices and of the Parliamentary offices of both the Commonwealth and the states. However, it seems reasonable to assert,

Table 6-1

Specific Purpose Payments in Relation to Total Commonwealth Payments to the States and Total State Outlay
(selected years)

	Specific Purpose Payments as per cent of	
	Total payments to the states *	Total state outlay
1956-57	23.4	n.a.
1960-61	23.7	10.6
1962-63	24.7	11.5
1965-66	29.7	13.4
1966-67	29.1	13.4
1969-70	29.5	13.7
1970-71	28.3	14.1
1971-72	31.4	14.7
1972-73	35.3 †	16.5
1973-74	41.2 †	20.3
1974-75 (estimates)	50.2 †	29.3

* Excluding Loan Council allocations.

† Housing advances are excluded from specific purpose payments.

Source: *Commonwealth Payments to or for the States*; *Treasury Information Bulletin Supplements on National Accounting Estimates of Public Authority Receipts and Expenditure*, and Australian Bureau of Statistics, *Public Authority Estimates*, 1974-75.

from information that is readily available, that in many areas (education, transport, water resources, for example) grants are designed to promote activites or facilitate the expansion of projects which are judged to be of national importance and where 'external' benefits are believed to be significant. In some instances (especially in relation to projects of a developmental character and related to infrastructure investment), state initiatives are quite important while in other instances grants seem to reflect little more than a desire by the Australian Government to secure short-term political advantage or to use its section 96 power to erode state influence in decision-making. However, in the welfare area there is also abundant evidence that grants are designed to assist disadvantaged groups in the community (Aboriginal advancement and government schools for handicapped children are examples). In addition there are grants to ease debt burdens for the states and to assist areas afflicted by natural disasters (e.g. drought, bushfires, cyclones, etc.).

In Australia, the rate of growth of specific purpose grants until recently was mainly a product of extended federal support for state education systems and for highway development. Although the grants cover a great range of public activities (including the development of rural industries, water resources, urban development, debt charges, health and welfare, Aboriginal advancement), payments for education and roads absorbed more than 70 per cent of total payments (current and capital) in 1973-74. Most categories involve some measure of federal control which is manifest in a variety of ways, for example through matching arrangements, revenue conditions, consultative machinery, direction of expenditure within the specified category, and standard of services. About two-thirds of specific purpose payments are of a capital nature and in sense therefore by-pass the Loan Council.[41]

Specific purpose payments have several advantages as well as disadvantages. In the Australian context these payments have enabled the Commonwealth to exert an important influence on the pattern of development in particular states as well as on the distribution of financial assistance between states. Greater national control can, of course, be counted as either an advantage or a disadvantage, depending on one's point of view.

As indicated above, these grants have been used in some measure to promote national goals by ensuring that a state does not underprovide for expenditures on services the benefits of which are to an important extent 'external' to the state (education, roads and, to a lesser extent, welfare services, would fall into this category). The importance of these grants in promoting expenditures which provide significant 'spillover' benefits is discussed further in Part IV.

But in so far as specific purpose grants promote spending which the states would have undertaken on their own initiative had they possessed the requisite finance, they form part of the vertical intergovernmental financial settlement. We can only guess what that amount is but it seems likely to be large, especially since the initiatives for many grants, especially those in the developmental as opposed to the welfare category, come from the states. Moreover, these initiatives are almost certainly related to the relative paucity of the states' financial resources. If this is true the states have an incentive to press for specific purpose grants (assuming they cannot receive general purpose grants and wish to avoid higher state taxes or charges), whatever the merits of the programs in question. In-

deed, one criticism is that the approach tends to be a pragmatic response to political pressures. It has been claimed, for example, that these pressures emanate from the states who regard specific purpose grants as the reward for successful bargaining power.[42] There is also little reason to doubt that these pressures would be much less intense were it not for the large vertical fiscal imbalance that is a prominent feature of Australian federalism. Political pressure of this kind appears to be much less in federal countries (USA, Canada, West Germany) where vertical fiscal imbalance is relatively small. The political pressures underlying the competitive struggle for finance, which is a natural concomitant of such vertical imbalance, tend, moreover, to cause inefficiencies in resource allocation.

This argument must be qualified to the extent that a large segment of specific purpose payments, such as grants to universities, schools and roads, are made on the advice of expert bodies. Nevertheless the point remains that both within and between broad functional categories, federal policies (based on expert advice) can distort state preferences. Thus, Queensland's assessment of needs in the education field was such that, had the state possessed greater freedom of action, relatively more would have been spent on schools and relatively less on universities and other tertiary education. Essentially the same idea has been highlighted by many economists in Australia. Thus Professor Mathews, after noting the possible advantages of intervention by the Australian Government into tertiary education, pointed out that 'the conditions attached to its grants ... have distorted the pattern of state spending in respect of education generally, by forcing the States to divert funds from primary and secondary education to universities and colleges of advanced education.'[43] However, since the Australian Government accepted full financial responsibility for tertiary education as from 1 January 1974, this particular resource-distorting effect has been removed.

The states would obviously prefer to have the same funds in unconditional form so that they could have more freedom to spend according to their own priorities and what they gauge the wishes of their citizens to be. From the point of view of the states as a whole it is not unreasonable to suppose that a significant part of specific purpose payments represent payments made to correct for vertical intergovernmental financial imbalance.

State opposition to specific purpose grants is not, of course, opposition to receiving money. It is rather that, given the availability of $Xm in grants, they have a clear preference for grants of the unconditional variety. In this respect, the states have made their position quite clear: they want as much freedom as possible to act according to their own assessment of needs and priorities.[44] According to that view, the proliferation of specific purpose grants has enabled the Commonwealth 'by indirect means to take out of the hands of the States the determination of priorities of expenditures over a widening area of functioning in which the States have a clear constitutional responsibility'.[45] The states would, then, prefer untied grants — but if they cannot get them they opt and bargain strongly for a second-best solution in which a measure of central government control over the direction of their expenditures is reluctantly accepted.

The actual degree of central control depends crucially on the existence of matching provisions, on maintenance of performance provisions and on other con-

ditions pertaining to the way in which the funds are to be used. Without such control it would be possible for states to divert portion of their own resources away from the activity in question so that, on balance, total spending on that activity may not increase significantly.

A close examination of the conditions surrounding a range of specific purpose grants in Australia reveals that well over 60 per cent of the grants contain revenue or matching conditions and a much larger proportion is subject to central control in one form or another. Many grants are matched on a dollar for dollar basis. The decision taken at the end of 1972 to proceed with a plan for financial assistance to states for schools is based on the assumption that the grants will be directed towards raising expenditure in schools and 'not be in substitution for continuing efforts by the States and non-government school authorities'.[46] The new Housing Agreement contains conditions designed to ensure that federal assistance is used for the benefit of those most in need.[47] Assistance for the development of new growth centres is likewise tightly controlled and the 1969 Commonealth Aid Roads legislation required each state to increase expenditure on roads from its own resources at the same rate as the increase in motor vehicle registrations. The Act also provided for specific allocations of the principal grant for urban arterial and sub-arterial roads, rural arterial roads, other rural roads, and for planning and research.[48]

In 1974 the Australian Government introduced legislation which provided for financial assistance to the states for roads, such assistance amounting (over a three-year period) to $1126m.[49] This legislation differed in several important respects from the previous legislation and reflected an attempt, not wholly successful, to secure for the Australian Government a much greater degree of control over state road programs. The *National Roads Act* 1974 provided $400m over a three-year period for major national highways and relieved the states of any financial responsibility for these highways. The *Roads Grants Act* provided for payments to the states of $700m over a three-year period for construction of rural arterial roads, developmental roads, rural local roads, minor traffic engineering and road safety improvements, urban arterial roads, urban local roads and beef roads. In his Second Reading Speech the Minister for Transport (C. Jones) pointed out that the quota requirements (relating to expenditure on roads from the states' own resources) afforded the states more flexibility in spending as between categories than had been proposed by the Bureau of Roads, which had envisaged matching by categories in some instances. The legislation also provided for a lower level of quotas than had been recommended by the Bureau.[50]

Despite the liberal provision of funds in total, the clear separation of finance for national highways and for other roads, and the lower quotas, the 1974 roads legislation attracted much criticism, especially in relation to those clauses of the Roads Grants Bill which required the states to obtain approval from the Minister for Transport for all road works carried out in a particular category. Senate opposition forced the government to amend clauses 4 and 11 of the Bill, which would have given the minister power to require states and local authorities to submit for approval not only programs which depended on federal money but also expenditure financed from their own resources. The House accepted all Senate amendments except those relating to the right of the minister to

control the expenditures by state and local authorities on urban arterial roads. However, in this connection, the net result seems to be that the only power to be exercised by the minister is that in respect of freeways or roads which are ancillary to them.[51] Despite a threat which the minister had made on 1 August 1974 to withhold money if the Senate proceeded with amendments, the more important amendments were in fact passed by the Senate and accepted by the House. The legislation, in amended form, was passed on 17 September 1974.

There seems little doubt that, despite stiffening opposition, specific purpose grants in Australia do, by and large, reflect a significant measure of effective control over state spending patterns by the central government; and in many cases they reflect nice judgments (implicitly normative) about how funds should be spent within broad categories. In most cases there would seem to be little scope for states to re-allocate their own spending so as to defeat Commonwealth intentions.

It is therefore very difficult to understand why federal officials on occasion deny that the Australian Government, through its increasing emphasis on specific purpose payments, is forcing its will on the states and distorting their spending priorities. The philosophy of the Treasury in Canberra was, at least until the Labor Government came to power at the end of 1972, that maximum reliance should be placed on unconditional grants (mainly financial assistance grants and Loan Council allocations) in order to correct for vertical fiscal imbalance; and this philosophy stems from a belief that it is desirable for the states to have as much freedom as possible in allocating finance between different activities.[52]

However, the Australian Treasury has argued, and this point seems less debatable, that while the central government can bring its own initiatives to bear in some important areas (education and welfare services, for example), it cannot make up investment projects which might qualify for specific purpose grants. For the great variety of development-type projects initiatives must, for the most part, come from the states. This may partly explain why Western Australia and Queensland have derived the most benefit from specific purpose grants of a capital nature;[53] for these are the states which have offered, at least in the period 1965-74, the best prospects for development and hence have created the largest demand for specific purpose grants of a capital nature. According to the Treasury, financial assistance should be channelled into those projects which offer the best prospect of return, irrespective of what state benefits. Thus, any resulting bias in favour of particular states in terms of higher per capita payments is seen as merely the end product of the bargaining process by which those states with the best potential for development can be expected to gain relative to other states.

This seems to be a rational approach. Interstate equalisation effects, if they occur, are incidental and not planned; and those effects may, if desired, be offset by changes in the interstate distribution of general revenue grants.

Specific purpose grants are not planned in an overall sense, although for some important categories (notably schools, universities, roads, urban and regional development and the National Water Resources program) a systematic approach is evident. It may also be noted that, with regard to the distribution of grants between states, objective measures of need are used wherever feasible. The yardsticks which have been employed

include state expenditure on the activity in question, population (e.g. in relation to grants for school science laboratories and technical training), school enrolments, number of aged persons (e.g. grants for dwellings for aged pensioners), and unsewered premises (grants for sewerage works).

The conclusion is that a substantial part (at least 50 per cent) of specific purpose payments is made, in effect, to regulate vertical fiscal imbalance. This is because at least that much spending would have occurred in much the same fashion had the states possessed the financial resources available to states in other federations. But there are three other problems:

(i) There is every indication that national priorities are twisting many expenditures in a way which is at variance with state priorities. The Federal Government has gained a tight control in this area. Decision-making is motivated to some extent by a desire to 'internalise' external benefits, partly to give effect to social policy for a better quality of life (e.g. decentralisation) and partly on the basis of value judgments regarding need.

(ii) A disturbing trend is that detailed conditions are being attached to specific purpose grants. This involves a duplication of effort and cost associated with numerous conferences of federal and state ministers and officials.[54]

(iii) Although apparently not part of deliberate policy by the Australian Government, specific purpose grants appear to have contributed something towards horizontal fiscal equalisation in that the four less populous states have received significantly larger per capita payments than have New South Wales and Victoria. This pattern is most noticeable in relation to grants of a capital nature. Moreover, it would appear that it is only in those spending categories where Commonwealth initiatives have been uppermost (e.g. education, welfare) that some conscious effort to 'equalise' has been present. It seems timely to note at this juncture that it would not be rational policy to bring expenditure for developmental purposes into the measurement of fiscal inequality. It would surely be economically wasteful to divert developmental expenditure into poorer regions regardless of their capacity for development and just because they are poor.[55]

Alleviation of State Debt Burdens

The heavy dependence of the states on borrowing and the falling trend of Commonwealth debt brought pressure for financial assistance to offset part of the debt burden facing the states. A major concession was made to the states at the Premiers' Conference in June 1970 when the Commonwealth agreed to make substantial increases in federal grants, especially with a view to easing debt burdens for the states, and to take over state debt.

Interest-free capital grants were started in 1970-71. These grants (amounting to $200m in 1970-71 and rising, in proportion to the total Loan Council program, to $278m in 1973-74) constitute a direct Commonwealth contribution towards the financing of capital works under Loan Council programs. The grants are unconditional (general purpose) and represent a partial substitute for the special loans (referred to above) on which states pay interest. They have therefore brought some relief to state budgets in terms of debt charges which would otherwise have faced the states.[56]

In addition, the Federal Government decided to offer financial assistance via specific purpose grants to meet state debt charges and agreed that these grants

would increase by about $11·5m a year for the ensuing three years. It was also announced (in June 1970) that the Australian Government would, with effect from June 1975, take over $1000m of debt from the states.

According to the then Prime Minister (J.G. Gorton), the interest-free capital grants were designed 'to relieve the burden of debt charges on non-revenue producing capital expenditure' and 'to help finance expenditure on capital works and services from which debt charges are not recouped, such as schools, public buildings and the like'.[57] However, no specific conditions were attached to the expenditure of the grant.

The benefits to the states of the interest-free capital grants and the specific purpose grants to meet debt charges were soon apparent. As shown in table 6-2 net borrowing by state and local authorities in the period 1971-74 averaged 15 per cent of total state and local outlay, compared with around 24 per cent in the mid 1960s and 35 per cent in the early 1950s.

Transfer of Pay-roll Tax to the States

Despite earlier opposition, the Commonwealth decided in June 1971 to transfer pay-roll tax to the states, such transfer to be offset by reductions in financial assistance grants (but with marginal adjustments favourable to the states).

Table 6-2

Interest Paid and Net Borrowing of State and Local Authorities as Per Cent of Total Outlay,
(selected years)

	Interest paid as per cent of current outlay	Net borrowing* as per cent of total outlay†
3 year average		
1953-54 to 1955-56	27.4	35.5
1956-57 to 1958-59	29.3	28.5
1959-60 to 1961-62	29.9	25.3
1962-63 to 1964-65	30.5	23.6
1965-66 to 1967-68	29.2	24.1
1968-69 to 1970-71	27.2	20.5
1971-72 to 1973-74	23.1	15.0

* Includes change in cash balances.
† Current and capital.

Source: Australian Bureau of Statistics, *Australian National Accounts*, 1953-54, 1971-72, 1972-73, and *National Income and Expenditure*, 1973-74 (1974-75 Budget Paper, No. 10)

While the Commonwealth Government did not regard this as an ideal tax, 'it was broadly-based, grew almost directly in line with the economy, was relatively simple to administer and offered some prospect for raising additional revenue should states wish to use it for that purpose'.[58] The states agreed to the proposal and decided immediately to increase the rate of tax from 2·5 per cent to 3·5 per cent (the rate was further increased to 4·5 per cent as from September 1973 and to 5 per cent from July 1974).

The transfer of pay-roll tax has enhanced the capacity of the states to raise their own revenues and reduced to some extent the vertical intergovernmental financial imbalance. In 1973-74 the states' own tax receipts (including pay-roll tax) amounted to $2240m, or about one-third of total outlay. By contrast, the states in 1969-70 financed barely one-quarter of their expenditures from their own taxes.

In recent years the states would appear, on the basis of calculations contained in table 6-3, to have made a greater effort to exploit more fully the tax resources at their disposal. This applies to taxes on

Table 6-3

Broad Indicators of State Tax Effort 1952-53 to 1974-75

	State tax receipts* as per cent of		
	Federal grants to the states†	State outlay	Revenue grants
	%	%	%
1952-53	44.3	n.a.	45.1
1955-56	49.7	n.a.	52.8
1958-59	50.7	21.3	57.7
1961-62	36.9	20.7	56.1
1964-65	45.1	22.4	65.1
1966-67	52.2	23.3	63.7
1967-68	53.4	24.0	66.1
1968-69	56.4	25.1	69.1
1969-70	55.5	24.8	67.2
1970-71	42.4	22.8	56.4
1971-72	56.0	28.8	76.7
1972-73	61.9	32.1	83.9
1973-74	60.7	32.0	84.8
1974-75	48.2	32.3	70.7

* Excludes fees, fines, etc., but includes pay-roll tax transfer since 1971-72.

† Excludes interest-free capital grants.

Source: *Australian National Accounts* 1948-49 to 1964-65; 1953-54 to 1966-67; and 1971-72. *Treasury Information Bulletin National Accounting Estimates of Public Authority Receipts and Expenditure* December 1966, December 1967, December 1972, March 1974; *Payments to or for the States 1973-74,* table 58, p. 99. *A Statement by the Premiers of all the States* (for figures in column 3 prior to 1961-62); Payments to or for the States and Local Government Authorities 1975-76, and Public Authority Estimates 1974-75.

motor vehicles, stamp duties, land taxes, probate and succession duties, the payroll tax and to the recent entry of certain states into the consumer tax field (discussed below).

This trend is a welcome one but, even allowing for a more intensive tax effort by the states as a whole in future, it would seem optimistic to expect the states' own revenues to exceed 40 per cent of their outlays for some time to come. According to Professor Prest, these revenues are 'unlikely to increase as rapidly as the need for, and the cost of providing, State services, given any degree of inflation.'[59]

State Consumer Taxes

A brief reference was made earlier in this chapter to the High Court's decision of April 1974 in *Dickenson's Arcade Pty Ltd* v. *Tasmania.* The High Court ruled, by majority decision, that Part II of the *Tasmanian Tobacco Act* 1972 — which imposed a consumption tax of 7½ per cent on the purchase of tobacco — was valid. However the court also ruled that the regulations attached to the Act, providing for the tax to be collected at the point of retail sale and purchase, were invalid since they amounted to a duty of excise within the meaning of section 90 of the Constitution.[60] The essence of the judgment was stated by Mason J.: 'The provisions of Part II of the Act do not impose an excise but once the provisions of the regulations are taken into account the effect of the tax is that it is an excise.'[61]

The High Court's decision on the validity of Part II of the Act would seem, on the face of it, to have far-reaching implications for intergovernmental fiscal relations in Australia. If this power were to be used by the states and extended to a range of consumer goods, it should greatly reduce the extent of vertical fiscal imbalance and hence the dependence of the states on federal grants. An across-the-board consumer tax of only one cent in the dollar could be expected to raise at least $200m a year for the states.

However, developments since the court's decision in the Tasmanian Tobacco case indicate that a broad-based consumer tax levied by the states (or levied by the Commonwealth on behalf of the states) is unlikely to be proceeded with in the near future. A major stumbling-block is that part of the Court's decision which ruled invalid the regulations attached to the Act concerning the method of collection of such a tax. Also, as usual, the states were finding it difficult to agree on a common approach. Although the Prime Minister (E.G. Whitlam) is reported to have told a Constitutional Conference in 1973 that a retail sales tax was a 'very reasonable' source of revenue for the states,[62] he appeared unwilling in June 1974 to instigate action by the Australian Government which might smooth the way for the states to implement such a tax. Also, as noted earlier in this chapter, Tasmania dropped the tax and accepted the offer of financial assistance from the Australian Government.

This fascinating episode did not, however, close as quickly as several commentators had anticipated. Several states, after a careful study of the text of the High Court's judgment in the Tasmanian Tobacco case, proceeded with plans to devise a tax on specific commodities which would take the form of a franchise charge rather than a tax on consumption as such (the latter being more susceptible to a successful legal challenge). In this connection both New South Wales and South Australia have taken as a basic model for their own legislation the *Victorian Licensing Act*

1958. In *Dennis Hotels Pty Ltd* v. *Victoria* (1960)[63] the High Court had ruled that the licensing provisions of this Act, other than provisions which fixed the fee for a temporary victualler's licence or a temporary packet licence, did not impose duties of excise and were within the competence of the Victorian legislature.[64]

The references to the Dennis Hotels case made in the judgment in the Tasmanian Tobacco case seem to have clarified the power of the states to raise revenue through franchise charges and to open the way for a state to impose a consumer tax provided it can overcome the objections of the Court to the methods specified in the Tasmanian Act for collecting such a tax.[65]

In September 1974 the *Business Franchise Licences (Petroleum) Bill* was introduced into the NSW Parliament. The Bill required all persons engaged in the business of selling petroleum products to hold a licence. The licence fee payable is a flat sum plus an amount calculated by applying 10 per cent to the value of the quantity of petroleum products sold in the year prior to the licence period.[66] The measure was expected to yield additional revenue to the state of $70m in a full year. This measure (which became effective in December) was followed closely by similar legislation in South Australia with respect to sales of both petrol and tobacco.[67] In responding to minor amendments proposed by the Legislative Council, the Premier (D.A. Dunstan) indicated his belief that the NSW legislation was susceptible to legal challenge and that the South Australian legislation had been carefully designed in the light of High Court decisions.[68]

It seems quite possible that, in the absence of a major change in the attitude of the Australian Government to tax sharing (especially in relation to personal income tax), state consumer taxes which take the form of franchise charges will be extended to other commodities. However, it would not come as a surprise if there were further High Court challenges to legislation of this kind. The High Court ruling in *Dickenson's Arcade Pty Ltd* v. *Tasmania* has established that states can, at least in principle, impose consumption taxes; and this decision would appear to have strengthened the bargaining position of the states and to have taken some of the sting out of federal moves in the direction of extended central control. In 1974 several State Premiers (including the Labor Premier of South Australia) indicated a clear preference for states to be given a fixed share in personal income taxes so that further incursions into the consumption tax field could be averted. Liberal Party policy also contained a proposal for a state share of income tax.

Summary

The interest-free capital grants go some distance in removing a long standing grievance of the states with respect to the adverse effect on their budgets of the debt burden. In the three years 1970-73 the overall deficit on a national accounting basis for all states was about 14 per cent of their total outlay, compared with more than 20 per cent in 1969-70. This improvement was partly a consequence of larger federal grants in 1970-71. But a steady underlying improvement over several years is evidenced by the fall in the proportion of interest payments to total receipts (including federal grants) — from 20·2 per cent in 1961-62 to 18·2 per cent in 1969-70 and 12·5 per cent in 1973-74.[69]

The sharp increase in federal grants in 1970-71 and a sustained effort by the states to raise more revenue from their own resources brought some improvement in the financial position of the states as a

whole. In fact, in 1970-71 something quite remarkable happened: the increase in general revenue assistance was proportionately higher than the increase in Commonwealth income tax collections. This situation, however, changed dramatically in the following year; and in 1973-74 and 1974-75 federal income tax collections (including or excluding collections from companies) rose by approximately 30 and 40 per cent respectively (compared with increases in general revenue assistance of 13 and 24 per cent respectively).

Repeated claims by the states that the growth of general revenue assistance tends to lag behind the growth of federal income tax receipts (which was true for most of the 1960s) seem to have more substance than ever. When this trend is considered in conjunction with the rapid increase in specific purpose grants (grants which increasingly constrict the freedom of states to allocate funds even within broad categories) and the persistent nibbling away at state functions by the Australian Government (consider the 1974-75 budget proposals on housing and hospitals), it is not surprising that states are increasingly restive. Their failure to obtain a share of personal income tax revenue stands out as the principal reason for their excursions into the field of consumer taxation.

Although in 1975 the State Premiers appeared to lose some of their earlier enthusiasm for obtaining a fixed share of personal income tax receipts, Liberal and National Country Party policies at the federal level have continued to stress the need for basic changes in intergovernmental fiscal arrangements. A policy statement issued by the Liberal Party in 1975 contained a proposal to link general revenue grants to personal income tax collections and subsequently to restore income tax powers to the states.

7 Intergovernmental Fiscal Arrangements in Canada

Intergovernmental fiscal arrangements in Canada differ markedly from those in Australia. The vertical intergovernmental fiscal imbalance is a good deal smaller in Canada. This springs partly from the nature of the Constitution (and legal interpretation by the courts), but important also is the greater stress put on provincial financial autonomy, especially since the mid-1950s.

This chapter contains a review of intergovernmental fiscal arrangements, with emphasis on recent developments in revenue sharing. Comparisons are made, where appropriate, with the federal systems of Australia, the United States and West Germany.

The Rowell-Sirois Commission

The economic slump of the 1930s brought acute financial difficulties for the provinces in the shape of falling revenues and large debt burdens. These financial problems led to the appointment in 1937 of the Rowell-Sirois Commission. The Commission was set up to investigate Dominion-provincial financial relations and the distribution of federal and provincial powers.

The Commission, whose report[1] was released in 1940, recommended that:

(a) unconditional grants be put on an orderly and systematic basis;

(b) less reliance be placed on conditional grants;

(c) income taxes and succession duties be reserved exclusively for the Dominion Government in order to make possible an effective anti-cyclical fiscal policy;

(d) equalisation (or 'national adjustment') grants be given to the less affluent provinces so as to enable them to provide a level of public services equivalent to the national average;

(e) an independent commission be set up to review the adequacy of provincial grants every five years and to make recommendations for revision;

(f) provincial debts and certain provincial functions (notably unemployment relief) be transferred to the Dominion Government.

The Commission's Report has been described as 'the most comprehensive investigation of a working federal system that has ever been made'.[2] Although the advent of war and opposition from several provinces caused the report to be shelved, it provided a basic framework for further research, discussion and policy change. The Commission fulfilled an important function in stimulating thought on the nature of Canadian federalism. It also helped to define the conflict of interests between provinces. This was especially valuable in relation to the proposal on horizontal fiscal equalisation which was later adopted, although in a modified form.[3]

The contents of the report reveal a strong preference for centralised financial power which was, of course, a feature of war and early post-war arrangements. To some extent the Commission embraced early Keynesian doctrine with respect to the need for the central government to be suitably equipped to influence total income and employment and the distribution of income in Canada. It also seems likely that the Commission was

impressed by its observations of the intergovernmental fiscal structure in Australia, particularly the centralised control of governmental borrowing[4] and the methods employed by the Commonwealth Grants Commission to assess the financial needs of less affluent states.

Most of the Commission's centralising recommendations were never followed up, but its searching analysis created an intellectual climate which was receptive to new ideas.[5]

The Commission rejected the notion that provincial autonomy is genuine only if the provinces have exclusive access to the more lucrative fields of direct taxation.[6] A province has genuine independence 'only if it has the revenues at its disposal to carry out those functions for which it is responsible, *free from federal control in respect to those functions*'.[7] The Commission's views of financial autonomy or independence therefore represented a departure from orthodox theory, in which financial independence was considered in terms of the matching of additional provincial expenditure with an increase in taxes levied by the Province.[8]

The Commission believed that provincial autonomy was an essential ingredient for a successful federal system. However, such autonomy was held to depend upon:

(i) a rough correspondence between the availability of revenues and expenditure commitments; and

(ii) a minimum of federal interference in the execution of provincial tasks.

This approach meant that the Commission did not favour an expansion of conditional grants-in-aid and argued strongly for a carefully planned system of federal unconditional transfers to the provinces. These transfers, unlike conditional grants-in-aid, would enable provinces to allocate funds between different activities in response to need and the preference of electors — without federal interference. Opposition to conditional grants-in-aid (shared-cost programs) was also based on the alleged drawbacks of joint Dominion-provincial administration of various programs sponsored from the centre. It was argued that effective administration requires unified direction. The Commission's aim was 'a clear delineation of the respective responsibilities of the federal and provincial governments and the unified control of particular programs by one or the other'.[9] This view tends to be at variance with the concept of 'co-operative federalism', which stresses that rigid divisions between functions of the two main tiers of government are neither evident nor desirable.

Background to Post World War II Fiscal Arrangements

Before World War I, revenue sharing consisted of federal financing by indirect taxation and provincial financing by direct taxation, supplemented by federal subsidies and grants. The Federal Government did not enter the field of direct taxation until World War I.[10]

There were unconditional per capita grants from the beginning but these were not put on a systematic basis. In the early years of the federation — in fact right up to World War I — the provinces were heavily burdened with debt. Increases in taxation revenues lagged far behind growing expenditure commitments, which were especially heavy in such fields as education, social welfare and highways.

The first experiment with conditional grants was made in 1913, when federal assistance to the provinces for agricultural instruction was given for a ten-year period. However, the first major

permanent program was the federal-provincial cost-sharing of old age pensions in 1927.

Led by Alberta, gasoline taxes were first imposed by Canadian provinces during the 1920s and these revenues supplemented those from income taxes and succession duties. Despite additional revenue sources, heavy capital expenditure involved a large debt burden.[11]

By the 1920s there was a growing awareness of increased provincial responsibilities (in the fields of mining and transportation) and of regional income disparities. Apparently with some reluctance, the Federal Government made emergency grants to the provinces to assist in the relief of unemployment. Needs grants were also developed to assist the Maritime and Western Provinces. These unconditional payments were essentially *ad hoc* in nature and were made in response to sectional pressures.

Tax Rental Agreements, 1941-1957

The tax rental era dates from 1941, when all provinces ceased to impose personal income and corporation taxes and in return received fixed annual payments until one year after the end of the war. The Dominion Government also agreed to guarantee the gasoline tax and liquor revenues of each province. Tax rental agreements were re-negotiated after the end of the war for further periods, and no major change was made until 1957.

Under a tax rental agreement one taxing authority (e.g. a province) agrees not to levy a tax in a certain field for a certain time and in return receives compensation (rent) from another taxing authority (e.g. the central government) that utilises the field.

The main advantages of such an agreement are stability of revenues for the province and simplicity and economy for both taxpayers and governments. Against this, certain disadvantages can be observed: the loss of provincial autonomy and the danger that the sense of financial responsibility on the part of the provincial governments will be impaired. Under tax rental agreements, provinces are not directly responsible to their electors for any part of the tax that is levied. The Federal Government incurs the displeasure of electors generally for any tax increase, when the main reason for the increase may be provincial agitation for additional grants.

For provincial autonomy what seems to be important is not that the provinces can vary tax rates at will but that their revenue sources are commensurate with their expenditure responsibilities (this was, in essence, the point of view of the Rowell-Sirois Commission). The autonomy of the West German states does not appear to have been threatened because of federal control over tax rates and structures; such autonomy is maintained through tax sharing arrangements, which guarantee a share of major tax revenues to the states in line with their responsibilities, and through appropriate machinery that will ensure that this share can be changed when new circumstances arise. Provided arrangements of this kind can be devised and a federal take-over of state functions avoided, there is little in the argument that tax rental agreements, because they deny to the states the right to vary tax rates, will undermine state autonomy.

The objection to the tax rentals on the ground that states lose their sense of financial responsibility is, however, more persuasive. Tax rental agreements have the major drawback that, if persisted in long enough and if they absorb too large a proportion of provincial revenues (say more than 40 per cent), they encourage

provinces to lose contact with their electors and to meet additional expenditures by putting pressure on the central government for additional finance. Since all provinces will want additional revenues they will act in unison in promoting that end and their combined bargaining power may be stronger than that of the central government. This may induce provinces to become reckless in their demands; in this situation additional expenditures may become wasteful or misdirected with the additional revenues required bearing no relation to tax burdens in particular provinces. Since the provinces have nothing to lose by bargaining for additional grants and everything to gain (they do not have to tax their citizens to provide the additional funds needed), they tend to plan ahead on this basis by budgeting for still larger expenditures. Contact with electors is lost since the latter are not conscious of what they are paying for — they know only that their overall tax burden is rising and that it is the Federal Government which is imposing the taxes. In commenting on the tax rental agreements in Canada, an expert committee in Ontario noted: 'the taxpayer was frequently completely unaware of the ultimate destination of the taxes he paid since only the federal parliament legislated taxes and raised revenues'.[12]

It is, however, easy to exaggerate these problems — especially in Canada. Federal grants of all types, although rising in absolute terms, accounted for less than 25 per cent of provincial revenues between 1948 and 1956 and less than 32 per cent between 1956 and 1961. By 1973-74 federal transfers accounted for less than 25 per cent of provincial revenues.

It is also true that there are defensive mechanisms which many countries have used to lessen the risk that these problems will assume major proportions. One such mechanism is to rely more heavily on conditional grants-in-aid, since these grants are designed to ensure that funds are channelled into particular avenues of spending judged to be in the national interest. Thus, about one half of federal grants to the Canadian provinces is conditional in nature (the cost is shared between the two levels of government); and even before the tax rental system was finally abandoned in 1962 these grants were increasing faster than unconditional payments. Between 1954 and 1961 conditional grants increased from 18·5 to 45·6 per cent of all federal payments.[13] However, since 1962 unconditional federal transfers (the main components of which are the equalisation payments) have risen faster than conditional federal transfers.

Another defensive mechanism, and the one to have gained prominence in the Federal Republic of Germany, is to erect machinery for intergovernmental cooperation and planning so that joint expenditure needs (in the public sector) can be seen in the context of competing demands for resources from the private sector. Such machinery can also ensure that public sector expenditure needs are assessed and rationalised on a sound economic basis (see chapter 19 for details of this experiment in 'Joint Planning'). Intergovernmental planning machinery of this type has not found favour in Canada, Australia or the United States.

Whatever the merits or otherwise of the foregoing arguments, there is little evidence, at least until the mid-1950s, that the Canadian provinces (other than Quebec) were hostile to the tax rental system. On fiscal matters the provinces appeared willing to accept the judgment and the initiatives of the Dominion Government. Grants were acceptable, even on conditions. The financially weak

provinces certainly had no reason to be unhappy, because if they had levied their own income taxes and succession duties it would have been necessary for them to impose higher rates than the richer provinces in order to obtain the per capita revenues provided under the agreements.[14]

This quiescent attitude on the part of most provinces can be attributed mainly to: (i) the fear of a post-war economic slump (a belief that disaster was just around the corner) and hence the need for strong fiscal control from the centre; (ii) the success of the Liberal leadership in Ottawa in guiding the economy through what turned out to be a period (1947-1953) of almost uninterrupted growth and prosperity;[15] (iii) an appreciation of the advantages of having the Dominion Government assume the major political responsibility for taxation; and (iv) the special advantages (of the tax rental system) for the financially weak provinces in a period prior to the introduction of sophisticated equalisation machinery.

It should also be noted that the tax rental system, as with the subsequent tax sharing arrangements (and other adjustments in relation, for example, to the 'opting-out' provisions), emerged as a result of voluntary agreement between federal and provincial leaders: they were not the outcome of constitutional amendment or an evolving pattern of judicial interpretation of the *British-North America Act*.[16]

Compensation payments to the provinces in the war years were based on financial need and were unconditional. In 1945 the needs criterion was replaced by an objective per capita criterion. In 1947 (and effective for a five-year period)[17] all provinces except Quebec and Ontario agreed to rent income taxes and succession duties to the Federal Government in return for unconditional grants based on population and adjusted annually for growth of population and national income. A new agreement in 1952 (also for five years) did not herald fundamental changes but Ontario joined the other provinces that had agreed to the tax rentals. This meant that only Quebec was outside the agreement and for this it was allowed tax credits of up to 7 per cent of corporate profits, 5 per cent of personal income tax (raised to 10 per cent in 1955) and 50 per cent of succession duties.

Compensation payments to the provinces, although designed primarily to reimburse them for their voluntary surrender of tax powers, also contained an implicit redistributional element, because the rental payments were geared to population and income growth. The compensation payments therefore served to correct for both vertical and horizontal fiscal imbalance. It was not until 1957 that horizontal fiscal equalisation was made explicit (see chapter 13).

It is also worth noting that the Federal Government repealed taxes on gasoline, amusement, cabarets and household use of gas and electricity so that provinces could obtain more revenue from those sources.[18]

An analysis of budget figures (on a national income basis) for the three levels of government between 1948 and 1956 suggests that the tax rental and other agreements (e.g. on shared-cost programs) entered into over that period were, on balance, favourable from the standpoint of the provinces as a whole. During the period there was an appreciable rise in federal transfers to provinces (the latter rose from 7·9 per cent of total federal expenditure in 1948 to 9·5 per cent of total federal expenditure in 1956). Federal transfers to provinces over the period grew at an average annual rate of 12 per cent, which compares favourably with

average annual rates of increase of 9·4 per cent for direct taxes (federal and states), 8·7 per cent for indirect taxes (all levels of government), and just under 10 per cent for total provincial revenues (including the transfers). Against this the combined deficits of provinces and municipalities rose sharply during the period in relation to total provincial and municipal revenues (excluding intergovernmental transfers).[19]

Drive for Greater Provincial Financial Autonomy

Over the last 15-20 years the Canadian provinces have increasingly stressed the need for greater financial autonomy. Provincial leaders have not only talked in generalities but have been active in initiating changes in federal-provincial fiscal arrangements that would widen the scope for independent decision-making at the provincial level. The net result has been impressive. It must also be added that Dominion governments in Ottawa have chosen, by and large, not to offer strong resistance to provincial demands. This may be in part a recognition of the mood of the Canadian people but it is interesting that in recent years (and especially since 1962) Dominion Governments have actively sponsored the cause of greater provincial fiscal autonomy.

Several explanations have been put forward for the emergence of this new pluralism in federal-provincial relations in Canada. Quebec's insistence that it should control its own destinies undoubtedly stands out as the most powerful force.[20] Quebec's special position in Canada, based on cultural and language differences, has no parallel in the other federations. The necessity to accommodate Quebec has involved Ottawa in significant fiscal concessions, a good example being the 'opting-out' arrangements of 1964-65 whereby Quebec (which accounts for nearly 30 per cent of Canada's population) was able to obtain access to additional income tax revenue (via special federal abatements) in lieu of participation in certain federal-aid programs such as those covering youth allowances and hospital insurance.

Another reason for greater provincial fiscal autonomy was the decline in Canada's defence burden (defence expenditure in 1974 was less than 2 per cent of GDP) and the dramatic rise, especially since the mid-1950s, in provincial/municipal expenditure responsibilities; the latter being associated with strong growth impulses in Canada. The accelerated exploitation of natural resources brought a vastly increased demand for a range of public services which came within the ambit of direct provincial responsibility (e.g. highways, education and social welfare).

A further point is that the Constitution and judicial interpretation have given extensive power to the provinces in such diverse fields as business, labour, roads, social services, conservation and development.[21]

The emergence in the late 1950s and early 1960s of relatively strong provincial leaders was also of considerable importance. Restoration of federal-provincial financial balance became a major election issue and there also developed, around the same time, a strong public reaction against the 'Ottawa knows best' mentality which was a hangover from the Depression and World War II years.[22]

Provinces in Canada have gained a much greater measure of financial autonomy than have the Australian states. But in seeking to explain this phenomenon and the much greater dependence of the Australian states on grants from the centre as compared with

their Canadian counterparts, two additional points of some importance should be kept in mind.

Under the Canadian Constitution the provinces are restricted to levying direct taxes within their own boundaries. However, the Canadian provinces have been able to make extensive use of sales taxes by providing (in legislation authorising the taxes) for the taxes in question to be consumer purchase taxes — with retailers designated as agents of the Crown for purposes of collection.[23] The incidence of these taxes was therefore made to fall directly on the consumer. This is in marked contrast to the situation in Australia where, until 1974, the High Court ruled that sales and consumption taxes were excise duties within the meaning of section 90 of the Constitution and could therefore be imposed only by the Federal Government.

The Canadians did, moreover, have yet another legal advantage over the Australians when it came to dismantling the wartime scheme, in that their federal taxes were not required to be uniform (as they must be in Australia) and could therefore be 'abated' in favour of the provinces at differential rates.[24] While there was in Canada until 1966 a 'standard' rate of abatement (representing the extent of withdrawal of the Federal Government from an income tax field to make room for the provinces), it was not incumbent on the provinces to levy exactly the same rate as the federal abatement, and over an extended period many provinces (in fact a majority) legislated for rates which were higher.

The abatement system with respect to the personal income tax was abandoned in 1972. Under the piggy-back arrangements then adopted, the Dominion Government imposed only federal taxes, to which were added provincial taxes as a percentage of the federal rates. For the personal income tax, the Dominion Government therefore no longer provides, in any formal sense, tax room for the provinces.

Provincial financial autonomy would seem to have reached its high-water-mark in the period 1966-71 when several provinces, with the active encouragement of the Dominion Government, raised personal income tax rates in excess of the federal abatement of 28 per cent of basic personal income tax rates. In the early 1960s the further development of 'opting-out' arrangements with respect to shared-cost programs was also indicative of the underlying pressures for increased provincial financial autonomy. These and other related aspects of federal-provincial financial arrangements are now considered in somewhat more detail in terms of three principal time periods from 1957.

Tax Sharing: 1957-1962

In retrospect the changeover in 1957 from tax rentals to 'tax sharing' (often called the abatement system) marked the beginning of a new era in federal-provincial financial relationships. The importance of this change has been stressed by many writers. From this point on the extent of federal dominance was steadily diminished and there seemed to be no turning back. This trend was symptomatic of underlying changes in the economic structure and in the attitudes of political leaders, at both the national and provincial level. The introduction of explicit equalisation payments to assist financially weak provinces and of stabilisation payments to afford protection against pronounced revenue fluctuations must also be counted as significant developments arising from federal-provincial negotiations conducted in 1955 and 1956.

According to Professor Graham, the new policy represented a marked departure from the trend towards greater rationalisation of the Canadian fiscal system. The intention was to shift back to the provinces the responsibility for levying their own income taxes at a time when they (the provinces) were in desperate need of larger revenues and the Federal Government faced large deficits.[25]

What *was* the new policy? The main change was that federal payments to the provinces were now based largely on the yields in the provinces from 'standard' rates of income tax and succession duties. These rates were set initially at 10 per cent for personal income tax, 9 per cent for the corporate income tax and 50 per cent for the succession duty.[26] In this way provincial revenues were made more responsive to economic growth and recognition was given, at least in theory, to the principle of fiscal responsibility, namely that the power to tax should be linked with the power to spend.[27]

For provinces which chose to impose their own direct taxes (Quebec with respect to all three taxes and Ontario with respect to the corporation income tax and succession duty), taxpayers were allowed federal abatements at the standard rates. Thus Quebec received an abatement of 10 per cent of federal personal income tax collections attributable to the province (increased in 1958 to 13 per cent along with the increase in the standard rate). For the corporation income tax the standard abatement was 9 per cent of corporate taxable income earned in the province. The abatement for Quebec was increased to 10 per cent in 1960. Fifty per cent of the federal succession duties was allocated to the province of origin. From 1957 to 1961 both Quebec and Ontario levied corporation income taxes. The Quebec rate was 9 per cent for 1957 to 1959. In 1960 this rate was increased to 10 per cent to allow for the additional abatement in lieu of university grants, and the rate was further increased to 12 per cent from 1961. The Ontario rate was 11 per cent throughout the whole period.

Tax sharing agreements in this period differed from the previous tax rental agreements in that each province was free to impose and administer any of the aforementioned taxes. However, only Quebec and Ontario chose to follow this course, Quebec fully and Ontario in part. The remaining eight provinces continued to rent the three taxes to the Dominion Government and in return received compensation payments based on the yield from the standard rates of these taxes.

It is clear that this system, without adjustment, would have put the rapidly growing provinces (notably Ontario, British Columbia and Alberta) in a relatively favourable position *vis-à-vis* the other provinces. Accordingly, a system of equalisation payments was evolved in order to make up any difference between the per capita yield from the three standard taxes in each province and the weighted average per capita yield of these taxes in the two provinces (Ontario and British Columbia) with the highest per capita yields. A province whose per capita yield from the standard taxes was below this average received an equalisation payment, irrespective of whether it decided to impose its own income taxes or to rent the taxes and receive compensation payments from the Dominion Government.[28]

A third part of the tax sharing agreement related to stabilisation grants. They were designed to ensure that provincial revenue from the standard taxation and equalisation payments would not fall more than 5 per cent below the average of the two preceding years. Thus, any serious

decline in provincial revenue would be cushioned by federal payments.

A review of national income data on revenue and expenditure trends of the Federal Government, the provinces and the municipalities between 1956 and 1961 shows that a marked deterioration occurred in the financial position of the Federal Government and of the provinces as a whole.

The deterioration in the federal position was related in part to the continued rise in payments to the provinces (see table 7-1). These payments expanded at a much faster rate than federal expenditures on goods and services, on transfer payments to persons, and on subsidies. Federal financial transfers to the provinces (including payments under tax sharing arrangements) grew at such a rapid rate that they constituted almost one-third of total provincial revenue in 1961 (compared with 24 per cent in 1956 and 16 per cent in 1948).

It is therefore clear that during this period (1957 to 1961) the provinces were becoming much more dependent on federal grants (federal payments were rising much faster than revenues from the provinces own taxes). But despite this trend, provincial expenditures (including payments to municipalities) were growing faster than total revenues (including grants from the Federal Government). It is against the background of sharply rising demands for a range of public services that the provinces kept on applying pressure for even larger federal payments, and a more liberal approach to tax sharing in particular. As a consequence, several important changes in federal-provincial relations were agreed on in 1962; and it is to these changes that we now turn.

Tax Sharing: 1962-1966

A further retreat from fiscal centralisation occurred in this period. According to Shoyama, the tax rental system was 'essentially undermined in the tax-sharing arrangements formulated . . . in 1957, and it was structurally dismantled by Mr. Diefenbaker and Mr. Fleming in 1962'.[29]

This trend away from centralised financial power gained impetus from additional provincial and municipal expenditure commitments, which were expanding faster than expenditure commitments at the federal level. While federal payments to the provinces had, as noted, been impressive, they had lagged well behind increases in provincial and municipal expenditures. If even larger federal payments to the provinces were to be resisted, and political opinion was clearly weighted strongly in that direction, a further modification of tax sharing arrangements — with greater scope for tax changes at the provincial level — seemed to be essential. Thus many provinces, especially the more affluent ones, began to intensify their efforts to secure more fundamental changes in the method of tax sharing; and these changes were designed to give provinces more scope for exploiting growing incomes in their provinces. As it happened, the Dominion Government needed little convincing on this score, since it was under pressure to curb its own deficit and was particularly anxious to effect a compromise with Quebec regarding the latter's insistence on a greater measure of provincial financial autonomy.

The four major reasons for the strong reaction against the centralisation of financial power in Ottawa were therefore: (i) the growing financial needs of the provinces; (ii) a reluctance to see the provinces become too dependent on

federal grants; (iii) pressure from several provinces anxious to exploit growing incomes in order to improve the standard of public services; and (iv) the desire of the Federal Government to meet Quebec at least half way in its insistence on greater financial autonomy.

From 1962 onwards all provinces began to levy their own income taxes;[30] and the Federal Government partially withdrew, via increased federal abatements, from both personal and corporation income taxes in order to make room for the provinces and hence avoid an overall increase in the tax burden on individuals and businesses. The provinces were free to change their rates annually but were required to accept the tax bases as defined in federal law. The procedure was to express the provincial personal income tax rate as a percentage of a federal basic tax.[31] This meant, in effect, that all provincial governments (with the exception of Quebec) employed the same progressive rate structure.

The federal abatement for the personal income tax was increased from 16 per cent in 1962 to 21 per cent in 1965 and to 24 per cent in 1966. This meant a significant increase in the scope for provincial income taxes without any additional tax burden being imposed on the community as a whole. During this period (1962-66) only Manitoba and Saskatchewan chose to levy taxes in excess of the federal abatement.

The Federal Government offered to act as collecting agent for provincial income taxes at no cost to the provinces provided their tax bases were identical with federal definition. All provinces except Quebec (whose taxpayers continued to file two income tax returns) entered collection agreements with respect to the personal income tax and all provinces except Quebec and Ontario entered collection agreements with respect to the corporation income tax.

In what some economists have described as a further erosion of federal power, the device of opting or contracting out of conditional grants-in-aid programs was first employed in 1958, when Quebec was granted an additional abatement of federal corporation income tax of one per cent in lieu of federal grants to universities. This device was again used in 1964 when the Federal Government introduced its youth allowances program. Quebec was granted a 3 per cent abatement of the federal personal income tax in consideration of the fact that it already had a similar program and did not utilise the federal plan.

In 1965 this practice was carried yet a stage further when the Federal Government passed the *Established Programs (Interim Arrangements) Act*. Under this legislation provinces could opt out of certain well established shared-cost programs (such as for hospital insurance, blind and disabled persons allowances, and health grants) and in return receive specified equalised abatements[32] of the personal income tax (provided, of course, that they did, in fact, carry out the particular programs and submitted the necessary returns to the Federal Government). Only Quebec chose to take advantage of this option and in 1966 its abatement of the federal personal income tax was raised by an additional 23 percentage points (including 3 points for the youth allowances program) to a total of 47 per cent.[33] This compared with a 24 per cent abatement in the other provinces.

Provincial autonomy was strengthened and the financial position of the provinces as a whole improved as a consequence of these new tax-sharing arrangements. The direct tax revenue of the provinces, which averaged 19 per cent of total provincial revenue between 1957-61 (and 17 per cent

between 1950-56), rose to an average of 26 per cent for the period 1962-66. This was accompanied by a lessening of provincial dependence on federal grants (see table 7-1), even though payments under many programs increased sharply (notably contributions under the *Hospital Insurance and Diagnostic Services Act*, unemployment assistance and payments for technical and vocational training and for the Trans-Canada Highway). In fact a growing share of federal payments was taking the form of conditional grants under shared-cost programs (the proportion rose from 46 per cent in 1961 to 85 per cent in 1966).[34]

Between 1962 and 1966 there was a decided improvement in provincial finances as a whole. While expenditures grew at an average annual rate of 14 per cent in this period, revenues expanded even faster. This was in part a product of the more liberal income tax abatements noted above. Part of the benefit filtered through to the municipalities, whose dependence on borrowing was less than it had been between 1956 and 1962.

We see therefore that, in the period between 1962 and 1966, the vertical financial settlement in Canada was regulated mainly through increases in the federal abatements. This system enabled the provinces, provided they did not raise taxes in excess of the federal abatement, to increase their taxes without any increase in the tax burden for the community as a whole; and it enabled them to reduce their relative dependence on federal grants — especially unconditional grants. It meant that provinces could 'enact income taxes at zero political risk because the taxpayer's provincial tax was offset by the reduction in the Federal liability'.[35]

The crucial importance of the abatement system in regulating the vertical financial settlement and reducing reliance by the provinces on federal grants was not the only significant change which occurred in this period. Most provinces responded to rising expenditure com-

Table 7-1

Federal Grants and Deficits of Provinces and Municipalities (1956-1966)

	Federal transfers to provinces as per cent of		Deficits of provinces as per cent of total provincial revenue	Combined deficits of provinces and municipalities as per cent of total revenue *
	Total federal expenditure %	Total provincial revenue %	%	%
1956	9.5	24.4	— 2.3	— 10.8
1958	10.5	25.7	— 2.0	— 8.1
1960	14.5	30.4	— 6.7	— 9.1
1962	14.7	25.7	— 1.3	— 5.5
1964	15.2	23.1	— 1.7	— 4.3
1966	16.2	21.9	— 2.3	— 5.1

* Excludes intergovernmental transfers.

Source: Dominion Bureau of Statistics, *National Accounts, Income and Expenditure 1959 and 1966* (tables 36 and 37).

mitments by increasing general sales taxes and also taxes on motor fuel and other commodities and services.[36] In 1967-68 general sales taxes financed 14 per cent of gross general provincial expenditure, compared with only 6 per cent in 1960-61.

Developments since 1966

Although the abatement procedures in the *Federal Income Tax Act* were retained until 1972, the Dominion Government since 1966 has resisted further attempts to have the abatements increased. Provinces were therefore unable to obtain additional revenue from this source.

The reluctance to provide more tax room for the provinces (via the abatement system) may have stemmed partly from a belief that the Federal Government should maintain a stronger position in the income tax field for purposes of business cycle control. But more important was the federal view that the provinces, instead of always looking to the Federal Government for increased tax abatements, should themselves shoulder responsibility for raising taxes to meet additional expenditures. Thus, in foreshadowing the new approach in 1966, the Federal Finance Minister (M.W. Sharp) stated that 'both Parliament and provincial legislatures must accept their financial responsibilities and ... each should look to its own electors for direction as to what money should be raised and how it should be spent'. The minister went further in suggesting that 'we must get away from what is tending to become a conventional notion that the Federal Government can and should be expected to give greater tax room to the provinces when they find their expenditures rising more rapidly than their revenues'.[37]

Provinces had been free since 1962 to impose tax rates at their own discretion. There was no legal obstacle in the way of provinces raising income tax rates in excess of the standard federal abatement and indeed several provinces moved speedily in that direction.[38] The decision by the Dominion Government to delete any reference in federal statutes to standard rates was, however, based on the belief that in practice the use of the term had a tendency to inhibit freedom of action by provinces to increase tax rates. The term had also tended to convey the impression that the national government was, in effect, suggesting the appropriate rate for the provinces to use; and it seems to have fostered the idea that if a provincial rate exceeded the federal abatement, 'double taxation' had somehow occurred.

In short, the Dominion Government argued that if the provinces needed more revenue they should tax their own citizens rather than expect the Dominion Government to 'bail them out' by giving them more tax room through an increase in general abatements. The Dominion Government rejected the notion that 'it should, by inference or otherwise, suggest the rate of provincial tax it considers to be appropriate'.[39] The fundamental concern, therefore, was that each unit of government (federal and state) should be free to levy whatever tax rate it deemed necessary on the common tax base.

Whether this 'new policy' signalled a change of substance in federal-provincial financial relationships can be debated. However, one expert (T.K. Shoyama) refers to the new approach as 'very basic' and 'most controversial'.[40] An underlying shift of thinking was certainly evident and the outcome of the 1966 discussions seem especially important in two respects:

(i) It was decided to call a halt to further increases in general federal abatements. The federal abatement for all provinces was, in fact, raised by 4 per-

centage points (to 28 per cent of the basic personal income tax rates) in 1967. But this was tied specifically to the program for post-secondary education which was a partial substitute for the per capita grants to universities[41] and did not therefore result, on balance, in any significant financial benefit for the provinces. However, the point of the measure was to give the provinces more freedom of action in administering their own programs in this area.

(ii) Efforts were made to induce provinces to raise their own tax rates above the percentage of federal abatement when additional expenditure commitments put pressure on their budgets. In this connection it seems clear that the Dominion Government was motivated by a desire to shift the burden of responsibility from the Federal Government to the provinces and to increase taxpayer awareness in all provinces (not only Quebec) of the additional costs involved. If the provinces needed more revenue the remedy was in their own hands — they should raise their own taxes and accept full political responsibility for such action.

This policy met with a reasonable response. After 1967 several provinces set personal income tax rates above the federal abatement. Thus in 1970 the rates imposed (i.e. as a percentage of basic federal rates) were as follows: Alberta 33 per cent; Newfoundland 33 per cent; Saskatchewan 34 per cent; New Brunswick 38 per cent; Manitoba 39 per cent. In other provinces, except Quebec, personal income tax rates were set at the same rate as the federal abatement — i.e. 28 per cent.[42]

Until recently the Dominion Government stood ready, through the device of special federal abatements, to surrender more tax room to the provinces in lieu of conditional grants-in-aid. Other provinces did not appear to be in any hurry to follow the example of Quebec in this respect, but it seemed that Ontario might be an exception. In his Budget Speech of April 1971 the Ontario Minister of Economics stated his government's position in unequivocal terms: 'it is the clear intention to assume complete responsibility for the established shared-cost programs in exchange for fiscal equivalence and to resist rigorously the establishment of new shared-cost programs'. Such a solution would 'leave each level of government [with] the full responsibility to plan and finance its own programs within its own framework of priorities'.[43]

Since 1971 the Federal Government has withdrawn its offer to provide additional tax room for provinces through special abatements and is attempting to control its contributions to shared-cost programs by placing a percentage ceiling on annual increases. Over a ten-year period there has been a slight fall in the overall dependence of provinces on conditional grants-in-aid. The only large new program since 1967, albeit an important one, was for medicare. It can be argued that to an important extent the remedy for a heavy dependence on federal conditional grants lies in the hands of the provinces themselves, in the sense that provinces are free to follow the lead of Quebec in opting out of shared-cost programs in terms of the *Established Programs — Interim Arrangements Act*. On the other hand it should be stressed that these programs are in any event subject to basic federal guidelines appertaining especially to coverage, accessibility and non-discrimination. Provinces are not free to operate the programs without regard to these guidelines.

The abatement system in relation to the personal income tax was formally abandoned in 1972. The Dominion Government no longer provides, in any formal sense,

tax room for the provinces. The Dominion Government, as indicated earlier, now imposes only federal taxes, to which are added provincial taxes as a percentage of the federal rates.

The abatement system has, however, been retained in the corporation income tax field. In 1973 the Federal Government allowed an abatement or credit of 10 per cent of the corporation's taxable income earned in a province. Seven provinces levied rates ranging from 1-3 per cent in excess of the federal abatement, making for combined federal-provincial rates in 1973 ranging from 49 to 52 per cent.[44]

Proposals for federal tax reform were considered by the Dominion legislature towards the end of 1971.[45] These proposals had certain implications for federal-provincial financial relations. In order to make good the loss in revenue to each province as a result of the smaller federal tax base, it was agreed that each province would express its own tax rates (for personal income) as a higher percentage of the federal tax.[46] For this purpose a conversion ratio of 30·5 to 28·0 was evolved. This ratio was established by taking account of the projected yields of the new and old tax systems for the entire five-year period of the progressive rate reduction.[47] Thus, for New Brunswick the 'break-even' rate (the estimated rate necessary to prevent the province losing revenue as a consequence of tax reform) was

$$\frac{30{\cdot}5}{28{\cdot}0}\,38{\cdot}0 = 41.5\%$$

The same procedure provided Alberta with a 'break-even' rate of 36 per cent (compared with a rate of 33 per cent before tax reform).

Moreover, since there was considerable uncertainty as to how provincial revenues would be affected once all reform measures had been implemented, a further safeguard, and a more complete form of protection to the provinces, was decided upon. The Federal Government offered to each province a five-year federal guarantee with respect to revenues that would have been derived by each province from personal and corporation income taxes at 1971 tax rates. The aim was to ensure that no province would be worse off (in so far as its participation in the income tax field was concerned) under the new system than it would have been under the old one.[48]

But this guarantee was subject to two important conditions:

(i) a province must not increase its rate of personal income tax above the federally stipulated 'break-even' rate (this being in line with a federal commitment that the 1972 tax reform would not mean increases in the overall level of income taxation); and

(ii) each province must harmonise its personal income tax with that of the Federal Government.[49]

By 1972 the ten provinces occupied close to 30 per cent of the combined personal and corporation income tax fields in Canada. Moreover, only Quebec, Ontario and Alberta chose not to take advantage of the Tax Collection Agreements whereby the Federal Government collected income taxes at no extra cost to the provinces, providing their tax bases were identical with federal definition (Quebec for personal and corporate income taxes and Ontario and Alberta for the corporation tax).[50] However, these provinces were in the process of modifying their tax laws so as to bring them into closer harmony with their federal counterpart.

The Federal Government also decided (in June 1970) to withdraw from estate and gift duties and to leave these two revenue fields entirely to the provinces.

In summary, it would appear that

intergovernmental fiscal arrangements between 1962 and 1974 have strengthened provincial fiscal autonomy and lessened provincial dependence on federal grants. In 1973-74 federal transfers to provinces (conditional and unconditional) accounted for 23·3 per cent of the gross general revenue of the provinces, compared with 24·6 per cent in 1967-68 and 26.5 per cent in 1962-63 (see table 7-2).

Although it was a condition of the federal guarantee with respect to personal

Table 7-2

Gross General Revenue of Provinces
(selected years)

	Percentage distribution				
	1962-63	1967-68	1970-71	1972-73	1973-74
	%	%	%	%	%
Income taxes	18.9	24.0	23.5	24.7	26.0
Sales taxes	25.2	26.0	20.6	22.7	21.1
Other taxes *	5.3	5.7	12.8	8.0	10.2
All taxes	49.4	55.7	56.9	55.4	57.3
Non-tax revenue†	23.9	19.6	19.0	18.6	19.3
Total revenue from own sources	73.3	75.3	75.9	74.0	76.6
Conditional transfers from Federal Government	19.9	15.4	15.7	18.2	15.7
Unconditional transfers from Federal Government ‡	6.5	9.1 §	8.1 §	7.6 §	7.6 §
Total transfers from Federal Government	26.4	24.5	23.8	25.8	23.3
Transfers from local government	0.3	0.2	0.3	0.2	0.1
Gross general revenue	100.0	100.0	100.0	100.0	100.0

* Health insurance premiums, social insurance levies, death and gift duties, property taxes and corporation (non-income) taxes

† Natural resource revenue, income from investments, liquor board profits, income from public enterprises and from licences, permits etc.

‡ Embraces tax equalisation and stabilisation, share of federal estate tax (except in 1972-73 and 1973-74), and income tax on certain public utilities

§ Includes transfers under the *Established Programs (Interim Arrangements) Act*

Source: Provincial and Municipal Finances 1972 (table 3-6, p. 36) and 1973 (tables 3-5 and 3-6, pp. 35-6), Canadian Tax Foundation; and *Tax Memo*, No. 54, July 1974 (table 6, p. 29), Canadian Tax Foundation.

income tax that provinces would not increase their rates above the federally stipulated break-even rates, in 1972 Nova Scotia increased its rate from 30 to 38·5 per cent of the federal tax and was thus disqualified. By an amendment in 1973 to the *Federal Provincial Fiscal Arrangements Act* 1972, this restriction on the federal guarantee was removed. By July 1974, Newfoundland and Saskatchewan had also increased their rates, from 36 to 40 per cent and from 37 to 40 per cent respectively.

One must also conclude this chapter by pointing to emerging strains in Dominion-provincial relations between 1971 and 1974.[51] The Dominion Government resisted pressure from the provinces to extend tax sharing via the reintroduction of federal abatements for the personal income tax which would have enabled the provinces to increase their revenue from this source without an overall increase in the tax burden (i.e. by a further encroachment on the federal share). Against this the Dominion Government used various devices ('break-even' rates, adjustments to the equalisation arrangements and federal guarantees) to discourage provinces from raising personal income tax rates to meet additional expenditure commitments. The policy of the Federal Government in this period would therefore appear to have been somewhat contradictory. It was certainly at variance with the policy which was prominent between 1966-71, which stressed the need for each province to act on its own initiative and to impose additional taxes on its own citizens to meet relatively large expenditure needs of the province. Federal tax reform and the indexing of the personal income tax for inflation have also caused provincial revenues to grow at a slower rate than the revenues of the Dominion Government.

8 Federal Revenue Sharing in the United States

Federal revenue sharing in the United States has attracted a great deal of attention,[1] not so much because the idea is novel but because it signals a major change in the structure of US intergovernmental fiscal relations.

To the extent that the Federal Government returns a specified share of personal income (and other) taxes to states and local authorities with few, if any, strings attached, revenue sharing might appear to resemble the Australian system of financial assistance grants. While there are many contrasting aspects to which attention will be directed, one interesting point of similarity is that the Australian system of unconditional grants and US revenue sharing are both concerned with correcting for vertical as well as horizontal fiscal imbalance. Revenue sharing in Germany takes place within the framework of fiscal uniformity and other ground rules which are quite unique;[2] the German system does, however, operate under the same basic principle as US revenue sharing — states and local authorities obtain a share of personal income (and other) taxes and can use the proceeds in any way they please.

Serious consideration of a proposal for federal revenue sharing was inspired by the work of Walter Heller as early as 1964. The Heller-Pechman plan of 1965 was developed during a period when it appeared that federal tax revenues were becoming unduly large while revenues at the state and local levels were not large enough in relation to spending needs at those levels. Revenue sharing was essentially a response to what many experts believed was a growing imbalance in the American federation. Thus, according to the Advisory Commission on Intergovernmental Relations, revenue sharing appeared to be 'the most effective way to deal with a basic power and fiscal imbalance within our federal system'.[3] A revenue sharing plan was put before Congress in 1969 and final approval for a $30b five-year program came in October 1972.[4]

Although the plan does not introduce anything that is entirely new into the existing body of knowledge concerning techniques for fiscal adjustment in a federation (it will be recalled that the Rowell-Sirois Commission had recommended a similar plan for Canada), the plan is of great interest in an American context since before 1972 virtually all federal grants had been of the specific purpose variety, and something like 80 per cent of conditional grants-in-aid programs had contained matching provisions.

We now deal with the main objectives of revenue sharing, the mechanism of the program (including equalisation provisions), the merits of the plan and some adverse criticism.[5] It should be emphasised at the outset that revenue sharing is intended as a supplement to, and not a substitute for, existing grants-in-aid programs which, by 1973, exceeded $32b. Nevertheless the advent of revenue sharing signals a major shift of emphasis from categorical to bloc grants. It is customary to use the term 'bloc grant' in the context of US revenue sharing, since

two-thirds of revenue sharing moneys are channelled to local authorities which are required to spend the money on functions specified in eight categories. The bloc grant is therefore slightly less unconditional than is the pure revenue equalisation grant, for example. Categorical grants are still held to be indispensable where there are large spillover effects.[6]

Main Objectives of Revenue Sharing

As noted above, revenue sharing was seen as a means whereby a growing fiscal imbalance could be corrected. This imbalance was linked with the great proliferation of federal aid programs which have clearly limited the power of independent decision making by the states. The foremost objective was therefore to strengthen the basis of decentralised government. As the Advisory Commission puts it:

> Revenue sharing harmonizes with one of the strengths of the American system — its diversity. States and localities must take different approaches to problems and all benefit by their experimentation. The national government has a clear-cut interest in creating a fiscal environment that is conducive to experimentation.[7]

Revenue sharing was therefore designed primarily to enhance the fiscal independence of state and local governments and to check the centralisation of power in Washington. Subsidiary objectives were to make state and local revenues more sensitive to rising incomes and to achieve a measure of interstate and interregional fiscal equalisation without torpedoing their tax efforts. To meet the problem of undue dependence by state and local authorities on federal unconditional or bloc transfers, a revenue effort clause was inserted in both the three- and five-factor formulas. In fact one of the goals of revenue sharing was to induce state and local authorities to make greater use of the sources of revenue at their disposal (by 1973, forty states had imposed a broad-based personal income tax and in thirty-six of these states the rate structure was moderately progressive).

It should also be added that revenue sharing is a simple method of fiscal adjustment, one which can be easily understood by politicians. It is also free of complex administrative problems. On the other hand, the likely impact of revenue sharing should not be exaggerated; in 1973 federal aid in the form of revenue sharing amounted to less than 3 per cent of total direct expenditures of state and local authorities.[8]

Mechanism of the Program

About 1·3 per cent of the federal income tax base for individuals is transferred to states and local authorities. The allocation is unaffected by variations in federal tax rates. The program called for the distribution of approximately $30·2b over a five-year period commencing in 1972.

The funds are first distributed to the states on the basis of a three-factor formula and a five-factor formula. The three-factor formula represents the Senate version of the original revenue-sharing bill while the five-factor formula represents the House version. In Conference Committee, both versions were included in the final bill. The greater of the two amounts is selected for each state but since the sum for all states will tend to be greater than the total amount appropriated for the entitlement period, the amount for each state is scaled down proportionately so that the total allocation is equal to the amount appropriated for the entitlement period.

Two-thirds of the amount allocated to each state flows through to local authorities with distribution at the local level being governed, for the most part, by the three-factor formula.[9]

The three-factor formula is based on population, general tax effort and relative income. The five-factor formula is based on population, urbanised population, general tax effort, per capita income and state income tax collections.[10] All told, more than 38,000 units of government — states, counties, municipalities and townships — receive revenue - sharing cheques from the central government.[11] A measure of redistribution is secured by providing larger grants to units with below-average incomes. The relative income factor features in both formulas for calculation of state entitlements and is also utilised in the formulas distributing funds at the local level. However, the positive equalisation effects (in terms of larger per capita unconditional grants being received by state and local authorities with low per capita incomes) is lessened by other elements of the formula, especially the tax effort clause. Thus the State of New York receives more, on a per capita basis, than three of the five states with the lowest per capita incomes.[12] The redistributional impact is also lessened by a stipulation that no local unit of government can obtain more than 145 per cent of the average per capita grant to local authorities in the relevant state.[13]

The revenue-sharing transfers have few strings attached. Although, as noted, local authorities are required to use the grant money in certain 'priority' fields of expenditure, there are no matching conditions as such and no maintenance of effort provision. It is therefore open to the authorities to use the grants in whole or in part as a substitute for their own funds, which would otherwise be used to support the priority categories.[14] This means that funds so diverted can be used for tax reduction or for spending in categories outside the priority list. However, the range of spending covered by this list is very large and the scope for tax reduction on the part of recipient governments is presumably narrowed by the tax effort factor which, in effect, serves as a matching condition.

Merits of the Plan

The merits of the plan are largely subsumed in the objectives. In particular one may stress the following advantages:

(i) greater financial resources at the state and local levels make it easier to meet expenditure demands in such areas as education, urban transport and city development;

(ii) in so far as funds from revenue sharing lessen dependence on conditional grants-in-aid the financial autonomy of the recipient governments is strengthened;

(iii) revenue sharing involves a measure of interstate fiscal equalisation;

(iv) state and local governments have access to a more elastic revenue source;

(v) revenue sharing reduces emphasis on categorical grants-in-aid programs 'the appropriations for which are often uncertain and delayed, making it difficult for recipient governments to plan effectively'.[15]

Criticism of Revenue Sharing

A basic objection to the plan rests on the idea that revenue sharing undermines financial responsibility. Legislatures which spend money should raise it. Categorical grants are said not to suffer from this alleged drawback, which might be true in theory and would, no doubt, be true in practice provided Congress was able to exercise an effective control over

the complex assortment of categorical grants-in-aid programs.[16] Allied to this is opposition to untied grants — a fear that additional money from revenue sharing will not be used to satisfy national goals. But this argument also seems to be exaggerated since, as pointed out already, categorical grants are not being displaced by revenue sharing. The latter provide recipient governments with additional funds and hence gives them greater flexibility and freedom of action at the margin in responding to public needs without jeopardising the attainment of national goals.

There has also been some support for the argument that many state and local officials are corrupt and are indifferent to urban problems.[17]

As stated elsewhere in this study, the orthodox and rather narrow view of financial responsibility in terms of recipient governments spending only what they raise from their own taxes is no longer of crucial importance. What *is* crucial is whether the recipient governments can still exercise an influence on spending patterns and on the means of financing. As applied to the United States, the answer seems clearly to be in the affirmative. The revenue-sharing formulas are composed of many diverse elements and provide, *inter alia*, an incentive for recipient governments to exploit their own tax resources and give them considerable freedom of action in choosing between different categories of spending. In the absence of corruption and if these choices are conditioned by preferences which citizens are able to make known, then an essential element of federalism has been retained. It is true that, in theory, the revenue-sharing cheques may be used for state-local tax reduction, although the tax effort element reduces the likelihood that this will actually occur on any significant scale.

A further basis for criticism — and one which seems more plausible — is that the federal budget surplus (at full employment) has been greatly exaggerated — and so have the deficits of state and local authorities. According to a study by Musgrave and Polinsky, several states have substantial unused fiscal capacity. A 5 per cent increase in taxes would have wiped out deficits in most states.[18] According to this view, the basic hypothesis of generalised vertical imbalance is invalid.

The dramatic rise in state and local government surpluses since 1969 is illustrated in a study undertaken by the Federal Reserve Bank of Philadelphia.[19] According to this study, the new trend can be explained by: (i) a slowing down in the rate of growth of expenditures (especially in construction activity); (ii) the tapping of new revenue sources; (iii) an increase in rates on existing taxes (especially on sales and income); (iv) a greater availability of funds from non-tax sources (such as increased fees at public hospitals and public educational facilities); and (v) general revenue sharing.[20] The net result was a rise in state and local surpluses from $3b in 1970 to over $12b in 1972. This trend, which continued in 1973, has moderated the stimulation effect on the economy of deficits at the federal level.[21]

There is also the claim that the revenue-sharing program does not offer a solution to the problem of horizontal fiscal imbalance. It is true that the effect of the existing program on interstate equalisation does not seem likely to be very marked. The Javits proposal would have been preferable from this point of view.[22] Under that proposal it was envisaged that 85 per cent of the total would be distributed on a population basis and the

remaining 15 per cent would go to states whose per capita incomes were below the national average.[23] This would increase the degree of fiscal equalisation between states but it would also divert funds from wealthier states which have serious urban problems. Several studies conducted in this area point to the fact that major disparities in fiscal need are intrastate and not interstate.[24] Account must therefore be taken of expenditure need as well as financial capacity. Some states with high per capita incomes also have high per capita expenditure needs. Opposition to revenue sharing is based partly on a belief that it cannot be used effectively to tackle this problem and that the best method is the use of variable matching grants. The revenue - sharing plan does, as noted, have a positive equalising effect via the relative income factor. Moreover, under the pass-through provision to local authorities, areas with high population densities and associated urban problems receive relatively more revenue - sharing money. But even this effect is muted to some extent by the tax effort provision and the stipulation that no unit of local government can receive more than 145 per cent of the average per capita grant to local authorities.

A final criticism is to the effect that if the Federal Government was doing its job properly (i.e. providing adequate low income relief) there would be no 'surplus' for distribution to the states; and if state and local governments were financing their own programs by the use of benefit taxes there would be little need for revenue sharing.[25] The objections to this argument were noted in chapter 3. There are too many 'ifs' in the argument. However desirable the attainment of such an ideal or rational fiscal structure might be in the future, the solutions to problems which exist now cannot wait for a structure which in all probability will never be attained. According to Break, the main problem with such an ideal is that there is little quantitative information about individual evaluations of different government services.[26]

Summary

Neither the system of relying almost exclusively on categorical grants nor a mixed system with revenue sharing as an integral part seems to offer the ideal intergovernmental fiscal structure. The American experiment is, however, interesting and offers the prospect of a much more viable fiscal structure. To gauge its true significance, revenue sharing must be viewed against the particular problems which have plagued the country (e.g. the plight of large cities, the apparent inability of the existing machinery of grants-in-aid programs to have a real impact on such problems, and the excessive zeal with which governments in the past have indulged in tax competition).

While a strong case can be made for categorical grants to secure certain national aims, it is hard to agree with the view that exclusive reliance should be placed on those grants. The transition to revenue sharing and to greater use of the bloc grant makes for greater freedom of choice at state and local levels. This should strengthen the basis of American federalism.

The oft-quoted danger of financial irresponsibility has been overplayed, especially in view of the tax effort clauses embodied in the formulas. The larger than average allocations to the large cities was clearly a response to popular feeling about the inadequate services provided by the cities. Built into the formula is a measure of fiscal equalisation.

This does not mean that all problems

are about to disappear. Revenue sharing is not a panacea. One particular cause of concern is the absence in the United States of a co-ordinated approach to interstate fiscal equalisation. This matter is taken up again in chapter 13. One problem with American fiscal federalism before 1972 was that the categorical grant, as an instrument of intergovernmental fiscal adjustment, was expected to achieve too many ends: the variable matching provisions were used to promote particular categories of spending; and they were also used to secure certain equalising effects and to ensure the attainment of certain minimum standards for selected essential public services. The advent of revenue sharing means that the authorities now have another policy instrument which can take some of the burden off the conditional matching grants.

9 The Vertical Intergovernmental Fiscal Structure in West Germany

State Autonomy and Fiscal Uniformity

The Constitution of the Federal Republic of Germany (1949) assigns a particularly important role to the Council of States (*Bundesrat*). As noted in chapter 1, the latter is, in effect, a permanent conference of state ministers and has acquired a place of key importance in the *Basic Law*.[1] It has evolved into a very powerful body representing and defending state interests. As a House of the States (and not simply a House of Review) it serves as a counter-balancing force in financial and other matters to the concentration of power at the centre. An important part of the jurisdiction of the Council relates to the regulation of taxes where proceeds accrue entirely or in part to states or local authorities. Laws which relate to state interests cannot be promulgated without the consent of the Council. Articles 105-7 of the Federal Constitution relate to tax matters, including the distribution of revenue between federal and state governments and horizontal fiscal equalisation at the state level. All laws in these categories require *Bundesrat* approval.

The strong position of the *Laender* (states) is evidenced by the fact that, in the early life of the Federal Republic, the Federal Minister of Finance was obliged to ask the *Bundesrat* for an increasing share of income tax revenue (in fact, in the budget year 1962 the *Laender*, because of growing surpluses, agreed to grant the *Bund* (Federal Government) a 'once for all' subsidy of DM1050m). The *Bundesrat* emerged very quickly as the keystone of the West German federal structure.

In West Germany, federal supremacy in tax legislation was firmly established from the outset. Laws governing the structure of income and other important taxes come squarely under federal jurisdiction. The Constitution gives the Federal Government and the states concurrent legislative powers in most taxes; but once the Federal Government has pre-empted a tax field — and it has been quick to do this — the powers of the states come to an end.[2]

The decision to opt for fiscal uniformity was joined by another important decision by which, in terms of a constitutional guarantee, revenues from certain taxes are assigned to the states and other revenues (income and value-added taxes) are shared between federal and state governments.

Legislators in Germany have therefore put a premium on tax uniformity but they have, at the same time, been eager to devise tax sharing arrangements to ensure that each level of government has financial resources which are adequate to perform the functions assigned to it.

The financial provisions of the Basic Law therefore represent a compromise between the desire for a strong central government and for fiscal uniformity on the one hand, and the importance attached to adequate machinery for the protection of state financial autonomy on the other. There is no necessary contradiction between these objectives. In order to secure state fiscal autonomy it is necessary in the first place that the states have a strong voice in decisions which

affect their vital interests, and in the second place that they have access to finance commensurate with their expenditure responsibilities. Accordingly, and despite strong opposition from the Allied authorities, the right was conceded to the national parliament to enact uniform tax rates for the whole nation. But in return it was agreed that all legislation on taxes relating to states and municipalities must have the approval of the Council of States whose important role has been noted. The only major concession to the Allied point of view was that the actual assessment and collection of taxes (with the exception of local taxes) was left to the states.[3]

Of particular importance for subsequent discussion was the arrangement for tax sharing within the framework of fiscal uniformity. By specifying what taxes were to be assigned to each level of government and what taxes were to be shared between each level (and on what basis), the federal authorities sought to avoid the problems associated with large grants from the centre — problems which had clearly emerged in federations which had failed to provide a flexible and meaningful arrangement for revenue sharing. What seems especially significant in the Federal Republic is that the clear advantages of fiscal uniformity have been combined with machinery which ensures ample protection to state autonomy and with a method of tax distribution which serves to regulate the vertical intergovernmental fiscal imbalance.

Tax uniformity — the inability of states to vary tax rates — seemed, in the judgment of the West German authorities, to be a small price to pay for the avoidance of tax competition, the proliferation of federal grants and, most important, the advantages of a flexible tax-sharing arrangement.

Distribution of Tax Revenues

Under Article 106 of the Constitution certain tax revenues are assigned to the Federal Government and certain tax revenues are earmarked for the states. In addition, there are taxes which are 'joint' in the sense that the proceeds are shared between the two or three levels of government.

Article 106 gives the states a captive revenue from taxes on wealth, beer, motor vehicles and inheritance. In the past the states have also obtained revenue from taxes imposed on gambling, share turnover and insurance. However, as noted in table 9-3 below, these taxes were transferred to the Federal Government in 1970. Apart from these and customs and excise duties (excluding beer), the Federal Government derives revenue from the turnover tax (now value-added tax), equalisation of burdens,[4] and a surcharge which it can levy (as part of economic stabilisation policy) on personal and corporate income taxes. The Basic Law specified, moreover, that income taxes (apart from the surcharge) should be shared between the federal and state governments. In terms of the recent finance reform measures,[5] intergovernmental tax-sharing arrangements have been extended to embrace the value-added tax (other than the tax on imports) and to provide for a direct transfer of a portion of personal income tax revenue to local authorities.

Revenue from property, business and pay-rolls was assigned to municipalities. The recent Finance Reform has, however, resulted in an agreement whereby municipalities return 40 per cent of the proceeds of their trade taxes to the *Bund* and *Laender* (20 per cent to each) as a partial offset against their participation in a portion (currently 14 per cent) of the

proceeds of the wage and assessed income tax.[6] Of minor significance in terms of revenue are a variety of taxes imposed by local authorities on amusements, beverages, bars and cabarets, dogs and hunting privileges. In all there are more than forty different federal, state and municipal taxes in West Germany.

Regulation of the Vertical Intergovernmental Financial Imbalance

In terms of conventional measurement, the vertical fiscal imbalance in Germany, by comparison with Australia, is practically non-existent. That is to say, there is a very close correspondence between revenue sources and expenditure functions at each level of government. This has not occurred by accident. It springs directly from provisions of the Federal Constitution and subsequent adjustments worked out by federal and state legislators. As a consequence we find, in marked contrast to the situation in Australia, that the *Laender* are not heavily dependent on federal grants or heavily burdened with debt. Between 1969 and 1973 less than 16 per cent of state income was derived from federal grants. In Australia, by contrast, federal grants constituted more than 55 per cent of state revenues in a broadly comparable period. Moreover, in West Germany the annual increase in state indebtedness in the eight years from 1966 to 1973 averaged 3·5 per cent of total state outlays, compared with 18 per cent in Australia.[7] When local authorities, which undertake about two-thirds of capital expenditures in the public sector in Germany, are brought into the reckoning, the contrast between the two countries may be illustrated by reference

Table 9-1

Net Increase in Indebtedness of State and Local Authorities as a Percentage of Total Outlay

(per cent)

	Australia*	West Germany
1966	20.5	9.6
1967	18.6	6.6
1968	17.1	3.8
1969	18.3	—
1970	15.8	8.3
1971	13.2	11.9
1972	15.3	6.2
1973	13.5	5.8
Average 1966-73	16.5	6.5

* Financial years 1965-66 to 1972-73. For comparability, the debt and outlays of semi-governmental authorities are included.

Sources: Australia: Commonwealth Bureau of Census and Statistics, *Australian National Accounts 1972-73.*

Germany: *Finanzbericht* 1971-1974; and *Monthly Report of Deutsche Bundesbank*, Vol. 22, No. 8, August 1970 (p. 15) and Vol. 23, No. 12, December 1971 (table VII, p. 56).

to table 9-1 below. State and local dependence on debt financing is also considerably less in Germany than in the United States or Canada.

The close correspondence of revenue resources and expenditure commitments at each level of government in Germany has been secured mainly through fairly flexible arrangements for the distribution of tax revenues.

There may be a temptation to argue that this correspondence is more apparent than real and that the financial independence of the *Laender* is far from complete, since they do not have the power to vary income tax rates or the tax structure. There are, however, two comments which seem appropriate in this connection:

(i) State financial autonomy can never be absolute since the Federal Government has the ultimate responsibility for economic management.

(ii) Given the overriding importance attached to interstate tax uniformity, a significant measure of state fiscal autonomy can be secured provided the states have a guaranteed source of revenue, the growth of which bears a close relation to the tempo of business activity (and hence income generation) within the borders of each state.

In short, if the states have ready access to revenues from a growth tax (e.g. income or value-added tax) and are in a position to exert an influence in increasing their share of such taxes in line with an expected increase in their expenditure needs (in relation to the expenditure needs of the Federal Government), a high degree of state fiscal autonomy can, in fact, be secured. This, as we shall see, is a fairly accurate description of some essential elements of the intergovernmental fiscal structure in West Germany. Such a structure lessens the need for *ad hoc* financial assistance from the centre, other than for purposes of horizontal fiscal equalisation.[8]

The Federal Government in West Germany does make grants to the eleven states (and to local authorities) — usually with conditions attached —[9] but these are on a comparatively small scale and are not intended to regulate vertical intergovernmental financial imbalance. The latter is accomplished mainly through adjustments to the percentage distribution of taxes which are shared by the Federal Government and the states. In stark contrast to the Australian system, where Federal Cabinet and federal officials exercise a dominating influence (e.g., in making adjustments to financial assistance and other grants), the percentage of 'shared' taxes that will go to the German states, and hence the vertical financial settlement, is regulated in a way which gives the states a much greater opportunity to have the decisive influence. The main reason is found, as noted above, in the pervasive influence of the *Bundesrat*.

The financial provisions of the Basic Law were framed, *inter alia*, with a view to avoiding tax competition between states (which has, for example, been a source of friction in the American federal experience) and at the same time ensuring that each tier of government would have access to revenue deemed adequate in the light of the expenditure functions specified in the Constitution and as influenced by legal interpretation and changing economic conditions.

While the Federal Government of West Germany exercises a tight control over the whole economy and has a range of functions comparable with those assigned to national governments in Australia, the United States and Canada,[10] it has managed to evolve a financial settlement which is quite distinctive in character. The financial settlement is regulated

mainly by means of a comprehensive scheme of tax sharing. This settlement is combined with a system of financial transfers from the Federal Government to the states (and local authorities). This also has distinctive characteristics, since it is planned several years ahead on the basis of economic and social criteria agreed upon by each level of government in joint consultation.[11] In Germany there is therefore comparatively little scope for political bargaining over grants and *ad hoc* decision-making. The contrast with the situation in Australia (and to a lesser extent in Canada) is quite striking.

Thus, what the West German authorities appear to have achieved (in a relatively short space of time) can be summed up in one sentence: tight overall economic control, an apparatus of joint decision-making and no heavy financial burdens pressing on the states.

The key to the regulation of the vertical intergovernmental financial imbalance is found in the constitutional provision relating to sharing arrangements with respect to income taxes and, more recently, the value-added tax. These taxes are joint in the sense that the revenue is shared between the federal and state governments.[12] The ratio is set out in the Basic Law but can be varied by Federal Statute (with *Bundesrat* approval) 'in the event that the relationship between Federal revenue and expenditure on the one hand, and State revenue and expenditure on the other, should become so unbalanced that a substantial deficit developed on either the Federal or the State level'.[13]

The shared income tax ratio has, in fact, been varied on several occasions. The federal share was 35 per cent between 1958-63, 38 per cent in 1963, 39 per cent from 1964-66, 37 per cent in 1967-68, and 35 per cent in 1969. The Finance Reform, which became effective in 1970, increased the federal ratio to 43 per cent for the wage and assessed income tax and 50 per cent for other income taxes but provided (for the first time) that 30 per cent of revenue from the value-added tax should be transferred to the states. The percentage distribution of joint taxes between the three levels of government — before and after Finance Reform — is shown in table 9-2. The state share of value-added tax revenue was raised in 1972 to 33 per cent, and in 1973 to 35 per cent of total collections (excluding the tax on imports) in order to meet an expected increase in state deficits.[14] These adjustments prevented the actual appearance of large deficits for the states as a whole in either 1972 or 1973 (see table 9-3). In 1974 the state share of value-added tax was raised from 35 to 37 per cent, but for 1975 and 1976 it has been reduced to 31 per cent to allow for the relatively large loss of federal revenue as a result of the fiscal reform which became effective on 1 January 1975. This reform involved DM 4 billion in direct tax cuts and DM 10 billion in additional family allowances.

The distribution of revenue from the value-added tax has now become the adjustable (or movable) part of the tax distribution whereby the vertical intergovernmental financial settlement is reached. Article 106 (4) of the Basic Law states that the proportional share of the value-added tax between *Bund* and *Laender* can be adjusted to take account of differential trends in revenues and expenditure of *Bund* and *Laender*.[15] Moreover, the distribution between states is on a population basis,[16] unlike the interstate distribution of income tax revenue which is on a 'derivation' basis (i.e. on the basis of actual tax moneys collected in each state).

Impact of Finance Reform on Government Finances

In the period 1966-70 there was a marked improvement in the financial position of the states as a whole. This improvement was to an important extent a direct consequence of rising receipts from the state share of the joint taxes. Finance Reform, approved in 1969 with effect from 1970, has also enabled the states to shoulder vastly increased expenditure commitments without undue strain. The improvement in state finances is illustrated in table 9-3, which presents the economic account of the states in an abridged form for the period 1966 to 1973. Adjustments on the revenue side have enabled the states to step up their rate of expenditure in real terms without incurring large deficits. In real terms spending rose from an average annual rate of approximately 3 per cent between 1966 and 1969 to almost 11 per cent in 1970 and about 7 per cent over the three years 1971-73.

As shown in table 9-4, federal grants and loans accounted for less than 16 per cent of total state income between 1969 and 1973. The table also shows that tax-sharing arrangements have been of decisive importance in regulating vertical intergovernmental fiscal imbalance in the Federal Republic. State revenue derived from tax sharing (the 'joint' taxes) accounted for 58 per cent of total state income in 1973 (compared with about 50 per cent from 1966-68).

Only income taxes were shared between the Federal Government and the states before 1970. In 1970 the value-added tax and trade tax were included in the financial settlement. Before 1970 all proceeds from the turnover tax (now value-added tax) went to the Federal Government and all proceeds from the trade tax went to the municipalities. The year 1970 therefore marked a decisive turning point in relation to the financial settlement between the three levels of government. The revised

Table 9-2

Tax Distribution (Joint Taxes)

(per cent)

	Before finance reform (1969)			After finance reform (1970-1971)		
	Federal	State	Local	Federal	State	Local
Wage and assessed income tax	35	65*	—	43	43*	14
Non-assessed tax on yields	35	65*	—	50	50*	—
Corporation income tax	35	65*	—	50	50*	—
Turnover (value-added tax)	100	—	—	70	30†	—
Trade tax	—	—	100	20	20	60

* Municipalities receive a certain percentage share of these taxes (and other revenues of the states) as laid down in state legislation.

† State share is calculated on the turnover/value-added tax excluding the tax on imports.

Table 9-3

Economic Account of the States 1966-73
(DM billion)

	1966	1967	1968	1969	1970	1971	1972	1973
Share of joint taxes*	27.0	27.6	30.5	36.8	41.0	46.4	56.1	65.1
State taxes†	9.3	10.0	10.4	11.5	11.0	12.1	13.1	14.5
Total tax revenue	36.3	37.6	40.9	48.3	52.0	58.5	69.2	79.6
Receipts from Federal Government‡	10.1	9.7	11.1	9.9	10.8	12.6	14.3	17.6
Other receipts§	7.4	8.4	9.3	9.9	11.6	12.5	14.7	15.1
TOTAL INCOME	53.8	55.7	61.3	68.1	74.4	83.6	98.2	112.3
Transfers to local authorities	11.0	11.3	11.5	12.8	14.1	16.1	18.7	22.2
Current expenditure	34.6	36.7	40.0	42.7	49.0	57.5	64.4	73.4
Capital expenditure	12.0	11.5	11.0	11.3	14.4	15.5	16.6	18.8
TOTAL OUTLAY ‖	57.6	59.5	62.5	66.8	77.5	89.1	99.7	114.4
Deficit (−)	− 3.8	− 3.8	− 1.2		− 3.1	− 5.5	− 1.5	− 2.1
Surplus (+)				+ 1.3				
Deficit/surplus as % of total outlay	6.6	6.4	1.9	1.9	4.0	6.2	1.5	1.8

* Embraces share of personal and corporation income taxes up to 1969 and thereafter includes share of value-added tax and trade tax.

† Includes local taxes of the city states. State taxes are headed in terms of revenue by taxes on motor vehicles, wealth and inheritance, beer, gambling and land acquisition. Several 'bagatelle' taxes (on insurance, securities, company incorporation and share turnover) were transferred to the Federal Government in 1970 in line with recommendations of the Troeger Commission. The annual cost to state revenues of this transfer, to be set against the gain from the new distribution of the 'joint' taxes, was estimated at DM1·3 billion.

‡ Grants and loans.

§ Includes fees, interest and other non-tax revenue and also capital receipts such as the sale of assets and loan repayments, but excludes drawing on reserves and borrowing in credit markets.

‖ Excludes additions to reserves and debt repayment.

Source: *Finanzbericht* (1971 table 2, p. 167 and table 5, p. 170; 1972, table 9, p. 29; and 1974, pp. 41-50, 62-63).

Table 9-4

Income Composition of the States 1966-73
per cent of total

	1966	1967	1968	1969	1970	1971	1972	1973
Share of joint taxes	50.2	49.6	49.8	54.0	55.1	55.5	57.1	58.0
State taxes	17.3	17.9	16.9	16.9	14.8	14.5	13.4	12.9
Total tax revenue	67.5	67.5	66.7	70.9	69.9	70.0	70.5	70.9
Grants and loans from Federal Government	18.8	17.4	18.1	14.5	14.5	15.1	14.6	15.7
Other receipts	13.7	15.1	15.2	14.6	15.6	14.9	14.9	13.4
Total income	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: From table 9-3.

tax-sharing arrangements, in combination with an extension of intergovernmental planning and the provision of federal finance to assist projects categorised as 'joint tasks' (see chapter 19), have enabled both states and local authorities to respond to expanding demands for public services (such as education, highways, public utilities, hospitals and city development) without undue strain on their respective budgets.

In 1970 the Federal Government received DM56·3b in revenue from the joint taxes. This was made up of 43 per cent of the wage and assessed income tax, 50 per cent of other income taxes, 70 per cent of the value-added tax (other than the tax on imports) and 20 per cent of the trade tax. As the figures in table 9-5 clearly show, revenue received by the Federal Government grew at a much faster rate in 1970 than revenue received by the states and municipalities. However, when all tax revenues are included and comparisons are made over several years, the position of the states and their municipalities is seen in a more favourable light. Indeed, in 1971 and 1972 the states and local authorities gained tax revenues, especially revenue from the 'joint' taxes, at a faster rate than the Federal Government. In 1973 tax revenues available to each level of government grew at about the same rate. Nevertheless, because of rising expenditure commitments, the deficits of the states and local authorities have been increasing in recent years. This trend has been more pronounced for local authorities, whose deficits in the aggregate in 1972 were about 9 per cent of total outlays;[17] the deficits continued at a relatively high level in 1973 and 1974. State deficits in relation to total state outlays, by contrast, did not increase in 1972 and were considerably lower in 1973 than in 1966 and 1967 (see table 9-3).

A close examination of relevant statistical data lends support to the view that recent adjustments to the distribution of 'joint' taxes (implemented as part of Finance Reform) have greatly strengthened the financial position of the states as a whole.[18] State tax revenues from their own sources (that is, revenues from taxes assigned exclusively to the states) accounted for 18 per cent of total state tax

revenues in 1973 (compared with about 26 per cent in 1966).

Another important outcome of Finance Reform was the decision to channel 14 per cent of the yield from the wage and assessed income tax direct to municipalities. This decision has given municipalities a more flexible revenue base and hence the prospect of a lesser reliance on financial allocations from the states.[19] The yield from income taxes tends to grow at a faster rate than the gross national product. The municipal tax system in Germany has therefore now attained a better balance as between three bases — enterprise, population and real estate. In 1973 the municipalities derived 46 per cent of their tax revenues from trade and pay-roll taxes, 41 per cent from income tax, less than 10 per cent from property taxes and about 4 per cent from other municipal taxes. Seven years previously property taxes had accounted for 15 per cent of tax revenue and trade and pay-roll taxes almost 80 per cent.

Thus, while the deficits of the local authorities as a whole have been rising in absolute terms, the deficits do not seem to constitute a burden when related to other magnitudes. In any event fairly large-scale borrowing by municipalities would be a reasonable expectation in Germany, where municipalities are directly responsible for about two-thirds of all investment in the public sector.

Two further developments, related to Finance Reform and having an important bearing on municipal finances, should be noted at this juncture: (i) the distribution of revenue from the petrol tax; and (ii) the prospect of further changes in the *Verbundsystem*[20] which will enlarge the share of 'joint' tax revenues to be transferred to the municipalities.

Under the Constitution, revenue from the petrol tax (in common with all excise

Table 9-5

Tax Income of Federal, State and Local Governments 1966-73
(% change from previous year)

	1967	1968	1969	1970	1971	1972	1973
Federal							
Joint taxes	– 6.0	+ 10.4	+ 10.6	+ 21.9*	+ 13.0	+ 10.4	+ 14.7
Total tax income	+ 1.3	+ 5.1	+ 18.6	+ 6.8	+ 11.3	+ 9.2	+ 13.8
States							
Joint taxes	+ 2.2	+ 10.5	+ 20.7	+ 11.4†	+ 13.2	+ 20.9	+ 16.0
Total tax income	+ 3.6	+ 8.8	+ 18.1	+ 7.7	+ 12.5	+ 18.3	+ 15.0
Local authorities							
Joint taxes	—	—	—	‡	+ 16.3	+ 22.3	+ 18.8
Total tax income	+ 0.7	+ 5.0	27.0	– 1.9	+ 15.2	+ 19.5	+ 16.3

* Comparison is with income tax revenue and turnover tax revenue (excluding tax on imports) actually received in 1969.

† Comparison is only with income tax revenue received in 1969 as the states did not share in the turnover tax until 1970.

‡ In 1970 municipalities received for the first time a direct share of income tax revenue (see text).

Source: *Finanzbericht* (various issues).

taxes, except beer) is assigned to the Federal Government. Revenue from this source has grown rapidly in recent years (rising from DM6·1b in 1964 to approximately DM12b in 1971). Under an agreement in force since 1967, the Federal Government contributes from its petrol tax revenues about 50 per cent of the cost of approved projects for road building in municipalities. The states are by-passed in this arrangement. In 1971 municipalities received approximately DM1b in revenue from the petrol tax, or 8·3 per cent of the total yield from the tax.

The Commission on Tax Reform, which released its *Report* early in 1972, had proposed a reduction by two-thirds in the current revenue which the municipalities derive from the trade tax.[21] The Commission also favoured an increase in the municipal quota of the income tax (currently 14 per cent)[22] and proposed that municipalities should share directly in the proceeds from the value-added tax.[23] These proposals have not been implemented at time of writing and, indeed, there is no immediate prospect that they will be in view of the 1975 fiscal reform. However, a further extension of the *Verbundsystem*, with municipalities gaining direct access to a portion of revenue from the value-added tax, would seem to be a logical development as the trade tax is gradually phased out. In the planning period to 1975 the tax revenues of municipalities were rising at an average annual rate of 10 per cent, compared with an average annual rate of increase for *all* levels of government of 8 per cent. In addition, the Financial Planning Council had repeatedly stressed the need for the states to increase their allocations to local authorities in line with an increase in the budget resources of the states.[24] The Financial Planning Council (or Council for Medium Range Planning), which comprises representatives of the three levels of government and is designed to co-ordinate the financial planning of each level, was set up under the *Economic Stability and Growth Law* of 1967 (for further comment see chapter 19).

Looking ahead it seems likely that a further improvement in the financial position of states and local authorities can be expected. Adjustments to the distribution of the value-added tax, the higher yield of the petrol tax and other anticipated changes in the distribution of revenue between the three levels of government are likely to permit further increases in infrastructure and other investment without excessive state or municipal borrowing or an undue strain on economic resources.

Advantages of the System Used in West Germany for Regulating Vertical Fiscal Imbalance

The full significance of the 'mixed' tax distribution system in Germany — the system in which taxes are either assigned to a particular level of government (*Trennsystem*) or shared jointly between levels of government (*Verbundsystem*) — cannot be gauged until there has been an opportunity to consider the machinery that has been established for intergovernmental financial planning and co-operation under the *Economic Stability and Growth Law*.[25]

The advantage claimed for the *Verbundsystem* is that both the Federal Government and the states (and now the local authorities) share in tax development; they all benefit as the economy expands. In view of the large and growing expenditure commitments of the states and the desire to avoid excessive state borrowing and/or piecemeal federal subsidies to states and local authorities on an *an hoc* basis, the Troeger Commission

flatly rejected the notion that, because of federal responsibilities for economic stability and growth, all income tax revenue should go to the Federal Government.[26] In fact the *Verbundsystem* was carried a stage further by adopting the proposal of the Commission that value-added tax revenue should also be distributed between the central and state governments.[27]

Use of the *Verbundsystem* as the main instrument for regulating vertical intergovernmental financial imbalance seems to have been an almost unmitigated success. It has, in particular, avoided many of the problems which arise when massive grants from the centre are used for that purpose.

The German system for regulating vertical imbalance has the prime advantage of simplicity and it has proved to be remarkably resilient over a 25-year period. Competition between rival taxing authorities is avoided, massive grants from the centre are not needed, and the important influence of the *Bundesrat* ensures that a handful of federal officials are unable, without proper explanation and due consultation, to impose their will on the states. State bargaining for short-term political advantage is also kept to a minimum.

The logic of the system is incontrovertible. The distribution of 'joint' taxes is designed to ensure that revenue receipts at each level of government are broadly commensurate with expenditure requirements at each level; and the available evidence certainly suggests that a high degree of success has attended efforts to attain this goal.

The distribution of tax revenues between the three levels of government is clearly set out in the Basic Law, but this law is not immutable. This is especially true of the state share of revenue from the value-added tax, a share which can be, and has already been, adjusted to take account of differing revenue-expenditure trends as between each level of government. It will be necessary to modify the tax distribution from time to time by varying the share of joint taxes to be received by each level of government. An awareness of this reality came to the fore in the course of discussions between federal and state officials concerning the distribution of value-added tax revenue in 1972.[28] Moreover, as noted above, the Tax Reform Commission proposed that local authorities should also participate directly in the proceeds of the value-added tax.

In West Germany horizontal fiscal equalisation at the state level is explicit and is not mixed up with the vertical financial settlement (although both are regulated by federal law). The separation is accomplished by a stipulation that the state share of income taxes is to be distributed between the states on a 'derivation' basis, in accordance with the income tax receipts actually collected in each state. Although on the surface this separation has been blurred somewhat by the recent decision to have the state share of the value-added tax distributed between states on a population basis (with provision for 25 per cent of this amount to be distributed beforehand to financially weak states), the basis of the separation is clear and the amount of horizontal fiscal equalisation at the state level can be readily ascertained. Thus, the intermingling of federal grants for purposes of vertical (federal-state) settlement and horizontal (interstate) settlement, which has emerged as one of the less satisfactory features of the financial settlement in Australia, has so far been avoided in West Germany. A clear separation is also accomplished in Canada.

The related tendency for federal grants

in Australia to be a product of short-term political bargaining is also largely absent in Germany. Machinery for intergovernmental financial co-ordination in Germany (see chapter 19) is designed to ensure that grants from the centre (most of which are earmarked for specific purposes)[29] are determined largely as a consequence of, and have a firm basis in, economic cost-benefit calculations with respect to specific projects.

Apart from horizontal fiscal equalisation at the state level (dealt with in Part III), federal grants in Germany fall into two broad categories: financial assistance for 'joint tasks' (the proportion of federal assistance usually being specified in federal law) and financial assistance to combat recession or for structural and other long-term purposes. As the terms and conditions of these grants are determined within the framework of sophisticated machinery for joint consultation and planning between the three levels of government, a full treatment is reserved for Part IV.

10 Inter-Country Comparisons

One method of gauging the magnitude of vertical fiscal imbalance is to compare, for each country, the revenues raised by state and local authorities as a proportion of total revenue (federal, state and local) with expenditure undertaken by state and local authorities as a proportion of total expenditure (federal, state and local). A comparison of these ratios, set out in table 10-1 indicates clearly that the 'gap' is far larger in Australia than in the other three federal countries.

Table 10-1

*State-Local Proportion of Total Revenue and Expenditure**

(per cent)

	Revenue	Expenditure
Australia (1972-73)	25	53
Canada (1972)	51	61
United States (1973)	36	46
West Germany (1973)	55	57

* Excludes intergovernmental transfers and debt transactions.

Source:
Australia: *National Income and Expenditure, 1972-73.*
Canada: Canadian Tax Foundation, 'The National Finances'
United States: *Survey of Current Business,* February 1974, p. 13.
West Germany: *Finanzbericht.*

An alternative approach is to compare the different income or revenue components, along the lines of chapter 4. Thus, on the basis of data for a six-year period (1968 to 1973) the coefficient of vertical balance (v) for each of the four countries has been calculated in table 10-2.

Table 10-2

Coefficient of Vertical Balance — I

	v′	v″
Australia	0.681	0.354
Canada	0.790	0.710
West Germany	0.837	0.821
United States	0.808	0.808

Source:
Data have been derived from the following sources:
Australia (averages for the six years, 1967-68 to 1972-73): *National Accounting Estimates of Public Authority Receipts and Expenditure, Supplement to the Treasury Information Bulletin,* December 1972, Table 1; and *Commonwealth Payments to or for the States,* 1972-73, Table 51.

Canada (averages for the six years, 1967-68 to 1972-73): Canadian Tax Foundation, *Provincial and Municipal Finance.*

West Germany (averages for the six years, 1967 to 1972): *Finanzbericht* 1973.

United States (averages for the six years, 1968 to 1973): U.S. Department of Commerce, *Survey of Current Business.*

Note: With the exception of the United States, where state and local authority expenditures are amalgamated, state expenditure includes transfers to local authorities.

Where $v' = 1 - \frac{G_c + B}{E}$

$$v'' = 1 - \frac{G_o + G_c + B}{E}$$

G_o = unconditional federal grants to the states
G_c = conditional federal grants to the states
B = net borrowing by the states
E = expenditure by the states

For reasons already given in chapter 4 (e.g. the practical difficulty of assigning weights to each income component) these results must be treated with great caution. In each measure the states' own taxes (T_o), the state share of 'joint' taxes (T_s) and state non-tax revenue (R) are assumed to be wholly under the complete control of the states. It is possible to challenge such an assumption, although in defence two points may be noted: (i) the inter-country comparisons are not greatly distorted since the existence of a high degree of control is well known as far as Canada, the United States and, to a lesser extent, Germany are concerned; and (ii) in so far as matching finance (involving changes in T or R) is closely geared to the size of conditional grants-in-aid (G_c), then any change in the latter (in relation to total state expenditure — E) will be reflected in the v values. Thus, to take an extreme case in which state expenditures are financed entirely by grants-in-aid (the latter being controlled from the centre)

$$v = 1 - \frac{G_c}{E} = 0$$

However, it is not entirely satisfactory to assume that all conditional grants-in-aid (G_c) lessen state autonomy. A large part of G_c will, in all probability, reflect national priorities which cannot be expected to coincide with those set by the states. But it has already been pointed out that these grants in Australia (specific purpose grants) reflect a mix of federal and state initiatives. In Germany, most grants in this category are assessed on the basis of intergovernmental planning which forms an integral part of the particular brand of co-operative federalism found in that country.[1] The opting-out procedures in Canada also give provinces the opportunity for greater financial autonomy.

It therefore appears that the v′ measure overstates, while the v″ measure understates, the extent of vertical fiscal balance in each country. In Germany it makes little difference which measure is selected since most grants from the centre are of the specific purpose variety. The same was true of the United States before 1973. But the advent of revenue sharing is a move which should, on balance, strengthen state fiscal autonomy since the states have greater freedom in the use of revenue-sharing funds than they have with funds provided under grants-in-aid programs. In some respects the US revenue - sharing system is similar to the Australian financial assistance grants (G_o).[2]

When account is taken of the foregoing and the fact that states or provinces have independent borrowing powers in the US and Canada and are reasonably free of federal control in Germany (contrast with Australia) estimates of vertical balance have been made (table 10.3) where

$$V''' = 1 - \frac{G_o''' + G_c''' + B''' + T_s'''}{E}$$

and G_o''' ... T_s''' represents a weighting of actual grants, borrowing and shared taxes in accordance with estimates (for each country) of the degree of central control.

Table 10-3
Coefficient of Vertical Balance — II
(estimates)

	v‴
Australia	0.55
Canada	0.80
West Germany	0.85
United States	0.85

These results are, broadly speaking, consistent with the picture as presented in table 10-1. When all aspects are considered the states or provinces in Germany, the United States and Canada enjoy a fairly high degree of financial autonomy — much higher than that of the Australian states. State dependence on borrowing and on centrally controlled grants-in-aid programs is relatively low in both Canada and Germany. This is explained by large tax revenues which accrue to the states or provinces under various agreements in both countries; and in each country the states or provinces are able to exert considerable influence on the size of their tax share.

Vertical intergovernmental fiscal imbalance is seen to be considerably greater in Australia than in most federations. Financial assistance grants may be viewed as a substitute for state participation in growth taxes (although Australian Governments have been unwilling to concede this point) but, as is well known, the grants are to a large extent manipulated at the behest of the central government and relatively large grants (in per capita terms) are made to states with below-average per capita incomes. The grants are not returned to the states on the basis of derivation or source of revenue. It is not therefore realistic to treat all or most of these grants (G_o) as being under state control as in the v' measure.

In Australia, vertical fiscal imbalance is a consequence of federal control over major taxes (income and sales taxes) and of borrowing. State dependence on federal grants has increased to fill the gap and in more recent years specific purpose grants, which limit state freedom of action, have increased faster than untied grants. However, despite this trend, specific purpose grants are far less important, in relation to untied grants, than in the other three federations.

Although there is evidence that Australian states as a whole have made a greater tax effort in recent years, state tax receipts in 1973-74 were only 32 per cent of total state outlay. This contrasts with 75 per cent for Canada and 84 per cent for Germany (if the proceeds of tax sharing are included).

State dependence on borrowing is also greater in Australia. Debt charges constitute a much larger proportion of total budget outlays of the states in Australia than they do in Canada or Germany. As noted in chapter 6, the Australian Government in 1970 moved to ameliorate this problem and state dependence on borrowing, while still relatively large, is much less than it was ten years ago.

In Australia, there has been an alarming proliferation of different grants to meet special problems. The system stands in urgent need of rationalisation. The best way to do this would be to devise a tax-sharing arrangement with respect to the personal income tax, with uniform rates and structures and with separate provision for horizontal fiscal equalisation.

Access to personal income tax and distribution on a derivation basis would give the states an elastic revenue base, providing an automatic increase in revenue to match expenditure commitments as the economy expands. Since states with low taxable capacity and large expenditure needs would lose revenue in consequence of a withdrawal of financial assistance grants, special action via explicit equalisation would be necessary to compensate those states adequately. This suggests a wider role for the Grants Commission in recommending special grants to states to enable them to provide public services at a level comparable with

the more affluent states (see chapter 12).

Australian states secured several concessions from the Federal Government in the early 1970s, of which the most important were the lessening of their debt burdens and the transfer of pay-roll tax. By 1974-75 the states were also more self-reliant than they had been ten years previously. This resulted from the pay-roll tax transfer and the exploitation of other taxes, including the imposition by several states of franchise charges. Despite these changes, the states have a legitimate basis for complaint when they are able to observe a persistent tendency for increases in general revenue assistance (untied grants) to fall behind the growth of federal income tax receipts. The discrepancy was especially marked between 1972 and 1974, a period in which the Australian Government took action in many areas, through specific purpose grants, to lessen state autonomy.

The weaknesses of Australian fiscal federalism can therefore be pinpointed as follows: (i) a large vertical imbalance; (ii) a proliferation of federal grants; (iii) the *ad hoc* nature of federal assistance to particular states; (iv) the growing extent of federal control over state spending patterns through the use of specific purpose grants; and (v) heavy dependence by the states on borrowing.

These weaknesses are interrelated. Action to reduce the vertical fiscal imbalance will, at one stroke, erase or at least ease the remaining problems. Intergovernmental sharing of the proceeds of personal income tax would not in any way impair the effectiveness of fiscal policy or the ability of the Australian Government to vary tax rates for purposes of overall fiscal control. Interstate tax uniformity would also be preserved. Such tax sharing would, however, have the major advantages of lessening vertical fiscal imbalance, reducing dependence on federal grants and on borrowing, and slowing down the increase in regressive state taxes and charges. Tax sharing would also make it possible to devise an orderly arrangement for assessing and dealing explicitly with the fiscal needs of particular states.

One may also question the present role of the Loan Council and the use of specific purpose grants to promote public investment without the express approval of the Council. But this matter falls more properly into a discussion of economic planning in a federation, as dealt with in Part IV.

Although tax sharing takes on a completely different form in West Germany, there has been persistent pressure in both Canada and West Germany to adjust the distribution of tax revenues so that it conforms more closely to the changing pattern of expenditure commitments as between the two main levels of government. Such adjustment in both countries is made as a result of intergovernmental agreement.

In Canada various intergovernmental agreements have followed conferences of political leaders and their officials. At these conferences revenue and expenditure trends are analysed. Also, the Dominion Government has displayed a good deal of enthusiasm for a system which enables particular provinces to tax at the margin to meet an increase in their expenditures. The greatly expanded role of the provinces in regional development in the 1950s was matched, not by a federal takeover of state functions, but by revised arrangements in tax sharing which soon had the effect of bringing more revenue sources under a measure of provincial control.

In Germany, where interstate tax uniformity is paramount, federal and state officials are continuously in touch with

revenue and expenditure developments at each level of government. Finance Reform was an occasion for making the fiscal system more responsive to state and local expenditure needs, principally by new federal legislation which widened tax sharing and permitted greater flexibility in assigning revenue to the states and local authorities. But this was done without undermining overall control of the economy. Since 1970, vertical financial settlement has been secured mainly through changes in the percentage of value-added tax revenues which flow to the states; and these changes must, according to Article 106 (4) of the Constitution, reflect differential trends in revenue and expenditure of the Federal Government and of the states. A powerful state voice in decision-making is assured by virtue of the special position and influence of the Council of States.

In the United States a prime objective of revenue sharing in 1972 was to lessen vertical fiscal imbalance and provide more scope for independent decision-making by state and local authorities. However, the imbalance appears, in retrospect, to have been exaggerated. In the last three years or so state and local authorities have had large surpluses while the Federal Government has faced large deficits. Where, then, is the 'fiscal dividend' to come from? While the original justification for revenue sharing in terms of a basic intergovernmental fiscal imbalance has therefore receded into the background, revenue sharing does have other major advantages. These include the provision of a more elastic revenue base for states and local authorities and the opportunity to secure important equalising effects.

In Australia, the intermingling of financial assistance grants for vertical and horizontal fiscal adjustment bears some similarity to the US revenue sharing scheme; the latter also aims to achieve equalising effects as well as a reduction in vertical fiscal imbalance. Neither system can be regarded as 'tax sharing' in the strict sense, as noted in chapter 5. However, whereas the Australian financial assistance grants are adjusted annually for wage increases, the US revenue sharing fund is fixed by legislation for a five-year period, and the real value of the revenue-sharing payments is therefore diminished by inflation.[3]

In contrasting Canada with other federations — especially Australia and Germany — allowance has to be made for attitudes regarding the ability of the central government to pursue an effective fiscal policy. Does tax sharing make demand management more difficult? In Australia it seems to have been assumed by successive governments in Canberra, and more importantly perhaps by those who have advised those governments, that tax sharing will impede a flexible fiscal policy. But convincing reasons for this view have never been forthcoming. Although the stabilising effects of fiscal policy have been far from impressive in recent years, the Federal Government has continued to base its opposition to a resumption of income tax powers by the states on the claim that the latter would inhibit an effective fiscal policy.

In Germany a similar argument has been used to justify an extension of federal fiscal powers. Federal legislation between 1966 and 1970, while assisting the states through a more flexible revenue-sharing arrangement, was also designed to shift some of the emphasis from monetary policy and to strengthen fiscal powers at the centre.[4] It is noteworthy that the *Bundesrat* gave its strong support for these proposals. In fact several proposals were the outcome of initiatives taken in that Chamber.

The contrast is with Canada, where there has been much scepticism regarding the alleged potency of fiscal measures. This scepticism may not seem misplaced in the light of developments in many countries since 1965. In any event, Canadian experience provided strong reasons for believing that centralisation of financial power is *not* a necessary condition for achieving economic stability and a good growth performance. According to Hood,[5] Canadians have never been ardent practitioners of the art of compensatory fiscal policy. This apparently stems from an innate fear of deficits and doubts about the efficacy of fiscal policy with respect to timing and flexibility. Rightly or wrongly, the Federal Government since 1962 has not been able, with confidence, to use tax policy to combat recession, because its efforts may be nullified by provinces which raise their own tax rates. This prospect has deterred the Australian authorities from acquiescing to pressure for greater fiscal decentralisation but does not appear to have unduly concerned the Canadians, or the Americans for that matter. In both these countries the federal authorities have urged state and local authorities to use income and other taxes more freely, even though this might reduce federal tax collections. A technique used in the United States to reduce vertical fiscal imbalance has been the allowance of most taxes paid to states and local authorities as deductions against federal personal and corporation income tax liabilities. Moreover, the tax effort clause in revenue sharing is designed to induce states to make a greater use of their income tax powers.

The federal systems of Australia and Germany are similar in that great stress is put on tax uniformity (at least for the major taxes) and on avoidance of tax competition. In both countries the central government does not have to worry about the states undermining federal authority through independent action on taxes. But that is about as far as the similarity goes. Unlike Germany, there is no tax sharing as such in Australia, there is a heavy reliance on unconditional federal transfers for vertical financial adjustment and, as yet, little evidence of forward overall planning for the economy as a whole. There is certainly no indication from Canberra that states might have a role to play in such planning. The German states are, by contrast with their Australian counterparts, in a strong position to bargain with the federal administration. This is mainly a product of the important role played by the *Bundesrat* as a House of the States and not merely as a House of Review. It should be added that the Federal Constitutional Court in Germany has brought down decisions which have tended to strengthen the power of the states in certain key areas, such as education and culture. Relevant judgments of the High Court in Australia have, until the recent Tasmanian Tobacco case decision, usually had the opposite effect.

Part III Fiscal Federalism: Horizontal Balance

11 Rationale of Horizontal Fiscal Equalisation

Meaning and Aims

This chapter deals with the rationale of horizontal fiscal equalisation transfers between states in a federation. Interstate fiscal equalisation is usually thought of in terms of preferred fiscal treatment to regions whose per capita incomes are below the national average or some composite figure representative of economic performance in high — or above-average income regions. Such equalisation is accomplished by the transfer of funds, usually by way of federal grants, to areas in the low-income category. These transfers are, ideally, of a 'balancing', nature, in that the amounts to be transferred are calculated after the impact of all other government transfers — mainly transfers to regulate the vertical intergovernmental fiscal imbalance and to satisfy certain national and other objectives — have been taken into account.

Hence it is necessary to have in mind a clear distinction between federal grants to regulate the vertical imbalance (that is the fiscal imbalance between the federal government on the one hand and the states as a whole on the other) and federal grants designed for purposes of horizontal fiscal equalisation between states (that is grants designed to equalise for differences in income and/or tax capacities and the standard of government services among the states).

When federal grants are used to correct for vertical imbalance by compensating the states for loss of tax revenues, they will usually be distributed on a 'derivation' or local collection basis. Such distribution will tip the scales heavily in favour of highly industrialised and densely populated states. Equalisation grants can be expected to lessen the impact of such a distribution on the less affluent states.

An important aim of the equalisation grants will be to ensure that each state has at its disposal the financial resources that would enable it to attain at least a certain minimum level of public services without resorting to an unduly heavy tax burden on its citizens.

The aim is not necessarily to achieve a state-by-state uniformity in tax treatment or in the level and quality of government services, since such a requirement would be tantamount to a negation of federal principle in which states are left reasonably free to allocate funds according to consumer preferences and their own assessment of needs and priorities. The appropriate aim is the more limited one of enabling state governments to aspire to the standards of the more affluent states, should they wish to do so. State freedom of action should as far as possible be preserved. In more general terms, a state receiving additional funds should be able to choose between a higher level of public services and lower taxes. This is one reason why equalisation grants are usually made without strings attached as to the particular use to which the funds are to be put.

The central aim of interstate financial equalisation is easily stated, and may even be widely accepted. While agreement on broad principles may not be difficult,

the way in which these principles are interpreted when it comes to assessing the financial needs of particular states is less straightforward and unambiguous. The approach to fiscal need and fiscal equivalence — the criteria employed in assessing the 'correct' amount of fiscal equalisation appropriate for each of the qualifying states — varies from country to country. The concept of fiscal need is indeed a slippery one. It can mean quite different things to different people in similar circumstances.

While there are certain common ideas running through the equalisation systems now employed in Australia, Canada, the United States and West Germany, there are also several important differences. We turn shortly to consider the methods of interstate fiscal equalisation used in each of these countries; but first it seems sensible to establish a suitable rationale for making these grants in the first place.

Arguments for Equalisation Transfers

In chapter 3 it was pointed out that the layer-cake model of public sector activity required substantial modification in a federation in which there were substantial differences in interstate tax capacities and in the costs of providing comparable services.[1] Since these differences are quite marked in most, if not all federations, it was concluded that equalisation grants would in all probability play an important role even though central governments may be reluctant to go much further than set minimum standards for services to be provided in each state.[2]

In the United States there is little to resemble the rather elaborate procedures for interstate fiscal equalisation which have been adopted in Australia, Canada and West Germany. In these three countries the purpose of horizontal equalisation is to narrow differences in state taxable capacities and/or expenditure needs. But to justify such a policy (whether the equalisation transfers take the form of payments between states as in West Germany, or of allocations from the federal budget as in Canada or Australia), it has to be demonstrated that there is a net benefit to the nation as a whole from a redistribution of tax revenues from financially strong to financially weak states. The demonstration of net benefit will inevitably lean heavily on value judgments of one sort or another. Even if equalisation transfers could be shown to reduce real income below the level it would have reached in the absence of the transfers, offsetting factors in terms of political and social pressures would in all probability outweigh the purely economic considerations. The benefits to be derived from the transfers can be part economic, part social and part political in terms of resource allocation, financial need, greater uniformity in living standards and perhaps the opportunity for low-income states to support certain minimum standards of public services.

Although national governments have with few exceptions moved to assist low-income regions in this manner, it has proved to be a difficult assignment to demonstrate that this action will necessarily result in a net benefit to the nation as a whole.

There are several arguments, containing a mixture of economic, social and political elements, which are advanced in support of equalisation transfers. These, briefly stated, are as follows:

(i) If grants are withheld, the relative position of the poorer states will deteriorate still further since there will be an incentive for labour and capital to move elsewhere — including resources whose productivity compares favourably with that in other parts of the country.[3]

(ii) If interstate income differences are large, the political pressures for equalisation transfers will undoubtedly be strong. The central government will feel a responsibility to see that all states are placed in a financial position that will make it possible for them to provide public services up to a level regarded as adequate in the light of standards established in the more affluent states.

(iii) Closely related to (ii) is the partly social and partly political argument that public services should be fairly uniform throughout the country. With regard to social services and education — and perhaps police — people have come to expect reasonably similar standards. Against this we have what Professor Musgrave has termed the 'multi-unit bias of fiscal location theory', which stresses interregional diversity and the need to allow a matching of spending decisions at the regional level with preferences exerted by citizens at that level. If preferences for particular services (e.g. education) differ as between states or regions (and this is more apparent in the United States and Canada than it is in either Australia or West Germany), then we may readily agree with Musgrave that each state or province should be able to exert an influence on the type of education system it adopts.[4] But this argument is not incompatible with horizontal equalisation transfers between states or provinces (or between areas within such states or provinces). National policies may stress the need for greater interstate uniformity in the provision of public services; and equalisation grants can then be used by the recipient governments to improve standards and bring them nearer to the levels which prevail in the more affluent states or areas.

Economic Rationale

Several economists have, however, been critical of the use of equalisation grants, mainly on grounds that such grants interfere with the optimum allocation of economic resources. What is the justification for these grants on economic grounds?

In an earlier discussion of economic theory relevant to fiscal federalism (in chapter 3), it was seen that by using broad welfare criteria it was not difficult to establish a basis in principle on which to support equalisation transfers between states or regions.

The proposition was that the welfare of the nation as a whole could be enhanced through appropriate equalisation machinery established at the centre. But an underlying assumption was the absence of resource-distorting effects; and this is a problem which can no longer be put aside.

The benefits of interstate fiscal equalisation, especially the economic ones, can be more imaginary than real. Interstate fiscal transfers may, for example, distort the resource pattern and cause real output for the nation as a whole to be lower than it would be in the absence of the transfers.[5]

However, it is necessary to perceive the so-called resource problem in its proper context. Most of the debate on this issue stems from the work of Professors Buchanan and Scott.

Buchanan-Scott Controversy

The most persuasive argument in favour of interstate fiscal equalisation has been put forward by Professor Buchanan on the basis of the principle of fiscal equity. This principle means that there should be equal treatment for equals whatever the geographic location.[6] The place of residence should not have a significant effect upon an individual's fiscal position. In accordance with this principle the desired

aim should be equal fiscal pressure upon the individual or family. The concept of fiscal equity is based on the rights and needs of individuals.[7] The fiscal residuum, by which Buchanan means the balance between contributions made (taxes) and the value of services rendered (benefits), should be equal for all persons similarly situated.[8] Only then do you have an equitable fiscal structure.[9]

If the principle of the fiscal residuum is adhered to, people in low-capacity or low-income areas must receive federal grants to offset the greater fiscal pressure (*vis-à-vis* high-income areas) to which they are subject. These grants must therefore be designed to compensate lower-income areas for their relatively high taxes and/or inferior public services. Citizens of low-income areas have the right to be placed at fiscal equality with their equals in other areas. The fiscal transfers necessary to ensure this must not therefore be regarded as gifts or subsidies.[10]

Professor Graham argued that equal fiscal residue does not necessarily mean equal fiscal treatment, since it is unlikely that a family will be indifferent between, for example, low taxes and inferior education as one option and high taxes and superior education as another, even though the fiscal residue is the same in each case.[11] According to Graham, a typical family will choose the second option. A family will feel indifferent between the two options only if public and private goods are perfect substitutes, which is unlikely to be the case. It may therefore be argued that the principle of the fiscal residue should only be implemented to the extent that states with below-average fiscal capacity are able more easily to attain a certain minimum level of public services. We can readily agree with Graham that 'autonomy means very little to the poorer provinces ... unless they have sufficient financial resources to perform their functions at levels comparable to those in other provinces.'[12]

Despite the modification suggested by Graham, the Buchanan fiscal equity approach provides a clear justification for federal financial transfers independent of any particular area or group of services. There is a clear separation of unconditional grants for equalisation purposes and other grants (conditional and unconditional). Although separated, the two are interdependent in the sense that an efficient method of equalisation can in time be expected to lessen the need for grants designed specifically to further certain national objectives. By way of illustration, if equalisation grants enable the recipient states to improve the standard of their education services they may also be expected to lessen the need for, or at least reduce the volume of, specific grants for that purpose.

Buchanan's fiscal equity principle can be said to establish a suitable rationale for federal equalisation transfers; and it is interesting that Buchanan defends this principle on economic (or efficiency), as well as on equity, grounds.[13]

A more cautious approach to interstate fiscal equalisation is suggested by several economists, who stress the danger that these grants, while desirable in point of equity, may adversely affect the allocation of resources and hence be inappropriate from the standpoint of economic efficiency.[14] It would clearly be unwise to pursue redistributional goals via equalisation transfers if the principal effect was merely to divert funds from more productive uses. To transfer funds from an area of high development potential to an area of low development potential would run counter to the economic ideal of securing the best use of

the nation's resources.[15]

In reality it is sometimes difficult to judge what is, in fact, the most productive use of resources because short and longer run situations are difficult to compare and evaluate. Thus when Professor Scott refers to the cost of equalisation transfers as being the loss of the theoretical maximum real GNP of a federal state, it is not at all clear what time horizon is contemplated.[16] Loss of a theoretical maximum product in the short run may be an acceptable price to pay for fiscal equity, provided the recipient states use the funds to improve the standard of their public services (education, transportation and health services, for example), and thus enable a more efficient resource allocation in future, and provided the recipient states do not simply reduce taxes or use the funds for non-productive purposes. Unless there are safeguards against such an occurrence, it seems legitimate to question whether equalisation grants should be unconditional. If there are no strings attached there can be no guarantee that the funds will be used to improve the standard of public services. If grants are unconditional the objectives may not be achieved.[17]

Up to this point there therefore seem to be no solid grounds for rejecting the use of equalisation transfers to correct for differences in fiscal capacities. The fact that real GNP may be fractionally lower than it would otherwise be is not necessarily a sound reason for rejection. In the long run equalisation transfers, if used to improve the standard of education, health and transportation services, are likely to assist in raising the capacity for development in the recipient states, even though such transfers may mean that in the short run the full development potential in higher-income states cannot be reached.

If the equalisation grants are used to improve public services it seems likely that the mobility of labour in low-income states will be enhanced and hence lead to a greater emigration to the high-income provinces.[18] Thus the longer run effect is likely to be resource-correcting rather than resource-distorting. Equalisation transfers which raise the quality of education — especially training for particular skills — in low-income states may, for example, widen employment opportunities and thereby enhance opportunities for development in these states over a longer term. As an investment in human capital, education may ultimately widen opportunities for real investment. Improved education and social services may also be expected to enhance the mobility of labour, capital and enterprise and make for a more competitive environment, in which case equalisation transfers will not interfere with the optimum resource allocation.[19]

Thus the growth argument against these transfers is far from persuasive. The usual practice for these transfers or grants to be unconditional is, however, open to challenge, but again the conflict of objectives inherent in a federation leads to an impasse. If it is desired that states retain maximum freedom in allocating funds in line with their own assessments of relative needs — and this principle of diversity is rather basic for the continued existence of the federal form of government — one can argue that equalisation payments need to be unconditional. If the grants are given in unconditional form, the goal of evening out tax capacity differences between states will be realised but the goal of equalising interstate performance in relation to the provision of public services is not necessarily realised.

In view of the socio-political argument mentioned earlier, a rebuttal of the central

economic argument that equalisation grants are bad for resource allocation — that they tend to discourage the movement of resources from low- to high-productivity areas — would make the case for these grants overwhelming. However, such rebuttal is proving to be a difficult assignment. In fact the question of the likely impact of equalisation grants on resource allocation has developed into a controversy which has not yet been resolved, and probably never can be at the purely abstract level.

Are policies designed to raise service levels in low-income states likely to necessitate an interference with the most efficient use of resources? Will the grants induce labour and other resources to remain in the poorer states even when their productivity at the margin would be higher in other states? The answer to these questions, on the theoretical level, depends on the particular assumptions that are selected about the degree of labour mobility, the degree of homogeneity in the factors of production, the way in which the funds are used in recipient states, the uses to which these funds would have been put in the absence of the grants, and so on.

Several writers have made important contributions in an attempt to resolve the dilemma.[20] But the leading roles have undoubtedly been taken by Professors Scott and Buchanan. Scott's point of view seems to be in direct confrontation to Buchanan's justification for equalisation grants based on the fiscal equity principle.

The argument, as presented by Scott, is as follows: the maximum income for the whole country will be achieved by maximising national production. This is turn can only be achieved when resources and labour are combined in such a way that the marginal product of similar units of labour is the same in all places. An increase in national production occurs when labour is transferred from places where its marginal product is low to places where it is high. Up to that point there can be little argument, except perhaps to challenge the overriding importance attached to national production and to question the time period that Scott has in mind. But the main bone of contention centres around Scott's insistence that transfers of government income from place to place counteract the incentive for labour mobility and hence prevent national production from reaching its maximum. As more amenities are provided to poorer states, the outward mobility of labour in accordance with the marginal productivity principle will be constrained.[21]

Buchanan was quick to take up the challenge.[22] He argued that income differences are not due solely to resource disequilibria, as Scott implies; but even if they are, the proposition that a transfer of income from high- to low-income areas will impede the desired resource movements is not necessarily valid.[23] Allowance has to be made: (i) for the mobility of capital as well as labour; and (ii) for the fact that human resources are not homogeneous.

On the first point, the provision of highways in low income areas will tend to attract capital to these areas, and this will help resource adjustment, not retard it (since poorer areas are assumed to have an abundance of labour relative to capital).[24] Likewise, better education facilities in low income areas not only help these areas to become more industrialised, but they make people more conscious of opportunities elsewhere, and hence promote a net out-migration from the lower income areas. They may also promote an inflow of capital to those areas. Again this helps and does not hinder resource adjustment.[25] On the other hand it is conceded

that if the funds are mainly expended on welfare services, the effects may be resource distorting in so far as an outflow of labour is prevented.

It also makes a great deal of difference what assumption is made about labour homogeneity. If the equalisation transfer reduces the outflow from poorer areas of highly skilled personnel already in short supply in those areas, the transfer is resource correcting; and this will then have to be set against the resource-distorting effects which result when unskilled or semi-skilled labour, in abundant supply in the poorer areas, is not induced to leave those areas.

Scott's rejoinder to Buchanan was based on the proposition — which is difficult to refute — that areas are relatively poor mainly because they are poor in natural resources. The prime issue according to Scott is not whether better education and the provision of capital and enterprise will assist the poorer states (he does not doubt that they will) but 'whether the same resources will pay greater dividends in poorer provinces than they would if transferred to rich provinces'.[26] Scott therefore relies on conventional economic doctrine in terms of opportunity cost analysis. The fact that the endowment of natural resources varies considerably between states means that there will be wide variations in the additional productivity that will result from the application of units of productive factors in these areas. The opportunity costs (returns forgone) of the mobile factors may be greater than their yield in the poorer states. In other words, we must, in the present context, compare the net yields from using resources in different regions. If yields are much lower in the poorer regions (as we might expect, at least in the short run) the transfer cannot be justified on the usual criteria of economic efficiency.

The viewpoints of Professors Scott and Buchanan can be reconciled once it is realised that the major difference stems from the use of the word 'poor'. Scott uses this word to mean an area with relatively scarce natural and other resources, whereas Buchanan has in mind an area with relatively low current income.[27] According to Mushkin, 'many low income states have demonstrated that they have sufficient natural resources to justify the immigration of capital and enterprise'.[28] Account must also be taken of the fact that amounts represented as equalisation transfers are, for the most part, very marginal in relation to budget aggregates of the recipient authorities.

Enough has been said to indicate that the resource effect cannot be determined *a priori*. There is no strong presumption that a fiscal system based on the fiscal equity principle will be in conflict with the goal of optimum resource allocation; but neither is there a presumption that the principle will *not* be in conflict with this goal. In each country it will be necessary to look at particular expenditures, consider how the transfer is carried out, and allow for the possibility that the transfer may not lead to any increase in expenditures on basic public services in the recipient states (this may be the outcome if matching conditions do not apply).

Summary

To bring the main threads of the foregoing together, the following points can be made:

(i) In considering the justification for equalisation grants, certain inherent conflicts in a federation become readily apparent. On the one hand there are the centralising tendencies, especially the political and social pressures for uniformity; and on the other hand there is the

proposition that states should be free to make decisions on taxes and on the allocation of funds between competing uses, in line with their own particular assessment of needs and priorities.[29] A suitable compromise might be to allow equalisation grants to be largely unconditional but with some machinery at the federal level to ensure that each region does, in fact, use the additional funds to raise the standard of its public services at least to a stipulated minimum, preferably based on average experience in the nation as a whole.

(ii) It is desirable that equalisation grants should be sufficient to ensure that each state can aspire to certain minimum levels of public service without the need to resort to unduly high taxes. This limited objective has the major advantage that grants will cease once these minimum levels are reached; otherwise a relatively poor area which remains a relatively poor area (which seems probable since the wealthier states are likely to become even wealthier) will always be a recipient of equalisation grants. However, experience in several countries suggests that these minimum levels are likely to be raised as society in general becomes more affluent. This means that equalisation grants are likely to be a permanent feature of a federal system. Moreover, these grants are unlikely to be unduly burdensome provided real incomes are rising in the affluent states.

(iii) It is clearly *not* desirable that equalisation grants be permitted to reach such a level as will jeopardise development in areas where prospective yields are relatively high. Grants should not be given to speed development in areas where prospective yields are low. However, grants which enhance performance (e.g. in relation to education, housing, highway construction and health services) could, in the long run, be expected to narrow the expected yield differentials as between regions from the application of given resource inputs.

(iv) Buchanan's fiscal equity principle provides a suitable justification for equalisation grants from the standpoint of horizontal equity. Distribution according to this criterion is unlikely to have significant distorting effects on the resource pattern; and indeed the net effect may be in the opposite direction. We cannot generalise too readily in this matter. A central issue is whether the net return to resources in poorer regions is as great as the return in the richer regions would have been if the grants had not been made. This proposition should not be ignored, but its importance should not be exaggerated. It is simply one of several criteria that have to be taken into account in evaluating equalisation grants, or for that matter any kind of federal grant. The economic efficiency criterion must be weighed against other considerations, such as equity, the more dynamic aspects of the problem and the political environment. Total national production may be marginally lower in the short run as a result of equalisation grants; but this does not necessarily constitute a convincing reason for withholding the grants. The longer run effects of the transfer in reducing income disparities between states and increasing the mobility of the factors of production must be taken into account. In particular, it will be necessary to consider, *inter alia*, the size of the grants in relation to other relevant economic magnitudes (they are typically very small), the actual uses to which the funds are put, the use to which the same funds could have been put in the absence of the grants, and the impact on the resource pattern of the actual transfer (including the longer run effects referred to above).

(v) Thus while a strong case can be made for equalisation grants, these grants cannot be carried too far and, in particular, the basis on which such equalisation is assessed must receive careful consideration. Thus a valid objection to equalisation in some countries — and this is particularly applicable to the Australian case — is that by giving specially favoured treatment to areas with relatively low populations there is a tendency to accentuate the problems encountered by the high income areas, especially in large cities which have high population densities and which therefore incur higher costs on that account.[30] In this connection one has only to reflect on the relatively heavy costs in high-income areas associated with transport congestion, pollution and slum clearance. In Germany, unlike Australia or Canada, these problems are given some recognition in the equalisation procedures by making favourable allowances for areas with high population densities. Under the US system of revenue sharing, the pass-through provision and the formulas governing distribution at the local level also ensure that special assistance will be provided to the larger cities which have high per capita expenditure needs. Thus a state or area with relatively high tax capacity may also have above-average expenditure needs. One aspect should not be considered to the exclusion of the other. On the other hand, fiscal need is an elusive concept and national governments may be buying trouble if they become obsessed with it. Relatively low (high) tax capacity is one aspect of relatively high (low) fiscal need. That aspect can be approached objectively but the assessment of differing expenditure needs (the other aspect of fiscal need) poses more problems, because the scope for subjective judgment is considerable. This and other related points are illustrated in the next four chapters, which deal with the equalisation techniques actually employed in the four federal countries with which we are concerned.

12 Equalisation Techniques in Australia

From one point of view the need for horizontal fiscal equalisation is less urgent in Australia, because income disparities between states are less pronounced than in many other federations. Nevertheless the desire for greater uniformity in the standard of public services and the provision of financial assistance to states with relatively low taxable capacities (to help satisfy that desire) have been important features of the Australian federation since the early years.

Equal per capita payments to the states (which have some effect in redistributing revenue from high- to low-income states)[1] were commenced after the first decade of the federation. Special grants were made to Western Australia and Tasmania from 1910 and 1912 respectively, and specific purpose grants for roads dated from 1923.

A most notable development occurred with the establishment in 1933 of the Grants Commission. Since then, at least up to the adoption of uniform taxation in 1942, the Commission's recommendations on special grants to the claimant states (at that time South Australia, Western Australia and Tasmania) were seen to have a decisive influence on interstate fiscal equalisation.

The Commission's methods, evolved over a relatively short span of years, were distinctive in several respects. Of particular note was the comprehensive approach to the question of relative financial need, the concepts developed to give it meaning, and the detailed examination of the budgets of claimant and standard states to ensure comparability and to assist towards a judgment of what an appropriate equalisation grant for each of the claimant states should be. In these respects the role of the Grants Commission was a pioneering one.[2]

The Grants Commission's methods came under close scrutiny by the Rowell-Sirois Commission in Canada, which recommended a system of horizontal fiscal equalisation not greatly different from the Australian model, with the principle of fiscal need as the cornerstone of the financial settlement.

In recent years the Commission's direct influence, as measured by the amount of special grants in relation to total general revenue assistance, has steadily declined. The advent of a system of financial assistance grants with its in-built bias in favour of the poorer states came to be the dominating factor in attempting to correct for horizontal fiscal imbalance between the states. However, the Commission still retains its foremost role as a balancing agent in financial equalisation, making recommendations for additional grants at the margin after taking into account the impact of other forms of general revenue assistance on the claimant and standard states.

It should be added that important interstate equalisation effects have also occurred — though perhaps not intentionally — as a result of (i) the particular distribution of a variety of specific purpose grants; (ii) the Loan Council allocations for state works and housing; and (iii) Loan Council allocations for borrowing by semi-government and local authorities.[3]

In this chapter, discussion will focus on

the following: (i) the Grants Commission's principles and methods; (ii) the diminishing importance of special grants; and (iii) prospects for the Commission to widen its sphere of influence in the 1970s and beyond.

The Grants Commission: Principles and Methods [4]

Membership, Functions and Procedures

Before 1973, the Grants Commission consisted of three members who were appointed by the Governor-General (on the advice of the Federal Government) for a term not exceeding three years at a time. The members of the Commission served on a part-time basis and were assisted by a full-time staff. The Commission was an independent statutory body (and therefore free of direct political influence) and was set up to inquire into and report upon applications made by any state to the Commonwealth for financial assistance in pursuance of section 96 of the Constitution.

Under the *Grants Commission Act* 1973 the Commission, in addition to its traditional role of considering applications by states for financial assistance, is entrusted with the task of inquiring into and reporting upon applications for financial assistance by approved regional organisations of local governing bodies.[5] The additional functions called for an enlarged Commission which now comprises a full-time Chairman and from four to six members (either part- or full-time). Comment on the Commission's new function in relation to fiscal equalisation at the local level appears at the end of this chapter.

To carry out its task in relation to applications from states for financial assistance, the Commission makes a detailed examination of the budgets of both claimant and standard states. The financial experience of the standard states, consisting of New South Wales and Victoria, serves as a yardstick by which the financial needs of the claimant states are assessed. Hearings are held annually to consider the claims put forward by the claimant states for financial assistance and the views of the Australian Treasury on these claims. Reports containing information on financial inequalities between states, the methods employed to compare and evaluate those inequalities and the basis of recommendations for special grants are published annually. By this means a unique corpus of experience and precedent has been built up.[6] The Commission's recommendations have always been accepted by the government.

The broad purpose of equalisation grants, as noted in the previous chapter, is to enable poorer states to aspire to standards of government services prevailing in the more affluent states without the need to resort to an excessive tax burden on their citizens.

The criterion employed by the Commission to assess the amount of special grants is not revenue equalisation (as in Canada) but financial need which embraces both revenue and expenditure needs. Before 1974 this criterion was subject to the constraint that the Commission would not recommend a grant in excess of the claimant state's modified budget deficit. More specifically, the special grant was the amount necessary to bring the adjusted per capita budget result into equality with the per capita budget standard. However, the amount of the completion grant was also subject to the limitation that it would not normally exceed the amount necessary to give the claimant state a modified balanced budget

for the particular year. Thus, if the standard states recorded budget surpluses a claimant state was only entitled to receive an amount that would bring its budget into balance. Equalisation was therefore not complete although, as noted below, since 1967-68 the limitation imposed by application of a balanced budget standard was relaxed in some degree. A major change occurred in 1974, when the Commission not only opted for a method of assessing revenue and expenditure needs by direct comparisons between claimant and standard states[7] but also decided that it would be prepared to recommend a special grant that would bring the claimant state's modified budget result into surplus provided the additional funds were spent in the year of payment and not accumulated as cash balances.[8]

The Grants Commission's functions and principles have acquired a unique character over the years and its methods, especially the detailed budget comparisons, have attracted a great deal of attention in other federal countries.

Fiscal Need

According to Ursula Hicks, the objective of the Grants Commission was to measure the inferiority of the poorer states and to give them a grant which would make it possible for them 'with reasonable effort to put their finances in about as good a state as those of the other States'.[9] This description comes close to the mark. At the outset, the Commission opted for fiscal need as its guiding principle, instead of either compensation for costs incurred in the federation or complete fiscal equality.

In its oft-quoted *Third Report* the Commission stated: 'special grants should enable the weaker states to function at a minimum standard based on the standards normal to the union as a whole'.[10] For this purpose the Commission proceeded to formulate what Professor Head has described as the 'modified financial equalisation principle'.[11] It was therefore necessary to ascertain the relative financial position of the states, but such relative position should not be the absolute basis of the grants: 'A State in need is not entitled to be raised to the high standard of welfare of the most prosperous states, but to a *minimum standard* which will enable it to carry on with reasonable efficiency'.[12] In another part of the *Third Report* the principle was restated and subsequently repeated in later reports: '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 by the amount of help found necessary to make it possible for that State by reasonable effort to function at a standard *not appreciably below that of other States*'.[13]

Thus the central idea expounded by the Commission was that states in financial difficulties — from whatever cause — should be assisted by grants from the centre, so that they can function at a standard which is close to that enjoyed in other states. The Commission was not therefore aiming at complete financial equality between states, though it was conscious of the need to reduce the extent of prevailing inequalities. It was also prone to link this goal with its role as a 'balancing agent' in financial adjustment. In focusing on budget results the impact of all general revenue grants made by the Australian Government to the states was automatically taken into account. This procedure was and is, of course, of great benefit to the claimant states who know that, whatever action is taken by the Australian Government with respect to

the distribution of financial assistance and other general revenue grants, any unfavourable impact on their budgets will be allowed for by the Commission. In 1955 the Commission reiterated that special grants should be the amount required to 'complete the work begun by other transfers and to reduce the financial inequality of the States sufficiently for the harmonious and effective working of the Federal government'.[14] As Professor Mathews has pointed out: 'Australian special grants are residual grants intended to enable claimant states to achieve budgetary equilibrium provided they adopt comparable taxing and expenditure standards.'[15]

In short, the intention was to use special grants as a vehicle for giving effect to this modified financial equalisation principle to such an extent (and no more) as would enable financially weaker states 'to provide a national average standard of services without imposing heavier taxes and charges or running larger deficits than the national standard'.[16]

As noted above, the approach to fiscal need has now been broadened, in that the recommended grant to a claimant state is no longer limited by a balanced budget standard. The full significance of the new procedures instituted in 1974 will be clear after the methods used before 1974 have been discussed.

The Methods Used Before 1974

The original basis of the Commission's calculations was the published budget results of the states, reduced to a standard form by means of modifications and adjusted to allow for differences between claimant and standard states in efforts to raise revenue and in the range and quality of services provided. A close scrutiny of the budgets was therefore required.[17]

Before 1974, the Commission proceeded by three steps to an indirect assessment of the revenue and expenditure needs of the claimant states. First, it made 'modifications' to the published budgets of claimant and standard states, the latter serving, in effect, as the benchmark states. The purpose was to ensure that the budgets were structured in a form which permitted direct comparisons. As a second step, 'adjustments' were made to the budget of the claimant and standard states to take account of differences in efforts to raise revenue and to provide certain services. As a third step, the Commission compared the adjusted budget results of the claimant states with the standard budget results. The three steps are illustrated in table 12-1

The two-part method, in vogue since 1949, was designed to overcome the time-lag problem. If the Commission had to withhold its recommendations until it had time to obtain recent data and assess their significance, then by the time the claimant state had received the grant it might no longer be a true reflection of current needs. To overcome this the Commission recommended an advance grant for the year of payment based on its assessment of current financial needs and two years later this assessment was, in effect, revised by recommending a completion grant in the light of the audited budget figures. The information used in assessing the completion grant was based on the final audited budget figures for the year of review.

In making adjustments, the Commission examined expenditure on social services, the relative severity of state taxation and the financial impact of state business undertakings on budgets. The Commission adopted a deficit standard where the standard states had average per capita deficits, and a balanced budget standard if the standard states had

Table 12-1
Method of Calculating Special Grants — Tasmania
($'000)

Year of Review for Completion Grant Year of Payment	1968-69 1970-71	1969-70 1971-72
Published budget result in year of review	− 3695	+ 2815
plus or minus budget modifications	+ 377	− 2362
Modified budget result*	− 3318	+ 453
plus or minus 'adjustments'	+ 1171	+ 995
Adjusted budget result in year of review	− 2147	+ 1448
Deficit standard as applied to Tasmania†	− 467	− 1752
Completion grant for year of review‡	+ 1680	− 3200
Advance grant for year of payment§	15,130	25,100
Actual special grant recommended (and paid in year of payment)	16,810	21,900

* Published budget result (including the advance payment for the special grant) as modified to ensure comparability with budgets of standard states.

† Average per capita modified deficits of New South Wales and Victoria multiplied by Tasmania's mean population. This provides the standard against which the adjusted budget result of Tasmania is compared in order to arrive at the special grant payable.

‡ When negative this means there was an overpayment of the advance grant (i.e. the estimates had overstated financial need).

§ Based on forecasts of prospective budget results with account being taken of likely modifications and adjustments to those results.

Source: Grants Commission Reports.

average per capita surpluses. Adjustments could not increase the grant to an amount where the claimant state would show a modified surplus. Adoption of a balanced budget standard was of crucial importance, because it meant that, when the standard states had budget surpluses, the special grant to a claimant state would not be sufficient to provide complete financial equality. The use of this criterion was opposed by the claimant states and after much debate it was agreed in 1967 and 1968 to allow states to carry forward unused net favourable adjustments and surplus standards respectively to offset modified budget deficits in later years.[18]

The true character of the adjustments should be noted. They did not act as a spur to economy in expenditures or to greater effort to raise revenues on the part of the claimant states, since any move in either of these directions did not affect the size of the grant. Any favourable adjustment reflected the fact that the budget deficit of the claimant state was lower than it would have been if the claimant state's policies had been similar to those of the standard states. Given the Commission's emphasis on budget results, the adjustments were obviously necessary to avoid penalising a claimant state for seeking economy in its expenditures and/or making a greater effort to raise revenue (and likewise to avoid rewarding a state for extravagance in spending and/or relatively low tax rates).

The size of the adjustments had regard to: (i) comparisons between per capita expenditures of claimant and standard states; (ii) allowances for greater difficulties of the claimant compared with the standard states in making provision for basic services; and (iii) comparisons of the relative severity of taxation as between claimant and standard states.

The procedure followed up to 1964 with respect to the adjustment for social service expenditure, which comprises a large part of total state expenditure, was to compare (i) the actual expenditure in each claimant state with (ii) the average per capita expenditures in the two standard states (New South Wales and Victoria) multiplied by the mean population in the claimant state, with an additional percentage to reflect the estimated higher costs of providing comparable services in the claimant state, based in part on an assessment of demographic, geographic or other difficulties encountered by the claimant state in providing those services.[19] If (ii) was greater than (i) the claimant state would receive a favourable adjustment in the calculation of its total grant. If (i) was greater than (ii), as in the example illustrated in table 12-2 for 1965-66, the adjustment would be unfavourable to the claimant state.

In 1964 the Grants Commission decided, for the purpose of determining relative financial need, to adopt the unit-cost method for calculating adjustments with respect to expenditure on education and hospitals in the budgets of the claimant states. In rejecting the previous method (by which a percentage allowance was set for greater difficulties of providing such services in the claimant states) the Commission felt that, although the per-

Table 12-2
Adjustment for Social Service Expenditure in a Claimant State

		1965-66 $'000	1969-70 $'000
(i)	Tasmania: actual expenditure	30,819	49,760
(ii)	Tasmania's population X average per capita expenditure in the standard states*	25,439	42,830
	Add Allowance for greater difficulties (17%)†	4,325	7,281
		29,764	50,111
	Adjustment for Tasmania	−1,055	+ 351

* Tasmania's mean population: in 1965-66 = 369,600
in 1969-70 = 390,800

Average per capita expenditure on social services in the standard states (New South Wales and Victoria): in 1965-66 = $ 68.83
in 1969-70 = $109.55

† Using the percentage in operation in 1961.

Source: The information on which the table is based is from Grants Commission Reports.

centage arrived at was supported by detailed research, there was in the final analysis too much scope for the exercise of 'broad judgment' by the Commission. The unit-cost method aimed at greater precision and a lesser reliance on such 'broad judgment'.[20] Briefly the procedure was to calculate the adjustments by taking the child-at-school as the unit for education and the net cost to the state Treasury per daily occupied bed as the unit for hospitals.[21] The earlier method (i.e. the per capita comparisons with allowance for greater difficulties as manifested in relatively high cost and hence relatively greater financial need) was, however, retained for other categories of social service expenditure such as public health, mental health, relief for the aged, and law, order and public safety.

In 1970-71, the Commission decided to bring its method of adjustment for hospital expenditure into line with its treatment of expenditure on nursing homes and mental health, using the per capita basis of comparison for all three. This revision of the earlier method was prompted by indications that utilisation was affected by state government policies.[22] However, for some state expenditure (e.g. on gaols) where there was no evidence that interstate differences in utilisation of the service were due to differences in state government policies, the 'units of use' basis was considered appropriate. A positive expenditure need was indicated where the ratio of units of use (e.g. average daily number of prisoners) to total population was higher in the claimant state than in the standard states.[23] However, in other areas of expenditure (e.g. child welfare and assistance to the aged or infirm), where it was possible to identify the section of the state population for which the service was made available, the Commission adopted the 'eligible population' method. In such cases a positive expenditure need was indicated if the ratio of eligible population to total population was higher for the claimant state than for the standard states. If the ratio was lower, a negative expenditure need was indicated.[24]

A new approach for comparing education expenditure was put forward in 1972 in order to make more appropriate allowance for differing education structures between states.[25]

Concerning the second type of adjustment — the relative severity of taxation — the procedure was to compare (i) the actual revenue raised by the claimant state with (ii) the revenue that would have been raised had the average rates and exemptions which applied in the standard states been operative in the claimant state. When (i) was larger than (ii), the adjustment was favourable (i.e., taxation was above standard) and vice versa. In 1944 a revision of procedures was necessary since the states no longer levied income taxes. Estimates of tax severity had therefore to be confined to an examination of non-income tax collections.

Again it can be seen that the Commission's approach mirrored its fundamental aim of achieving a modified financial equality between states. The Commission has not concerned itself with the question of whether or not the tax system is equitable from the standpoint of individuals (and the same comment could be made of its treatment of expenditure items); its prime concern has been to ensure that reasonable equality between states in the severity of taxation and in costs of services is capable of being achieved.

While the aims are clear, it is also true that in many instances comparisons of revenue-raising effort are far from simple. Examples are taxes on gambling[26] and

mining royalties. The Commission has on several occasions made no secret of the many problems which it has faced in comparing revenue-raising efforts in several areas. Thus: 'Direct comparisons of mining royalty rates are of limited relevance because of the wide variation in the type and grade of minerals produced in the States'.[27] For this and several other reasons the Commission has been obliged to exercise a good deal of broad judgment and to concede that 'there was a very wide range of possibilities in relation to the size of the adjustment that would be warranted for mining royalties'.[28] The scope for broad judgment has, however, been narrowed as a result of a comprehensive investigation into mining revenues which the Commission carried out in 1973.[29] As a result of this investigation, the Commission has been able to establish a fairly objective basis for comparing efforts by states to raise mining revenue. The main area of broad judgment is now limited to cases where particular minerals are produced in the claimant states but are not produced in significant quantities in the standard states (examples are bauxite and iron ore).[30]

Under the method of assessing the fiscal needs of claimant states which operated before 1974 (the 'indirect' method of assessment), the exclusion of any tax from the Commission's comparisons in arriving at the net favourable or unfavourable adjustments would give the claimant state an incentive to reduce the rates of that tax. It would not then on that account incur an unfavourable adjustment for failure to make sufficient effort to raise revenue from that source (and yet the budget deficit, and hence the special grant, would rise). The exclusion of any expenditure item from the comparisons would, for the same reason, give the claimant state an incentive to increase expenditure on that item (and perhaps standard states an incentive to reduce such expenditure).

Debt charges seem to be in a rather special category, since the scope for variations in loan-financed expenditure by a state is constrained by virtue of Loan Council control over borrowing programs. While accepting this point, the Commission has also drawn attention to various ways in which states can, on their own initiative, augment funds set aside for capital expenditures, for example by applying to the Australian Government for funds to finance specific projects (in most cases involving the states in the payment of debt charges).[31]

The general principle followed by the Commission has been that a claimant state should only be reimbursed (through the special grant) to the extent that an above-standard impact of debt charges on the claimant state's budget has arisen from special difficulties. The Commission is still grappling with the many problems of comparison which this principle entails. The Commission's intention is that 'where it modifies a particular activity out of a State budget it will also modify out any unrecouped debt charges in the State budget which are attributable to that activity'.[32] For the remaining debt charges the Commission has decided that when, in its judgment, the impact of debt charges (as between the claimant state and the standard states) differs as a result of variations in policy, it will not take that difference into account in assessing a claimant state's financial need.[33]

The only major tax to be omitted from the Commission's calculations appears to be motor taxes, which have been regarded as benefit or special-purpose taxes rather than general-purpose taxes. The impact of road finance (taxes and expenditure) is excluded from the Commission's bud-

getary comparisons in assessing relative fiscal needs.

The third type of adjustment has involved a comparison of the impact of business undertakings on state budgets. The Commission looks closely at the financial results of the operations of business undertakings. But the comparisons have, in the Commission's own words, 'presented many difficulties because of differences between states in the form in which the undertakings are constituted, the conditions in which they operate, and the extent to which their operations are brought within the ambit of the budgets of the respective States'.[34]

For these and other reasons, the Commission has not been able to inculcate the same degree of sophistication into its calculations in this as in other areas, such as social services where comparisons are more readily made and data more readily available. In its adjustments for the impact of business undertakings on state budgets the scope for the exercise of 'broad judgment' therefore continued to be considerable. The main problem in comparing efforts by state business undertakings (e.g. railways) to raise revenue is that the level of charges may have a quite different (and unpredictable) effect on the amount of traffic in each state, and the latter may of course be influenced by partially hidden subsidies and controls on alternative or competing modes of transport.

The central aim of the Commission's comparisons in this area was to place the claimant states on a similar footing to the standard states by making adjustments for above- or below-standard charges and services. In short, the Commission ideally was interested in ascertaining the extent to which the claimant states experience greater difficulty in providing comparable services. However, considerable attention was focused on the level of wages and salaries and on the range of fringe benefits, as well as on the level of charges. As with the other adjustments discussed above, the effect of the Commission's procedures has been to avoid penalising a state which imposed above-standard charges and incurred below-standard expenditures (or rewarding a state with below-standard charges and above-standard expenditures) whilst at the same time leaving the claimant states free to determine charges and the standard of services which they provide.

New Method of Calculating Special Grants

A new method of calculating special grants was adopted by the Commission in 1974. The change from an indirect to a direct assessment of the revenue and expenditure needs of the claimant states appears to have been prompted largely by evidence of misunderstanding concerning the nature of adjustments — a mistaken impression that the various components of the total adjustments were in the nature of penalties or rewards. It should be stressed that what has changed is the method of calculation, not the criteria used for assessing financial need: 'the Commission has adopted the new approach primarily because it considers that on balance it will facilitate understanding of the criteria and methods used in assessing the special financial needs of claimant states'.[35] Moreover, the Commission's new functions with respect to financial assistance for local government authorities was also of some relevance, since it is clearly desirable that the same method of assessing financial need be used both for states and local authorities which apply through the Commission for special assistance.

Suggestions that the Commission

might, with advantage, adopt an alternative method of calculating special grants were made by the Australian Treasury as early as August 1970.[36] The Treasury's proposals were summarised by the Commission in 1972 in a special report prepared in connection with Queensland's application for a special grant.[37] In short, in order to overcome misunderstanding in relation to the adjustments the Treasury proposed that there should be a direct quantitative assessment of a state's relative financial need in each major area where such assessment was possible so that it would then be more clearly understood that it was the purpose of special grants to compensate the state for greater needs (in relation to the standard states).[38] In areas where direct quantitative assessments of need were not feasible because of lack of data or a satisfactory basis of comparison, the methods already employed by the Commission could be retained.[39]

A major advantage claimed for this approach was that 'it would make no reference at all to comparisons of revenue-raising and expenditure-controlling efforts in the claimant and the standard states'.[40] In commenting on the Treasury proposal in 1972, the Commission expressed doubt whether there would be a net advantage in making such a change, arguing that: 'While such a procedure might reduce misunderstanding of some aspects of the Commission's methods it might make others harder to follow and perhaps give a spurious impression of accuracy in some areas of comparison.'[41] Nevertheless, the Commission continued to explore the possibilities of an approach along the lines suggested by the Treasury and sought the views of claimant states. As noted, the Commission decided to adopt the new approach in its 1974 report.

In this connection it is interesting that Professor Mathews in June 1970 had put forward a simple model for determining the size of equalisation grants which should be paid to states suffering from revenue and cost disabilities.[42] In this model, the grant (G) to the claimant state is the sum of R and E, where R is the amount needed to compensate the claimant state for its lower revenue-raising capacity and E is the amount needed to provide compensation for the claimant state's relatively higher cost of providing services. Both R and E can be expanded as follows:

$$R = P_c \cdot \frac{T_s}{Y_s} \cdot \frac{Y_s}{P_s} \cdot r$$

and $$E = P_c \cdot \frac{E_s}{P_s} \cdot c$$

where P_c = population of claimant state

$\frac{T_s}{Y_s}$ = severity of taxation in the standard state (Y_s = income in the standard state)

r = the percentage deficiency in revenue capacity in the claimant state relative to the per capita revenue capacity $\frac{Y_s}{P_s}$ of the standard state.

c = the additional percentage cost of providing services in the claimant state relative to the per capita cost in the standard state $\frac{E_s}{P_s}$

The grant payable to a claimant state (G_c) in this model is therefore the sum of the revenue and cost components:

$$G_c = (P_c \cdot \frac{T_s}{Y_s} \cdot \frac{Y_s}{P_s} \cdot r) + (P_c \cdot \frac{E_s}{P_s} \cdot c)$$

Such a grant would enable the claimant state to reach the budget standard, provided its tax effort and level of ex-

penditures were comparable with those of the standard states. Mathews has demonstrated that this method gives the same result as the methods used by the Grants Commission before 1974 'provided the same budget standard is used and provided adjustments for differences in severity of taxation and expenditure standards are applied to all items of revenue and expenditure in the claimant state's budget'.[43] Adjustments had not been possible for all items, as noted earlier. Moreover, the use of adjustments had given rise to certain misunderstandings. An alternative approach along the lines suggested by Mathews and the Treasury clearly has much to commend it as constituting a more rational approach to an assessment of financial need.

Details of the new approach are provided by the Commission in its *41st Report*. It is necessary to reiterate that the changed method of calculation has not affected the assessment of financial need. Apart from the decision to remove the condition which had previously limited the recommended special grant to the amount of the claimant state's modified budget deficit, the grant recommended is the same under the new method of assessment as it was under the old method.

Under the new method the Commission uses modified budgets and other data to calculate directly the claimant state's need for special financial assistance. As in Mathew's model, the amount of the grant is represented as the sum of revenue and expenditure needs, after allowing for other relevant federal grants. Revenue need is calculated by reference to the average revenue effort of the standard states, it being the product of the standard revenue effort and the shortfall in the claimant state's revenue base. Likewise, expendi-

Table 12-3
Commonwealth Payments to the States by Type of Payment
(selected years)*

	per cent of total				
	1938-39	1954-55	1964-65	1971-72	1973-74
Tax reimbursement grants	—	64.8	—	—	—
Financial assistance grants†	—	—	68.9	69.3	51.8
Special grants	10.8	5.3	3.2	0.7	1.1
Specific purpose grants	89.2	29.9	27.9	30.0	47.1‡
	100.0	100.0	100.0	100.0	100.0

* Excluding Loan Council allocations.
† Including special revenue assistance.
‡ Includes housing advances.

Source: 1938-39 and 1954-55 data from Hanson, 'Australian Commonwealth Grants Commission', p. 145.
1964-65, 1971-72 and 1973-74 data from *Payments to or for the States*, 1973-74.

ture needs are defined as the additional costs to the claimant state of providing services of the same average range and quality as are provided in the standard states.[44] Under the new method, no explicit reference is made to the modified budget result of the claimant state or to adjustments for differences between states in revenue-raising effort or levels of expenditure.[45] Thus, the assessed special grant (G_a) is given by [46]

$$G_a = G_r + G_e - G_g$$

where G_r = assessed revenue needs
G_e = assessed expenditure needs
G_g = assessed needs met from other Australian Government grants

The Diminishing Importance of Special Grants and Recent Developments

Under the impact of the uniform tax legislation (1942), which gave the Commonwealth an effective monopoly of income taxes, the importance of special grants diminished greatly. This trend has accelerated in recent years, especially since 1959 when the Commonwealth used the occasion of a review of Commonwealth-state financial relations to limit the Commission's influence. By 1971-72 special grants accounted for less than one per cent of all Commonwealth payments to the states, compared with 5 per cent in 1954-55 and about 11 per cent in 1938-39.

During the 1950s and 1960s the rather elaborate procedures and detailed investigations which surrounded the Commission's deliberations and its recommendations for special grants were increasingly called to question. In the light of Commonwealth policies with respect to the interstate distribution of tax reimbursement (later financial assistance) grants and other payments, was there still a place for special grants as recommended by the Grants Commission? The claimant states apparently answered in the affirmative, which is not surprising in the light of their dependence on special grants and the Commission's role as a 'balancing agent' in interstate financial equalisation. The Commission could, in effect, correct for any decisions of the Australian Government which reacted unfavourably on the budgets of the claimant states.[47]

From the standpoint of the claimant states, special grants have continued to be important. In Tasmania, special grants made up 20 per cent of total state revenue in 1958-59 and 17 per cent in 1969-70. Special grants made up 14 per cent of the revenue of the three claimant states in 1958-59, nearly 13 per cent of the combined revenue of the two claimant states (Western Australia and Tasmania) in 1964-65 but only 2·5 per cent of the revenue of the three claimant states (Queensland, South Australia and Tasmania) in 1972-73. Tasmania ceased to be a claimant state in 1974 and South Australia in 1975.

Under the new financial arrangements entered into in 1959, South Australia's special grant was absorbed in the base amounts of the financial assistance grants, as was a part of the special grants paid to Western Australia and Tasmania. Table 12-5 illustrates the extent to which the new financial assistance grants were biased in favour of Western Australia and Tasmania and to a lesser extent South Australia. This was in contrast to the earlier tax reimbursement grants the distribution of which, on a per capita basis, was much more even. With the notable exception of Tasmania, the net effect on the distributional pattern, when allowance was made for special grants and special revenue assistance, was not significantly different in each of these

Table 12-4
Claimant States: Main Revenue Items (Selected Years)
(per cent of total)

	1958-59*	1964-65†	1969-70‡	1971-72§	1972-73§
Financial assistance grants	28.9	39.4	35.4	39.9	39.8
Special grants	14.1	12.5	16.8	2.3	2.5
Special revenue assistance	—	—	1.7	1.5	—
Commonwealth payments under 1927 Financial Agreement and for debt charges assistance	1.0	1.1	0.3	1.7	1.2
Total Commonwealth payments	44.0	53.0	54.2	45.4	43.5
State taxation	13.2	12.0	14.4	20.5	23.9
Debt charges — recoveries	8.6	10.8	15.9	7.1	6.8
Other revenue	34.2‖	24.2‖	15.5	27.0¶	25.8**
Total revenue	100.0	100.0	100.0	100.0	100.0

* SA, WA and Tas.
† WA and Tas.
‡ Tas.
§ Qld, SA and Tas.
‖ Includes railway revenue in WA.
¶ Includes railway revenue in Qld.
** Includes railway revenue in Qld and SA.

Source: Grants Commission Reports, 1961, 1967, 1971, and 1974.

years (1957-58 and 1959-60) but the role of special grants in influencing the goal of horizontal financial equalisation was greatly diminished.

While the Commission's recommendations were clearly important for the claimant states (since they afforded protection against any adverse impact on their budgets of the mainstream of federal payments), the Commission's role was a declining one during the 1960s. This was evidenced by the fact that between 1960-61 and 1967-68 there were only two claimant states — Western Australia and Tasmania — and thereafter until 1970-71 only one — Tasmania. In this period special grants were very small in relation to other federal payments (between 1966-67 and 1970-71 the total amount paid in special grants actually fell from $40m to approximately $18m).

The Commission's declining role during the 1960s should be related to: (i) the Commonwealth Treasury's concern at the steeply rising trend of special grants in the 1950s (and perhaps a feeling of frustration that the grants did not appear to be having a pronounced impact in reducing financial inequalities between the states); and (ii) the decision in October

Table 12-5
Commonwealth Grants Per Head of Population in each State in Relation to the Australian Average (= 100)

	1957-58		1959-60	
	Tax reimbursement grants	General revenue grants*	Financial assistance grants	General revenue grants†
NSW	98.7	89.4	90.7	87.8
Vic.	95.7	86.6	88.7	85.8
Qld	106.4	96.3	101.6	98.2
SA	100.5	120.8	122.3	124.4
WA	109.9	167.2	146.4	161.3
Tas.	103.1	144.3	130.7	166.1

*Tax reimbursement grants (including supplementary grants) *plus* special grants.
† Financial assistance grants *plus* special grants *plus* special revenue assistance.
Source: *Commonwealth Payments to or for the States.*

1958 by Victoria and Queensland to apply for special grants (this action had the effect, as was no doubt the intention, of forcing the Commonwealth to instigate a major review of federal-state financial relations).

The advent of financial assistance grants from 1959-60 (as a substitute for tax reimbursement and supplementary grants) [48] was accompanied by a new arrangement under which South Australia ceased to be a claimant state (its special grant being absorbed in the financial assistance grant), New South Wales and Victoria agreed not to seek special grants, and Western Australia and Tasmania continued to be claimant states but with their special grants substantially reduced. Queensland and South Australia were not to be denied the right of access to the Commission but would be expected to seek special grants only in 'exceptional circumstances'. [49] Western Australia continued to be a claimant state until 1968-69, when the Commonwealth agreed to pay $15·5m in each of the years 1968-69 and 1969-70 to that state in lieu of special grants. [50] From 1970-71 this amount was reduced by $3m a year in view of the apparent improvement in the relative capacity of Western Australia to finance its budget expenditure. [51]

It was clear, therefore, that while the 'balancing role' of the Commission was important to the claimant states, the margin on which the Commission works was being steadily eroded by the equalising effects of various Commonwealth payments. Also, by 1968-69 Tasmania was the only claimant state and by early 1970 the Commission's future looked decidedly bleak. As one expert put it: 'It is paradoxical that a fiscal device, which many observers had felt would be of great value if adopted by other federations, is now threatened with impotence, if not extinction, in Australia.' [52]

This threat to the continued existence of the Commission was undoubtedly linked with the action of the Federal

Government, especially in relation to the 1959 financial assistance base grants and subsequent *ad hoc* adjustments, in injecting a major redistributional element into Commonwealth payments to the states. Commonwealth policy no doubt lacked cohesion, but the impact of its actions was substantial in terms of differential per capita payments which favoured low income states.

But the anticipated demise of the Commission did not eventuate. After 1970 the Commission enjoyed a new lease of life and on present indications it seems destined to play an even more active role in future. States are now moving into and out of claimancy much more frequently than in the past. By 1972 there were three claimant states again: South Australia joined Tasmania in July 1970 and Queensland became a claimant state in September 1971. But Tasmania ceased to be a claimant state in June 1974 and South Australia followed suit in June 1975. In June 1975, Tasmania applied for special grants for 1974-75 and 1975-76, but the application was subsequently withdrawn.

How is this activity to be explained? The main reason was a change in the attitude of the Federal Government itself. Faced with mounting criticism over the large interstate redistributional effects of its grants, the impact of inflation on state budgets and the problems inherent in calculating relative financial needs, the Commonwealth has, in effect, abdicated — or at least expressed its intention to abdicate — in favour of the Commission.

At the Premiers' Conference in June 1970, the Prime Minister (J.G. Gorton) made it clear that he would like to shift more of the responsibility for horizontal fiscal equalisation to the Commission. After stressing the practical difficulties 'in attempting to determine the correct distribution of grants', Mr Gorton took the state ministers (and even some of his colleagues) completely by surprise when he put forward the interesting suggestion that 'the Grants Commission could be given the task of recommending on the distribution of grants between all the States, not necessarily annually but mainly for the purposes of the regular reviews of the revenue grants arrangements'.[53] It was stressed, however, that the success of such a scheme depended on the full co-operation of all states. The next review of intergovernmental financial relations took place in 1975, but the Commission was not asked to report on the fiscal needs of *all* the states for purposes of this review.

It is clear that after 1969 the Australian Government was becoming increasingly disenchanted with the task of interstate fiscal equalisation — a task which it had foisted upon itself without perhaps a full appreciation of the inherent difficulties. The prospect that the Grants Commission had every chance of assuming a wider significance in future was illustrated by the nature of the Federal Government's response to criticism following the decision (taken in June 1970) to make additional grants to New South Wales and Victoria equivalent to $2 per capita. This decision sparked off a strong reaction from the other states, especially from South Australia which complained bitterly of the treatment it was receiving from the Commonwealth. In a brief reply the Prime Minister made it clear that if *any* state considered that its capacity to provide services of a standard comparable to those provided in New South Wales and Victoria was adversely affected by the decision to assist New South Wales and Victoria, the way was open for that state to apply to the Grants Commission for a special grant.[54] (South Australia accepted

the advice and submitted an application within a matter of weeks.) The Prime Minister's statement on that occasion is worth quoting in full:

> If a disability in a State compared with other States is proved to the Commonwealth Grants Commission, that disability is corrected. That is to say, the Commission looks at the level of services comparable with other States, looks at the effort made by a State to raise revenue for its services, and should it be satisfied that there is a disability it corrects that disability. That may be a better way of correcting any alleged disability than for the Commonwealth to be asked to do it.[55]

If this is a true reflection of the trend of Commonwealth thinking, it suggests that the Grants Commission is unlikely to be phased out in the near future. Once the decision has been made to embark on a comprehensive evaluation of state financial needs, it seems convenient politically and sound economically to ensure that an issue as contentious as the interstate distribution of grants be made the subject of regular and independent review and advice.

The Grants Commission: Financial Assistance to Local Government

An expansion of the Commission's functions occurred in 1973, when federal legislation was passed to allow local authorities access to the Commission.[56] This was an important development for Australia, where local authorities are relatively less important than in other federations and where little has been done in a systematic manner to regulate horizontal settlement at the local level.[57]

In 1974 the Grants Commission released its *First Report* dealing with applications on behalf of local governing bodies for financial assistance. The present comparative study of federalism and fiscal balance is focused mainly on horizontal fiscal equalisation at the state level. However, this is a convenient point at which to note certain features of the aforementioned report, especially in relation to the objectives of fiscal equalisation at the local level, the criteria for the grants and the methods which the Commission has indicated it intends to follow.[58] Moreover, it was not without interest to discover that grants recommended in 1974-75 for local authorities amounted to $56·3m in all states, including $13·7m in Queensland and South Australia. This compares with an amount of $48·2m in special grants recommended for payment to Queensland and South Australia in 1974-75. These figures would, on the face of it, seem to indicate that the Commission's role in providing direct assistance to local government promises to be an important one.

The features of the report, which command special interest in the light of the foregoing discussion of the Grants Commission's functions and methods over many years, are as follows:

(i) The overriding objective of providing financial assistance to local government is to enable local government bodies to function, by reasonable effort, at a standard not appreciably below the standards of other local bodies. This is in conformity with the Commission's objectives in recommending grants to claimant states and implies that allowance will be made for differing revenue-raising capacity and expenditure needs. Financial need is therefore the guiding principle.

(ii) Federal Ministers are required to consult the appropriate state ministers about the regional organisations which need to be established under the Act for

the purpose of submitting applications for local authorities and about the referral of applications to the Commission. This indicates that the states will not be completely by-passed by the Australian Government in providing financial assistance for local government. Such formal requirements for consultation with the states amount, however, to very little of substance. As long as the states continue to be heavily dependent on financial aid from the Australian Government, they are in no position to quibble over aid provided from the centre to local authorities, especially when the recommended aid is based on a critical and comprehensive evaluation of relative financial need by the Grants Commission. Nevertheless, the Liberal - National Country Party Government elected in December 1975 has indicated its intention to involve the states more directly in the process of allocating grants to local government.

(iii) The financial assistance envisaged in the Act is for general revenue supplementation and not for specific or developmental purposes.

(iv) Local authorities will continue to be free to vary rates and the standard of services provided.

(v) The Commission has decided to use population as the basic unit of measurement for all comparisons.[59]

(vi) The choice of equalisation standards posed the most difficult problems. A standard based on average revenue-raising capacity of all local governing bodies and their average cost of providing services[60] was rejected mainly because the functions of local councils differ so markedly. In the first instance the Commission has established six categories of local authorities in each state. The groupings reflect the rate of population growth for metropolitan and municipal local governing bodies and the degree of urbanisation and concentration of population for local bodies in rural areas, other than municipal bodies.[61]

13 Equalisation Techniques in Canada, the United States and West Germany

Horizontal Fiscal Equalisation in Canada

Interstate fiscal equalisation in Canada was not put on a systematic basis until 1957, when for the first time equalisation payments to provinces with below-average taxable capacity were clearly separated from the tax rental payments. Ten years later the arrangements for fiscal equalisation were overhauled, the most important change being the extended scope of the formula to encompass sixteen different classes of revenue, in place of the three standard taxes which up to 1967 had been used as the basis of comparing the fiscal capacities of the provinces. By 1975 the number of tax and non-tax revenues included in the equalisation arrangements had been increased to twenty-two.

Our main interest is in examining the nature of the new formula, the method of computation and its impact on interstate fiscal equalisation. However, it is useful first to trace out the main developments leading up to the acceptance of the more comprehensive approach embodied in the formula.

The Rowell-Sirois Commission

In its investigation of federal-state financial relations in Canada before World War II the Rowell-Sirois Commission was confronted with a situation, certainly not unusual for a federation, in which great differences could be discerned in financial need and revenue-producing capacity as between provinces. An important question, therefore, was whether anything should be done by way of federal assistance to narrow these differences. The Federal Government had already been providing financial assistance to particular provinces to meet particular situations and some degree of favoured treatment had been accorded the lower-income provinces. However, these various payments had been largely *ad hoc* in character and had lacked a systematic basis. The Commission, after careful study, came to the conclusion that a completely new approach — at least new to Canada — was urgently needed.

In its *Report* presented in 1940 the Commission recommended a system of national adjustment grants to financially weak states. The proposals put forward by the Commission were designed to introduce in Canada a system of 'fiscal needs' grants, the purposes of which were not unlike the special grants recommended by the Australian Grants Commission. The Rowell-Sirois Commission proposed that: 'all provincial governments be put in a financial position, by National Adjustment Grants from the Dominion, to supply education and welfare services, equivalent in quality ... to the national average'.[1] The Commission wanted these grants to be the subject of review every five years by an independent advisory body and considered that an increase in an adjustment grant should be given to a province if it could be established that the province was unable to supply Canadian average standards of service and balance its budget without the need to impose taxes at rates appreciably above the national average.

In short, the Commission envisaged the

use of national adjustment grants to enable each province to achieve an average standard of government services without the need for above-average tax severity. The object was to enable the financially weak provinces to provide a level of social services equal to the Canadian average.[2] As the grants would be based on fiscal need, estimates of taxable capacities and expenditure requirements of the provinces would be required.

In line with the importance attached to state fiscal autonomy, the Commission insisted that the adjustment grants should be unconditional. It was important to raise the fiscal capacity of a financially weak province to a level which would make it possible for that province to bring its standard of public services up to the equivalent of the Canadian average; but there should be no conditions attached to the way in which the additional funds were applied. It was open to each participating province to apply the funds to any use — including tax reduction.

Implicit Equalisation Before 1957

The onset of war and opposition from several provinces prevented the adoption of the Commission's proposals. However, the Commission's report was not without effect. It was not long before the principle of equalisation payments to low-income provinces was widely accepted. The Tax Rental Agreements provided the Federal Government with an opportunity to make a positive move in this direction.

From 1945 to 1947 a system of per capita grants ($15 a head) to the provinces was initiated. Between 1947 and 1957 an element of equalisation was implicit in the tax rental payments since the latter were geared to increases in the population of a province and in GNP per capita for the preceding three years. According to Moore and Perry this arrangement 'did not go as far as the Rowell-Sirois recommendation that each province should be enabled to provide the average level of services while imposing no more than the average level of taxation, but it went some distance in that direction'.[3]

Explicit Equalisation: 1957 to 1967

Explicit equalisation was introduced in 1957. Equalisation payments were made in order to bring the per capita yield from the three standard taxes (taxes on personal and corporate income and on deceased estates) in each province up to the weighted average per capita of these taxes in the two provinces (Ontario and British Columbia) with the highest per capita yields. These payments were clearly separated from the tax rental payments and all provinces with below-average tax capacity were able to participate. According to Clark,[4] the formula which emerged was distinctly a revenue equalisation formula. There were separate measures of tax base for each of the three revenue sources included in the formula. Differing expenditure requirements of the provinces were not taken into account.[5]

Some relatively minor changes were made to the system in the ensuing years up to 1967. In 1958 special grants to the four Atlantic provinces were introduced. In 1962 natural resource revenue was incorporated in the formula. In addition to the yields of the three standard taxes, the revenue to be equalised included 50 per cent of a three-year moving average of natural resource revenue. Also between 1962 and 1964 a national average was used as the equalisation yardstick in place of the two provinces with the highest per capita yields,[6] and the national average standard was adopted again under the 1967 arrangements.

The 1967 Provincial Revenue Equalisation Formula

In 1967 all major revenue sources, and not just the three standard taxes together with natural resource revenue, were brought to account in an assessment of the revenue-raising capacity of each province in relation to the national average. One writer has described the new approach as 'an attempt to affirm the constitutional role of the federal government in national income redistribution' and further as an attempt 'to tidy up two decades of "ad hoc" development, to formulate a basic set of principles and to provide a system of objective but practical measurement'.[7]

The major purpose of the new arrangement was to construct a formula which would more accurately reflect the revenue-raising capacities of each province and of the nation as a whole. A subsidiary purpose was to get away from the notion of 'standard' rates of income tax set by the Federal Government. It will be recalled that in 1966 the Federal Government embarked on a new tax policy designed to shift more of the responsibility for tax changes on to the shoulders of the provinces.

However, the extent of change reflected in the new formula for fiscal equalisation should not be exaggerated. The formula made no attempt to equalise provincial expenditure needs (interprovincial cost differentials were not taken into account), municipal revenues were left out of the calculations, and there was a mechanical application of the formula in the sense that in determining the grants to be paid to each qualifying province there was no element of 'broad judgment' involved.[8] In these three important respects the 1962 and 1967 formulas were identical.

The 1967 Formula: Main Components

The three components of this formula used for the calculation of the equalisation grants were as follows:

(i) *Fiscal capacity and revenue sources*. Fiscal capacity was measured in terms of a 'representative revenue system' which took separate account of sixteen different types of tax and non-tax revenues.[9]

(ii) *Tax base for each revenue source.* This was the base to which the given uniform rate of tax was applied to arrive at revenue needs (i.e. value of the revenue base).[10] Under the Canadian system a separate base was devised for each of the sixteen revenue sources (examples as applied to any province are: value of retail trade — for the general sales tax; volume of gasoline and diesel oil sold — for the gasoline tax and for motor vehicle licenes; assessed federal individual income tax — for individual income tax; and value of natural gas production — for natural gas royalties).

(iii) *Population yardstick.* Population was the yardstick or common denominator used to determine what a province's appropriate portion of any revenue base should be.[11] Other yardsticks are possible. Population was used because it was regarded as the best general barometer of expenditure needs. Use of the population yardstick in this way carries the implication that expenditure needs and costs of public services are equal per head of population.[12] Thus, although differences in expenditure needs were not expressly taken into account, grants to provinces were nevertheless based on the rather dubious assumption that areas with identical or similar populations have identical or similar expenditure needs.

1967 Formula: Method of Calculating Equalisation Grants

The equalisation payment to a province in respect of a given type of revenue is determined as follows:

$$E_i = P_i\left[\frac{(R_c}{(B_c}\cdot\frac{B_c)}{P_c)} - \frac{(R_c}{(B_c}\cdot\frac{B_i)}{P_i)}\right]$$

where E_i = equalisation payment in respect of a given type of revenue
P_i = population of a province
P_c = population of all provinces
B_i = common revenue base of a province for a given type of revenue
B_c = common revenue base of all provinces for a given type of revenue
R_c = actual revenue of all provinces for a given type of revenue

This formula reduces to

$$E_i = R_c\left[\frac{P_i}{P_c} - \frac{B_i}{B_c}\right]$$

Thus, an equalisation grant to a province will depend on the difference between the province's share of total population and its share of the common revenue base multiplied by total actual revenue from the particular tax or revenue source. It therefore seems clear that a province can obtain an increase in its grant from any one or combination of the following:

(i) an increase in the total revenue of all provinces from the tax or revenue source in question (R_c);

(ii) an increase in the province's population relative to that of all provinces $\left(\frac{P_i}{P_c}\right)$;

(iii) a decrease in its share of the common revenue base with respect to that revenue $\left(\frac{B_i}{B_c}\right)$.

Conversely, a decrease in total revenue, a fall in the population ratio or a rise in the share of the common revenue base would result in a fall in the equalisation grant with respect to the particular type of revenue. These three elements may, of course, be offsetting in some degree. A fall in R_c may be more than compensated by a rise in $\frac{P_i}{P_c}$ or a fall in $\frac{B_i}{B_c}$. Alternatively, and more realistically, a rise in R_c may be more than compensated (in terms of the net effect on the grant payable) by a fall in population in the province (relative to other provinces) or by a rise in the province's share of the common revenue base.

Assume, initially, that total revenue from a given tax is \$100m, that the province in question has 10 per cent of total population and 5 per cent of the total tax base with respect to that tax.

Then $R_c = 100$

$$\frac{P_i}{P_c} = \cdot 10$$

$$\frac{B_i}{B_c} = \cdot 05$$

The province would then receive a grant (with respect to that tax) of \$5m, calculated as follows:

$$E_i = R_c\left[\frac{P_i}{P_c} - \frac{B_i}{B_c}\right]$$
$$= \$100\text{m}\,[\cdot 10 - \cdot 05]$$
$$= \$5\text{m}$$

Now assume that total revenue from the tax (R_c) is unchanged and that changes in the other two components are such as to neutralise each other. Thus $\frac{P_i}{P_c}$ rises by say 10 per cent and $\frac{B_i}{B_c}$ rises by 20 per cent

Then $E_i = \$100\text{m}\,[\cdot 11 - \cdot 06]$

$= \$5m$

The grant is then unchanged.

The grant may rise, despite a fall in R_c, if the population component rises and the base tax component stays the same or if the population component is unchanged while the province's share of the common tax base falls. Assume that total revenue from a particular tax falls to \$90m, that $\frac{P_i}{P_c}$ remains at 10 per cent while the $\frac{B_i}{B_c}$ ratio falls to 3 per cent. The equalisation grant for the revenue type in question then rises to \$6·3m:

$E_i = \$90m\,[\cdot 10 - \cdot 03]$

$= \$6 \cdot 3m$

The above examples relate to a particular revenue source. When the same exercise is repeated for all twenty-two revenue sources[13] the sum total of the pluses and minuses will give the total equalisation grant payable to the province. (If the minuses exceed the pluses, as has occurred in British Columbia, Ontario and Alberta, no grant is paid and the province is not required to make any payment.) Thus, if E_{t_1} is the equalisation payment (+ or —) for the first tax, E_{t_2} for the second and so on, the equalisation grant payable to the province is given by:

$E_i = E_{t_1} + E_{t_2} + E_{t_3} + \ldots\ldots\ldots + E_{t_{22}}$

The size of the total equalisation payment to a province can therefore be influenced by the tax mix as well as by total revenue (R_c) of each tax or revenue source, the population ratio and the province's share of the common revenue base for each revenue type. If taxes in which the province has a small share of the tax base are growing relatively fast there will be a favourable effect on the grant payable to the province (assuming other components remain unchanged). Conversely, if the taxes which are growing in importance are those in which the province has a large stake, the total grant to the province will tend to fall. Take a province which has an 'equalisation factor' $\left(\frac{P_i}{P_c} - \frac{B_i}{B_c}\right)$ for tax 'A' of 5 per cent and an 'equalisation factor' for tax 'B' of 3 per cent. It would then be to the advantage of that province to increase rates for tax 'A' and reduce rates for tax 'B' so as to keep total revenue from the two taxes constant.[14]

The total equalisation grant to a qualifying province is thus determined by:

(i) the total revenue from all sources subject to equalisation;

(ii) the provincial share of tax base with respect to each of the twenty-two categories;

(iii) the proportion of total population in the province; and

(iv) the tax or revenue mix.

Implications of the Formula

A major advantage claimed for the new approach was that equalisation became sensitive to growth over a much broader canvas than was the case with the previous formula which utilised only the three standard taxes, the yields from which could fluctuate sharply in the short run. Provided total revenue (the R_c factor) increases, the grant to a province with below-average tax capacity will also increase. It makes no difference in what province or provinces the increase in revenue occurs. Thus, as the economy expands the financially weak provinces are able automatically to participate in the benefits of that expansion. The poorer states automatically receive financial compensation through equalisation grants as the economy expands (i.e. as R_c grows).

This may be counted as an advantage. It means that poorer provinces will continue to receive the benefits of an expanding R_c and hence large equalisation

grants as long as they remain poor (in relative terms). If the difference between the national average per capita revenue and the per capita revenue of a given province narrows, the grant will fall. This can be shown as follows:

$$E_i = R_c \left[\frac{P_i}{P_c} - \frac{B_i}{B_c}\right]$$

Because the federal average tax rate (r_a) — the equalisation yardstick — is used to determine the potential revenue of each province (R_i) from the application of the average rate to its base (for t_1), then $B_i = \frac{R_i}{r_a}$ and the equalisation payment with respect to t_1 becomes:

$$E_{t_1} = R_c \left[\frac{P_i}{P_c} - \frac{\frac{R_i}{r_a}}{\frac{R_c}{r_a}}\right]$$

$$= R_c \left[\frac{P_i}{P_c} - \frac{R_i}{R_c}\right]$$

$$= \left[\frac{R_c \cdot P_i}{P_c} - R_i\right]$$

$$\text{and } \frac{E_{t_1}}{P_i} = \left[\frac{R_c}{P_c} - \frac{R_i}{P_i}\right]$$

Thus the equalisation payment per capita with respect to t_1 equals the national average per capita yield of the tax (t_1) *less* the per capita yield of the tax (t_1) in the province (at the national average tax rate). Therefore, the grant paid in respect of the tax (E_{t_1}) is equal to the difference between these per capita yields multiplied by the population of the province. Thus as $\frac{R_i}{P_i}$ increases relative to $\frac{R_c}{P_c}$ the grant will tend to fall.

There may be no strong objections to this procedure, since the purpose of an equalisation formula (as opposed to a tax effort formula) is to equalise revenue differences between provinces whatever the cause of those differences and irrespective of the tax efforts of particular provinces. Thus, once the per capita revenue differences disappear, the equalisation grants also disappear.

A fall in the collective population share of the financially weak provinces has tended to reduce the size of the equalisation grants, but this has been offset to some extent by lower absolute tax capacities. The crucial relationship is that between $\frac{P_i}{P_c}$ and $\frac{B_i}{B_c}$ since any province with below-average taxable capacity benefits when R_c rises. In the financially weak provinces $\frac{P_i}{P_c}$ will nearly always be larger than $\frac{B_i}{B_c}$ which, as noted above, is the same as saying that $\frac{R_c}{P_c}$ is greater than $\frac{R_i}{P_i}$. If a given province's share of total population increases or its share of the total revenue base decreases, its equalisation payment with respect to that type of revenue will increase. Although the $\frac{P_i}{P_c}$ ratio may be falling, it is likely that E_t will be positive for most revenue sources since $\frac{P_i}{P_c}$ will still be greater than $\frac{B_i}{B_c}$.

This seems to be sensible enough. However, a possible weakness of the formula — and this applies to any revenue equalisation formula — is that there is no great incentive for poorer provinces to improve their position. If $\frac{B_i}{B_c}$ rises faster than $\frac{P_i}{P_c}$, the grant is reduced below what it would have been, assuming a given rate of growth for R_c. There is no reason to expect any major effort on the part of the poorer provinces to increase taxes, since such efforts 'would produce much less additional revenue per capita than similar tax effort by one of the wealthy provinces'.[15] Put another way, if the more affluent provinces raise taxes and a poorer

province does not, the equalisation grant to that province (the population component remaining the same) will actually rise. In fact if a province does not levy a particular tax at all it receives an equalisation payment with respect to that tax. Because national averages are used, a change in tax rates by a province in receipt of equalisation payments will not have much effect on its equalisation entitlement. This point has been made clear by the Canadian Tax Foundation: 'Using national averages and aggregates minimizes, for most provinces receiving equalisation, the effect on equalisation payments of changing tax rates, since the larger provinces will have a greater weight in establishing the national average.'[16]

Formula Adjustments Since 1970

In 1971 the equalisation formula was extended to take into account three additional revenue sources, namely health insurance premiums, race track taxes and the provincial share of income tax on power utilities.[17] A more important change occurred in 1973 with the addition of municipal taxes imposed for local school purposes. This was the first municipal tax to be included in the equalisation formula and for 1974 was estimated to provide an additional $190m in equalisation grants to the Atlantic provinces, Quebec, Manitoba and Saskatchewan.[18] By 1975 the representative revenue system embraced twenty-two different tax and non-tax revenues.

Towards the end of 1974 amendments were proposed to the equalisation formula (under the *Federal-Provincial Fiscal Arrangements Act* 1972) in order to offset the distorting effects of the large increases in revenue of oil and gas producing provinces created by the international oil disturbance. (The effect of this disturbance on federal-provincial relations and the serious conflicts between governments which have resulted from the impact of the oil crisis in Canada are discussed at the end of chapter 18.) It was provided that there should be a distinction between 'basic' and 'additional' revenues from these sources, that the 'basic' element should be equalised in full and the additional element to the extent of one-third. The arrangements were to apply from 1974-75 to 1976-77.[19]

Adjustment for Tax Effort

In point of equity it may seem wrong that a province should be able to share fully in revenue equalisation grants even though it makes little or no effort to improve its services by raising its own taxes. The fault, of course, lies with the choice of the method of revenue equalisation used to assist financially weak states. Moreover, since these equalisation payments are unconditional, states are free to reduce taxes rather than to increase expenditures.

In the formula employed in Canada the revenue equalisation entitlement varies with the collective tax effort of all provinces and not with the tax effort of the particular province. The Canadian method can be regarded as unsatisfactory in that it does not allow a proper reward or incentive for tax efforts in low income provinces. This follows, as noted, from the fact that the revenue equalisation formula is based on averaging so that when a province whose tax revenues are small in relation to the Canadian total raises tax rates, the impact on its equalisation entitlement will be insignificant.

If it is desired to adjust the formula for a tax effort element (this element being clearly separate from tax capacity, or tax revenue per capita), this may be done by allowing for any change over a period in the proportion of a province's own

revenues for each tax to the yield of each tax at average provincial tax rates, and then adding the pluses and minuses (for each tax) to obtain the tax effort adjustment factor. This result may be obtained in the following manner: Let the adjusted equalisation entitlement for a province in the current period (AE_{iT}) be equal to the equalisation entitlement under the existing formula (E_{iT}), plus or minus the change in the tax effort adjustment factor (as between the current and the previous period) as applied to the equalisation entitlement for the current period under the existing formula.

$$\text{Hence } AE_{iT} = E_{iT} + \Delta TEAF \cdot E_{iT} \quad (1)$$

Let change in tax effort adjustment factor ($\Delta TEAF$) for tax t_1 =

$$\frac{\Delta R_{it_1}}{\Delta RAct_1} = \frac{\text{Change in revenue raised in province i from tax } t_1}{\text{Change in revenue raised in all provinces at average tax rates for tax } t_1} \quad (2)$$

Therefore for all taxes

$$\Delta TEAF = \frac{\Sigma_t \Delta R_i}{\Sigma_t \Delta RAc} \quad (3)$$

and

$$AE_{iT} = E_{iT} + \frac{\Sigma_t \Delta R_i}{\Sigma_t \Delta RAc} \cdot E_{iT} \quad (4)$$

By way of illustration, let

$E_{iT} = \$500$

And assume that during a year in province i $\frac{\Sigma_t R}{\Sigma_t RAc}$ has increased from 4·5 to 6 per cent.

$$\text{Then } AE_{iT} = 500 + .015 \cdot 500 = \$507.5$$

On the basis of data presented by Professor Herber,[20] it would appear that provinces which receive equalisation payments have a significantly higher tax effort than provinces not in receipt of these payments. The index of tax effort used is one arrived at by dividing — for each province — the actual revenue from own sources by the total yield at the average provincial rate. It therefore seems clear that an allowance in the formula for tax effort would, on balance, tend to increase equalisation payments.

Horizontal Fiscal Equalisation in the United States

Before 1972 interstate and intrastate equalisation effects were brought about in the United States by way of federal grants-in-aid programs. For many programs the amounts paid to recipient governments are adjusted to reflect differing fiscal capacities. Equalisation is introduced via variable matching ratios. A typical feature of matching grants is that the federal share or contribution varies inversely with per capita income in the state or locality. But tax effort factors are often included in allotment formulas and the latter are 'quite complex and are not easily understood by either legislators or program administrators'.[21] In a relatively new departure, some recent programs (such as the now superseded economic opportunity programs and regional economic development programs) provided federal moneys almost entirely to poorer jurisdictions.

The United States clearly lacks a systematic or overall approach to horizontal fiscal equalisation. Comprehensive horizontal fiscal equalisation procedures are notably absent from the American scene. The proliferation of grants-in-aid programs, some of which contain equalisation provisions, smacks of a piecemeal approach. There is certainly nothing comparable to the techniques employed by the Australian Grants Commission, to the system of interstate financial transfers in Germany, or to revenue equalisation in

Canada. Moreover, according to a detailed study by the Advisory Commission on Intergovernmental Relations, only 23 per cent of all federal aid is adjusted on the basis of relative fiscal capacity: 'When relative per capita amounts are examined, only public welfare grants show a consistently inverse relation to revenue capacity.'[22]

The advent of revenue sharing does, however, offer the prospect that the American system will come closer to procedures being followed in other countries. One of the objectives of revenue sharing was to use unconditional federal transfers as a means of securing a measure of both inter- and intra-state fiscal equalisation.[23]

Revenue sharing does, however, differ in several important respects from revenue equalisation in Canada:[24]

(i) The Canadian system is open-ended in the sense that the Dominion Government must compensate a low-income province for any deficiency in its fiscal capacity relative to the national average. There is no such commitment in the American plan, since all states receive revenue-sharing cheques irrespective of whether their fiscal capacity is above or below average. Moreover, the amount to be distributed in any entitlement period is allocated from a fixed total appropriation for that period.

(ii) In addition to population and relative income, the amount received by a state under US revenue sharing is also contingent on the state's relative tax effort. There are functional restrictions on the use of shared revenues at the local level as well as a stipulation as to the maximum amounts which any local authority can receive in revenue sharing money. (In the Canadian formula there is no specific allowance for tax effort and no restrictions are placed on the use of equalisation grants.)

(iii) The American aim is to equalise at the local as well as at the state level by means of a pass-through provision of funds to local authorities. The Canadian formula contains no such provision.

(iv) The Canadian revenue equalisation grant formula includes user charges, while the US formulas include only tax revenues.

Horizontal Fiscal Equalisation in the Federal Republic of Germany

The Financial Settlement law of March 1951 was designed primarily to offset or even out differences in tax capacities as between states; but some special allowance was also made for burdens relating to refugees, unemployment, interest on loans, higher education, and harbour maintenance.

A constitutional amendment in 1955 made it clear that the impact on the states of a distribution of state and shared taxes according to local receipts was to be offset, in accordance with Article 107, by an appropriate financial settlement between financially strong and financially weak states. This Article also envisaged supplementary allocations from the Federal Government to financially weak states.

Since 1955, the state financial settlement has been designed to offset differences in taxable capacities, but with some allowance for special burdens (*Sonderbelastungen*) facing particular states.[25]

Financial Settlement Among the States

The actual settlement is worked out as follows: first, the *tax capacity yardstick* of each state is calculated by the addition of revenue from (i) state taxes, (ii) the state's share of the joint taxes according to local yields, and (iii) half of the pro-

perty and trade taxes of the municipalities, also according to local yields and worked out on the basis of uniform *Hebesaetze*.[26] Deductions are then made for any special burdens (extraordinary expenditures) facing a particular state. In this way the *adjusted tax capacity* of each state is determined.

Comparisons of the adjusted tax capacity for each state are then made with the average tax capacity per capita of all states. When the average tax capacity is multiplied by the population of each state the result is the so-called *equalisation yardstick* of each state. In calculating the equalisation yardstick consideration has been given since 1955, by way of an allowance for population density, to the higher tax needs of the City States and to the size of municipalities. Thus, in so far as tax-strong states also tend to be states with relatively high population densities (large cities) — and this is in fact the general pattern — the intensity of the financial settlement has been somewhat reduced.

Finally, the *financial settlement yardstick* is calculated for each state as the difference between its adjusted tax capacity and its equalisation yardstick.

The way the settlement works can perhaps best be illustrated with the aid of symbols, as follows. Consider the process in three steps.

In step (I), let TC_i represent the taxable capacity of state i. When allowance is made for special burdens facing that state (S_i) then the adjusted taxable capacity $ATC_i = TC_i - S_i$.

In step (II), we may represent the average taxable capacity per capita of all states by the expression

$$\frac{TC_a + TC_b + \dots TC_n}{P_a + P_b + \dots P_n}$$

where TC_a = taxable capacity of State a
TC_b = taxable capacity of State b
TC_n = taxable capacity of State n
P = population
This expression can be denoted by $\frac{TC_x}{P_x}$ where x refers to the whole federal area.

But the equalisation yardstick for a particular state (E_i) is weighted to allow for the higher revenue needs assumed to be associated with large population densities, which we can denote by w (which is unity when no such allowance is made).

Thus $E_i = \frac{TC_x}{P_x} \cdot wP_i$

where P_i = population in state i.

The final step (III) is to compare I and II above in order to ascertain the financial settlement yardstick and calculate how much a state must pay into the financial settlement pool or how much it is entitled to receive from the pool. If the financial settlement yardstick is denoted by Y, then

$$Y = [TC_i - S_i] - E_i$$
$$= [TC_i - S_i] - \frac{TC_x}{P_x} \cdot wP_i$$

Y is therefore positive for a state with above-average taxable capacity, as adjusted for special burdens and population density, thus requiring payment into the pool. Y is negative for a state with below-average taxable capacity, as adjusted in similar fashion, thus implying revenue entitlement from the pool.

We see, therefore, that the system of interstate financial equalisation in Germany works in terms of a 'brotherly' rather than a 'fatherly' settlement. States whose adjusted taxable capacities exceed the equalisation yardstick (i.e. those whose taxable capacity is computed at above the federal average) are in effect

surplus states and, as such, are obliged to transfer funds to the so-called deficit states whose adjusted taxable capacities are calculated to be below the federal average. No federal grants, as such, are involved, Instead, tax revenues are simply redistributed as between states through appropriate allocations in the budgets of the financially strong states. The Federal Government's role is as intermediary or broker — to see that the rules set out in the equalisation law are adhered to and that the appropriate transfers are made each year in accordance with these rules.

These rules govern, *inter alia*, the treatment of deficits and surpluses and the intensity of the financial settlement. For one thing, the settlement is not complete. From 1959 to 1968 the tax capacity of the financially weak states was brought up to only 91 per cent of the settlement yardstick. During that period the contributions of the financially strong states were calculated to embrace three-quarters of the surpluses between 100 and 110 per cent of the settlement yardstick and all surpluses in excess of 110 per cent of the settlement yardstick.

The 1969 Finance Reform

The finance reform had, as one of its aims, the strengthening of the state financial settlement in favour of the financially weak states. The reform did not fulfil the expectations of the financially weaker states[27] but it did result in some improvement in the relative financial position of these states.

The decisive change occurred with respect to the interstate distribution of the state share of value-added tax revenue. This change had effect from 1 January 1970. It will be recalled that, through the revised tax-sharing arrangements, the states gained a 30 per cent share of the value-added tax starting with the year 1970. However, unlike the distribution of income tax revenues which continue to be in accordance with local yields, 75 per cent of the state share of the value-added tax was distributed on a population basis and the remaining 25 per cent (the so-called supplementary portion) could be used beforehand to assist the financially weak states.[28] The latter portion is specifically designed to assist states with below-average tax receipts to reach at least 92 per cent of the federal average (Berlin excepted).

This new development does not do away with the need for a horizontal financial settlement, as described above. The financial settlement transfers are, however, smaller since the interstate distribution of the value-added tax already has a significant effect in evening out differences in financial capacities among the states. A law has also been passed (*Zerlegungsgesetz*) for the purpose of correcting distortions in the income tax receipts of the states which result from a distribution according to local receipts. These distortions are particularly acute in the case of the corporation income tax. The new law has been used since 1970 to redistribute revenue in accordance with the principle that revenue is to be paid to the state in which the business premises are located and not to the state in which the head office is located.

Apart from the foregoing law, the amended version of Article 107 means that horizontal fiscal equalisation can now be thought of as being the sum of three elements:

(i) distribution of the state share of value-added tax on a population basis and according to other 'need' criteria;

(ii) contributions from financially strong to financially weak states in accordance with procedures outlined

above for the state financial settlement; and

(iii) federal supplementary allocations to states whose tax receipts per head of population lie below the federal average and/or to states in financial need (*Article 107* (2)).[29]

Finance reform has assisted low income states in two principal ways: (i) through the distribution of the state share of the value-added tax revenue; and (ii) by the decision to augment below-average tax capacities up to the level of at least 95 per cent of the settlement yardstick (91 per cent previously).

The treatment of surpluses was also changed, so that surpluses in the range 100 to 102 per cent of the settlement yardstick were not counted and the financially strong states were required to contribute 70 per cent of surpluses from 102 to 110 per cent of the settlement yardstick together with all surpluses in excess of 110 per cent of that yardstick.

Two other decisions about this time also had an important influence on the interstate distribution of tax revenues:

(i) The increase in special burdens for the Saarland from DM35m to DM55m (mainly in recognition of high costs associated with the University of Saarbruecken) and the creation of a new special burden for Rhineland-Palatinate at DM20m, ostensibly to meet high administrative costs in relation to compensation for victims of Nazi persecution. (The existing scale of special burdens for Hamburg, Bremen and Lower Saxony for costs of harbour maintenance, at DM55m, DM25m and DM6m, respectively, was retained. An allowance of DM30m in recognition of excessive burdens in Schleswig-Holstein, a predominantly agricultural state, was also retained.)

(ii) A more liberal approach, for purposes of calculating the settlement yardsticks, to burdens imposed on large municipalities. This part of the financial settlement is fairly complicated. The benefits are on a sliding scale starting with a population valuation of 100 per cent for cities with 5000 people and moving up by steps to a valuation of 135 per cent for cities with 500,000 people. Over and above this level there are extra percentage allocations to synchronise with population density. These range from 2 per cent where there are 1500 to 2000 people per sq km to 6 per cent where there are more than 3000 people per sq km.[30] This adjustment serves to lessen the intensity of the financial settlement, because it is by and large the wealthier states — especially North Rhine-Westphalia — which stand to gain most from it (North Rhine-Westphalia has four cities with more than 500,000 people in which population densities are large enough to attract the favourable valuation in the settlement yardstick for that state). In addition, the valuation rate for Bremen in respect of population density has been brought up to the same level as Hamburg — namely 135 per cent. This change, which secured an additional DM40m for Bremen, was considered necessary to offset the particularly unfavourable effect on that state of the new tax distribution.

The various decisions taken as a result of the 1969 Finance Reform assist some states more than others and provide that an important part of horizontal financial equalisation at the state level shall be secured beforehand, through changes in the interstate distribution of the state share of the value-added tax. But these decisions, while they reduce the amount of the equalisation transfers, do not alter the basic mechanism for arriving at a financial settlement between states. The transfers made in terms of that settlement (*Laenderfinanzausgleich*) still represent

the true financial settlement in the Federal Republic. In terms of our earlier formula the Finance Reform means that the value of the TC_i factors are somewhat larger than they would have been under the previous arrangements; for the financially weak states the increases are particularly significant, for the financially strong states less so. Thus when the formula is used to determine the net receipts from, and net contributions to, the financial settlement pool, there are advantages to states with low income/population ratios, although these advantages are partially offset by the population density rating which clearly favours the wealthier and more heavily industrialised states.

Summary

It will be apparent from the foregoing that the West German authorities have been active in devising a system of interstate fiscal equalisation which has regard to differing tax capacities and expenditure needs. The main emphasis is on differing tax capacities but allowance for differing expenditure needs, involving a measure of arbitrary judgment, intrudes into the financial settlement in three respects: (i) the assessment of special burdens; (ii) population valuations; and (iii) a distribution of one quarter of the state share of the value-added tax in a way which assists states facing relatively high costs of providing public goods.

Financial settlement takes the form of what was described earlier as a 'brotherly' rather than a 'fatherly' settlement. Whereas in other federations equalisation transfers take the form of appropriations from the federal budget, in Germany there is a clear-cut settlement between the states. The system shows clearly the amount which each state annually pays into, or receives from, the financial settlement pool. Appropriations must therefore be provided for in the budgets of the financially strong states.

There is a constitutional provision for federal supplementary payments to assist states in special financial need, but the actual amounts paid are small and have been used only to offset, at the margin, unfavourable and unanticipated developments in the revenues of these states.

A major advantage of the West German system is that equalisation is explicit. It is not difficult to calculate, with the aid of the formula employed above, how much revenue has been transferred from states A′, B′ ..... to states A″, B″ ..... for purposes of horizontal financial equalisation. Use of an explicit equalisation formula can be counted as a major advantage, in that it limits the scope for subjective judgment or piecemeal subsidies to placate particular states. Such a 'brotherly' financial settlement tends to make for a clear separation between vertical (federal-state) and horizontal (interstate) financial settlement. Use of an explicit formula for interstate fiscal equalisation makes it clear to all parties how much revenue is being redistributed and what criteria are being used to determine the net result. Looking ahead each state can therefore make a reasonably accurate assessment of how much it will have to pay into the financial settlement pool or how much it can expect to receive from that pool. In short, a 'brotherly' type financial settlement appeals as an orderly system in which, for the most part, objective criteria are used.

14 Impact of Horizontal Fiscal Equalisation

Australia

Horizontal Financial Transfers Implicit in General Revenue Grants

In Australia, where grants are paid to all states to close the gap between the states' own revenues and their expenditure commitments and to assist financially weak states by providing for relatively large grants per capita to those states, the grants have a dual purpose: they are designed to correct for vertical fiscal imbalance and to secure a measure of horizontal fiscal equalisation (HFE).

There is no single criterion which is widely accepted as the appropriate measure of the extent to which financial assistance and other general revenue grants contain payments for horizontal fiscal equalisation.

Financial assistance grants are, in effect, paid mainly to compensate states for their loss of income taxation and to satisfy the HFE goal. It might therefore be tempting to argue that the latter can be measured by the difference between the actual interstate distribution of grants and a distribution based on income tax receipts in each state. Such a comparison is interesting because it reveals the extent to which the distribution has been varied from a distribution based on receipts of personal income tax (see table 14-1). But this method is unsatisfactory because HFE is not related only to tax differences.

A more acceptable benchmark would

Table 14-1

Actual Distribution of General Revenue Grants and Distribution on Basis of Personal Income Tax Receipts (1970-71)

	(1) Actual distribution ($m)	(2) Distribution on tax basis* ($m)	(3) (1)-(2) ($m)	(4) (3) as per cent of (1) (%)
NSW	485.0	598.0	−113.0	− 23.3
Vic.	361.6	432.2	− 70.6	− 19.5
Qld	223.3	171.7	+ 51.6	+ 23.1
SA	161.2	122.9	+ 38.3	+ 23.8
WA	168.3	118.4	+ 49.9	+ 29.6
Tas.	80.8	37.0	+ 43.8	+ 54.2
Total	1480.2	1480.2	—	—

* Distribution in proportion to personal income tax collections.

Source: Australian Bureau of Statistics, *Australian National Accounts*; and *Commonwealth Payments to or for the States.*

Table 14-2

Horizontal Fiscal Equalisation Implicit in General Revenue Assistance (GRA)
(selected years)

	Implicit equalisation grants on a per capita basis* ($million)					Implicit equalisation grants as a percentage of actual GRA (%)				
	Qld	SA	WA	Tas	Total	Qld	SA	WA	Tas	Total
1956-57	4.7	12.3	21.5	7.4	45.9	8.6	28.6	46.9	38.9	28.3
1960-61	9.2	16.5	30.3	16.1	72.1	11.5	26.8	46.9	49.4	30.2
1964-65	11.3	20.1	42.5	23.7	97.6	11.2	25.7	48.5	54.0	31.4
1970-71	33.1	38.6	62.0	39.9	173.6	14.8	23.9	36.8	49.4	27.4
1972-73	68.5	67.9	76.6	42.7	255.7	24.3	33.5	39.0	49.0	33.3
1973-74	91.4	77.5	90.9	51.7	311.5	27.5	34.1	40.4	51.1	35.1
1974-75	135.5	96.0	108.6	69.5	409.6	31.2	34.4	39.6	53.6	36.7

* Excess of per capita general revenue assistance over average for NSW/Vic. multiplied by state population.

Source: *Payments to or for the States, 1974-75.*

seem to be one based on average per capita general revenue assistance (GRA) in New South Wales and Victoria (taken as the standard). This method permits a calculation of implicit HFE in each of the other four (non-standard) states by comparing GRA per capita in each of these states with the standard, and then multiplying the differences by the population of each non-standard state. The necessary calculations are contained in table 14-2 for selected years between 1956-57 and 1974-75. This table shows that, over the whole period, implicit HFE grants grew in absolute terms from $46m to $410m. The increasing relative importance of HFE is evident from the table, since implicit HFE grants in the four states grew from 28 to 37 per cent of actual general revenue assistance received by those states.

On a per capita basis, the impact of HFE in Australia has therefore been very pronounced. Table 14-2 reveals, for example, that over one-half of Tasmania's GRA contained an element of implicit HFE (up to 1973-74, the latter included special grants recommended by the Grants Commission and these grants accounted for about one-quarter of implicit HFE). Since 1960 Tasmania's dependence on the fiscal equalisation component of GRA has clearly been much greater than any other state, although by 1974-75 HFE was still considerable for Western Australia and, since 1970, had increased sharply for Queensland[1] and South Australia.

A comparison of GRA for each of the six states on an equal per capita basis with the actual assistance received by each state for the years 1956-57, 1964-65 and 1973-74 reveals a similar pattern (see table 14-3).

As was observed earlier, the 1959 Financial Agreement had the immediate effect of reducing special grants. This move did not, however, work to the disadvantage of the low-income states since the new formula contained a built-in bias which favoured those states.[2] The total amount of HFE embodied in the general revenue grants in 1959-60 was not

Table 14-3

General Revenue Assistance — Actual and Equal Per Capita Distribution,
(selected years)

		NSW	Vic.	Qld	SA	WA	Tas.	Total
1956-57								
Equal per capita basis	($m)	146.0	106.7	56.6	35.0	27.6	13.2	385.1
Actual	($m)	130.6	92.1	54.5	43.0	45.8	19.1	385.1
Difference	($m)	−15.4	−14.6	−2.1	+8.0	+18.2	+5.9	—
Difference as % of actual	(%)	−11.8	−15.9	−3.9	+18.6	+39.7	+30.9	—
1964-65								
Equal per capita basis	($m)	265.2	200.7	104.1	67.3	52.3	23.5	713.1
Actual	($m)	230.5	171.8	101.1	78.2	87.6	43.9	713.1
Difference	($m)	−34.7	−28.9	−3.0	+10.9	+35.3	+20.4	—
Difference as % of actual	(%)	−15.1	−16.8	−3.0	+13.9	+40.3	+46.5	—
1973-74								
Equal per capita basis	($m)	701.8	535.4	287.9	179.1	160.4	58.9	1923.5
Actual	($m)	593.4	443.6	332.5	227.6	225.3	101.1	1923.5
Difference	($m)	−108.4	−91.8	+44.6	+48.5	+64.9	+42.2	—
Difference as % of actual	(%)	−18.3	−20.7	+13.4	+21.3	+28.8	+41.7	—

Source: See Table 14-2 and Australian Bureau of Statistics *Public Authority Finance* (for population by states)

significantly different from the total in 1957-58, because the latter came under the combined influence of special grants and the adjusted population basis of distribution provided for in the tax-reimbursement formula. As was illustrated in table 12-5, in essence the main difference between the two years is to be found in the method used to achieve the desired interstate redistributive effects. The declining role for special grants was more or less matched by a distribution of direct Commonwealth assistance which was heavily biased towards the less affluent states.

After 1960 (and especially between 1960 and 1966) a series of adjustments to the base grants for financial assistance and *ad hoc* payments to particular states served to accentuate even further the unequal distribution of general revenue grants on a per capita basis.

Impact of Other Commonwealth Payments

The foregoing shows that the policy of the Australian Government on the distribution of general revenue grants (including acceptance of Grants Commission recommendations) has been such as to create large interstate differences in per capita grants. The redistribution has been mainly from the 'standard' or high income states (New South Wales and

Victoria) to the other four states, but especially to Western Australia and Tasmania. Since 1965 both South Australia and Queensland have shown an improvement in relation to Western Australia and, to a lesser extent, Tasmania.

However, the discussion so far has been confined to general revenue grants. Account must now be taken of the likelihood that other Commonwealth payments also contain a redistributional element.

While general revenue grants are made to regulate the vertical intergovernmental financial settlement (VIFS) and to secure horizontal fiscal equalisation effects between states, the *raison d'être* of specific purpose grants is much more complex. These grants are paid for a great variety of purposes and are made on the basis of several criteria. Commonwealth-state bargaining is, of course, important but the initiatives for grants of a developmental character come mainly from the states whereas the main initiatives for grants in other fields (e.g. welfare services) come from the Commonwealth. For roads, universities, and many other categories, grants are based on recommendations of expert bodies set up to assess needs and priorities in their respective spheres. Grants for debt charges fall into a special category and are clearly part of the VIFS. Grants to meet national disasters can also be isolated and linked with special circumstances over which the states have little, if any, control in the short run. But for the great bulk of specific purpose payments (of which roads and education account for almost three-quarters of the total), their size, distribution, matching and other conditions will reflect the relative importance attached to a range of criteria appertaining to VIFI, HFE, resource allocation, development potential in particular areas and political pressures.

If resource allocation and development potential are linked together we can say that a very large proportion of specific purpose grants are motivated by the need to:

(i) correct for VIFI;
(ii) influence interstate income distribution (grants for beef roads would be a case in point);
(iii) influence the allocation of resources (especially to ensure that states do not underspend in areas such as education and roads where benefits tend to spill over into other states); and
(iv) satisfy the political pressures of the moment.

It is well nigh impossible to disentangle these various elements with any pretence at precision. The VIFI element is quite important, since in several instances the grants finance expenditure which the states would have undertaken on their own initiatives had they had the financial resources to do so. In other instances, however, the Australian Government has taken the initiative in promoting expenditures which the states would not have undertaken, particularly in areas (such as roads and education) where benefits extend beyond the borders of a particular state. In fact a common criticism voiced by the states is that specific purpose grants distort state priorities and force the states into a spending mix which they would not otherwise adhere to.

While these various elements are obviously important they are not easily quantified. It is therefore necessary to work in terms of aggregates and establish a suitable yardstick as regards horizontal fiscal neutrality. The most acceptable yardstick would seem to be equal per capita payments as between states. This yardstick is, however, more meaningful for revenue (or current) grants than for capital grants; and it is therefore desirable

Table 14-4

Specific Purpose Payments by States: Actual and Equal Per Capita Payments (1973-74)

	Specific purpose Payments — current			Specific purpose Payments — capital		
	(1) Actual	(2) Equal per capita basis	(3) Percentage deviation	(1) Actual	(2) Equal per capita basis	(3) Percentage deviation
	$m	$m	%	$m	$m	%
NSW	203.5	222.6	− 8.6	300.0	349.8	−14.2
Vic.	177.6	169.5	+ 4.8	208.4	266.4	−21.8
Qld	84.8	91.5	− 7.3	185.0	143.8	+28.7
SA	63.9	56.7	+12.7	118.2	89.1	+32.7
WA	57.8	50.6	+14.2	108.8	79.6	+36.7
Tas.	22.2	18.9	+17.5	38.0	29.7	+27.9
Total	609.8	609.8	....	958.4	958.4	....

Source: *Payments to or for the States and Local Government Authorities, 1974-75* (table 89, p. 141) and *Public Authority Finance: Authorities of the Australian Government, 1973-74* (p. 79 for population distribution).

to maintain a clear separation between the two categories. Use of the population yardstick has its problems, since financial need is linked with factors besides population. However, the population yardstick is useful for gauging the differential impact of specific purpose payments on the states. By comparing the actual distribution of these payments (current and capital) by states with a distribution on an equal per capita basis we obtain an approximate measure of the redistributional element contained in the payments.

This method is illustrated in table 14-4 for the year 1973-74. The calculations shown in the table indicate that specific purpose payments of a current nature favoured Tasmania, Western Australia and South Australia, in that order. The percentage deviations for capital payments are much more pronounced, with Victoria and New South Wales receiving considerably less on a per capita basis than the four less populous states.

A convenient breakdown of specific purpose capital payments can be made in terms of roads, education, housing and 'other', as shown in table 14-5. In the residual category it can be seen that grants are relatively much more important in Queensland, Western Australia and South Australia than in the other states. This suggests that grants for purely 'developmental' purposes in states with relatively small populations and large areas (e.g. grants for railways, irrigation, power stations, water resources and Aboriginal advancement) are closely linked not only with opportunities for development but also with the goal of

interstate fiscal equalisation. However, it bears repetition that this pattern is partly a reflection of state initiatives and is, for the most part, not a consequence of a deliberate policy by the Australian Government.

Per capita federal payments (including loan allocations) to each state in relation to the Australian average for selected years between 1959-60 and 1973-74 are shown in figure 14-1. The inclusion of Loan Council borrowing programs and state semi-government and local authority borrowings twists the distribution further in Tasmania's favour and also helps South Australia relative to the other states.

Loan Council allocations have favoured those states which in the past have relied heavily on loan expenditure. In the event that states cannot agree on a distribution, the 1927 Financial Agreement provides a formula under which distribution is geared to net loan expenditures in the states over the previous five years. While the formula has never been applied, the threat that it would be should the states fail to agree has meant that the dis-

Table 14-5
Specific Purpose Capital Payments
by States and Main Categories
(1973-74)

	Roads	Education	Housing	Other	Total
NSW					
$m	99.4	61.9	90.5	48.2	300.0
per capita ($)	21.0	13.1	19.1	10.1	63.3
VIC					
$m	66.6	52.2	56.2	33.4	208.4
per capita ($)	18.4	14.4	15.5	9.2	57.5
QLD					
$m	64.5	22.7	17.6	80.2	185.0
per capita ($)	33.1	11.6	9.0	41.2	94.9
SA					
$m	32.0	25.4	32.8	28.0	118.2
per capita ($)	26.4	20.9	27.1	23.1	97.5
WA					
$m	49.3	20.2	13.2	26.1	108.8
per capita ($)	45.4	18.6	12.1	24.0	100.1
TAS					
$m	14.0	4.5	16.2	3.3	38.0
per capita ($)	35.1	11.2	40.6	8.2	95.1
SIX STATES					
$m	325.8	186.9	226.5	219.2	958.4
per capita ($)	25.1	14.4	17.4	16.9	73.8

Source: *Payments to or for the States and Local Government Authorities, 1974-75* (table 87, p. 137); and *Public Authority Finance: Authorities of the Australian Government, 1973-74* (p. 79 for population distribution).

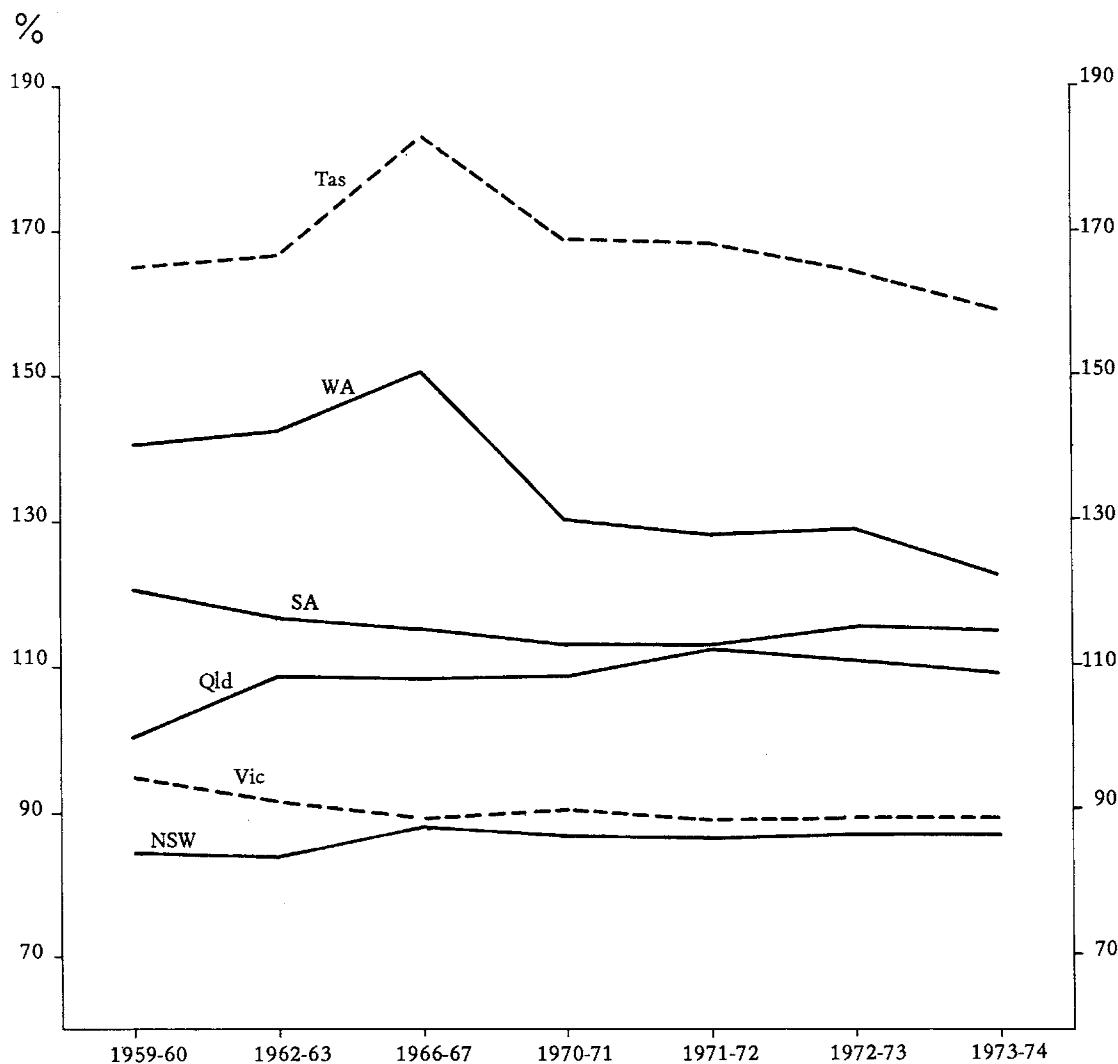

Fig. 14-1 All Commonwealth payments per head of population in each state in relation to the Australian average (1959-60 to 1973-74). Australian average = 100.

tribution has worked to the advantage of states with relatively high loan expenditures.[3]

This method of distributing loan funds between states appears to be in urgent need of revision since it seems unlikely that a distribution based on past loan expenditure will coincide with federal objectives for horizontal equalisation between states. If there is a conflict it is, of course, still possible (and this has been done) for the Federal Government to make appropriate adjustments to the distribution of general revenue or specific purpose grants and advances.

Queensland Treasury officials have drawn attention to the adverse effects on their state of the present method of distributing Loan Council funds.[4] In 1971-72, Queensland received 12·6 per cent of these funds whereas it had 14·3 per cent of the population. However, when semi-governmental and local authority borrowings are taken into account, Queens-

land's position compares favourably with that of other states. Thus, in 1973-74 borrowings by the state and its semi-government and local authorities amounted in total to about $112 per head of population, which was appreciably larger than for any other state except Tasmania. It is, of course, still open to debate whether Queensland, because of the relatively high cost of servicing its population in conjunction with the high capital needs of the state, should receive even larger loan allocations.

In summary, it seems clear that the distribution of various grants and loan moneys has heavily favoured Tasmania. This is brought out in table 14-8 which compares, for the six years to 30 June 1974, the per capita grants and advances received by the four less populous states in relation to grants and advances received by New South Wales and Victoria.

Over 50 per cent of Tasmania's general revenue grants embodies an element of implicit horizontal fiscal equalisation. Considering general revenue grants alone, the distribution has greatly aided Tasmania and Western Australia and, to a lesser extent since 1965, South Australia and Queensland. When specific purpose grants are considered it is Western Australia and Tasmania which, in recent years, have gained most on a per capita basis. In the allocation of funds under Loan Council programs (including borrowings by semi-government and local government authorities), Tasmania has again received much larger amounts on a per capita basis than have the other states. For total payments (all grants and advances), table 14-6 shows the extent to which each of the less populous states has benefited by comparison with New South Wales and Victoria.

It must be recognised that, while differential payments per capita as between states are such as to suggest a significant impact in terms of horizontal fiscal equalisation, the net result is conditioned by the mixture of motives referred to earlier. The differential payments reflect, to some extent, differential costs in providing public ser-

Table 14-6
Per Capita Commonwealth Payments to the States
Average 1968-74 (NSW/Vic. = 100)

	General revenue grants	Specific purpose grants		Loan allocations or advances*	General purpose capital payments†	Total payments
		Current	Capital			
Qld	127	106	159	117	97	125
SA	141	109	166	111	165	132
WA	166	110	216	111	126	148
Tas.	201	130	196	181	258	190

* Includes semi-government and local authority borrowings.
† Excluding advances for housing.

Source: *Payments to or for the States and Local Government Authorities, 1974-75* (tables 90, pp. 144-5 and 103, p. 174).

vices; and they also reflect varying expenditure needs and opportunities for development. While many initiatives for developmental projects come from the states and are eligible for federal financial assistance if the projects are considered to be economically viable, the differential payments are also influenced by political and social pressures (e.g. the desire for greater uniformity in the provision of public services as between states). The impression should not be conveyed that interstate distribution of specific purpose grants and advances is necessarily haphazard. This is certainly not the case when grants follow the advice of expert bodies in such key areas as roads and education. In such cases there is great reliance on intensive analysis and the use of objective criteria for gauging relative expenditure needs. The Australian Government has also used its specific purpose grants as an instrument for reducing state financial antonomy and in order to facilitate development in particular areas (and thereby influence the pattern of economic resource use for the nation as a whole).

Canada

Importance of Equalisation Payments

Equalisation payments to the seven qualifying provinces in 1971-72 amounted to approximately $1000m, or 7 per cent of federal budgetary expenditures. This compares with $590m in 1968-69 (5·5 per cent of federal budgetary expenditures) and $140m in 1957-58 (2·8 per cent of federal budgetary expenditures). Equalisation and stabilisation payments now account for more than three-quarters of all unconditional federal payments to provinces and about one-quarter of total federal payments (conditional and unconditional).

The growing importance of equalisation payments can be seen from table 14-7. However, the rise in the percentage in column 4 reflects to some extent the reduction in tax rentals between 1957-58 and 1962-63. A major addition to unconditional federal payments to the Canadian provinces occurred in 1968-69 with the introduction of bloc grants for post-secondary education.

The equalisation payments are of

Table 14-7

Equalisation Payments in Relation to Other Federal Payments to Provinces

	(1) Equalisation + stabilisation payments	(2) Total unconditional payments	(3) Total federal payments	(4) (1) as % of (2)	(5) (1) as % of (3)
	$m	$m	$m	%	%
1957-58	140.1	393.2	548.0	35.6	25.6
1962-63	155.5	275.3	1,121.2	56.5	13.9
1969-70	712.3	934.3	2,686.7	76.2	26.5
1972-73*	986.7	1,275.2	4,323.4	77.4	22.8

* Estimated.

Source: Data in columns (1), (2) and (3) from *Provincial and Municipal Finances 1971* (table 6.6) and 1973 (table 6.6).

particular significance to the four Atlantic provinces. They are of less significance to other provinces that qualify for assistance — Quebec, Saskatchewan and Manitoba. For every $100 raised from their own or independent revenue sources, the equalisation payments in 1972-73 range from a low of $12 in Manitoba and Quebec to a high of $61 in Newfoundland. In the six years from 1966-67 to 1972-73 the overall dependence on equalisation payments is seen to have increased slightly, as shown in table 14-8; however, dependence on equalisation payments has been reduced in several provinces — notably Prince Edward Island, Nova Scotia and Manitoba.

Perhaps the best method of measuring the financial impact of horizontal equalisation is to compare the per capita revenues of each province before and after equalisation and to relate per capita revenues in each province to the national average. Such a comparison for the years 1966-67 and 1972-73 is made in table 14-9.

It is evident that equalisation transfers have had a pronounced effect in narrowing tax capacity differences between provinces, thereby providing the financially weak provinces with funds to supplement their own tax revenues. Equalisation payments per capita in 1971-72 ranged

Table 14-8

Equalisation Payments in Relation to Gross Revenue from Own Sources (by Province)

	1966-67			1972-73		
	(1) Gross revenue from own sources $m	(2) Equalisation transfers $m	(3) (2) as % of (1) %	(1) Gross revenue from own sources $m	(2) Equalisation transfers $m	(3) (2) as % of (1) %
Newfoundland	78	40	51	197	120	61
Prince Edward Island	17	11	65	50	22	44
Nova Scotia	117	52	44	324	105	32
New Brunswick	105	46	44	274	110	40
Quebec	1602	156	10	3640	452	12
Ontario	2025	—	—	4618	—	—
Manitoba	196	33	17	499	59	12
Saskatchewan	290	34	12	441	119	27
Alberta	487	—	—	1038	—	—
British Columbia	633	—	—	1311	—	—
	5550	372	7	12392	987	8

Source: 1966-67 (i) Dominion Bureau of Statistics, *Provincial Government Finance: Revenue & Expenditure 1968*.

(ii) Advisory Commission on Intergovernmental Relations, *In Search of Balance — Canada's Intergovernmental Experience*, Report M 68, September 1971 (Table 5, p. 20).

1972-73 (iii) *Provincial and Municipal Finances, 1973,* table 3-1, p. 29.

Table 14-9

Per Capita Revenues of Provinces from Own Sources and Equalisation Payments in Relation to National Average

	1966-67		1972-73	
	Before equalisation %	After equalisation %	Before equalisation %	After equalisation %
Nfld	69	99	65	97
PEI	63	90	78	105
NS	66	81	72	88
NB	75	91	75	98
Que.	106	99	105	110
Ont.	126	106	104	96
Man.	87	86	88	92
Sask.	119	114	85	100
Alta	140	118	110	102
BC	149	125	103	95

Source: Federal-Provincial Conference of Prime Ministers and Premiers, *Notes by Prime Minister on Fiscal Arrangements* (Press Release 15-17 Nov. 1971)
Provincial and Municipal Finances, Canadian Tax Foundation, Tables 3-1 and 3-2, pp. 29-30.

from $210 in Newfoundland to $51 in Manitoba. In the four Atlantic provinces equalisation payments per capita averaged $167, compared with an average of $61 for Quebec, Saskatchewan and Manitoba.[5]

There was a much more even distribution of per capita revenues between provinces in 1972-73 than in 1966-67. Per capita revenues after equalisation in 1972-73 ranged from 88 to 110 per cent of the national average, whereas the range in 1966-67 was from 81 to 125 per cent of the national average.

Horizontal fiscal equalisation has therefore been of major importance in Canada in reducing differences in interprovincial tax revenues on a per capita basis. In the last five years the four Atlantic provinces have derived major benefits from equalisation. Differences in per capita revenues as between provinces can, however, be affected by differences (as between provinces) in dependence on borrowing, in the level of tax rates and in the growth of income. Thus taxes are somewhat higher in low income provinces and this accounts for some part of the narrowing in interprovincial per capita revenues. Dependence on borrowing, on the other hand, can be expected to be somewhat greater in provinces with relatively low tax capacities and to the extent that this is true it tends to accentuate differences in interprovincial per capita revenues.[6]

The federal program for stabilising provincial revenues, which is linked to the equalisation payments, has also been important. This program provides a guaranteed payment to each province of an amount equivalent to 95 per cent (recently raised to 100 per cent) of its revenues of the previous year (calculated

on the basis of constant rates and structures). The stabilising feature of the equalisation formula has been important for Quebec and Saskatchewan, because these provinces in recent years have experienced a fall in their respective shares of the national tax base.[7] The federal guarantee relates to all revenue from own sources plus unconditional federal transfers.

The process of horizontal fiscal equalisation (HFE) has also contributed to a situation in which the financially weak provinces have been able to attain a level of per capita public expenditures which now exceeds the level prevailing in the three provinces with the highest income per capita.[8] The ratio[9] was 107 per cent in 1972-73, compared with 92 per cent in 1968-69 and 75 per cent in 1956-57.

Looked at in this way, the impact of HFE in Canada appears to have been quite pronounced. The prime objective of the Canadian equalisation formula is achieved. As long as a province remains relatively poor it will continue to receive compensation in the form of equalisation payments as the economy grows; and these payments will enable the province to raise the level of its expenditures on a per capita basis.

But the relative poverty of a province, and hence its equalisation entitlement, reflects the relatively low per capita tax base of the province; and this in turn reflects to an important extent the relatively low income level which prevails in that province. Data from Statistics Canada show that personal income per capita in the three more affluent provinces (Ontario, Alberta and British Columbia) is about 30 per cent higher than in the seven provinces which qualify for equalisation payments.

The only sure way to reduce the size of the equalisation payments in relation to provincial revenues (and hence lessen the burden on the federal budget) would be to narrow interprovincial income disparities, a difficult assignment since the latter are partly a manifestation of differing resource patterns and opportunities for development.

But it is clear that equalisation payments are at least making it possible for low income provinces to attain certain minimum standards in the provision of public services, using experience in high income provinces as the benchmark of comparison. This is an objective which has support from most experts in public finance.

United States

As noted in the previous chapter, there is no systematic approach to horizontal fiscal equalisation (HFE) in the United States of the kind which has been described for Australia and Canada. However we may expect federal policies, in relation to a great variety of federal grants-in-aid programs and, more recently, revenue sharing, to have interstate equalising effects.

To gauge what these effects are is not an easy task, although general text-books on public finance usually make some broad reference to the impact of federal policies on interstate income distribution.

According to studies carried out by Musgrave and Musgrave there is little relationship between grants (categorical and revenue sharing) and per capita income rankings. Categorical grants actually show a positive relationship with per capita income.[10] Although the variable matching arrangements which apply to some programs (i.e. lower rates of matching from states with lower per capita incomes) demonstrate a desire to afford more favourable treatment to low

income states (as noted in the previous chapter), the available evidence would suggest that 'conditional grants-in-aid have produced no significant redistribution of income among states'.[11] This assessment is in line with a detailed study by the Advisory Commission on Intergovernmental Relations which concluded that only about one-fifth of federal grants-in-aid programs had positive equalising effects.[12] The equalising effects of functional grants at the local level are, however, more pronounced.

The absence of any substantial equalising effects from federal categorical grants-in-aid can be used as an argument for unconditional grants to the states via revenue sharing. In 1971-72 these grants, as shown in table 14-10, did have quite a pronounced equalising effect by comparison with federal grants-in-aid. Revenue sharing grants in 1972 per $1000 of personal income were approximately 80 per cent greater in the ten poorest states than in the ten richest states. By contrast, federal grants-in-aid programs produced a relatively weak equalising effect, since per capita income in 1971 was 34 per cent lower and federal grants-in-aid per capita 16 per cent higher in the ten poorest states than in the ten richest states.

In a systematic follow-up to its earlier investigations of the impact of revenue sharing, the Advisory Commission on Intergovernmental Relations (ACIR), with the aid of data on state-by-state per capita personal income and revenue sharing allocations for 1973 and 1974, has confirmed the existence of a modest fiscal capacity equalisation tendency: 'On the average for each $1000 increase (decrease) in per capita personal income the per capita state area allocation will decrease (increase) by $3.40'.[13] At or near the extremes (e.g. Connecticut and Mississippi) the divergences are considerably larger. ACIR was also quick to point out, however, that the equalisation effects would have been greater in the absence of the provisions which place a 20 per cent floor and a 145 per cent ceiling on local government entitlements for revenue sharing money. According to ACIR computations, nearly one-third of local governments (and notably many of the large cities) were affected by these constraints.

It seems reasonably clear, therefore,

Table 14-10

Equalising Effect of US Federal Grants

	Federal grants-in-aid per capita, fiscal 1971	Revenue sharing grants in 1972 per $1000 of personal income, 1971
	$	$
Ten poorest states	178.44	9.60
Ten richest states	154.22	5.30

Source: Advisory Commission on Intergovernmental Relations, *Federal-State-Local Finances: Significant Features of Fiscal Federalism*, Report M 79, February 1974, p. 319; and B.P. Herber, 'Revenue Sharing and Fiscal Equalization in Canada and the United States', table 6, p. 29.

that the relative income factor in the revenue-sharing formulas does produce positive but by no means substantial equalisation effects. This factor is not swamped by other elements in the formula, particularly tax effort. Although the revenue-sharing plan which was adopted in the United States has positive equalisation effects in the sense that states with relatively low per capita income receive relatively large grants, the equalising effects are much less than they would have been if an alternative formula, such as that proposed by Senator Javits, had been employed (see chapter 8).

But it is by no means certain that a significant redistribution of revenue to low-income states would be the ideal policy. This is mainly because many high-income states (the urbanised Eastern states in particular) which have high per capita incomes also have high per capita expenditure needs.[14] It has therefore been suggested that the spotlight should be focused on intrastate fiscal needs. The pass-through provision to local authorities under the revenue-sharing plan does help in this connection, although the benefits are neutralised in some degree by the tax-effort component embodied in the three-factor formula. The five-factor formula implicitly takes some account of cost differences by including a factor for 'urbanised population'. In Germany, as we see below, problems of urban growth are highlighted and the formula for interstate fiscal equalisation makes some allowance for these problems.

Equalising differential fiscal capacities in the United States revenue-sharing scheme is achieved mainly through the relative income factor, there being very little allowance for differing cost or expenditure need. There would, it seems, be a great deal of opposition to any policy which systematically set out to redistribute revenue in favour of states with below-average taxable capacity and above-average expenditure need, whilst leaving those states free to use the additional funds in any way they please. Such opposition is not surprising in a country with more than 78,000 separate units of government and marked by such diversity in economic conditions, in institutional arrangements and in social and cultural features. This opposition stems in part from a belief that untied equalising transfers may be resource-distorting (as argued by Scott — see chapter 11), and that they may lead to a misuse of funds and may even encourage irresponsibility on the part of recipient jurisdictions.

However, a more important reason for opposition to large-scale equalisation grants or transfers is based on the contention, noted above, that these transfers may only exacerbate problems facing urban communities which, although they have relatively high per capita incomes, also have above-average expenditure needs. Related to this is the possible side-effect (especially if federal low-income relief is inadequate or ineptly administered and if high income earners are able to exploit to their advantage loopholes in the tax law) that the equalisation transfers will produce benefits (in terms of better roads, schools etc.) to wealthy citizens residing in poor areas, such as North Carolina and Georgia, and reduce the benefits (in terms of overcrowding, traffic congestion, etc.) to poor citizens who live in more affluent and highly urbanised areas such as New York and New Jersey.

For these and other reasons, and until federal programs to assist low income earners become much more effective, it is understandable that in the United States there will remain a strong undercurrent of

support for a continuation of the more selective approach to HFE via the technique of categorical grants-in-aid. Support for this technique is based mainly on the control which it gives the central government over the direction of spending in the public sector. The technique has also gained support from economists who see in it an ideal method by which to identify and assist areas of real need.

Despite the probability that categorical grants-in-aid will continue to be used selectively to achieve equalisation effects, the plain fact remains that the categorical grant-in-aid has failed to come up to expectations as an instrument for intergovernmental fiscal adjustment in redressing both vertical and horizontal fiscal imbalances. It is this failure which explains why the trend towards bloc grants has been gathering such momentum since 1971. In sorting out instruments and targets it seems best to reserve categorical grants-in-aid mainly for the task of spillover correction, as noted in chapter 3.

Table 14-11

Estimates of Interstate Fiscal Equalisation in West Germany 1965-1974

	(1) LFA* (DMm)	(2) State share of VAT 25% (DMm)†	(3) 75% (DMm)‡	(4) Federal supplements (DMm)	(5) Total (DMm)	(6) (5) as per cent of state tax revenues %
1965	1590	–	–	–	1590	4.6
1966	1604	–	–	180	1784	4.9
1967	1739	–	–	260	1999	5.3
1968	1725	–	–	440	2165	5.3
1969	2433	–	–	240	2673	5.5
1970	1215	953	858	100	3126	6.0
1971	1289	1072	965	100	3426	5.9
1972	1556	1370	1233	550	4709	6.8
1973	1626	1443	1300	550	4919	6.2
1974	1835	1716	1545	800	5896	6.5

* *Laenderfinanzausgleich* (= state financial Settlement).

† Based on 1968-70 observations that approximately one-third of the distribution of the 25 per cent portion represented a redistributional effect.

‡ When Finance Reform first took effect, approximately 10 per cent of the 75 per cent portion was 'equalising' (i.e. a distribution on a per capita basis had an equalising effect equal to about 10 per cent of the amount so distributed as compared with a distribution on a derivation basis, which in Germany is taken as the bench-mark of neutrality for HFE).

Sources: a) *Finanzbericht* 1970 (pp. 172, 179);
1971 (p. 186);
1972 (p. 192);
1974 (p. 175);
1975 (pp. 133; 171).
b) Wick, 'Die Regelung des Finanzausgleichs unter den Laendern', table 4, p. 271.

Federal Republic of Germany

Before 1970, total interstate fiscal equalisation was the sum of the financial settlement transfers and the federal supplementary payments to the financially weak states. Between 1965 and 1969, the sum of these two elements tended to increase somewhat faster than state tax revenues as a whole, as shown in table 14-11.

The new procedures instituted in 1970, and outlined in chapter 13, made it possible to reduce the amount of financial settlement (*Laenderfinanzausgleich*) transfers. Such reduction, which had advantages from the standpoint of fiscal psychology,[15] was made possible by virtue of the redistributional effects achieved through the decisions to distribute 75 per cent of the state share of value-added tax revenue on a population basis and the remaining 25 per cent of that share on a 'needs' basis.

The 'equalised' revenues which low-income states receive from the value-added tax distribution have more than offset the reduction in the financial settlement transfers, as can be seen from table 14-11. The new tax-sharing arrangements devised as part of Finance Reform have significantly reduced the need for these transfers[16] and they have increased the total redistributional effect of federal policies. The absolute size of the financial settlement transfers in 1974 was still appreciably below the 1969 level, even though the sum total of all components of HFE (when considered in relation to state tax revenues) had shown a significant increase during the five-year period.

Now consider the impact in terms of individual states. The trend between 1968 and 1973 (which takes in the impact of Finance Reform) can be seen from table 14-12. In 1973 financially weak states such as Niedersachsen (Lower Saxony), Rheinland-Pfalz (Rhineland-Palatinate),

Table 14-12

Per Capita State Tax Revenues After Financial Settlement as Related to the Federal Average (Berlin Excluded)*

	1968	1969	1970	1971	1972	1973
Nordrhein-Westfalen	101.8	100.0	100.9	101.5	100.4	100.6
Baden-Wuerttemberg	104.1	102.1	100.0	99.4	100.6	100.8
Hessen	106.4	106.7	99.9	99.7	100.8	101.1
Bayern	92.4	92.8	95.7	95.3	97.0	96.3
Niedersachsen	89.3	92.4	94.9	94.3	95.7	95.8
Rheinland-Pfalz	89.1	91.5	95.7	95.6	95.2	95.1
Schleswig-Holstein	91.0	95.8	97.9	99.0	96.7	96.8
Saarland	93.3	100.0	103.7	103.3	100.8	101.0
Hamburg	156.9	155.0	133.8	135.2	131.8	131.2
Bremen	126.9	126.9	128.4	130.8	124.4	123.5

* Revenues included for purposes of the financial settlement.

Source: (i) *Finanzbericht*, 1970-1974
(ii) *Statistisches Jahrbuch*, 1971, p. 25; 1972, p. 27.
(iii) *Monthly Report of Deutsche Bundesbank* Vol. 24, no. 10, October 1972, pp. 56-7
(vi) Latest population distribution from West German Embassy in Canberra.

Schleswig-Holstein and Saarland had per capita tax revenues (after the financial settlement) which range from 95 to 101 per cent of the federal average (excluding Berlin which does not participate in the financial settlement). This compares with a range of 89 to 93 per cent of the federal average in 1968. The states to lose ground in the redistribution were Hamburg, Baden-Wuerttemberg and Hessen. The equalisation machinery in the Federal Republic of Germany would therefore appear to have had a substantial impact, especially since the Finance Reform, in narrowing differences in tax capacities between states. The redistributional effect would have been even greater had it not been for the population valuation or adjustment factor, which has favoured several high income states. This adjustment is made in recognition that several states with high incomes per capita also have relatively large expenditure needs arising from urban growth.

An examination of data on per capita income distribution by states[17] shows that there has not been a very marked change in the pattern since 1960. Of the financially weak states, only Rhineland-Palatinate and Bavaria have improved in relation to the national average. The adjustment for population density may partly explain this result, since the states which benefit most from the special population valuation, namely Hessen, Baden-Wuerttemberg and Hamburg, have become relatively stronger since 1960 in terms of per capita income distribution.

15 Inter-Country Comparisons of Horizontal Equalisation

The rationale for horizontal equalisation transfers is similar in each country. The transfers are considered necessary in order to enable low-income regions to attain relatively high standards of public services, and usually at least a minimum standard based on either average experience for the whole federation or the experience of the high-income states.

In most federal countries equalisation payments are made available as untied grants from the centre. However, in Australia and Canada a measure of interstate equalisation is implicit in specific purpose or conditional grants, while in the United States a measure of equalisation is achieved under variable matching grant formulas as well as under the 1972 revenue-sharing arrangements.

As to form, the funds for equalisation in Australia, the United States and Canada come to the recipient states as appropriations from the federal budget. In Germany, by contrast, there is a financial settlement between states.

In Germany, no attempt is made to bring the financially weak states up to the level of financial affluence experienced in the states with the highest per capita incomes. Aside from the City States (Hamburg and Bremen) which have exceptionally high per capita incomes, Hessen, North Rhine-Westphalia and Baden-Wuerttemberg rank high on the income scale. The equalisation yardsticks, while modified in several respects, are based essentially on average experience in the whole federation.

Since 1967 the Canadians have also employed, as an equalisation standard, average taxable capacity in each of a wide range of revenue fields. In Australia the Grants Commission since 1961 has used the experience of New South Wales and Victoria as its benchmark of comparison. The Commission has not adopted a national average yardstick, although with the substantial improvement in the fiscal capacity of Western Australia since the late 1950s and the addition of Queensland to the ranks of the claimant states, there would seem to be a strong case for the adoption of either a national standard or one based on average experience in New South Wales, Victoria and Western Australia.

Financial Need

There are important differences between Canada, Australia and West Germany in their approach to financial need. The Canadians neatly sidestep the problem by making an implicit judgment or assumption that the needs for, and costs of, public services are equal per capita in the high and lower income provinces.[1] The Canadian model is purely an exercise in revenue equalisation and no element of subjective judgment is introduced. This procedure can be defended on the grounds that there is no satisfactory measure of expenditure need,[2] that it is therefore extremely difficult to evaluate with any precision the relative expenditure needs of the provinces, and that, in any event, the foremost aim of HFE (that of raising the standard of public services in low-income provinces) can be reached by concentrating on differences in taxable

capacities between provinces. The relatively high per capita expenditures by low-income provinces support this argument.

With regard to financial need, West Germany follows a procedure which is closer to Canada than to Australia, because prime attention is given to offsetting differences in tax capacity. However, some allowance is made for various facets of expenditure need. There is some degree of subjective judgment in the German method, since allowance is made for special burdens which face particular states and which are judged to require above-average expenditure in those states.

Thus, to take what is probably the most important example, the settlement yardstick applicable to each state in the West German federation is modified so as to take into account the number of people living in cities. What is involved is a judgment that there is a close relationship between expenditure needs and population density: as cities grow larger, the need for public expenditures increases even faster. No such allowance is made in Australia or Canada. By means of the population valuation, some recognition is therefore given in Germany to the fact that high-income states may have above-average expenditure needs. The same can be said of the US revenue-sharing scheme, under which an allowance is made in favour of states and local authorities which have large populations and which make above-average tax efforts. The pass-through requirement to local authorities of two-thirds of the revenue-sharing payments is designed to assist large cities. These measures negate, in some degree, a distribution of grant moneys which is biased in favour of regions with below-average personal incomes per capita.

As already noted, differing expenditure requirements as between regions are not ignored in Germany. The 'special burdens' method has not escaped criticism. Allowances for special burdens are intended to apply to expenditures which affect states unevenly or which benefit the nation as a whole (e.g. expenditures on harbour facilities or incidence of unemployment). However, if this is the intention it is clearly not being taken very seriously, since not only are the allowances very small in relation to other equalising effects (such as value-added tax distribution and financial settlement transfers) but it would surely not be difficult to compile a fairly long list of expenditures which satisfy either or both criteria (universities, for example) and for which at present no comprehensive system of special allowances is in existence. It seems that the authorities have acted wisely in not pursuing this particular route to an allowance for differing expenditure needs. The allowances are somewhat arbitrary and their further extension would tend to destroy the simplicity and apparent effectiveness of the present system.

The West German fiscal authorities have so far been able to resist pressures for a widespread use of financial need yardsticks. For this we have to thank the structure of government in the Federal Republic. Thus the Council of States, with the support of the financially strong states (which have relatively large voting power) and Bavaria (which, like Quebec, puts great stress on state tax sovereignty), was able to defeat a proposal by several states (a proposal backed by the Lower House) which had as its foremost objective a system of financial transfers based on a rather comprehensive assessment of expenditure needs of all the states. The prime emphasis in Germany therefore continues to be on offsetting tax

capacity differences between the states (but with the important allowance for population density).

In Australia, the principle of financial need is paramount. In the 1930s and early 1940s the Grants Commission had relied on comparisons of personal income per capita. However, when the states ceased to levy their own income taxes, the Commission opted for an approach by which a detailed examination was made of revenue and expenditure items. In Canada, the detailed examination is confined to the revenue side of the budgets under the rather sophisticated 'representative tax' system, while in the United States there is no separate equalisation component for each tax, the main emphasis being on personal income per capita, the needs of large cities and relative tax efforts. The method employed by the Australian Grants Commission of making detailed budget comparisons between claimant and standard states is unique. Since 1973 the Commission, on the basis of modified budget results, has proceeded to a direct comparison of the revenue and expenditure needs of each claimant state with the standard states. This method replaced the indirect method, whereby adjustments were made to the modified budget results of a claimant state to allow for differences between the claimant state and the average of the standard states in tax severity and the range and quality of services. The criteria for assessing the financial needs of claimant states have not, however, changed. The direct comparisons are designed to assess the additional financial assistance which a claimant state needs to function at a standard not appreciably below that of other states without the need to levy taxes and other charges at a greater severity than other states.

However, the Commission's role in financial equalisation ought not to be exaggerated. The main equalising policy in Australia is pursued by the Federal Government by means of its various decisions which influence the interstate distribution of financial assistance grants. The Grants Commission then adjusts at the margin by recommending special grants to states which apply for such assistance. The main criticism of federal policy is that decisions which affect the interstate distribution of financial assistance grants are not guided by an objective formula or an appeal to quantitative analysis. The method used in Australia tends, therefore, to be cast in the shadow of short-term political bargaining and, unlike the formula used in West Germany, the interstate distribution of grants has been such as to exacerbate the problems which face areas with high population densities, especially the problems of the large cities in the high-income states of New South Wales and Victoria. In Australia, financial allocations have been biased in favour of regions with relatively low populations.[3] Thus, Professor Mathews noted growing indications that 'population density affects the financial needs of the larger states in a way that has never been considered in determining the case for equalisation grants'.[4] In Germany, on the other hand, there seems to have been no difficulty in reconciling the use of horizontal fiscal equalisation transfers to assist low-income states with the need to have regard to the high costs associated with the growth of cities. The needs of large cities are specifically allowed for in the financial settlement. Thus Hamburg and Bremen have the benefit of a special valuation rate for population of 135 per cent and other areas which have cities of a million people or more have a valuation rate of 130 per cent. As it is the more

affluent states which tend to have the large cities and areas with high density population, this part of the adjustment for fiscal need lessens somewhat the intensity of the financial settlement. Canada occupies an intermediate position, because in the equalisation formula an equalisation grant to a province in respect of various revenue sources increases as a province's share of population increases relative to its share of the tax base. As population growth has been somewhat faster in the higher-income provinces, the population factor has tended to reduce the size of the equalisation payments.

Unconditional Nature of Grants

As noted above, equalisation grants are unconditional in most countries. In theory, the recipient states can spend the additional funds as they see fit — and in Australia and Canada the assistance can even be used to lower taxes. However, it would still be possible in practice for the administration of equalisation transfers to be regulated in a manner which involves a measure of federal control over state spending patterns. In Canada and West Germany, theory and practice are identical in this respect because an objective formula is used to determine equalisation entitlements and there is no evidence that the formulas used have had any marked influence on state spending patterns.

The Grants Commission can (and has) pursued its own methods free of political interference. Its various comparisons are, for the most part, based on objective criteria. Its recommendations are supported or accompanied by rational argument, information about the nature of submissions made by various parties, and a detailed explanation regarding the choice of methods used, availability of data, scope for 'broad judgment' and so on. However, the Commission operates at the margin and directly affects but a small part of total horizontal fiscal equalisation. Of much greater significance is the action taken by the Federal Government with respect to the interstate distribution of financial assistance and other grants. Because such action is not guided by an objective formula, it is not surprising to find that the central government has on occasion used its various grants as a lever (and without proper consultation with the states) for promoting certain types of expenditure which do not have a high priority in state planning.

Explicit Equalisation

A major drawback of the Australian system is that interstate fiscal equalisation is not regulated at one point. There is no *explicit* equalisation formula which permits a clear separation between vertical and horizontal fiscal imbalance. In the absence of a systematic approach to HFE — guided by an explicit formula — the door has been opened for a series of *ad hoc* payments (including changes in the base amounts of financial assistance grants paid to each state) by the Commonwealth to assist particular states. These payments are no doubt influenced in part by a careful evaluation of the relative financial needs of the states; but the scope for subjective judgment and short-term political bargaining is also considerable. Moreover, 'behind the scene' deals worked out between federal and state officials may mean that what a particular state receives in the form of so-called unconditional grants is, in fact, governed to some extent by expenditure policies which the Commonwealth would like the states to pursue. At least the Commonwealth can and does make its priorities clear and states which ignore them do so at their own risk.

In Australia, adjustments to the base

grants for financial assistance to the states are essentially *ad hoc* and in many instances the grants seem little more than responses to pressure from the states. Political bargaining tends to dominate the distribution of the grants. The reasons for a particular distribution are not spelt out beyond general, and at times rather vague, references to changes in the relative financial capacity of particular states.[5]

By contrast, the great merit of the equalising procedures adopted in Canada and West Germany is that the intentions of the central government are made explicit. There is little scope for subjective judgment and piecemeal subsidies to placate particular states. There is no explicit equalisation formula in the United States. However, the US revenue-sharing formula does have positive equalising effects and there is no scope for *ad hoc* payments to particular states (the same cannot be said of categorical grants-in-aid programs — the traditional source of federal assistance to low-income states). In Germany, the federal authorities do not interfere with the interstate distribution of taxes other than to formulate the settlement rules and ensure that the rules are being properly observed. Fiscal uniformity has, of course, made their task easier.

The scope for bringing pressure on state spending decisions is much less where an explicit equalisation formula is in vogue; for what the qualifying states then receive is determined by objective criteria embodied in the formula. The states are then able to estimate fairly accurately in advance the amounts they can expect to receive under the formula. When there is pressure on the states for changing their spending habits — and this is typical of all federations — it is preferable that it be made explicit outside the equalisation formula through the use of tied grants or through direct assistance from the centre.

An Independent Commission to Evaluate Financial Need

Australia is unique among the four countries in having an independent Commission to report on, and make recommendations with respect to, financial assistance to states which apply for assistance. Although the Grants Commission conducts formal hearings to receive submissions from the Australian Treasury and from other interested parties, including the claimant states, it is free to pursue its own methods. This approach has found little support in other countries. In Germany, Canada and the United States HFE is administered by the Federal Government. No part of the equalisation process is delegated to an independent authority.

In Germany, there is a specific federal law on interstate fiscal equalisation and that law is administered by the Federal Department of Economics and Finance. The law sets down certain guidelines to be observed, including criteria to be used in assessing the below- or above-average tax capacities of particular states, the extent to which deficiencies or surpluses of adjusted taxable capacities of each state in relation to the settlement yardstick are to be included in the financial settlement, and the amount of the special burdens to be allowed for in that settlement. The law on financial equalisation does not therefore leave a great deal of discretion to federal officials. However, the law can, and has been, adapted to meet changing circumstances. The settlement rules have been changed to meet new conditions. This applies particularly to the intensity of the financial settlement, the assessment of special burdens and the more favoured treatment to be accorded areas

with large population densities. The law is therefore reasonably elastic. Moreover, as noted in chapter 13, the Federal Government is empowered to make supplementary payments to financially weak states if, in its view, the financial settlement which results from the application of the equalisation law is not optimal in a particular year. Such payments are, however, relatively small and are clearly separated from other federal payments.

It should not be overlooked that the task of the West German authorities has been made easier by fiscal uniformity, by the centralisation of equalisation at one point, and by the decision (a wise one it seems) to stop short of a comprehensive approach to fiscal need. The unburdening of the financial settlement through prior adjustments to the interstate distribution of value-added tax revenues in favour of regions with below-average tax capacities also warrants special mention. It can be said that the federal authorities in West Germany have been active in this area: they have been conscious of the fact that some regions face greater financial stringency than others, and they have moved to correct or at least ameliorate the position of the disadvantaged areas. But following the report of the Troeger Commission, there has been little inclination to consider seriously any suggestion for the creation of an independent authority to deal with the financial needs of the states. The problems associated with an assessment of such needs are very great as, indeed, the Australian Grants Commission has been quick to recognise. The German approach has been pragmatic: certain outward manifestations of need (such as population density, and above-average expenditures in areas facing special difficulties) have been identified and an appropriate allowance has then been made in the financial settlement.

The main focus of the German system is on differential tax capacity and the use of a simple formula governing the rules for interstate financial settlement. As a result of the Troeger Commission's recommendations, the ground rules for both the vertical (federal-state) and the interstate financial settlement were suitably modified. The Commission was certainly independent and had made a very detailed examination of intergovernmental fiscal relations. Further commissions on a continuing basis would not seem to be warranted, especially since the German system does not aim at a comprehensive assessment of financial need. Moreover, the German mentality is accustomed, especially in areas where controversy between interested parties is inevitable, to the practice of reaching a compromise in terms of a set of rules embodied in law. The granting of discretion to outside bodies is not therefore favoured. The compromise is effected by intensive bargaining within the committee system of the Council of States. Given this procedure and the historical development of techniques for interstate fiscal equalisation (with major emphasis on differing tax capacities), there seems to be no compelling reason to create an independent body such as the Australian Grants Commission. A system of checks and balances is an integral part of the governmental structure and it is nowhere more evident than in the sphere under discussion. The equalisation law, as noted above, does not leave a great deal of discretion to federal officials. Yet the law can be adapted to meet changing circumstances and pressures for change. Any change in the law must, however, gain the approval of the Council of States.

The Rowell-Sirois Commission, which reported in 1940, recommended the appointment in Canada of an independent

type Grants Commission; this was linked with its belief that a comprehensive approach to financial need was necessary. However, this proposal apparently met with a cool reception.[6] The Canadians decided to reject the expenditure needs approach and to use a formula which is wholly concerned with offsetting tax capacity differences between provinces. This formula leaves no room for discretionary decision-making or subjective judgments about relative expenditure needs. As long as Canadians do not feel compelled to seek an interprovincial financial adjustment in which there is a comprehensive assessment of expenditure needs, the argument for setting up an independent Commission would not seem to have much to commend it.

In the United States there has been no concerted move to develop a systematic approach to interregional fiscal equalisation. The possibility of creating a separate body along the lines of the Grants Commission in Australia has therefore never seriously been considered.

Revenue Coverage

In Australia the Grants Commission, in evaluating financial need for the claimant states, makes comparisons with respect to all major taxes. But it goes much further. Its detailed examination of state budgets and adoption of a budget standard of comparison has meant that the claimant states cannot be disadvantaged by the financial assistance grants. The Commission, acting as a 'balancing agent' in financial equalisation, automatically considers the effect of those grants on the budgets of the respective states.

In Canada and West Germany, prime attention is given to differences in tax capacities between provinces or states. Differing expenditure requirements are not highlighted. This is particularly evident in Canada. Moreover, the interprovincial comparisons until quite recently have not embraced municipal revenues.[7] In Germany, by contrast, municipal revenues are quite important. Exclusion of municipal revenues from the comparisons reacts to the clear advantage of provinces whose municipalities possess relatively large independent revenue sources and do not therefore depend so much on grants from the provinces. This is not such a problem in Australia, where the Grants Commission takes some account of a claimant state's need to subsidise local authorities; if subsidies need to be higher than standard the state may be compensated via the special grant.[8] Comparisons are not easy in view of differences, between states, in the functions and responsibilities of local government bodies. Moreover the Commission's procedures must now take account of its new role in assessing local government financial needs in all states. Although strictly outside the scope of this study, one can note in passing that most states in Germany have developed fairly sophisticated techniques for evening out tax capacity differences as between municipalities and taking some account of differing expenditure needs. All Canadian provinces make equalisation payments to local authorities, but equalisation techniques at the local level have been more fully developed in Ontario and New Brunswick than in the other provinces.

Tax Mix and Tax Effort

The tax mix is one of several factors which determine the size of equalisation payments in Canada. On the face of it the Canadian formula seems to provide a moderate incentive for provinces which qualify for equalisation payments to change the tax mix in order to increase

total receipts. The larger the economic base of the province, the greater the incentive. Thus, while Quebec may derive a significant advantage from a change in the tax mix, the same could not be said of the Atlantic provinces. Changes in the tax mix are likely to be fairly neutral as regards the magnitude of equalisation payments. By and large provinces are free to vary the tax mix in response to the usual political and economic motivations.

As noted in chapter 13, the Canadian equalisation formula does not contain a specific allowance for tax effort as do the revenue-sharing formulas in the United States. In Germany, where interstate tax uniformity prevails, neither the tax mix nor tax effort is of any consequence, since the equalisation mechanism embraces all state revenues (including the state share of joint taxes and a large slice of municipal revenues). No separate equalisation component is computed for each revenue source, as in Canada. The tax mix is not important in Australia in view of the approach of the Grants Commission in calculating, for each major field of taxation, the revenue which each claimant state would have raised had it applied (to its own tax base) taxes of standard severity (the latter being derived from the average of the tax structures of the standard states — New South Wales and Victoria).[9] If the standard tax effort, as derived from the average of the tax structures of New South Wales and Victoria and applied to a claïmant state's tax base, yields an amount which is less than the standard tax capacity (= average per capita tax revenue of the standard states multiplied by the population of the claimant state) the claimant state has a positive revenue need (and vice versa). This method ensures that tax capacity is related to the standard states and the tax mix has no particular relevance in terms of equalising effects; each claimant state is free to vary tax rates without penalty or reward. Since a standard tax effort is used in comparisons, states do not gain (in terms of equalisation payments) from above-standard efforts, and they do not lose from below-standard efforts.

Problems Arising from the Australian Method of Horizontal Fiscal Equalisation

The methods employed by the Grants Commission are susceptible to criticism on the grounds that, whatever the intention, attempts to arrive at anything near precision in assessing financial needs are fraught with many difficulties. Perhaps the greatest danger is that fundamental differences between regions are obscured. The wisdom of seeking precision in this area can be questioned.

In its detailed budget comparisons, designed to embrace as many facets of financial need as possible, the Commission has come up against several thorny problems. Once broached, these problems tend to be magnified out of all proportion and cannot be easily put aside later. They tend instead to linger on and become the subject of detailed analysis each year. It seems clear that any pretence at precision in calculating relative financial need opens the way to a whole range of decisions on what items to include in the comparisons and what the basis of these comparisons should be. There are also problems in comparing items of expenditure in different states since what may appear to be like items may, in fact, have a different significance for the states concerned. In several instances the comparisons are not very meaningful. An example is the comparison of efforts by state business undertakings to raise revenues when these undertakings are not, in fact, offering the same services in each state and the alter-

natives open (e.g. in public transport) are certainly not the same.

The Commission has been at pains to demonstrate that its procedures do not influence state policies. Its new method of calculating the revenue and expenditure needs of a claimant state certainly helps to dispel any suggestion that the Commission's procedures imply that a uniform standard of services is desirable. It will also be recalled that in many fields of expenditure and revenue the Commission has been able, through painstaking analysis and by developing objective criteria to serve as the basis for comparisons, to reduce markedly the scope for broad judgment. Examples are mining royalties and debt charges. Its new direct method of assessing financial need has also assisted towards this goal.

The Commission's work in its field has been remarkable and must be commended, although the uninitiated may perhaps be excused for asking whether all the detailed comparisons are really justified in terms of the net result achieved. However, a more basic objection concerns the practice followed of examining in detail the financial needs of the claimant states against the experience of the standard states which serve as a benchmark for the comparisons. If the present approach to financial need is to continue, the examination should be extended to *all* states.

Indeed, the argument could be carried even further by questioning the underlying rationale of HFE at the state level. Several American writers have drawn attention to the problems inherent in such an approach, which they say does not come to grips with the realities of the situation in which states (or areas within states) with high per capita incomes also tend to have relatively high per capita expenditure needs. The German technique does meet this problem in some degree by means of the population valuation, but in Australia and Canada the problem is not dealt with systematically.

This comment highlights one of the major shortcomings of the Australian method. A large segment (62 per cent) of the Australian population lives in the six capital cities, and another 13 per cent lives in thirty-five major provincial centres. Yet the equalisation payments appear to have little or no regard to the expenditure needs of large cities; and the cities continue to grow despite the financial problems with which they are faced.

A more fundamental solution would be to prevent or slow down the further growth of large cities by offering incentives to individuals and businesses to move out of cities as a counter to the apparent attractions which the cities offer. Efforts at decentralisation have begun but their impact is understandably slow and uncertain. Meanwhile, the problems which face the large cities must be tackled. HFE, at both the state and municipal levels, has tended to accentuate the problems of the cities even further, because financial allocations have been biased in favour of regions with relatively low populations. An examination of any one of the *Reports* of the Australian Grants Commission leaves no doubt on that score. Thus 'As a result of Tasmania's comparatively small population and its high percentage of people residing in rural areas of low population density, that State may need to incur greater expenditure per head of population in order to provide government services.'[10] This statement is no doubt true and the Commission's terms of reference have, until recently, been such that it cannot be blamed for the failure to counter-balance the special needs of the low-population states with the need to compensate high-

income areas for specially large expenditures associated with city development. With the acquisition of new powers relating to financial equalisation at the local level, this criticism may have less validity in the future than it appears to have at the present time.

The problems associated with overcrowding in large cities are often more acute in high- than in low-income areas. Any special allowance for high population density is therefore likely to reduce the degree of financial equalisation that would otherwise be achieved. But perhaps the end justifies the means. The special status of the City States in Germany with their high population densities has put those states in a position of paying less into the financial settlement pool. Hence it is not surprising that per capita expenditures in those states have been appreciably higher than in other states. However, the difference between per capita expenditures in the other states is not appreciably different from the situation in Canada.

The failure to take account of population densities in determining the interstate distribution of equalisation grants in Australia has produced a result that is probably not generally appreciated. Per capita expenditures in low-income states are considerably higher than in the higher-income states of New South Wales and Victoria. Thus, in 1972-73 $747 per head was spent in Tasmania and $671 per head in Western Australia. This was much higher than in the other states. The relative advantage of the low-income states in this respect is markedly greater in Australia than in Canada or West Germany. In 1972-73 per capita expenditures of states receiving equalisation transfers in Australia were 21 per cent higher than per capita expenditures in states not receiving equalisation transfers. In Canada and Germany the comparable ratios were 7 per cent higher and 7 per cent lower respectively.[11]

State Bargaining Power

In all four countries the states are able to bargain with the Federal Government for larger grants; but since financial equalisation benefits some states at the expense of others, there is an inherent conflict of interests *among* states. The net outcome may therefore depend crucially on central government policies.

In Canada and Australia there are informal meetings between federal and state politicians and officials and some sort of compromise plan emerges. In Australia there is considerable scope for political bargaining and *ad hoc* decision-making, but the Federal Government because of its dominant financial position clearly sets the pace. In Canada the bargaining mainly concerns the vertical financial settlement since, apart from some recent changes in the equalisation formula with respect to revenue coverage, there is virtually no scope for *ad hoc* decision-making in relation to horizontal financial equalisation. The advantages of such a system have been noted.

In Germany, by contrast, proposals for changes in the interstate distribution of taxes are often initiated by a particular state or by several states, with or without the support of the Federal Finance Minister. Intensive bargaining then takes place by each state within the committee system of the Council of States in Bonn. States may be outvoted in the final analysis, but they exert as much pressure as they can to ensure that any changes are in their own interests. In 1969, for example, the interstate financial settlement was strengthened to provide a guaranteed revenue to each state of 95 per cent of the national average. The legislation to give effect to this proposal was

opposed by both North Rhine-Westphalia and Hamburg — the states which stood to lose most — but these states did not have sufficient votes in the Council to defeat the proposal. On another occasion however, the financially stronger states acted in unison to defeat a proposal, put forward by Lower Saxony, to distribute tax receipts in accordance with 'need' yardsticks. Thus unlike the *ad hoc* bargaining process in Australia and the pure revenue equalisation formula used in Canada, a formal voting mechanism in the Upper House is the prime vehicle for securing changes in financial settlement in Germany.

In short, where state governments have direct representation at the centre (for example where the upper house is able to function as a house of the states) their bargaining power is likely to be appreciably stronger than in federations where the upper house functions primarily as a house of review.

Conclusions

One conclusion to emerge is that there are several virtues in adopting a fairly simple approach to horizontal financial equalisation. The system employed in Germany seems to represent the best compromise when all relevant considerations are examined. The Australian system is unsatisfactory because a systematic evaluation of financial need is one-sided, being directed at the claimant states and being susceptible to whatever degree of interstate equalisation the Australian Government wishes to impose through the distribution of financial assistance grants and other payments. In Australia the lack of a co-ordinated approach to HFE is conspicuous by its absence. It should be emphasised that criticism of the Australian system is not criticism of the Grants Commission but of the failure of the Australian Government to develop a systematic approach in which equalisation is explicit and not confused with and merged into the vertical financial settlement. There is little doubt, as Professor Prest has stated, that 'nothing would do more to clarify the true nature of Federal-State fiscal relations in Australia than a clear separation between tax sharing and equalisation, and the consolidation of the present fragmented equalisation procedures'.[12]

One writer has criticised the Canadian formula on the ground that it is more complex than its predecessor.[13] But it is at least possible to understand this formula and its component parts, to gauge the effect of state policies and economic trends on HFE and to see the possible effects of the latter on state policy responses. It is not possible to say the same of the Australian method.

The shortcomings of the Australian method can easily be pinpointed. It is fragmented, susceptible to changes in the political environment, and allows far too much scope for subjective judgments about relative financial need. No magic formula is available that will solve this problem in one stroke. However, it is better to have an objective formula that can take account of major aspects of financial need than to have no objective basis of comparison and to rely solely on short-term political bargains. If governments decide to 'live dangerously' and attempt to encompass financial need in all its complexity, it is still desirable to ensure that fiscal need grants can be computed in terms of a fairly simple formula (based on adjusted population or other objective criteria). To fail to do this is to invite all the undesirable consequences of a distribution of grants which bears little relation to the real needs of the states and their ability to satisfy those needs. As one

authority on this subject has put it: 'Apart from the work of the Commonwealth Grants Commission ... there has been no attempt by the Commonwealth to justify, by means of quantitative analysis, the distribution of grants which its action [i.e. those of the Commonwealth Government] have brought about.'[14] While the Commonwealth has indicated as a broad aim that grants should be distributed on an equitable basis, it is difficult to see what equity there is in the wide discrepancies that were observed in chapter 14 between per capita payments to the states.[15]

An urgent need in Australia is therefore to put HFE on a systematic basis so that the financial needs of all states are considered. As matters now stand, the needs of states with large population densities do not receive special consideration. Financially weak states should receive some favoured treatment to reflect higher per capita costs of health, welfare and other services and to make up for low relative tax capacity, but not to the extent of receiving nearly twice the amount per capita as the high-income states.

If the present interstate distribution of financial assistance and other Commonwealth grants is a true reflection of interstate need differentials, it appears that the Australian Government has made little effort to defend it and hence to explain the basis of the various decisions which bear on that distribution. The Australian Government has not, in fact, given practical effect to the laudable principle that is said to govern decisions in this area — that grants should be sufficient to enable each state 'to provide government services of a standard broadly comparable with those of each other state without imposing higher taxation or other charges'.[16] It has instead, as Professor Mathews aptly points out, used

> a series of arbitrary judgments based on bilateral political bargains ... Any state which complained has been placated by an increased grant if it seemed that the Commonwealth Government would derive short-term political advantage as a result of such action, while the effect on the relative position of the other states has been ignored. The resulting distribution has been quite haphazard and generally to the disadvantage of the more populous states.[17]

Even the Australian Government has conceded that these procedures are grossly inadequate since, as noted in chapter 12, it has acted to shift more responsibility on to the Grants Commission.

A short-cut method to an estimation of financial need may be preferable. Since the composition of a state's expenditure is not (or should not be) a concern of interstate fiscal equalisation, would it not be useful, as a first approximation, to compare per capita net public expenditures in each state? It would certainly only be a first approximation since it is likely that some allowance would have to be made for differing population densities and structures. But why not start at the expenditure end? Once the equalisation transfers have enabled low-income states to finance a level of per capita expenditures not much different from the level prevailing in high-income areas, without tax rates in lower-income areas being significantly higher than those in the higher-income areas, the central purpose of the equalisation exercise would appear to have been achieved. Further equalisation transfers would then require special justification and would have to be balanced against the needs of high-income areas.

Part IV Intergovernmental Co-operation and Planning

16 The Need for Co-operation

The foregoing chapters point up the need for (i) retention by the states of considerable independence of action in their spheres of competence, including the requisite financial autonomy to enable functions to be discharged in a responsible manner; and (ii) national initiatives in the pursuit of growth, stability and distributional goals, including action to correct for interjurisdictional spillovers.

Are these two aims compatible? Many would answer in the negative and stress what appears on the surface to be an inherent conflict between state autonomy and the pursuit of various national goals.

But are the aims of the states really in conflict with those of the national government any more than, say, the aims of the labour unions are necessarily in conflict with management? Certainly, conflicts can and do arise but there is nothing inevitable about them. To avoid, or at least lessen, conflict what is clearly needed is the setting up of machinery which provides for intergovernmental co-operation and consultation in areas (e.g. education, highway construction or water conservation) in which both federal and state governments have an interest. This machinery, if properly devised, will make it possible for the aims of both parties to be considered objectively, with emphasis not on the independence of each level of government but on their *interdependence* — at least in areas where both parties, possibly for different reasons, have a legitimate interest. When combined with an effective planning of public sector expenditures (see chapter 20) the outcome should reflect a mix of federal, state and even local priorities.

The vast extension of specific purpose grants in all four federal countries and the use of these grants to influence statewide and nationwide spending patterns underlines the need for such machinery. Grants-in-aid programs can be an instrument for intergovernmental co-operative action (as would appear to have been the case in the United States, at least since 1964) or they can be a means by which the central government dominates state policies and distorts their preferences. To ensure that these programs operate to secure co-operation, the consultative machinery must do more than merely provide information and rubber-stamp decisions made elsewhere. The machinery must itself constitute a part of the apparatus for effective decision-making by governments and have particular relevance to matters where federal and state functions overlap. Machinery for an exchange of views and/or discussion of major issues (such as Premiers' Conferences in Australia) which provide the states with no effective voice in decision-making is likely, on balance, to intensify conflict and therefore offer no solution to current problems in federal-state finance. The states must be able to have a say in matters which affect their interests as sovereign states. If this opportunity is denied them, then financial autonomy will be undermined and they then become little more than administrative agencies of the central government.

In order to have such effective machinery, appropriate trade-offs are, of course, inevitable. It was noted earlier that each level must be prepared to surrender a measure of sovereignty in order to achieve national goals and preserve a viable federal system. As Scott points out, 'Coordination is an empty phrase unless it implies some willingness to trade some aspects of local sovereignty for participation in the planning of other sovereign bodies.'[1]

What is needed, therefore, is recognition that there is no inherent conflict between national and regional goals and to the extent that conflicts do arise these can be resolved to the mutual satisfaction of both parties if appropriate machinery is set up for that purpose. In this respect we find a marked contrast between Australia and Germany. The Australian states are heavily dependent on federal grants and there is no effective machinery for joint decision-making in the public sector as a whole. The German states are not heavily dependent on federal grants (since tax sharing provides the states with an elastic revenue base) and sophisticated machinery exists for decision-making in areas where national and regional interests overlap.

What this comes down to is a recognition that it is no longer appropriate to think of each level of government as an autonomous and self-contained unit. For a range of expenditures in the welfare and growth areas, it is clear that there must be a close interdependence between the two levels; and if this is true decision-making for a large part of the Allocation Branch should ideally be arrived at on the basis of intergovernmental co-operation. This in no way undermines federal policy on income and/or wealth distribution or economic stabilisation, since those objectives can be, and are in large measure, satisfied through marginal adjustments to taxes and expenditures.

Where functions and responsibilities of national and regional governments clearly overlap (e.g. housing, welfare, education, transport, city development, decentralisation and infra-structure expenditure) rigid divisions between functions and responsibilities of the two main tiers of government are clearly inappropriate. It should not be imagined that freedom of action for either tier (especially the lower tier) is necessarily guaranteed by a constitution which specifies the functions which are to be assigned to each level of government. Grants-in-aid programs, common in all four federal countries, show this clearly enough.

The political scientist characterises the mix of government in the provision of public services as a 'marble-cake', as distinct from a rigid demarcation of roles of government as represented by the 'layer-cake' model. As Mushkin and Adams point out:

> The search for a clear role, respectively, of the national government, of state governments, and of local governments has long since been abandoned by the political scientist. In its place has come an emphasis on a federal-system partnership of governments, within which there are changing mixes of national, state, and local action with respect to any specific function or activity.[2]

Some functions at each level will necessarily overlap with functions at the other level. This means that each level will have to consult with the other and come to an arrangement whereby an undue duplication of effort is avoided. Such co-operation will, of course, involve each level giving up some autonomy with respect to particular activities. Grants-in-aid programs (the 'back door' method

of central control) is the most obvious method by which state freedom of action is curtailed, and often in areas where states have important constitutional responsibilities. In these instances machinery for intergovernmental co-operation is essential because states will then be in a better position to ensure that a careful analysis is made of the implications, mainly in terms of possible resource-distorting effects, of the programs in question. To avoid friction, to reach a consensus and to preserve a measure of state autonomy, the states should be able to participate in decision-making in this area. In fact in all four federations the states are able, in varying degree, to exert an influence on these decisions (see chapters 17-19).

In the case of grants-in-aid a nexus between revenue and expenditure is immediately established. Once decisions are made on the spending side, the way in which the programs are to be financed must be determined. This will concern the nature of various conditions attached to the grants, including the extent of matching by the recipient government.

No such direct link is established for other transfers. If co-operative efforts along the lines suggested above are to succeed, proper consideration must be given to state revenue as well as expenditure. In this connection, emergence of a large vertical fiscal imbalance, as has been shown to exist in Australia, immediately places states at a disadvantage in bargaining with the central government. Bargaining without adequate financial backing is hardly likely to be effective. Where, as May has stated, 'there is a very great imbalance of revenue sources and expenditure obligations between Commonwealth and States, it is inevitable that the Commonwealth is bound to give a fairly strong priority to its own expenditure functions'.[3] Undue dependence on federal financing is not a good basis upon which to plan and co-ordinate public sector spending in a federation. A prerequisite for such planning must therefore be action to reduce vertical fiscal imbalance, preferably through a sharing of income taxes which provides states with an elastic revenue base.

From this point it is necessary to examine what machinery for inter-governmental co-operation does in fact exist in each of our four countries. This examination will be followed by a chapter dealing specifically with economic planning in the Australian federation.

17 Intergovernmental Co-operation in Australia

As noted at the outset, the Grants Commission, the Loan Council and the Premiers' Conferences have often been cited as prime examples of early moves in Australia towards co-operative federalism.

The Grants Commission is a unique body and it appears to have achieved considerable success in relation to one of the main objectives of intergovernmental fiscal relations, namely horizontal fiscal equalisation at the state level (and in 1974 the Commission was poised to assist towards equalisation at the local level). The question of whether and to what extent the Commission's functions might be augmented in the context of economic planning in Australia is taken up in chapter 20.

Leaving the Grants Commission on one side, it would appear that intergovernmental co-operation in Australia has been largely *ad hoc*, being directed to particular fields of expenditure and to activities where it is obvious that national and state interests overlap. In the developmental field there are several examples — coal, housing, immigration, water conservation, hydro-electric power, transport, education, urban and regional development. There are also many standing committees — comprising representatives from federal and state departments — in such areas as agriculture, labour relations, health and consumer affairs.

Specific examples of bodies which have evolved in response to federal-state co-operation are not hard to find: the Australian Universities Commission, the Schools Commission and the Bureau of Roads are probably the most important in terms of monetary outlays. Co-operation has not been lacking but efforts have been largely *ad hoc* with little conscious endeavour to formulate a systematic approach to overall needs and resources in the public sector and to relate the latter to revenue-expenditure patterns of each level of government.

In this connection, the functions of the Loan Council and the regular Premiers' Conferences have come under mounting criticism in recent years. There are serious doubts whether these arrangements (at least in the forms which can be observed in 1975) can hope to cope with the problems currently facing Australian federalism.

These and related matters will now be discussed in the context of fiscal federalism in Australia, the main focus being on intergovernmental co-operation with respect to:-

(i) sources of revenue;
(ii) access to loan funds;
(iii) various fields of expenditure.

Looking first at sources of revenue, it is clear that intergovernmental arrangements, such as they are, have been of very limited value. Intensified conflict has, more often than not, been the end result. Premiers' Conferences during the 1950s and 1960s had given the states a forum by which they could air their grievances. The states did not always present a united front and the Commonwealth, with one or two notable exceptions (e.g. the decision to transfer the pay-roll tax to the states),

was mainly concerned to mollify state discontent by *ad hoc* increases in grants to particular states. The annual wrangles over the size and distribution of financial assistance grants hardly requires elaboration.

Apart from the pay-roll tax transfer, the Federal Government has stood firm in its opposition to any transfer of growth taxes to the states. This opposition relates particularly to efforts by some states to impose income taxes but it also came to the surface during the discussions in June 1974 concerning the feasibility of a state consumer tax. However, it must also be said that the attitude of the states has at times been quite ambivalent. The states often leave the impression, perhaps unintentionally, that they want more money but are unwilling to suffer the consequences of imposing growth taxes. If that is true it is hard to understand because the states usually end up by increasing other taxes (e.g. motor taxes, receipt and franchise charges) which are regressive in their incidence and hence politically unpalatable.

In January 1970 the states, taking the cue from the Victorian Premier (Sir Henry Bolte), put on a show of solidarity and managed to reach a consensus with the publication of a document[1] in which a tax-sharing arrangement after the Canadian pattern was advocated. The scheme proposed a partial withdrawal of the Federal Government from the personal income tax field so as to leave tax room for the states. For reasons stated in chapter 6, the Prime Minister of the day (J.G. Gorton) refused to have anything to do with the idea.

However, because of the declining political fortunes of the Liberal Party, as evidenced by the results of the Federal Elections of 1969 (House of Representatives) and 1970 (Senate) and a setback to his own popularity, the Prime Minister was obliged to make major concessions to the states in 1970.[2] The tireless efforts of the Premier of Victoria and particularly his public confrontation with the Prime Minister was also a major factor in this outcome.[3] In fact, Bolte seems to have played almost a lone hand in his negotiations with the Commonwealth and is reported at one stage to have said: 'No matter what proposition Victoria puts up you not only have to fight the Commonwealth, but you have to fight every other jolly state as well.'[4]

In short, it would appear that on the revenue side there has been more evidence of conflict than of co-operation. The superior bargaining position of the central government and, in several instances, the failure of states to agree among themselves has perhaps made this the inevitable outcome. Premiers' Conferences seem to have done little more than bring conflicts out into the open. While various state leaders have often espoused the principle of financial responsibility they have backed down when the crunch has come and a threat of a loss of federal money has loomed.

This attitude has not gained the states sympathy for their cause. Thus, under the heading: 'The Recurring Triumph of Expediency', Professor Gates pointed out in November 1971 that 'almost without exception, the outcome [concerning the revision of revenue sources between the two levels of government] has been dominated by concern for access to funds in the short term, and the State governments have abandoned a prospect of fiscal autonomy for an offer of grants'.[5] In the final analysis the states have shown that their major concern is with the total and distribution of various grants. 'The short term has held sway. It has been a recurring triumph of expediency.'[6] And

more than three years later (in January 1975) several states seemed almost jubilant at the prospect of obtaining sufficiently large federal handouts to enable them to remove the unpopular petrol and tobacco franchise and other taxes (taxes which did not help the Australian Government in its efforts to contain inflation). The rational alternative course of sharing in personal income tax, which had gained wide publicity in 1974, was pushed into the background once states realised that larger federal grants might be forthcoming.

For its part, the Federal Government has been content to adopt a doctrinaire approach. It has not come forward with any concrete plan which could offer a lasting solution to the large vertical fiscal imbalance. It has, instead, been content to placate the states from time to time with patching-up subsidies.

Financial assistance grants, like tax-rental agreements in Canada between 1941 and 1957, give rise to two major difficulties, which are interrelated: (i) they involve a loss of financial autonomy for the states, and (ii) they impair state financial responsibility. As pointed out earlier in discussing the Canadian tax rentals, the loss of financial autonomy caused by the inability of the states to change income tax rates may not, of itself, constitute much of a problem, provided the states have reasonable access to revenue and are able to match revenue sources and expenditure commitments at the margin. The 1959 formula and subsequent adjustment have met this problem in some degree, but an agreement for intergovernmental sharing of taxes would be a better solution. The second problem relating to financial responsibility is, however, much more serious. In pressing for additional financial assistance the states tend to become reckless and irresponsible in their demands, with little thought for the sources of revenue and, what is more worrying, little inclination to raise additional revenues themselves. Only when the Federal Government stands firm and does not acquiesce to demands for additional grants to meet rising budget deficits have the states been obliged to increase their own taxes and seek out new revenue sources.

Given the relatively narrow band of revenue sources available to the states and the regressive nature of most of their taxes, a system which relies extensively on financial assistance grants induces all states to bargain for larger grants without much thought for the matching of public expenditure needs with revenue-raising capacity.

This is hardly a satisfactory state of affairs. To meet the first problem — that of diminished state financial autonomy — the obvious solution is a tax-sharing arrangement — an arrangement which can take many forms (see chapter 5). One way out of the second problem is, of course, to reduce reliance on open-ended grants and lean more heavily on specific purpose grants — a trend which is already evident in Australia. Another solution, and one which would encompass grants-in-aid and Loan Council programs, is to erect machinery for intergovernmental co-operation and planning — a method which is explored in chapter 20.

To meet problems which arise from the limited revenue base of the states, what is urgently needed is machinery which will serve to ensure that changing revenue-expenditure patterns of the national government and the states can be adjusted without frequent resort to the sort of *ad hoc* arrangements following Premiers' Conferences which have become the accepted pattern for intergovernmental fiscal adjustment ever since World War

II. The appropriate machinery, which has been advocated elsewhere, should be based on a sharing of the proceeds of personal income taxes, with uniform tax rates and structures and provision for special financial assistance to states disadvantaged by virtue of the withdrawal of financial assistance grants. Such machinery should, however, be related to intergovernmental planning as described in chapter 20.

Turning now to access to loan funds, it would appear that the Loan Council, as presently constituted, also leaves much to be desired. In theory, five states can out-vote the Commonwealth and one state. But in practice, whatever the voting pattern, the Australian Government makes the decisions which affect the availability of loan funds to the states for capital expenditures. It has been able to do this because of a shortfall in loan raisings for most years since 1951 and hence the need for the Commonwealth to find funds from its own resources to fill the gap. Commonwealth domination is a direct result of its tax and banking powers. In reality, therefore,

> it is not the Loan Council but the Commonwealth Government which determines the size of the State loan programmes by indicating the amount of support it is prepared to give. This fact is of fundamental importance for Commonwealth-State financial relations, and underlines the dependence of the States on Commonwealth decisions in this area.[7]

The Federal Government's pre-eminence in finance is well known. Decisions of the Loan Council (e.g. on interest rates for new loans, the securities to be offered, the timing of new issues, etc.) are, in reality, decisions of the Australian Government acting on the advice of the Treasury and Reserve Bank. The amounts to be raised may, or may not, be sufficient to meet the capital expenditure needs of the states and their authorities. In most years since 1951 they have not been sufficient. In any event it is the Australian Government which, in the light of the prevailing state of the nation, decides on the total program and makes available whatever additional funds are necessary to meet the shortfall in loan raisings.

The co-ordination of governmental loan raisings under the present Loan Council system does in fact find its major justification in terms of variations in the annual growth of the programs to assist in demand management. It is not far from the truth to describe the Loan Council as an Assembly of State Treasuries 'to hear the Commonwealth Treasurer announce his plans for a national loan programme'.[8]

It is quite misleading — and it would be naive in the extreme — to regard the Loan Council as an example of co-operative federalism or intergovernmental co-operation. The Federal Government specifies a total program which it thinks the economy can bear and which it judges as being sufficient to meet the most pressing needs of the states and their instrumentalities for capital expenditures in the coming year. The Loan Council, as it currently functions and has been functioning for some time, is not an instrument of co-operative federalism any more than are the Premiers' Conferences. There are formal meetings which enable federal and state political leaders and officials to present various viewpoints on financial matters; and this is followed with an announcement by the Prime Minister or his Deputy of decisions which, in effect, have been worked out elsewhere.

The importance of the Loan Council as an instrument of intergovernmental

co-operation is further diminished when one reflects that a growing proportion of state capital outlays is being financed by direct Commonwealth grants and advances. It is not to be overlooked that the Federal Government, in supporting programs in excess of amounts which can be obtained from loan raisings, has been obliged to set aside federal revenues for that purpose. This policy is hard to evaluate — it has, on balance, meant relatively low interest rates (and hence less of a debt burden for the states); and it may also be argued that the use of growth-induced taxes (i.e. tax revenues which increase on the basis of a progressive tax system without any increase in tax rates) to finance subsequent capital expenditures (which, in turn, induce growth) is sound economic policy. Moreover, since 1970 the Federal Government has even provided part of the funds to the states for Loan Council programs on an interest-free basis. The Federal Government has, rather belatedly and partly for political reasons, responded to state demands to ease the debt burden. But is there not something anomalous in a situation in which states have no real voice in decision-making with respect to funds required for development in areas where they — the states — are primarily responsible? And is it surprising to find the states disenchanted when they were obliged to make provision in their current budgets for substantial amounts to service the resulting debt, especially when the Commonwealth was reaping a revenue bonanza by virtue of the growth in income tax revenue at constant rates? The ease with which the Australian Government has financed its own capital works program from revenue further intensified state resentment, even though this policy has much to commend it and should, in theory, have left more loan funds available to the states at relatively low interest rates.

With regard to the allocation of loan funds between the states, it seems very improbable that the existing method of distribution (unanimity or an allocation on the basis of net loan expenditures over the past five years in accordance with the terms of the Financial Agreement) will coincide with an allocation of these funds according to state needs.[9] It would seem highly desirable to establish a more rational basis for the allocation of loan funds between the states. This and other needed reforms of the intergovernmental fiscal structure are brought together in chapter 20.

Consideration is now given to co-operation in various expenditure fields. In 1951 Professor Copland[10] gave several examples of joint Commonwealth-state action in specific fields of policy: irrigation; the Snowy Mountains hydro-electric scheme; rail standardisation; the Joint Coal Board; and the Commonwealth-state housing agreement. In more recent years there has been a considerable expansion in the number of bodies set up with respect to various fields of expenditure, in which both the national government and the states have a legitimate interest. There have also been regular meetings of federal and state officials, especially where it has been necessary to negotiate and bargain over the form, size and allocation of grants of the specific purpose variety. The Bureau of Roads perhaps serves as the outstanding model of co-operative federalism in its own particular sphere.

Professor Knight has provided a list of thirty special agreements or bodies set up (excluding the Loan Council and Premiers' Conferences) at various times to cope with what he terms 'the fragmentation brought about by the federal system'.[11] These are

based on specific legislation (Joint Coal Board, railway construction), on administrative decision (meat inspection, electoral arrangements) or executive decision (Australian Water Resources Council and National Health and Medical Research Council). Professor Prest has also noted that in more recent years several joint ministerial conferences have become a regular feature of Australian federalism. Examples cited are uniform company legislation, agriculture, transport and the exploration and exploitation of off-shore oil resources.[12] However, while there has been a significant growth in collaboration between the various governments and in contacts between their ministers and officials, 'co-operation between the States and the Commonwealth is still mainly on a voluntary basis'.[13]

In Australia, efforts at intergovernmental co-operation have been piecemeal and the role of officials has been vital.[14] The various efforts are unco-ordinated and, in most instances, unrelated to national policy objectives.

When Mr Whitlam was Leader of the Opposition before 1973, he was highly critical of the existing machinery for intergovernmental co-operation and pointed the way to certain improvements that would assist in overall planning.[15] By the end of 1974 there was evidence that several important initiatives with respect to public sector expenditures had been taken in the direction of co-operative federalism. In its three-year term of office the Labor Government, while not willing to tackle the fundamental problem of vertical intergovernmental fiscal imbalance, was very willing to set up new committees and commissions to deal with particular areas of policy (e.g. schools, health, foreign investment, housing finance). It also relieved the states of financial responsibility for tertiary education. However, in retrospect it is debatable whether these new initiatives amounted to much more than an effort to extend the sphere of influence of the Australian Government. The new committees and commissions were, for the most part, Commonwealth agencies rather than co-operative (federal-state) agencies. The Australian Government established some necessary groundwork for national planning, but what did it do to embrace the principles of co-operative federalism?

The answer is that there has been a good deal of talk but little positive action in relation to co-operative federalism. This is particularly true in the area of urban and regional development. The Department of Urban and Regional Development (DURD) has seen its overriding goal as 'the achievement of a new and comprehensive approach to urbanisation in Australia'.[16] Moreover, in working towards this goal, it has indicated that it must 'work in co-operation with state and local governments on the co-ordination of investment in, and administration and management of, the urban process...'.[17] In its first *Report*, DURD stated its intention to be 'closely involved in establishing effective procedures for working with and through the States and local governmental bodies in implementing urban regional development programs'.[18] The *Report* also observed that 'If the most effective use is to be made of national resources and investment in urban and regional development, *new ways must be found to ensure full co-operation and consultation between governments in Australia*'[19]

Such statements of principle are, on the face of it, highly commendable. But early in 1975 there was little evidence that these statements of good intention had been

reflected in positive action. The means for ensuring 'full co-operation and consultation between governments' had apparently yet to be discovered. Nevertheless the work of this important department had forged ahead, despite some initial scepticism. Progress was made, through the Cities Commission, in planning for regional growth centres in four states. The Albury/Wodonga growth complex held out the prospect of being one of the most successful attempts at intergovernmental co-operation, in this instance between the Commonwealth, New South Wales and Victoria. The department was also active in other areas, notably in efforts to have states set up commissions to regulate land prices,[20] in assessing demands for transport services as a consequence of regional development (jointly with the Department of Transport),[21] in a regional grouping of local authorities[22] and in area improvement programs.

In planning for urban and regional development it seemed that in DURD the nucleus had already been established for national planning, especially of the public sector. But this fact was slow to be recognised by the Australian Labor Government. The implications of DURD's actions are not yet fully appreciated. Every new initiative taken (say on cities) has implications for other activities (e.g. housing and transport) in terms of resource use, social policy and community needs. Since many of these areas are ones in which the states have a legitimate interest in our federation, the intergovernmental planning of public sector activities — planning which must encompass revenue resources as well as expenditure needs — should now rank as one of the foremost tasks of government.

18 Intergovernmental Co-operation in the United States and Canada

The United States

Intergovernmental co-operation takes on a completely different form in the United States. On the financial side, this is partly because the states have greater autonomy than the Australian states. The vertical intergovernmental fiscal imbalance is much smaller in the United States than it is in Australia. Of more fundamental importance, however, is the emphasis on conditional grants-in-aid. This emphasis makes for a system of co-operation which is very definitely program orientated.

Apart from that, intergovernmental co-operation in the United States is constrained by the structure of government, the great diversity of American society (including the diversity of opinion at the political level between states) and the relatively large number of states. The diverse policy objectives of the several states have often been cited as a major explanation for the absence of a unified approach to important public problems. According to one writer, there is no definable point of view, at the state level, to intergovernmental relations as a whole.[1] Nor is there any single approach at the national level: Presidential views are not binding on Congress, and departments and agencies can also have different policies on intergovernmental relations.[2]

It is not surprising, therefore, that the approach to intergovernmental relations in the United States has been piecemeal in character, being related to particular programs where federal and state interests are involved. (There are also many examples of co-operation between several states whose interests converge with respect to particular public programs.)

In the United States there is no institutional arrangement which bears a close similarity to the Loan Council, the Premiers' Conference or the Grants Commission in Australia. It would, indeed, be difficult to imagine any benefits being derived from such arrangements even if fifty governors could, within the framework of the governmental and administrative structure, come together and agree on a common approach to intergovernmental relations. Regular conferences of state governors date back to 1908. But those conferences are essentially political in nature and their main function is to serve as a forum for an exchange of views on matters of common political interest. A Council of State Governments was set up in the 1920s but the Council is a state body with no federal representation and is mainly concerned with interstate adjustments. Neither the conferences nor the Council has had a significant impact on the structure of American federalism. At the local government level, there are the National League of Cities, the US Conference of Mayors and the National Association of Counties.

The structure of American federalism has been influenced more by Congressional committees, such as the Joint Committee on Internal Revenue Taxation, the House Ways and Means Committee, and the Senate Finance Committee, which have played a useful role in pinpointing and examining various problems in the federal sphere. In the executive branch,

the Council of Economic Advisers has also been quite influential.

Following the publication of the *Report* of the President's (Kestnbaum) Commission on Intergovernmental Relations in 1955, action was taken (in 1959) to establish the Advisory Commission on Intergovernmental Relations (ACIR), a body of twenty-six members with no counterpart in any of the other three federal countries.[3] ACIR is a creation of Congress but is composed of representatives from federal, state and local government. There are also three members who represent the general public. Its main purpose is to examine all aspects of intergovernmental relations in the United States and to recommend improvements. ACIR has, through a vigorous research effort and in other ways, stimulated a greater interest in, and promoted a more mature understanding of, the US federal system. Its recommendations have influenced federal-state policies adopted in Canada (the 'representative revenue system' as applied to interprovincial fiscal equalisation) as well as in the United States (e.g. revenue sharing).[4]

It is of interest to note that several recent initiatives for intergovernmental co-operation have come from the states. Perhaps the best example is the nationwide policy of elementary and secondary school assistance which was adopted in 1965.[5]

An accelerated interest by the Federal Government in intergovernmental co-operation was also apparent after 1965. The regional development program reflected the aim of Congress to devise a framework for planning which spanned the three levels of government. Regional commissions were established, composed of the governor of each participating state and a federal appointee. The basic idea was to increase national financial involvement in intergovernmental programs and at the same time encourage experimentation at the state and local levels.[6] Moreover, 'surveys, subsequent planning in terms of the survey findings, and eventual programming in relation to planning have increasingly become preconditions to receipt of federal aid'.[7] Thus, provision for highway aid required the development of a comprehensive transportation planning process in urban areas. Comprehensive community planning for urban development was fostered by grant programs under the US Department of Housing and Urban Development (HUD). Federal financial support in many other areas was also made conditional upon the preparation of a co-ordinated program.[8]

In relation to a range of conditional grants-in-aid programs there was therefore clear evidence of intergovernmental co-operation and planning. However, the proliferation of these programs was thought by many to constitute a threat to the autonomy of the states. To counteract this tendency and to provide the states with a broader and more elastic revenue base (and encourage states to exploit their own revenue resources more fully), the scheme for federal revenue sharing was put into effect in 1972. This move can be seen as an important new development in intergovernmental co-operation. Thus, according to the Advisory Commission on Intergovernmental Relations: 'Because Federal revenue sharing is "power sharing" in the very best tradition of equal partners in a joint governmental endeavour, this Federal aid approach stands out as the most direct and the most effective method to redress the fiscal and power imbalance. . .'.[9] A related and very important aspect of revenue sharing, which was discussed in chapter 8, is the move to substitute bloc grants for

categorical grants. Bloc grants enable recipient governments to spend freely within broad functional categories (e.g. education, health, transport). This trend, if continued, is consistent with co-operative federalism in that, while the central government is still able to achieve national goals and implement the necessary fiscal policy adjustments, it leaves more authority and responsibility to state and local authorities, avoids unnecessary duplication of administrative effort and is conducive to greater fiscal decentralisation. The bloc grant can, therefore, be seen as an important (and relatively new) tool of intergovernmental fiscal adjustment. It does indeed occupy a central position in the 'targets-instruments' (or 'eclectic') approach to intergovernmental fiscal relations, which was highlighted in chapter 3.

By means of revenue sharing, the United States would therefore appear to have achieved a better balanced system of intergovernmental fiscal adjustment. There is, however, no overall planning of public spending programs on a joint federal-state basis. The planning is rather loose, informal and unstructured. A piecemeal or program approach can, however, be regarded as appropriate in view of the diverse nature of American society, the absence of any clearly defined state or even federal view on intergovernmental relations, the complexity of the American federation with its large number of governmental units, and the divisive structure of government itself. The growing use of the bloc grant does, however, give co-operative federalism (American brand) a strong forward impetus.

Canada

The Judicial Committee of the Privy Council and, more recently, the Supreme Court of Canada, have had the ultimate authority to determine the precise meaning of the powers distributed by the *British North America Act*. The Judicial Committee's decisions on balance enhanced the powers of the provinces. Apart from the work of the Committee, intergovernmental co-operation in Canada has progressed mainly on the basis of informal arrangements 'with no foundation in the written constitution or in statutes'.[10] There has therefore been a strong tendency for machinery of consultation and negotiation to proliferate without effective planning and organisational purpose.[11] Co-operative arrangements are, for the most part, loose, pragmatic, related to particular interests, closely linked to financial involvement and lacking in systematic organisation. These arrangements bear little relation to overall policy goals. In Canada there is a complex network of intergovernmental liaison machinery with more than 170 committees, commissions, councils etc. involved.

Attempts have, however, been made, especially since 1955, to evolve a more systematic approach to intergovernmental co-operation. Although the idea of continuing federal-provincial consultation dates back to the period before World War II, it received impetus in 1955 from the advocacy of Premier Frost of Ontario.

The main instruments of intergovernmental co-operation in Canada are:

(i) The Conference of First Ministers (including various Ministerial subcommittees).
(ii) The Federal-Provincial Continuing Committee on Fiscal and Economic Matters.
(iii) The Tax Structure Committee.
(iv) A large number of bodies concerned with specific areas (e.g.

education, water resources, health and welfare).

The Conference of First Ministers is broadly comparable to the Premiers' Conference in Australia. This is the prime vehicle of co-operation at the ministerial or policy-making level. Meetings are now on a regular basis but there are no clearly defined terms of reference and the Conference has no legal basis. At this level of intergovernmental co-operation the most conspicuous success has been in the sphere of federal-provincial tax sharing agreements. These agreements have been the most important vehicle of vertical fiscal adjustment in Canada.

The Federal-Provincial Continuing Committee on Fiscal and Economic Matters came into being in February 1956. It is the only intergovernmental group on a regularly constituted basis with an interest in the whole range of economic policy. But the Committee works under the direction of the Federal-Provincial Conference. It is composed of federal and provincial officials who act only in an advisory capacity. The Committee has no executive power. It examines economic problems and presents the facts to the Federal-Provincial Conference, the Ministerial Committee and to the officials' own ministers.[12]

In this and in other initiatives in this area, leaders in the Province of Quebec have been active. Thus the Tremblay Commission (appointed by Premier Lesage in 1953) placed considerable emphasis in its 1956 *Report* on the need to put machinery for intergovernmental co-operation on a more institutionalised basis.[13] This move was related to various initiatives taken about this time for the purpose of securing a greater measure of provincial autonomy in social and economic matters. Pressure from Premier Lesage for improved liaison machinery was one of the factors which led to the creation of the Tax Structure Committee in 1964. Unlike the Continuing Committee on Fiscal and Economic Matters, the Tax Structure Committee was made up of ministerial representatives — three federal representatives and one from each of the provinces. The Committee's main task is to examine the allocation of tax resources of each level of government in relation to expenditure responsibilities.[14]

Mention should also be made of intergovernmental co-operation during the period of constitutional review (1967 to 1971) and of the new Institute for Research on Public Policy, a federally financed institution which will include research on federal-provincial relations among its activities.

Intergovernmental co-operation in Canada, at least to an Australian economist or political scientist, appears to have been highly successful in meeting provincial demands for greater financial autonomy. The agreements arrived at in the course of various ministerial conferences (assisted by various committees of federal and state officials) have enabled this objective to be achieved. For that purpose the lack of formally constituted institutions (such as the Medium Range Planning Council in Germany and the Loan Council in Australia) does not seem to have been a handicap. In any event there seems to be little value in creating institutions which are not able to have an effective influence on policy.

A good measure of success has also attended efforts at co-operation in particular areas, where broad lines of policy have already been agreed upon and the task is essentially a technical one of assembling data and agreeing on the best method of implementing programs within the framework of the established aims. One of the best examples of this sort of

co-operation is the Canada Assistance Plan, a comprehensive public assistance measure developed in consultation with the provinces and which came into effect in 1966. The Plan provides a basis for co-ordinating the various public welfare programs in each province. The existing shared-cost programs — old age assistance, blind persons' allowances, disabled persons' allowances, and unemployment assistance — were largely replaced by one general co-ordinated program for assisting all needy persons regardless of the causes of the need. The Dominion Government covers 50 per cent of the total assistance costs incurred by the provinces provided they have entered into an agreement and undertaken to meet the 'basic requirements' of recipients.[15]

Success at intergovernmental co-ordination with respect to the attainment of national goals has been less impressive. What appears to be lacking in Canada is some formalised machinery for joint intergovernmental planning (and perhaps joint decision-making?) on a systematic basis in relation to fiscal policy, and especially in determining the scope and composition of public sector activities. For co-ordination of public sector outlays (in that extensive grey area of public activity where both federal and provincial governments have a legitimate interest) and for related decisions on priorities and forward planning in terms of community needs and resource availability, mere consultation on an informal basis — an interchange of information and views — is hardly adequate. The Economic Council drew attention to this problem in 1965:

> in view of the increasingly predominant dimensions of provincial and municipal expenditures in relation to those of the federal government, an adequate basis must be evolved for effective continuing consultation between the Federal and provincial governments and in order that fiscal policy may be more effectively co-ordinated'.[16]

Also, a year later, the Council said:

> To deal with the policy problem requires, among other things, better planning of public expenditure; and this in turn requires more specific recognition of the role of all three levels of government and improved public understanding of the interrelationship between government fiscal actions and the progress of the Canadian economy.[17]

The Economic Council of Canada, which was established in 1963, does not itself form part of the machinery for intergovernmental co-operation. Its principal functions are to assess in a systematic manner medium- and long-term trends in the context of the growth potential for the economy as a whole, and to make recommendations (e.g. on major development projects) to the Dominion Government which will contribute to that growth. However, as noted above, the Council has been very conscious of the need to establish a better basis of co-operation between federal and provincial governments.

The existing machinery for intergovernmental co-operation (notably the annual meetings of Finance Ministers and Provincial Treasurers, the Continuing Committee on Fiscal and Economic Matters and the Tax Structure Committee) has made for a more effective integration of federal-provincial fiscal policy in Canada. Moreover, some further progress has been made in more recent years to improve consultation. At the Federal-Provincial Conference in November 1971 it was decided that future conferences of Finance Ministers and Provincial Treasurers should include in

the agenda a review of basic long-term trends in the economy and an examination of the medium-term outlook.[18]

In the Canadian federation there is therefore tangible evidence of progress in efforts to achieve a better policy co-ordination by federal and provincial governments. The stress which some had put on the struggle for political power seems, in retrospect, to have been exaggerated. However, there is still scope for improvement, because it seems very doubtful that the informal and loose arrangement of a Conference of First Ministers can really hope to serve as anything other than a forum for an interchange of information and views. Such a forum is probably inevitable and perhaps even desirable in Canada as in Australia. But it cannot serve as an effective agency of intergovernmental planning for both revenues and expenditures in a modern federation, where community needs are changing and inflation and stagflation flourish. Co-ordination of governmental borrowing programs is also entirely absent in Canada.

If the advantages of a federal system are to be retained and these national problems contained, a joint effort and systematic processes will have to be evolved. Political struggles and the inevitability of conflict should not be overplayed; but it is also clear that if a consensus is to emerge and intergovernmental co-operation is to be meaningful, certain conditions must be satisfied:[19]

(i) each partner must have comparable fiscal capacity;
(ii) there must be an acceptance of joint interests and responsibilities; and
(iii) each partner must be willing to accept the obligations as well as the benefits of co-operation — the recognition that 'liaison as part of co-operative federalism involves a limitation of initiative and the acceptance of responsibilities as well as advantages'.[20]

In summary, intergovernmental co-operation in Canada has not faced obstacles of the kind noted for the United States. The British structure of government has proved equal to the task of co-operation in many areas. By and large co-operation has been more successful in Canada than in Australia; one suspects that this is largely to be explained by the fact that the Dominion Government on the one hand and the provinces as a whole on the other are more equal in fiscal capacity (although fiscal capacity differences between provinces are much greater in Canada than in Australia) and because successive Dominion governments have not been obsessed with central control. On the other hand, the Canadian authorities have not made any real attempt to emulate Australia in respect of the co-ordination of public borrowing through the Loan Council; and in Canada, as in Australia, there is a notable absence of machinery for intergovernmental planning of public sector outlays. In this connection it is interesting to observe the recent efforts at such planning which have been made in the Federal Republic of Germany.

In the period 1955 to 1972, intergovernmental co-operation was, as a general rule, quite impressive. Although great reliance was placed on loose and somewhat informal arrangements (notably the Meetings of First Ministers and officials), this method seemed well suited to the Canadian environment and managed to avert any major confrontation.

In 1973-74 these co-operative arrangements were put to the test with the advent of the international oil crisis. The federal-provincial dispute on oil and gas revenues

(and, to a lesser extent, on other minerals) widened in 1974, and the Federal Government and the provinces, especially the Western provinces, seemed set for a head-on collision. In fact the tension had mounted to such an extent by the end of 1974 that the many conflicts in Australian federal-state relations looked rather tame by comparison. (Also, the conflicts in Australia have been more or less continuous and may therefore attract less attention with the passage of time.)

The emerging crisis in intergovernmental financial relations in Canada was triggered off by the sharp rise in oil prices. This brought substantial benefits to Alberta, which produces 85 per cent of Canada's oil (Saskatchewan accounts for a further 11 per cent). Alberta's oil revenues rose from $300m in 1972 to about $2000m in 1974, creating among other things substantial problems for the Federal Government's revenue-equalisation arrangements. Confrontation between the Federal Government and the provinces was heightened when, following increased royalties and other taxes (on oil, gas and minerals) imposed by Western provinces, the Federal Government decided: (i) to impose an export tax on oil (to subsidise eastern consumers); (ii) to make provincial mining taxes, and notably oil and gas royalties, non-deductible for purposes of federal corporate income tax liability; and (iii) to tighten the rules on depletion allowances. The higher taxes angered the business community and threatened a slowdown of the exploration effort. The Premier of Alberta (Mr P. Lougheed) was particularly upset. Because of the Federal Government's budgetary measures and opposition from industry, he found it difficult to make his taxes stick — an unpalatable outcome in view of the constitutional right which provinces have to impose such taxes and use the revenue in their own provinces.

The essence of the problem was that the Dominion Government sought, and apparently obtained, a 'back-door' method for curbing provincial power in relation to mineral and oil royalties.[21] The situation was further aggravated by the decision of the Federal Energy Minister to reduce oil exports to the United States, a decision which was said to be necessary in view of an assessment that Canada could become a net oil importer after 1982.[22]

It appears that this episode has been marked by a lack of co-ordination between federal and provincial governments, as manifested in the competitive struggle for tax revenues[23] and the implications of Alberta's new-found affluence for the revenue equalisation arrangements. At a Conference of First Ministers in January 1974 it was not possible to reach agreement on a national oil pricing policy,[24] but subsequent conferences were able to secure a measure of agreement on the oil export tax and its distribution and on an appropriate adjustment to the equalisation formula (see chapter 13).

19 Economic Planning in West Germany

By contrast to the three federal countries discussed above, West Germany has, since 1967, taken several decisive steps in implementing a system of national planning which rests importantly on intergovernmental co-operation. The results, so far, have been encouraging. Fiscal policy is more flexible, thus requiring less reliance on monetary policy, and the federal system has apparently been strengthened by virtue of constitutional amendments, institutional arrangements and efforts by each major party to reach a consensus for policy adjustment in the light of competing goals and changing economic conditions.

Again it is necessary to reiterate what was said earlier regarding the need to interpret change in terms of a country's economic, legal and political structure. In Germany, the progress made with co-operative federalism cannot be seen in true perspective without an adequate understanding of the role and influence of the Council of States. It is necessary to bear this in mind when attempting comparisons with other federal countries. The Council has not only acted to protect the interests of the states; it has also taken important initiatives in ensuring that the Federal Government has adequate powers to assert itself in areas of general economic policy. The Council has at least this dual role, a fact which helps to explain the success of the German experiment with co-operative federalism.

This success can also be linked with the Federal Government's widespread taxing powers and the use of a simple method of tax sharing to regulate vertical intergovernmental fiscal imbalance. This explains, in part, why most federal grants to states and local authorities are of the specific purpose variety and are relatively small in relation to total state income. These grants, as noted elsewhere, can be justified in terms of interjurisdictional spillover benefits and the promotion of national goals; but since the grants impinge on state and local functions and responsibilities, they can logically be seen to fall within the ambit of joint co-operation and planning.

Also, by way of introduction, it is necessary to keep within view the importance of the 1969 Finance Reform in regulating vertical fiscal imbalance and the explicit and rather sophisticated method used in Germany to effect the horizontal financial equalisation between states.

The first thing that is apparent about the system of intergovernmental co-operation in West Germany is that it is institutionalised and has a firm basis in law. The system therefore presents a striking contrast with the pattern of intergovernmental co-operation in the other three federal countries. The institutionalised form of co-operation is in keeping with the German aversion to loose arrangements and a penchant for strict provisions in law, which leave little doubt about the role of each party and the overall objectives. The great variety of committees, commissions, advisory councils and the like which was found to be a feature of a tangled web of inter-

governmental co-operation in Australia, the USA and Canada, is much less evident in Germany. Detailed feasibility studies are, of course, made with respect to particular programs, but the decisions ultimately made must conform to the requirements of law and/or administrative arrangements sanctioned by law.

There is, moreover, no parallel for the annual Premiers' Conferences which are a feature of federal-state relations in Canada and Australia. The Council of States obviates the need for this method of co-operation because the Council serves, in effect, as a *permanent* conference of State Ministers or their deputies. The Council, forming an integral part of the governmental structure in Bonn, is in constant touch with national needs and aspirations as espoused by the Federal Administration. The Council has its own committees which discuss, on a continuing basis, a range of problems in federal-state financial relations.

The Economic Stability and Growth Law

Apart from efforts to refine the instruments of intergovernmental co-operation, there has recently been considerable emphasis on the need for a system of overall financial planning. The latter is, to a large extent, a product of the Economic Stability and Growth Law of 1967.[1]

An amendment to the Constitution (Article 109), together with the passage of the Economic Stability and Growth Law (ESGL) in June 1967, has brought important changes in relations between the Federal Government, the states and municipalities and has opened up possibilities for co-ordination of budgetary policies of each level of government.[2] The essential spirit of the law is that the Federal Government and the states must co-operate in financial planning. For this purpose two bodies were set up: the *Konjunkturrat* (for business cycle control) and the *Finanzplanungsrat* (for medium-term planning).

In terms of the ESGL each level of government in its budgeting is required to take account of the total economic equilibrium.[3] Medium-range financial planning and anti-cyclical financial policy are tasks of both the central government and the states. Moreover, under paragraph 16, the states have legislative power to compel municipalities to adjust their budgets according to economic conditions. (It will be recalled that municipalities in the Federal Republic of Germany account for almost two-thirds of total real investment undertaken in the public sector.) The states are expected to take whatever steps might be necessary to ensure that municipalities share in any burdens which a particular policy may impose.

As for the special responsibilities of the Federal Government, the law requires the preparation of an annual economic report — a report which is submitted to both Houses of Federal Parliament. Included in this report must be an assessment of total economic development, of the current and prospective economic situation and an indication of how economic equilibrium can best be secured. The report must specify the economic and fiscal policy aims for the current year and the measures required to reach the goals specified. The law lays down that federal budgeting is to be based on a five-year period. If the goals specified in the law (price stability, high employment, external equilibrium and appropriate economic growth) are endangered, the Federal Government must make available orientation data for concerted action by governmental units, trade unions and employers' associations in order to reach the above goals.

In theory the Trade Cycle Council

(*Konjunkturrat*) is a purely advisory body concerned with questions of public credit. However, in practice the Council has become more than an advisory body since its composition is such that its recommendations are rarely rejected. For example, if it becomes evident that the capital market is being over-loaded, the Council can recommend that state governments and municipal corporations place limits on the amounts they plan to borrow. Control over state and local borrowings is, however, subject to a fixed limit and can only be applied in exceptional circumstances when it is clear that economic equilibrium is at risk.[4] Such measures of control do, in any event, require the approval of the *Bundesrat*.

The Trade Cycle Council also advises, *inter alia*, on the pattern of expenditures by the three levels of government and on the reactivation of funds frozen with the central bank.

Each level of government is represented on the Council: there are two federal representatives (Federal Ministry of Economics and Federal Ministry of Finance); one representative of each state (usually the finance ministers); and four representatives of the municipalities.

Similarly constituted is the *Finanzplanungsrat* (the advisory Financial Planning Council) which is designed to co-ordinate the financial planning of federal, state and local authorities. A five-year plan is put forward by the Federal Ministry of Finance. A decision is made by the Federal Government and is then considered by Federal Parliament. The plan is adjusted annually to take account of current and expected changes in the economic situation.

An important part of the ESGL relates to the freezing of funds (*Konjunkturausgleichsruecklage*) by *Bund* and *Laender* in a boom and the release of part or all of these funds in a recession.[5] In order to combat boom conditions the Federal Government can, by decree (under paragraph 15) and with approval of the Upper House, rule that both federal and state governments increase the total of funds frozen with the central bank; but such additional amounts cannot exceed 3 per cent of tax revenues raised by federal and state governments in the previous year. These funds can only be released by a decision of the Federal Government with the concurrence of the Upper House,

Under paragraph 26, the Federal Government also has the power to issue decrees, again with Upper House approval, which have the effect of increasing or decreasing personal and corporate income taxes by a maximum of 10 per cent for a period of one year in order to combat a disturbance to equilibrium. A similar provision is in force regarding depreciation allowances and/or investment bonuses.

Criticism of the ESGL has been directed mainly at the possible loss of parliamentary control and the alleged threat to the financial independence of the states. On the question of parliamentary control, the position appears to be as follows. If both houses of Federal Parliament are convinced of the need for an increase or decrease in income tax or investment bonuses, action can be taken in a matter of days — and outside the Stability and Growth Law. It might be thought that such ideal conditions (all-round agreement) would be rare, especially for tax increases. But in recent years there have been two excellent examples of speedy action taken by the federal authorities: (i) the imposition of a tax on exports at the end of 1968 as a partial substitute for an appreciation of the Deutsche Mark; and (ii) the imposition of a *Konjunkturzuschlag* (a 10 per cent surcharge on income and wage tax

liabilities above DM100 a month) which gained Parliamentary approval in 1970.

If the two houses of Federal Parliament disagree on a proposed course of action, a 'Compromise Council', comprising representatives of each House, is formed; and these representatives sit together and try to reach agreement. For disagreements on budget policy, a mediation committee (comprising 11 members from each legislative chamber) is asked to work out a compromise; and if the compromise is not accepted, the majority vote of the *Bundestag* prevails. When governmental funds are 'frozen' in accordance with the provisions of the ESGL, the states are protected. The *Bundesrat* can effectively block the measure. But the *Bundesrat* apparently is not likely to take such a stand, especially if the weight of expert opinion is pressing for speedy action.[6]

Between 1968 and 1974 the Federal Government, following the advice of its advisory committees (which comprise representatives of each level of government), has acted on several occasions to make fiscal adjustments under the ESGL. In May 1969 the Federal Government and the states lodged a total of DM3·6b in the anti-cyclical reserve fund at the central bank. Further amounts were transferred to the fund in May 1971 and certain limitations were placed on governmental borrowing requirements. In March 1972 the Trade Cycle Council and the Financial Planning Council advised against the activation of federal and state contingency budgets and the liquidation of part or all of the anti-cyclical reserves. The temporary anti-cyclical surcharge on personal income taxes (imposed in August 1970) was repaid in June 1972. (The author, whilst lecturing in Germany, was himself required to pay the *Konjunkturzuschlag* and about a year later received reimbursement.) In May 1973, when inflation was again the major problem, it was decided (under the authority of paragraph 19 of ESGL) to limit governmental borrowing to a figure DM1b below the 1972 level. This followed closely on the heels of other anti-inflationary measures, notably a 10 per cent stability levy on high incomes, a reduction in investment allowances and some deferment of joint federal-state capital projects.[7] The stability levy was removed in the middle of 1974 and other financial restraints were progressively relaxed as recessionary trends became evident during the year.

There is ample evidence to show that fiscal policy has become much more flexible in recent years; this has been accomplished without undermining the financial independence of the states. Each party must, of course, give up some independence if co-operative federalism is to succeed. This has clearly happened in West Germany. The central government has a more effective control over public sector expenditure than it did before the passage of the ESGL in 1967; but the need for *Bundesrat* approval serves as a buffer against ill-considered or arbitrary action on the part of Federal Cabinet. The mechanism for co-operation between governmental units set down in the law also helps the states to assert some measure of financial independence without losing sight of national goals and problems. The actual decision to release funds from the anti-cyclical reserve deposits is made by Federal Cabinet and the Upper House, but only after the matter has been discussed by the Financial Planning Council and the Trade Cycle Council. There is little chance of by-passing these planning bodies on which states have strong representation. If both bodies call for swift action on taxes, borrowing or on freezing of excess governmental funds, the action can be taken without protracted

parliamentary debate.

The new legislation therefore permits a more effective fiscal policy and it also provides ample safeguards for the states. In summary, these safeguards are:

(i) Provision of machinery for inter-governmental co-operation. The views of the states must be sought.

(ii) The measures can only apply for a year at a time.

(iii) A limit to the amount which must be deposited in the 'frozen' anti-cyclical reserve fund. The 3 per cent limit (see above) corresponds to only about 0·5 per cent of GNP.[8]

(iv) The *Bundesrat* must approve. This is the strongest safeguard.

The provisions of the ESGL therefore seem to represent a fair compromise between the need to protect the fiscal autonomy of the states and local authorities (e.g. independent budgeting, representation on advisory bodies, Upper House approval) and the need to equip the Federal Government with the means necessary to control the direction and magnitude of public sector expenditures. The ESGL clearly makes for a better co-ordination of the budgetary policies of federal, state and local authorities. Any effective management of the economy requires regulation of all government finances, not just those of the central government. In a federal system, the closest possible co-ordination at all levels of government is necessary. The central focus of the ESGL is on the need for such co-ordination and the provision of machinery to give it the force of law.

A further point is that under paragraph 6 (3) of the ESGL the Federal Ministry of Finance can, in order to finance additional expenditures necessary in recession, borrow an amount of up to DM5b in excess of budget authorisations (and in addition to amounts which may be drawn from the 'Anti Cyclical Control' funds). The position in West Germany is that the Federal Treasury cannot demand money from the central bank;[9] but it can borrow cheaply on the short-term money market if the central bank co-operates by creating additional liquidity, as it did on a large scale in the recession year of 1967, by lowering minimum reserve requirements, reducing interest rates, and purchasing securities in the open market.

The Economic Stability and Growth law points the way to financial planning over a five-year period and stresses the need for co-operation between the three levels of government in the execution of public tasks. The law provides a suitable framework in a federal system by which these tasks can be tackled with a minimum of delay. The law states the various facets of the economic situation which must be considered in assessing economic equilibrium and indicates what actions should be taken in the event that such equilibrium is disturbed. On the other hand, the mere existence of such law does not necessarily guarantee timely and effective action. The law does not work automatically; the Federal Government has to decide on its application. The law can be compared to a cook book — the right recipes have to be chosen at the right times and the various ingredients have to match the occasion. The Federal Government makes annual projections, but these are not fool-proof. The problems of correct diagnosis and accurate forecasting have not been solved — not even in West Germany. But the instruments of law can be applied, if the will to use them is there and the pressures working against their application are successfully resisted. Economic fluctuations cannot be eliminated but they can be kept within narrow

limits. This law, together with the finance reform proposals considered earlier, enables the Federal Government to make speedy adjustments in fiscal policy for purposes of counter-cyclical control. The extent of publicity which surrounded the introduction of these measures seems also to have had the added advantage of creating a greater awareness throughout the community of the need for federal action for economic stability and growth purposes.

Joint Federal-State Planning

Unlike Australia, untied or open-ended grants are not used in Germany to correct for vertical intergovernmental fiscal imbalance. As noted, this correction is accomplished mainly through revenue-sharing arrangements with respect to income and value-added taxes.

The central government of West Germany does make large grants to states and municipalities, but these grants are usually for well-defined purposes and are made as part of the machinery for joint federal-state co-operation.

The main thrust of federal financial assistance is now concentrated on assistance for 'joint tasks'. The joint task concept gained prominence in discussions surrounding Finance Reform in 1968-69. The central idea was to clarify the nature of those tasks which the Federal Government and the states should jointly plan and finance.

The term 'joint tasks' was coined by the Fiscal Reform Commission (*Troeger Kommission*), whose recommendations formed the basis of subsequent reform measures. These are tasks which were hitherto the responsibility of the states but which, under federal law, have now been declared to be 'joint' because of their national importance and because they require joint long-term planning.

Co-operation between *Bund* and *Laender* in promoting certain categories of expenditure is not new. Housing construction has been promoted jointly by *Bund* and *Laender* and the *Bund* has participated in measures to improve the structure of agriculture and to finance the extension of higher education. However, before the 1969 Finance Reform, these efforts tended to be *ad hoc* in nature and were often responses to particular pressures. Overall planning was lacking and the nature of the joint tasks was not clearly defined.

In order to overcome these shortcomings, the Constitution was amended in 1969. The amendments were designed to achieve a more systematic approach to joint planning and financing with respect to task areas which have national importance or which are likely to assist towards the goal of uniform economic development.

The tasks which federal and state governments jointly plan and finance under Article 91(a) of the Constitution relate to:

(i) extension and construction of institutes of higher education, including the university clinics;
(ii) improvement of the regional economic structure; and
(iii) improvement of the agricultural structure and of coastal protection.[10]

Another amending clause was Article 91 (b) which envisaged co-operation between the federal and state governments in educational planning and in promoting scientific research of extra-regional significance. However, in contrast to Article 91 (a), no firm guidelines are established for federal financial participation and there is no formalised machinery for intergovernmental co-operation. The latter proceeds on the basis

of simple administrative agreements. This clause has, for example, covered agreements for the joint financing of the Max-Planck Foundation and the German Research Foundation.[11]

An important part of Article 91 relates to framework planning (*Rahmenplanung*) by which planning boards have been set up for the various fields of expenditure. In this connection, certain points are worth noting:

(i) Before a project can be incorporated in a plan it must have the approval of the state in whose area the project will be initiated.

(ii) There are two federal representatives and one representative from each of the eleven states on each board, making a total of thirteen representatives. States are usually represented by their finance ministers. Both the Federal Government and the states have 50 per cent of the voting power.

(iii) Before any project can be approved, a 75 per cent majority of votes is required. This means that if the Federal Government approves, it needs to gain the support of six of the eleven states (each of which commands approximately 4·5 per cent of voting power) before the seal of approval can be granted and the necessary funds set aside in the respective budgets.

(iv) Once agreement is reached for the inclusion of particular projects in framework plans, the Federal Government provides at least half of the necessary finance. In some categories — coastal protection, for example — the Federal Government provides 70 per cent of the total finance required.[12]

(v) The Federal Parliament and the relevant state parliaments must approve the budget allocations for the planned expenditures put forward by the planning boards. Members of each Board must therefore reach agreement over the plans with their respective governments.

(vi) The determination of tasks which are to be jointly planned and financed must have *Bundesrat* approval.

(vii) The Federal Government is concerned with planning in a broad sense and is not involved in the details of the planning.[13]

Apart from the framework plans for joint financing of approved projects, the new Finance Reform provided for a Constitutional amendment (Article 104 (a) (2-4)) relating to federal financial assistance, either to fend off a recession or to support especially important investments of the states or municipalities in the interest of uniform economic development.[14] Financial aid under this amendment can be secured either in terms of a federal law (which needs the approval of the Council of States) or by means of an administrative agreement between the Federal Government and one or several states (when, in the federal budgetary law, an authorisation for the administrative agreement has been provided). With regard to federal assistance to local authorities, plans have been formulated providing aid for such purposes as improvements in traffic conditions, housing, city development and hospitals.

Finance Reform, Co-operative Planning and Fiscal Policy

Machinery for intergovernmental financial co-ordination in Germany is designed to ensure that grants from the centre are determined largely as a consequence of, and have a firm basis in, cost-benefit calculations with respect to specific projects which are examined by the various planning boards. The finance reform measures of 1969 leave no scope for general financial aid paid in an *ad hoc* fashion to particular states. Outside the

joint financing arrangements, as encompassed by Article 91 of the Constitution, the Federal Government can extend aid only in accordance with conditions and procedures set out in Article 104 or as supplementary allocations in terms of Article 107 (2) (see chapter 13).

The benefits to be derived from Finance Reform rest to an important degree on the machinery (established under federal law) for co-operation between the three levels of government. Such machinery relates to trade cycle control, medium-range planning, the execution of joint tasks, and the distribution of tax revenue. As a leading public finance expert in Germany has said: 'Effective co-ordination can be achieved only if the parties confer jointly on . . . measures necessary to regulate the trade cycle, passing resolutions which lay down precisely the extent of each party's participation in the joint action.'[15]

The West German authorities seem determined to prove that co-operative federalism is not a pipe dream — that tangible benefits can emerge to all parties if efforts are made to co-ordinate their various activities. While in this process the states have necessarily been obliged to accept some limitations on their fiscal autonomy in order that the Federal Government can proceed with its task of guiding the economy in the interests of overall economic management, these limitations (e.g. on public borrowing or in relation to amounts lodged in the anti-cyclical reserve fund) attain effective significance only in the event that economic equilibrium is in jeopardy.[16]

The vital point is that the states are protected from arbitrary action by the Federal Government. Such protection finds expression in several ways, including *Laender* participation in policy formulation through membership of the Trade Cycle Council and various planning boards. The fact that most policy initiatives can be expected to come from the central government will not endanger the federal system as long as the interests of the states are adequately safeguarded. Representation on major policy boards, participation in project planning for public sector outlays and, most important, the need for *Bundesrat* approval, provide the necessary safeguards and make it extremely difficult for federal officials to act in an arbitrary fashion. To quote Haller again: 'Co-ordination means orientation to each other and dependence on each other.'[17] A federation works effectively only when each party can participate in decision-making and the states are not placed in the position of having decisions (which affect their interests as sovereign states) being imposed upon them by the Federal Government. An essential feature of co-operative federalism is joint decision-making. The latter does not automatically evolve; it must be consciously sought by all the parties and it must have a firm basis in law. In Germany these conditions appear to have been met. Thus the composition and functions of the Trade Cycle Council and the Financial Planning Council are clearly set out in the Economic Stability and Growth Law.

Economic planning takes on a diversified form in Germany; no single institution or government department has too much power. Each level of government — federal and state — is represented on the planning councils; and the work of these councils with respect to the joint task concept is an outstanding example of federalistic or co-operative planning. No major decision regarding medium-term planning is made without prior discussion between representatives of each level of government.

In Germany, federal financial assistance to the states usually takes the form

of grants which are earmarked for specific purposes. Open-ended (unconditional) grants are on a relatively small scale. Open-ended grants relate to horizontal fiscal equalisation but the grants are very small in view of the system of interstate financial transfers. In addition, there are some general purpose grants which have been made (e.g. in 1967 and 1974-75) to counter recession but those grants are more in the nature of bloc grants since they are usually designed to stimulate activity in certain areas (e.g. building). Unlike federal funds provided under the Joint Tasks, these grants, which are given under the authority of Article 104 (a) of the Constitution, are determined at the discretion of the Federal Government.

Specific purpose grants are not provided in an *ad hoc* fashion. Before a decision is made on financial assistance, the advice of the planning bodies is sought; and each proposal has to be justified on economic and social grounds — it cannot easily be a mere response to political pressures. Although a system of program budgeting is still a long way off in Germany, the authorities are moving gradually in that direction.

Co-ordination for medium-range planning takes the form of collaboration between federal, state and local authorities in setting up the plan and specifying, for example, the likely future expenditure needs of the states and municipalities in such important fields as education, housing, transport and health. The states and municipalities actually participate at the planning stage (through the Financial Planning Council) in assessing the availability of resources for satisfying these needs in view of competing demands in the private sector. For the three levels of government, planning therefore becomes a co-operative enterprise rather than a competitive struggle by each level to maximise its own revenue.

But the rather elaborate machinery for co-operative planning which has evolved would mean little in itself if careful attention had not been given at the outset to the question of an appropriate sharing of tax revenues between the three levels of government. The success of co-operative planning in Germany has depended to an important degree on the fact that it has been involved in revenue as well as in expenditure decisions.

What the West German authorities have achieved in a relatively short space of time can be summed up as follows: tight overall economic control (with a gradual scaling down of the emphasis on monetary policy), flexible arrangements for revenue sharing, an apparatus of joint decision-making in areas where federal-state functions and responsibilities overlap (and where a greater uniformity of living conditions is desired), and the absence of massive intergovernmental transfers or heavy financial burdens pressing on the states.

The critical importance of the tax-sharing arrangements in regulating the vertical financial settlement and in establishing a viable basis on which to proceed with intergovernmental planning of public sector outlays should by now be only too apparent. The distribution of joint taxes is designed to ensure that revenue receipts at each level of government are broadly commensurate with expected expenditure requirements at each level. The distribution of tax revenues between the three levels of government is clearly set out in the Basic Law, but this law is not immutable. This is especially true of the *Laender* share of revenue from the value-added tax; this can be adjusted to take account of changing revenue and expenditure trends within each level of government.

German experience therefore demonstrates the key importance of having a workable system of distributing tax revenues between federal, state and local authorities; the system will only be workable if it is based on a careful assessment of the expenditure commitments of each level of government. With such a system the scope for federal 'handouts' in response to political pressures is greatly reduced. Moreover, the new plan in Germany for distributing a portion of revenue from the value-added tax to the states on a population basis — and with a built-in bias for assisting financially weak states — automatically reduces in advance the need for *ad hoc* federal assistance. This means that the amount of 'equalising' to be done under the *Finanzausgleich* (financial settlement) formula is less than formerly and supplementary payments by the Federal Government to assist financially weak states can also be kept to a relatively small figure.

In so far as fiscal policy is concerned, there is an interesting situation. The work of the Trade Cycle Council (on which states and local authorities are represented) has assumed a role of fundamental importance. In a nutshell, the Council ensures that there is adequate consultation between federal, state and local authorities on any matter relating to economic stabilisation policies. This, as noted, is provided for in the ESGL which is designed, *inter alia*, to spell out procedures for policy adjustments relating to the fiscal operations of the federal, state and local authorities.

For fiscal policy to be effective as a counter-cyclical weapon, it must be possible to introduce and implement tax and expenditure changes at relatively short notice. The impression one gains — and this may come as a surprise to many — is that the federal authorities in West Germany have been able to achieve a high degree of flexibility in this area in a manner which has not posed any serious threat either to the accepted institution of parliamentary control or to the financial independence of the states. It therefore appears that remote control from the centre (e.g. from Canberra) is not a necessary condition for an efficient economic management in a federation.

Economic Council

An Economic Council, or Council of Economic Experts (*Sachverständigenrat*) was set up in 1963. Each November the Council publishes a report containing a general survey of the economy and forecasts for the following year. The Council, whose influence has grown steadily in recent years, is more independent of the Federal Government than its USA counterpart (the Council of Economic Advisers), which furnishes advice direct to the President. The law establishing the Council expressly forbids government employees from being appointed, a fact which appears to have contributed to its prestige. The Council is composed of five independent economic experts drawn either from the universities or from economic and social institutes. Unlike the CEA, the German Economic Council cannot make specific policy recommendations.[18]

Special mention is made of the Economic Council at this juncture because it provides yet another example of how the Federal Administration must justify and explain its actions, including those which may impinge on state rights and responsibilities. In the January following publication of the Council's report the Federal Government publishes its own annual report in which it refers to the work of the Council, its general influence and the conclusions it has reached. The Council's

influence is such that the government in Bonn is compelled to take a position with the Council on each major issue presented and discussed in the Council's report. This has the major advantage that the Federal Government must subject its own point of view to critical analysis in an effort to defend and justify particular policies. In this way problems have been brought out in the open and a consensus within the government and its various planning bodies more easily reached. It should be added that the ESGL has widened the field of this expert council in that the latter is 'now obliged to take action and report whenever the general economic targets are considered in danger'.[19]

Summary

It should not be imagined that the federal system in West Germany has been, or currently is, free of problems. The three levels of government do not always agree on important issues. City mayors complain frequently that their cities are starved for finance, despite the benefits derived from finance reform. Tensions in intergovernmental fiscal relations will inevitably emerge and will not always be speedily resolved. But so far these tensions have not reached unmanageable proportions and there is no evidence that the working of the federal system has been seriously impaired.

It seems not unreasonable, in the light of recent German experience, to argue strongly that tension will be lessened where there are flexible revenue-sharing arrangements (extending down the line to municipalities) and opportunities for meaningful consultation and co-operation in areas of mutual interest. The system of intergovernmental liaison should aim at a middle-of-the-road solution, whereby national initiatives in fiscal policy are combined with adequate scope for the efficient execution of state tasks and joint involvement in decision-making in that large grey area where both levels of government have legitimate interests and responsibilities.

20 Fiscal Federalism in Australia: a Framework for Planning

The weaknesses of the Australian federal system have been referred to earlier. They include an undue dependence of the Australian states on federal grants and on borrowing and a failure to make the transition to co-operative federalism. The time is long past when it was possible to view federalism solely in terms of state rights. We now live in a mixed world in which there will be some state functions financed by the states, some federal functions financed by the Federal Government and a great many functions financed by both the Federal Government and the states, with decision-making power divided between them.[1] To lessen intergovernmental conflict it is clear that some machinery must be devised that will ensure intergovernmental consultation and effective decision-making. It would seem appropriate that this machinery should be considered as a vital part of the apparatus of national planning which has not as yet been fully developed in Australia.

By comparison with Germany, planning techniques in Australia are piecemeal, *ad hoc* and unsystematic. There are numerous examples of effective co-operation by the Commonwealth and the states in several fields. Recent initiatives taken by DURD are of particular interest. Development of Albury-Wodonga as a growth centre provides an excellent example of intergovernmental co-operation in the sphere of decentralisation policy. Similar initiatives to establish growth centres at Geelong (Victoria) Monarto (South Australia) and elsewhere are also welcome.

There are, however, grounds for arguing that DURD was very largely an instrument for promoting greater centralised control in Canberra. DURD reports are impressive as statements of principles and the need for intergovernmental co-operation. And yet the states (and local authorities) claim that the DURD framework for planning provided them with little, if any, say in the decision-making process. It is difficult to avoid the impression that the new focus on regionalism is largely a ploy for achieving greater central control. According to Professor Harris,

> regionalism, as viewed by the Federal Government and most of its advisers, seems more designed to strengthen central government and to centralize priority and program choices, rather than to develop effective and autonomous regional political units as part of the planning structure. Yet the most efficient and speedy way of achieving wide-spread regional planning would be first to improve and strengthen the financial positions of state governments, which are essentially regional governments, and then to do the same thing for local authorities, although in this case amalgamations of many local authorities could be required to produce effective sub-regional political units.[2]

Taken in conjunction with the multiplicity of committees and commissions, most of which are essentially Commonwealth bodies rather than instruments of

co-operative government, and the associated rapid expansion of specific purpose grants, the conclusion seems inescapable that the essential elements of national planning in the context of co-operative government have yet to make their appearance in Australia.

An urgent need in Australia is therefore to devise a national plan and, in particular, to make a more concerted effort to plan public sector development in areas where both the Federal Government and the states have a legitimate interest. In short, such planning should be structured to cater for national and regional needs in a federal system; and this planning should be considered in relation to: (i) competing demands for resources from private sector activity; (ii) community needs; and (iii) the fiscal goals of government. The regional aspect of planning can be pursued but it seems logical that this should occur within the existing governmental framework of states and local authorities. It seems pointless in a federation to create regions which have no effective political or economic power. In short, success in regional policy calls for effort to create new forms of co-operation between the three levels of government.[3]

The main purpose of this chapter is to suggest a method by which a more effective planning of public sector outlays in Australia could be achieved.

Revenue Sharing as a Prerequisite for Planning

States in a federal system must have access to flexible sources of revenue to meet commitments in their spheres of competence. Without a proper allocation of financial resources, the federal system can disintegrate. It is especially damaging to a federal system when national policies imposed from the centre, on which there is no machinery to ensure prior consultation with the states, set up pressures for increased expenditures which the states cannot finance with the resources at their disposal. The net result is a greater dependence on federal grants or on borrowing.

Undue dependence on federal grants or on borrowing tends to undermine the federal system in that independent decision-making by the states is impaired and, as one writer has put it, 'the State governments are encouraged to see every problem as one of getting more money from the Commonwealth'.[4] In these circumstances the states become financially irresponsible and it is difficult to see how they can plan ahead. It is also difficult to see how rational planning of the use of resources by the public sector as a whole — given the absorption of resources in the private sector — can be achieved. What is clearly needed, as a prerequisite for national planning in a federation, is an arrangement that will ensure that as revenue/expenditure patterns between federal and state governments change over time, an appropriate adjustment can be made to the distribution of finance as between the two levels of government.

One of the reasons for the success of co-operative planning in Germany was that careful attention was given to revenue resources of each level of government as well as to their likely expenditure needs. Piecemeal attempts at co-operative planning in various fields of governmental activity are likely to be ineffectual if states are constrained by revenue-raising limitations. This can be seen in Australia in such fields as housing, transportation, health and education. Providing larger federal 'handouts' to patch up and conceal the underlying problem is a negation of the objectives of co-operative federalism. The states cannot pretend to be able to

assert any measure of real independence if they continue to have narrow and inelastic revenue sources and have no effective voice in decisions appertaining to shared revenues. It is not therefore surprising that co-operative planning in Australia as it now stands amounts to little more than centralised planning with a token recognition of state and local responsibilities.

Thus, in a federation an integral part of planning must consist of intergovernmental machinery to regulate the vertical intergovernmental fiscal imbalance through revenue sharing. The decision must, in the final analysis, be a political one. The Australian Government should be empowered to change the participation ratio for personal income taxes when economic conditions warrant or where there is clearly a growing divergence between revenue-expenditure trends at each level of government. The states will, however, be protected from arbitrary decision if the planning machinery specifies the relevant criteria to which states subscribe and if decisions which change the state share have to be justified by reasoned argument, using as a basis the estimated receipts and expenditure for each tier.

A necessary precondition for public sector planning in Australia is tax sharing, designed to achieve a better financial balance between the two levels of government. Planning in a federation will mean little until moves are made in that direction. It is recognised that this will entail a major overhaul of the existing methods of federal financial assistance to the states.

Co-operative Federalism and Revenue Sharing

Australia appears to be moving in the direction of 'organic' federalism — a term used frequently by Professor Sawer to indicate a federal system in which a high degree of power is vested at the centre.[5] This problem is not peculiar to Australia, or indeed to federal countries. There is, moreover, an increasing awareness of the dangers of too much centralised power, even in countries with relatively small geographical areas. Thus, in a recent report of a Royal Commission into the structure of government in Britain, the majority of Commissioners noted that 'nearly all complaints of substance spring from the centralisation of government in London and the absence of a regional voice in deciding the allocation of public funds within a region'.[6]

It cannot be stressed often enough that the first essential component of reform is to formulate rules or guidelines which give each of the main parties in the federation an opportunity to exert some influence on revenue shares. To be effective, co-operation must rest on a balanced division of revenues which stand in close harmony with expenditure needs. Ideally, a Council of State Ministers (CSM) should be set up for that purpose. The Council should have its offices in Canberra and be established under federal law. It could be constituted somewhat along the lines of the highly successful Tax Structure Committee in Canada. The decision late in 1975 by the Premiers of New South Wales, Victoria, Queensland and Western Australia to set up a permanent secretariat or State Council in Canberra falls far short of what is required, even if other states decide to participate.

Once a standard arrangement embodying the decision-making rules has been worked out by such a Council in consultation with federal officials, the future adjustment of revenue shares should not be a contentious issue, because the shares logically relate to expenditure responsibilities. Given the arrangements

for federal-state participation in planning public sector outlays (see below), changes in revenue shares are clearly justified when there occurs, or is likely to occur, a significant change in the relative expenditure needs of either level of government. There is, therefore, an unambiguous benchmark on which the need for adjustment of revenue shares can be assessed.

In an Australian setting it seems realistic to think of revenue sharing primarily in terms of the personal income tax. A state share initially of 30 per cent of total receipts from this tax would not impair fiscal policy adjustments by the central government and it would be sufficient to eliminate about 80 per cent of financial assistance grants (the remaining 20 per cent being largely of a redistributional nature). Provided that such a revenue share can be adjusted in line with forward estimates of expenditures by each level of government, states (and possibly local authorities) will automatically secure a measure of financial autonomy. Revenue sharing therefore emerges as the linchpin for effective intergovernmental co-operation. It is crucial for any efforts which are made to achieve greater co-operation in planning public expenditures.

The decision on the actual share (be it 26, 30 or 33 per cent) must, as noted above, be a political one at the national level. It is envisaged that the Prime Minister would receive reports on revenue sharing from the Council of State Ministers and that the Federal Government would have the power to change the participation ratio when economic conditions warrant or when there is clearly emerging a growing divergence between revenue/expenditure trends at each level of government. The states will, however, be protected from arbitrary action if the Council of State Ministers has previously agreed with the Australian Government on relevant criteria of assessment and if decisions which change the state share have to be justified by reasoned argument (on the basis of estimated receipts and expenditures for each tier).

Co-operative Federalism and Public Expenditure

The essence of the foregoing proposal is that there should be an apparatus for intergovernmental consultation and joint decision-making. The same is true on the expenditure side, although for constitutional and other reasons the difficulties of setting up appropriate planning machinery are likely to be more formidable.

Planning on a national basis is long overdue in Australia. Most countries have national plans, and some of these countries operate under a federal system (e.g. India, Germany and Malaysia).[7] The Vernon Committee pointed the way in 1965 with a suggestion for a Special Projects Commission.[8] It was envisaged that such a Commission would have power to investigate proposals for major developmental projects. This and other suggestions of the Vernon Committee (e.g. the creation of an 'Advisory Council on Economic Growth')[9] were not followed up at the time, mainly because of opposition from the Prime Minister and Treasury resistance to any proposal which threatened its position as foremost adviser on economic and financial matters.

Some sort of Planning Council, independent of the Treasury and suitably equipped to look ahead and plan on the basis of national needs and priorities, does however seem to be required. Such a body, while serving in an advisory capacity, would provide a stimulus to the Treasury and perhaps lead to a greater public awareness of the costs and benefits of

alternative policies. One could expect the Planning Council to be concerned with specific purpose grants of a capital nature, which are often now given in an *ad hoc* manner with a mix of federal and state initiatives. The Council might be a permanent body with federal and state representatives and perhaps several independent experts. The Council could be concerned also with the availability of loan funds and it could have the responsibility for making recommendations for the allocation of these funds between states. It will be recalled that such allocation is determined either on the basis of unanimous agreement between the states or in accordance with the Financial Agreement, which provides for an allocation on the basis of net loan expenditures over the past five years. A more rational basis for the distribution of these funds is urgently needed.

Such a body would operate within the framework of a federal system and it would therefore need to be assisted by guidelines set out in federal legislation relating to the smooth functioning of such a system. The Council would operate predominantly in the public investment field, being concerned with the detailed planning of public investment projects, especially those which are of national and regional importance.

In 1969 the South Australian Premier pointed out that 'if the federal system . . . is to continue to work, then the way ahead is in *joint involvement* in a number of fields . . .', and further that 'if in Australia we are to have effective economic planning, then it must be flexible and decentralized'.[10] Perhaps more significantly, when referring to various new problems such as urban renewal and redevelopment, Mr Dunstan stated that 'the only way ahead . . . is not a tug between the States and the Commonwealth, but . . . effective close administrative and financial co-operation'.[11]

The idea of intergovernmental co-operation and planning in areas of community need (for infrastructure and other investment outlays) is clearly implicit in what Mr Dunstan said in 1969. It also features prominently in Australian Labor Party proposals at the national level.[12]

However, the Australian Labor Government, which held office between December 1972 and November 1975, was unable to reconcile its inherent centralist leanings with the need to seek and achieve the necessary co-operation of the states in an arrangement which could ensure an effective planning of the nation's resources in a federal system. In fact, as the *Australian* in an editorial of 17 July 1973 put it: 'The problem is that few Labor Ministers have clearly understood what planning really is. They have tended to use the word as an ideological slogan, carrying the promise that all things are possible in a planned economy . . . In fact, the very essence of planning is the recognition that all things are not, after all, possible in a planned economy'.

This extract from the *Australian* touches on an issue of crucial importance: the need for a central or overall plan in which there is a reconciliation of priorities at different levels of government. Such a plan would have a wide horizon and relate needs in the public sector to competing demands in the private sector and to the availability of resources to satisfy the needs of both sectors. This is a task for experts, since it would be necessary to plan so as not to weaken the federal structure and not to put too much strain on resources. The plan would, of course, require periodic review in the light of changing economic conditions. But it would at least provide a framework by

which proposed increases in government expenditure could be considered in relation to projected economic trends and the availability of real resources. The deliberations of Federal Cabinet are presumably guided by such considerations, especially in its pre-budget discussions when it has the advantage of Treasury submissions on the state of the nation and on forecasts of revenue and expenditure trends. In addition it would, however, be useful to have machinery which looks at the public sector as a whole and in relation to other economic trends and prospects.

This author is not alone in believing that existing institutions are inappropriate for planning in a modern federation. For example, one writer has asserted that Commonwealth payments to the states have been determined by a 'hotch-potch of political bargains, arbitrary and inflexible formula and *ad hoc* arrangements which for the most part appear to be unrelated to national policy objectives'.[13] Moreover, in recent years a growing proportion of states' capital expenditure has been financed by direct Commonwealth advances and grants. Specific purpose grants of a capital nature grew at an annual average rate of more than 20 per cent during the ten years up to and including 1973-74; the comparable rate of increase for Loan Council programs or general purpose capital grants was only 5 per cent.[14] In any event, the Australian Government, by virtue of its superior fiscal position, has come to dominate the Loan Council. The states, while they have nominal voting rights, have no real decision-making functions. The Loan Council co-ordinates public borrowing but it does not function as a planning agency for public sector investment.

It seems clear that existing arrangements (in relation to specific purpose grants and Loan Council allocations, in particular) are hopelessly inadequate to cope with the requirements of a modern federation. What is needed, therefore, is the creation of machinery which will streamline existing arrangements, afford a better planning of public sector outlays, and ensure that states can exercise an important influence on decision-making in areas where they have constitutional responsibility.

In order to strengthen the machinery for intergovernmental co-operation and planning, there is some support for expanding the functions of the Grants Commission to make it into a Fiscal Commission with a direct involvement in development policy.[15] An alternative proposal is to establish a Special Projects Commission, along the lines advocated by the Vernon Committee, and to reconstitute the Grants Commission so that it can investigate the fiscal needs of all the states.[16] The second proposal (or some variation of it) seems preferable, because the Grants Commission's exclusive concern with interstate fiscal equalisation would be continued and the much broader issues involved in allocation policy would then be entrusted to a separate body, as outlined below.

Suggestions for Reform

If there is to be a better planning of resource use without undermining the authority of the states, certain rather sweeping reforms appear to be needed. A suggestion for a sharing of the personal income tax and the setting up of a Council of State Ministers (CSM) has already been discussed. Once this reform has been instituted the way will be clear to introduce other needed reforms to secure an effective planning of economic resources in the federation.

In this connection it seems logical to

establish a National Planning Council (NPC). The Council would be concerned with planning for the whole economy, preferably looking five years ahead. It would advise the Prime Minister and submit annual reports to the Australian Parliament. A suggestion is that it be composed of six experts, of which no more than two will be drawn from government. The NPC would be not unlike the Advisory Council on Economic Growth which was proposed by the Vernon Committee and would bear some similarity to the Council of Economic Experts in Germany, the Economic Council of Canada and the Council of Economic Advisers in the United States.

The main functions of the NPC would be to formulate a national plan for the economy, investigate particular matters referred to it by the Prime Minister and make recommendations for policy change. The Council would be purely advisory and would report direct to the Prime Minister.

A second body, also advisory, should be created. Such a body might be called the Public Sector Advisory Council (PSAC), because its exclusive concern would be with the public sector, and particularly the interlocking interests of the Federal Government and the states. This body, which would need to have a large secretariat,[17] would assess public sector needs, attempt to reconcile federal and state priorities and conduct feasibility studies. It would give particular attention to the availability of loan funds, the need for federal assistance to supplement these funds and the use of specific purpose grants. These matters would be looked at in terms of total funds available and their distribution between the states.

The PSAC would not have any authority in relation to purely national areas of competence or to fiscal policy as such. But it would help to co-ordinate the various programs presented by several existing advisory bodies, such as the Bureau of Roads and the Schools Commission. Creation of the PSAC would, it is hoped, obviate the need for further expansion of Commonwealth commissions and *ad hoc* committees.

It seems desirable that the PSAC should be composed of both government and non-government members. A suggested composition for a ten member Council is as follows:

(i) two representatives from the Federal Treasury or Prime Minister's Department;

(ii) one Treasury representative from each state;

(iii) two non-governmental representatives.

The PSAC would report, as required, to a policy-making body made up of federal and state ministers. This latter body — which might be called the Commission for Intergovernmental Relations (CIGR) — must be political and it must be free to accept, reject or amend the Council's recommendations and to formulate alternative proposals. However, the crucial point is that it must be a body which provides the states with an opportunity to have a voice in decision-making.

The Commission would consider recommendations submitted to it by PSAC and formulate policy with respect to intergovernmental fiscal relations, with special focus on public investment expenditures by all levels of government and the need for intergovernmental co-ordination to achieve national and regional goals. It is suggested that the Commission might have two federal representatives and one representative from each of the states. The Commission would therefore have eight members.

To allow for divergent opinions in such a Commission, voting rules would have to

be devised and embodied in federal legislation. In decision-making it is envisaged that the Commonwealth and the states would each command 50 per cent of the votes. Decisions would be made on the basis of a 75 per cent majority of the votes. This would mean that if the Commonwealth agreed, three out of the six states would also have to agree (including the state in which a particular project was to be initiated) if the project was to go ahead. No project could go forward without Commonwealth approval but once approval was forthcoming, the Commonwealth might, for example, agree to provide at least half of the necessary finance for the expenditure in question. The Commission would therefore have the ultimate authority in relation to specific purpose grants of a capital nature and to the provision of loan funds to the states.

CIGR would not conduct detailed studies on its own initiative. This would be the responsibility, as now, of special boards and commissions (e.g. for roads, schools, housing etc.) and of various Commonwealth and state planning departments or agencies (e.g. DURD and the NSW Planning and Environment Commission). The co-ordinating and overall advisory functions would be performed by PSAC.

With the institution of tax sharing, the Grants Commission (GC) would emerge with a wider and more clearly defined role. It would be the sole body responsible for making recommendations on horizontal fiscal equalisation at the state and regional levels in accordance with differential tax capacity and expenditure need. Equalisation would be explicit and the techniques already developed by the Commission could be used to assess the financial needs of *all* the states. The Commission could, as Professor Mathews has suggested, establish equalisation criteria and advise on the allocation of grants, 'having regard to the Commission's analysis of relative revenue-raising capacity and relative costs in the several states or local government areas'.[18]

Premiers' Conferences need not be dispensed with, but would have less meaning since the states would have the Council of State Ministers and have direct representation on both the Public Sector Advisory Council and the Commission for Intergovernmental Relations.

An indication of how it is envisaged that these new arrangements would operate in terms of advisory and decision-making functions is shown in figure 20-1.

Summary

Now to summarise the main points of the foregoing discussion in relation to planning in Australia.

(i) States have become too financially dependent on the Australian Government. To satisfy goals in a federal system, several moves should be made towards co-operative federalism. There must be recognition that the major parties or tiers of government have legitimate rights and responsibilities and that conflicts are not necessarily inevitable. Machinery for co-operative government can help to reconcile diverging priorities between the central and state governments.

(ii) The first step in Australia should not be directed towards the re-imposition by states of their own income taxes. There are clear-cut advantages in interstate tax uniformity, especially for income taxes. There is, however, a pressing need for tax-sharing arrangements, especially with regard to personal income tax revenues. To set the necessary machinery in motion, it has been suggested that a Council of State Ministers (CSM) should be es-

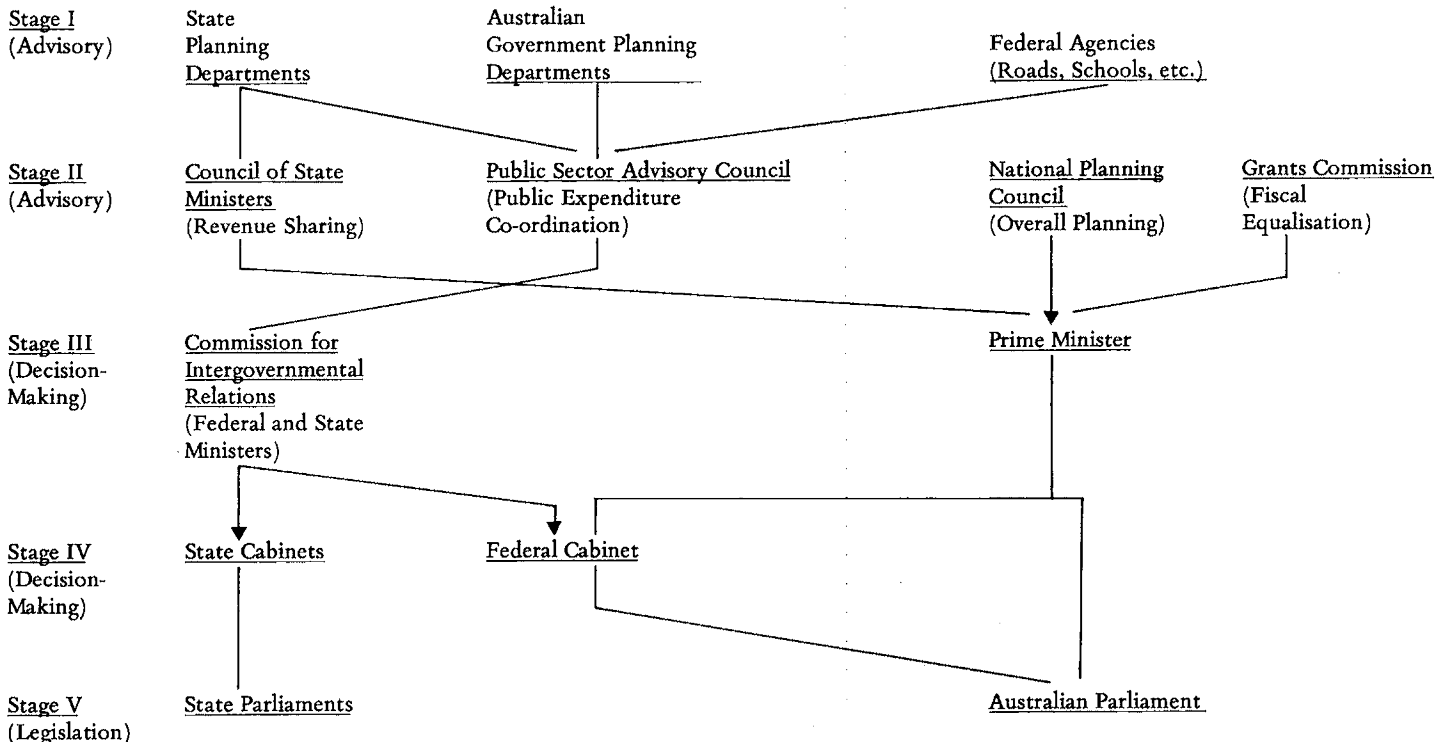

Fig. 20-1 Proposed arrangements for federal-state co-operation: advisory and decision-making functions

tablished in Canberra; the Council should work in consultation with federal officials to establish suitable criteria for determining what the appropriate state share of these tax revenues should be and what factors should dictate changes in the share. The final decision should be with the Australian Government which must, however, justify and explain any decision which is at variance with the views of the State Council.

(iii) This should be the first step in the direction of co-operative government. The other major initiatives relate to government expenditures and must be seen in the context of national planning. A National Planning Council (NPC) is needed. Such a Council would take a broad view of the economy and would serve a purely advisory role.

(iv) Once tax sharing had been implemented, the Grants Commission (GC) would emerge with an expanded and clearly defined role, requiring it to report and make recommendations with respect to horizontal equalisation based on financial needs of all states (and areas within states). Some regard should also be given to the relatively large expenditure needs of areas with high-density population. The proposed method of tax sharing should enable horizontal fiscal equalisation to be explicit and clearly separated from vertical intergovernmental fiscal adjustment.

(v) These reforms would greatly reduce the amount of unconditional federal grants, give the states greater financial autonomy and enable the Australian Government (acting through the Commission for Intergovernmental Relations) to concentrate on assistance to the states (and possibly local authorities) for clearly defined purposes which are in the national interest. However, such assistance would form an integral part of the planning machinery in which the Public Sector Advisory Council, as adviser and co-ordinator, would have a major role. The Commission for Intergovernmental Relations would make decisions relative to expenditures in areas where federal and state interests overlap, and especially in the use of loan funds and specific purpose grants. The creation of more planning departments within the Australian Government would be unlikely to assist towards national planning in the Australian federation.

(vi) The foregoing proposals would not threaten the execution of an effective fiscal policy. The Federal Government would retain a large share of income tax revenue, and would retain full control over company taxes, excise and sales taxes. If Commonwealth revenue needs were growing faster than the states, the state percentage share of personal income taxes would be adjusted downwards. The machinery to justify such a decision has been described above. The Federal Government would retain full control over the tax structure and its ability to make marginal expenditure adjustments for reasons of counter-cyclical policy would in no way be affected.

(vii) At present, planning in Australia is *ad hoc* and unco-ordinated with new committees and commissions making their appearance at an alarming rate. It is surely time to tidy up and prepare the way for planning on a national basis. But such planning must be of a type which will permit of active participation and necessary co-operation between levels of government in a federal system.

21 Conclusion

In this study an attempt has been made to clarify the main issues for fiscal federalism and to highlight the emerging trends in fiscal federalism in Australia, Canada, the United States and West Germany.

The introduction of revenue sharing has strengthened the basis of fiscal federalism in the United States. It is not a panacea but it has further enhanced the financial autonomy of the states. The formula governing the allocation of funds is such that important interstate and intrastate fiscal equalisation effects have been possible without undermining the tax efforts of recipient governments. The advent of revenue sharing has had the added advantage of being able to lessen reliance on grants-in-aid as a tool of intergovernmental fiscal adjustment.

In Canada, the trend towards greater provincial financial autonomy gained considerable momentum in the period 1958 to 1968. Since then the Dominion Government has been rather less willing to countenance an erosion of the federal financial power base and has refused to give up more income tax room to the provinces through the use of federal abatements.

In comparing the Canadian experience with that of other federations such as Australia, account has to be taken of the special position of Quebec, the extensive reliance of the provinces on sales taxes, and the considerable support which Dominion Governments have given to most proposals for greater fiscal decentralisation.

There seems little doubt that Canada has reached an advanced state of fiscal decentralisation compared with other federal countries. The 1971 tax reform and the abandonment of the abatement system in 1972 have, however, posed several problems for the provinces. Tax reform has meant a slower growth of provincial revenues compared with the growth of Dominion revenues. Provincial revenue growth has also been affected by the decision of the Federal Government to index personal income tax for inflation. The provinces argue for an extension of tax sharing which would, in effect, mean a return to the abatement system, but the Federal Government continues to adhere to the view that provinces which need more money should go out and raise taxes.[1] Thus there is the very real prospect, while this policy continues, of an increase in the overall tax burden and the necessity for further tax reform measures. It would therefore be a mistake to imagine that intergovernmental fiscal relations in Canada have reached a point at which there are no major problems. Canada has not been free of intergovernmental conflict and tension. In fact the tension arose in 1973 and 1974 with the advent of the international oil crisis. A disturbing feature of this episode is that the problems would have been lessened and tension eased if there had been more concerted attempts at co-ordination between the Dominion and provincial governments.

In both the United States and Canada, state taxation and spending policies, especially the former, have limited in

some measure the flexibility of fiscal policy. However, the authorities have not been unduly concerned with this trend, since it is seen as an unavoidable cost associated with the overwhelming advantages of decentralised decision-making. This attitude can also be explained by growing scepticism regarding the ability of fiscal policy to achieve stabilisation aims and by a realisation that national objectives in several key growth areas can be promoted by the instrument of federal grants-in-aid. There can be little doubt that experience in many countries since 1968 has demonstrated that the conventional (Keynesian) use of fiscal policy is of little value in meeting the twin problems of unemployment and inflation, especially when wage pressures aggravate both problems. A better planning of resource use under the umbrella of co-operative government and greater emphasis on decentralised decision-making seem more appropriate in meeting these problems.

A study of the Federal Republic of Germany is of special interest in this connection. Interstate tax uniformity prevents the states from taking action that could undermine federal tax and other stabilisation policies. Great stress is, however, placed on the need to preserve ample scope for independent action by the states in their own sphere and in spheres where national and regional interests overlap. Flexible tax-sharing arrangements have been designed with this in view. State independence of action is also preserved by virtue of the structure of government and, in more recent years, by the development of techniques for effective intergovernmental planning with respect to capital expenditures in the public sector.

Germany appears to have achieved the best compromise of all federations: there is a strong central government but this is coupled with a system of checks and balances which limit opportunity for arbitrary action by the federal administration. As noted in chapter 19, there seem to be adequate safeguards to ensure a continuing high degree of state fiscal autonomy.

The weaknesses of Australian fiscal federalism have, by contrast, been pinpointed. Most problems, and most sources of friction and tension, spring from the very large vertical intergovernmental fiscal imbalance and the inadequate machinery for intergovernmental planning.

The problems in Australia are more deep-seated than in Canada, the USA or Germany where the vertical fiscal imbalance is not large. For Australia, the first task must be to reduce this imbalance by introducing tax sharing. A related need is an improved framework for economic planning, with particular emphasis on the formulation of procedures for joint federal-state involvement in decisions on public investment outlays (including the use of specific purpose grants).

The Australian Labor Party in its three-year term of office (1972-75) seemed to show no interest in any proposals for the sharing of tax revenue between the Australian Government and the states as a means of reducing vertical fiscal imbalance. This is, perhaps, not surprising in view of the Party's centralist philosophy. The Liberal Party in this period seemed to be split on the issue, which was in any case relegated to a position of relatively little importance in the Party platform. The advent of a Liberal-NCP Government in Canberra at the end of 1975 and the release of a new policy statement on federalism suggested that important new initiatives on tax or

revenue sharing were about to be taken.

Action on tax sharing would enable horizontal fiscal equalisation policy to be concentrated at one point, preferably with the Grants Commission. To aid this policy in practice, basic guidelines should be set down in federal legislation (e.g. to indicate whether specially favoured treatment should be accorded areas with high-density population even though these areas have above-average fiscal capacity). The present tendency for a proliferation of federal grants on an *ad hoc* basis should be reversed. The reforms set out in this study should help to make this possible.

If one were to take at face value the pronouncements and statements of principle emanating from federal ministers it might be imagined that co-operative federalism existed in Australia under the Labor Government, that state and local governments were consulted and central financial dominance was not being abused. The publicity surrounding DURD and its many useful initiatives (e.g. the creation of growth centres outside the capital cities) is a case in point. The problem here is that DURD and bodies like it are Australian Government agencies or the equivalent — they are not agencies for co-operative government. If they were then the states and local authorities would presumably have been able to have some say in decision-making, which appears not to have been the case. In fact state and local officials have argued that the Australian Government set up new departments or agencies of its own, ostensibly to work through the accepted channels of government (state and local), when bodies such as state planning authorities already existed with the necessary expertise. This policy therefore leads to an unnecessary duplication of pseudo-planning agencies, increases the prospect of intergovernmental conflict and, of course, adds to the cost of planning.

These comments also apply to housing, hospitals and perhaps to a lesser extent, transport, as well as to urban and regional development. Moreover, it is not an effective counter-argument to note the weak-kneed attitude of several states and their ready acceptance, on many occasions, of federal proposals. The states can hardly afford to do otherwise when they do not have ready access to finance; this pinpoints the overriding problem of vertical fiscal imbalance.

In any event not all states have chosen to be weak-kneed on every single issue. States have, on occasion, been prepared to stand up to federal intrusions, to assert and proclaim a state point of view, and even to back up this view with positive action. This has led to further friction between Canberra and the states; and the source of friction is not merely a matter of party politics. Thus in 1966-67 there was an agreement between the seven governments in relation to control of offshore oil and gas exploration. Since then Australian Governments (first a Liberal Government and then a Labor Government) sought to assert their legislative authority in this area but were countered by a state challenge to the High Court on the validity of federal legislation. A recent development is of particular interest: in February 1975 the State Labor Government of South Australia, contrary to the wishes of the Australian Labor Government, granted new off-shore petroleum exploration permits (for six years) to BHP-Esso. Other states also renewed existing permits for the same period. This action embarrassed the Australian Government and the prospect is for continuing intergovernmental conflict (although the High Court has since confirmed the Commonwealth's juris-

diction over offshore seas and submerged lands and the new Liberal-National Country Party Government has said it will co-operate with the states in administering these areas).

The squabble over road grants in 1974 was also symptomatic of underlying conflict between the Federal (Labor) Government and state authorities. The responsible federal minister threatened at one stage in the controversy to withdraw the grants altogether if the Opposition-controlled Senate continued to obstruct the passage of the legislation. Such obstruction was, however, based on substantive grounds, namely the stringent conditions attached to the grants, conditions which left very little discretion to the relevant state authorities as to the way in which funds could be spent. In such an important area, co-operation seemed to be replaced by confrontation. Similar problems came to the surface with regard to efforts by the Australian Government to secure greater control in the housing field.

In both these important areas of public activity (roads and housing) the states have constitutional responsibilities and the Federal Government also has a legitimate interest in promoting national goals. In these circumstances and given the continuance of the federal form of government, there is an urgent need for a system of intergovernmental co-operation and planning embracing all investment outlays in the public sector. A suggested method of reform has been outlined in chapter 20.

It is not intended to convey the impression that decentralised decision-making is an end in itself or that it is equally desirable in all countries. There are limits on the extent to which decentralisation in government can or should be carried (see chapter 3). The problems created by large centralised government (and hence the need for some degree of regional diversity) are not peculiar to a federal system or, indeed, to countries with relatively large geographical areas, a point which is amply demonstrated by the 1972 reform of local government in the United Kingdom and the more recent pressure for legislative devolution in terms of special treatment for Scotland and Wales.

It is clear that each country will have its own particular need for decentralisation, a need which will, in large measure, reflect the extent of diversity in the country itself. Thus, for historical, political, ethnic and other reasons the United States and Canada have more reason to stress diversity and decentralised decision-making than do Australia or Germany. In Germany there is considerable support (support which, interestingly enough, has been enshrined in the Federal Constitution) for the notion that federal policies should aim at a greater uniformity of living conditions throughout the country. Given such a political bias for greater uniformity, at the national level, in juxtaposition to various constraints on federal policies which a federal system of government imposes, the need for formalised machinery to secure intergovernmental liaison and planning should be readily apparent. Germany's success does seem to have a bearing on what Australia might hope to achieve by following a similar course.

Recent developments in all four federal countries — the considerable expansion of grants-in-aid programs and the desire for greater uniformity of living conditions throughout each country — make it clear that a rigid division of functions and responsibilities between the Federal Government and the states, as embodied in the layer-cake model of public sector

activity, is no longer appropriate. Instead, the modern brand of fiscal federalism must stress a sharing of functions and responsibilities between each main level of government and their interdependence. This requires rather sophisticated machinery for intergovernmental financing and planning in relation to both revenue and expenditure.

Addendum

The Federal Government's Policy on Federalism*

Soon after it was elected to office in December 1975, the Liberal-National Country Party Coalition announced a new policy on federalism. This policy is designed to reverse the trend toward greater central control and ensure that the states are able to regain a greater measure of autonomy and responsibility in the management of their affairs.

The most important policy changes relate to the introduction of income tax sharing, local government financial assistance, specific purpose grants, and intergovernmental co-operation.

As indicated in chapter 20 and 21, intergovernmental financial relations in Australia by mid 1975 stood in urgent need of reform, the most important being the need to introduce a tax sharing arrangement that would in large measure replace the system of financial assistance grants. The first instalment of the new policy is therefore a move in the right direction.

Under Stage I of the new plan, states are given a specified share of personal income tax collections (with retention of a uniform basic rate structure, central collection and a standard tax form). The total states' share of income tax is calculated by reference to the proportion of financial assistance grants to personal income tax collections. In the light of discussions at Premiers' Conferences held in February, April and June 1976, it would appear that the states will be protected from an absolute fall in tax yields. For the first three years of the new scheme (1976-77 to 1978-79) state entitlements will not be less than the amounts of the financial assistance grants which would have been payable under the *States Grants Act*, 1973-75.

Although the precise nature of the new arrangements is not, as yet, entirely clear, the intention (for Stage I of the plan) is to use the existing distribution of financial assistance grants as the basis for calculating the distribution of the states' share of income tax. Equalisation grants paid on the recommendation of the Grants Commission will not form part of the distribution calculation but the four less populous states will still be free to apply to the Grants Commission for special financial assistance. The Commission will also recommend equalisation payments with respect to any surcharge imposed by a state. Under Stage II of the plan (operative from 1977-78), any state can impose a percentage surcharge or allow a rebate on personal income tax payable in that state.

The tax sharing arrangements are to be reviewed periodically and the first review will be made before the end of 1980-81. Certain aspects of the new tax sharing scheme, which could affect its viability in future, should be noted.

* In setting out the main elements of this new policy, considerable use has been made of the *1975 Report and Review of Fiscal Federalism*, Centre for Research on Federal Financial Relations, ANU, Canberra. Valuable assistance was also obtained from information provided by Senator J. L. Carrick. The author's comments and opinions are, of course, his own and are not necessarily shared by the Centre or by Senator Carrick.

1. The total state entitlement of the personal income tax will continue to depend on decisions of the Australian Government. Insufficient attention would appear to have been given to the need for variations in the state entitlement. The ability of the Commonwealth to change the revenue base, and hence the state entitlement, poses a threat to the smooth functioning of the new arrangements. Unless the fixed percentage method is abandoned, continued wrangling between the states and the Commonwealth seems just as likely to occur in the future as it has in the past.

2. For purposes of securing vertical financial balance, the states' share should be capable of adjustment (at least every two years) in the context of improved intergovernmental consultation and agreement, and in line with differential revenue/expenditure trends of the Federal Government and the states. This method was suggested in chapter 20. If the Federal Government alone retains the power to determine the state share, the other initiatives for co-operative federalism will be largely negated. The inherent weakness of the new system in this respect is illustrated by the fact that the proportion of general revenue grants to personal income tax collections has fallen steadily since 1970-71. An unchanged percentage (for the state share) as applied to a revenue base which in future grows at a slower rate (as seems likely in view of personal income tax indexation) would clearly be to the detriment of the states.

3. The new arrangements for tax sharing in Australia differ significantly from the Canadian system in that individual Australian states are not able to nominate their own rates of income tax. Tax sharing arrangements in Australia bear a closer resemblance to the system in West Germany (where the states have a guaranteed share of income tax collections) but they differ in respect to points (1) and (2) above and to the extent that individual states introduce surcharges or rebates in Stage II of the plan (which the German States cannot do). Another difference is that in West Germany it is the value-added tax which serves as the movable peg for regulating the vertical financial settlement.

4. The basic equalisation arrangements in Australia are embodied in the method of distributing the state share. This may make it clearer that it is the more affluent states that are subsidising the less affluent ones but it still falls a good way short of the West German or Canadian system of inter-state fiscal equalisation in which the transfers or equalisation entitlements are determined by a formula (with explicit criteria) and are to a large extent separate from the regulation of the vertical financial settlement via tax sharing.

5. If the distribution of the state share were to be effectively determined by political bargaining rather than by the Grants Commission and if equalisation arrangements were to be subsumed in the tax sharing arrangements, the system would be similar to the Loan Council method where distribution seems to depend more on past allocations than on an assessment of current needs. The Commonwealth would then be seen to have shifted responsibility for fiscal equalisation from itself to the states. An unexpected boost to a particular state's fortunes (such as an increase in oil revenue of the kind which put strains on the Canadian equalisation arrangements in 1974) would not then involve the Commonwealth in additional equalisation payments. Although such an outcome would no doubt be viewed favourably by the Federal Treasury, it would be far less equitable for most states than the system which existed before

1976.

6. At this stage of negotiations the role of the Commonwealth Grants Commission is far from clear. If the Commission is not able to review relative state shares periodically and if the distribution is left to the states to determine by political bargaining, the equalisation system would be largely unworkable. A more efficient and equitable system would be (as recommended in Chapters 20 and 21) to widen the role of the Grants Commission by providing initially for a distribution of the states' share of income tax on a collection or per capita basis and then authorising the Grants Commission to conduct regular reviews and to recommend explicit equalisation payments to particular states on the basis of differential fiscal capacity and expenditure need.

The new policy on federalism also has important implications in relation to local authority finance, specific purpose grants and machinery for intergovernmental co-operation.

Local authorities will now receive a fixed share of personal income tax collections (in lieu of equalisation grants previously provided by the Commonwealth Grants Commission). It is estimated that local authorities will receive about 1.5 per cent of personal income tax collections in 1977-78, such assistance to consist of two parts: (i) per capita grants weighted by area or population density, as determined by the states; and (ii) equalisation grants of up to 70 per cent of each state's share of the total entitlement, and to be distributed by the states on the recommendations of their respective Grants Commissions.

The creation of State Grants Commissions may appear, on the surface, to carry the risk of duplication of administrative machinery and overlapping responsibilities. However, if the Commonwealth Grants Commission should assume a wider role in inter-state fiscal equalisation (as indicated above), it would seem sensible for each state to have the responsibility for equalisation payments to particular local authorities in the state. Each State Grants Commission might, of course, be expected to draw on the experience and expertise of the Commonwealth Grants Commission in this area and may even elect to use the same criteria.

One of the major mistakes of the Whitlam Government's policies was to allow a rapid (and largely unplanned) expansion of specific purpose grants. This policy had effectively undermined the financial responsibility of the states and distorted their spending priorities. The new policy on federalism is designed to arrest this trend by the absorption of some specific purpose grants into the general purpose funds provided under the tax sharing arrangements and by using these grants only to initiate programs in agreed areas of national need, to encourage innovation and to meet special situations.

A further aspect of the Liberal-National Country Party policy on federalism was provision for an independent statutory body, to be called the Council for Intergovernment Relations and apparently to be modelled on the U.S. Advisory Commission on Intergovernmental Relations. The role of the Premiers' Conference will be extended to make it a forum for general debate on broad economic matters and on issues developed by the Council. In April 1976 agreement was reached to establish an Advisory Council for Intergovernment Relations. The Advisory Council is to be established by Federal legislation, but on the basis of agreement between the Prime Minister and the Premiers. It will consist of three Govern-

ment and two Opposition members of the Federal Parliament; one representative from each state; three representatives from local government and five citizens representing different community interests. The Council is expected to conduct studies with a view to improving inter-governmental relations, prepare reports for Premiers' Conferences and make an annual report to the Federal Parliament.

There are grounds for scepticism about the value of such a Council. This stems from its diverse composition, the danger that the Council will become a research secretariat to service the State Premiers and the likelihood that its activities will overlap significantly with the highly successful Centre for Research on Federal Financial Relations at The Australian National University. As indicated in chapter 20 and in point (2) above, a State Council is needed at the point where the real power balance lies — at the new tax sharing arrangements. The idea of a Council of States should be developed further in conjunction with reform of the Loan Council system and the planning of public sector activity along the lines discussed in chapters 20 and 21.

J.S.H.H.
August 1976

Notes

Preface

1 See R.L. Watts, *New Federations: Experiments in the Commonwealth*, pp. 1-5.

2 An example is Nigeria which modelled its Loans Advisory Board on the Australian Loan Council pattern in order to co-ordinate federal and state public borrowing. See U.K. Hicks *et al.*, *Federalism and Economic Growth in Underdeveloped Countries: A Symposium*, pp. 38-9 (R.L. Watts in Discussion).

3 R.J. May, *Federalism and Fiscal Adjustment*; U.K. Hicks, *Development Finance: Planning and Control* (chapter 6); U.K. Hicks *et al.*, *Federalism and Economic Growth in Underdeveloped Countries*; J.R. Hicks, 'A Chapter on Federal Finance — The Case of Nigeria', chapter 10 in *Essays in World Economics*, pp. 45-56; and R.L. Watts *New Federations*.

4 G. Sawer, *Modern Federalism*, p. 127.

5 Ibid., pp. 126-7.

6 A valuable addition to the literature for Australia which has recently appeared is R.L. Mathews and W.R.C. Jay, *Federal Finance — Intergovernmental Financial Relations in Australia Since Federation*.

7 *Revenue Sharing in the Federal Republic of Germany*; 'Finance Reform in West Germany: Its Nature and Impact', *CEDA M Series*, No. 33, November 1971; 'Inter-State Fiscal Equalisation in the Federal Republic of Germany and Comparisons with Australia and Canada', *Australian Economic Papers*, June 1973.

Chapter 1

1 K.C. Wheare, *Federal Government*, p. 8.

2 See A.J. Robinson and J. Cutt eds., *Public Finance in Canada: Selected Readings*, pp. 85-6; and R. Dehem and J.N. Wolfe, 'The Principles of Federal Finance and the Canadian Case', ibid., p. 123.

3 E.S. Griffith, *The American System of Government*, pp. 4-5.

4 A detailed analysis of the Australian Constitution, including Commonwealth legislative powers and their interpretation and Commonwealth-state finances, has been made by Professor Richardson of the Australian National University. See J.E. Richardson, *Patterns of Australian Federalism*. The main financial provisions of the Constitution are set out in a convenient form in R.J. May, *Financing the Small States in Australian Federalism*, pp. 155-8.

5 The Grants Commission derives its authority from legislation under section 96. For comment on the Commission's methods and procedures, see chapter 12.

6 On this point, see E.J. Hanson. 'Federal-State Financial Relations in Australia', *Canadian Public Administration*, Vol. V, No. 1, March 1962, p. 11. For further information on surplus revenue payments and Commonwealth grants to the states, see R.L. Mathews and W.R.C. Jay, *Federal Finance*, pp. 65-70.

7 Ibid., p. 109. For a comprehensive review of the Loan Council and its role in the Australian federation, see R.S. Gilbert, *The Australian Loan Council in Federal Fiscal Adjustments, 1890-1965*.

8 Richardson, *Patterns of Australian Federalism,* pp. 6-10. Legislation has now been passed in the national parliament to enable the election of two senators from each of the Australian Capital Territory and the Northern Territory.

9 As a statute of the British Parliament, the Canadian Constitution can only be amended by the UK Parliament (on a request from the Canadian Parliament). There have, in fact, been few amendments, although the need for amendment has not been great in view of the clear limitation of provincial power to matters of purely regional or local concern. Owing to opposition from certain provinces, the future of constitutional amendment is completely

obscure, although efforts are now afoot to clarify the procedure. See R.M. Burns, 'The Evolving Structure of Canadian Government', *Lecture to the University of Manitoba*, 1966, p. 48. A recent federal proposal for constitutional change is set out in *Federal-Provincial Grants and the Spending Power of Parliament*, Queen's Printer, Ottawa, 1969. For a critical appraisal of this proposal, see D.V. Smiley and R.M. Burns, 'Canadian Federalism and the Spending Power: Is Constitutional Restriction Necessary?', *Canadian Tax Journal*, Vol. 17, No. 6, Nov./Dec. 1969. In June 1971 a Canadian Constitutional Charter, which set out specific constitutional reforms, including a revised amendment procedure, was considered at a constitutional conference. These reforms were not accepted by all governments. See *Canada Year Book*, 1973, Statistics Canada, pp. 70-1.

10 See S. Muller, 'Federalism, and the Party System in Canada', in J.P. Meekison ed., *Canadian Federalism: Myth or Reality*, p. 125; J. Paxton ed., *The Statesman's Year Book*, 1972-3, p. 229; and *Canada Year Book*, 1973, pp. 108-10.

11 On this point see W.A. Mackintosh, 'Federal Finance' reprinted in *Federalism: An Australian Jubilee Study*, G. Sawer ed., p. 92.

12 See J. Sirois *et al.*, 'The Rowell-Sirois Views on Canadian Tax Policy' from *Report of the Royal Commission on Dominion-Provincial Relations* (Book II, Section G), reprinted in *Public Finance in Canada: Selected Readings*, pp. 105-6.

13 K.C. Wheare, 'Federal Government Defined', ibid., pp. 88-9. A list of Dominion powers which indicate the desire for a strong central government is found in B.U. Ratchford, 'The Constitutional Basis of Public Expenditure in Canada', ibid., p. 92.

14 K.C. Wheare, 'Federal Government', p. 21. References to the 'power of disallowance' are to be found in J.H. Lynn, 'Federal Provincial Fiscal Relations', *Canadian Federalism: Myth or Reality*, p. 195; S. Muller, 'Federalism and the Party System in Canada', p. 121; and E. Forsey, 'Concepts of Federalism: Some Canadian Aspects', ibid., p. 349.

15 E. Forsey, 'Concepts of Federalism', p. 352.

16 See F.R. Scott, 'The Special Nature of Canadian Federalism', *Canadian Journal of Economics and Political Science*, Vol. XIII, 1947, p. 24.

17 According to Graham, grants to the provinces often took the form of *ad hoc* adjustment by the Dominion in response to sectional pressures exerted by maritime and western provinces. J.F. Graham, *Fiscal Adjustment and Economic Development: A Case Study of Nova Scotia,* p. 34.

18 B.U. Ratchford, 'The constitutional Basis', p. 95.

19 In Australia the High Court's rulings, at least up to 1973, have been such as to exclude states from the highly lucrative sales tax field. (In Canada retail sales taxes finance about 15 per cent of the gross general expenditure of the provinces.) Also, the continuation of the Uniform Tax System, which pre-empts income taxes to the Commonwealth, has greatly reduced the fiscal autonomy of the Australian states. These matters are dealt with fully in Part II.

20 *The Statesman's Year-Book*, 1972-3, p. 531.

21 R.E. Wagner, *The Fiscal Organisation of American Federalism: Description, Analysis and Reform*, p. 16.

22 M.J.C. Vile, *The Structure of American Federalism*, p. 25.

23 US Constitution, Article 1, Section 9.

24 See R.A. and P.B. Musgrave, *Public Finance in Theory and Practice*, p. 31.

25 It is especially interesting that the Federal Government has not chosen to compete with the states in the field of general sales taxation. For a discussion of this issue in the context of the lack of tax co-ordination and the complexities inherent in the US tax system, see D.H. Eldridge, 'Equity, Administration and Compliance and Intergovernmental Fiscal Aspects' in *The Role of Direct and Indirect Taxes in the Federal*

Revenue System, pp. 187-200.

26 See E.S. Griffith, *The American System of Government*, p. 12.

27 Ibid., p. 15.

28 The Lower House, or *Bundestag*, and the Upper House, or *Bundesrat.*

29 H.J. Gumpel, *Taxation in the Federal Republic of Germany*, p. 313.

30 Ibid., p. 317.

31 State voting power in the *Bundesrat* is adjusted so that the larger, more populous states are given a greater influence. Each state has at least three votes, but states with more than two million people have four votes while states with more than six million people have five votes. Again we see a contrast with the American style Senate on which the Australian system is based. See J.F. Golay, *The Founding of the Federal Republic of Germany*, p. 53.

32 For a more detailed discussion of the role of the Council of States, the reader is referred to the study by the author on *Revenue Sharing in the Federal Republic of Germany*, pp. 10-18.

33 J.F. Golay, *The Founding of the Federal Republic of Germany*, p. 77

34 Ibid., pp. 82-3.

35 This meant that the Federal Government (with *Bundesrat* approval) would fix the rates and principles of assessment for non-federal taxes if uniformity was considered desirable, which it was for the major taxes. But this power does not infringe on the right of municipalities to regulate taxes of purely local origin; and municipalities can (with the consent of their state) fix their own surtaxes or multipliers (*Hebesaetze*) to determine the effective revenue to be derived from taxes within their jurisdiction, namely, those on property, business and payrolls. However, to conform with the principle of fiscal uniformity, tax rates (which are applied to the tax bases) are fixed by federal law. Thus, as an example, a municipal tax on the profits of a small business — assuming the *Hebesatz* is fixed at 100 per cent — may amount to DM5000 (an average tax rate of say 5 per cent being applied to profits of DM100,000). A *Hebesatz* fixed as high as, say 500 per cent would, however, increase the tax payable to DM25,000, thus effectively increasing the rate to 25 per cent.

Chapter 2

1 For a comprehensive analysis of Wagner's 'law', see R.M. Bird, 'Wagner's "Law" of Expanding State Activity', *Public Finance*, Vol. 26, 1971, pp. 1-26.

2 See E.R. Fried *et al.*, *Setting National Priorities*: *The 1974 Budget*, table 7-1, p. 271.

3 H. Koschnick, 'Ursachen und Lösung der Kommunalen Finanzkrise', *Kommunalpolitik*, Wirtschaftsdienst 1972/II, p. 73.

4 In Germany, general and university education are the prime responsibility of the states. However, since 1964 the Federal Government and the states have undertaken the joint financing of the extension and improvement of universities and other institutions of higher learning. See chapter 19.

5 J.A. Corry, 'Constitutional Trends and Federalism', reprinted in *Canadian Federalism: Myth or Reality*, p. 61.

6 M. Fletcher, 'Judicial Review and the Division of Powers in Canada', ibid., p. 157.

7 J.A. Corry, 'Constitutional Trends', p. 60.

8 See R.L. Mathews and W.R.C. Jay, *Federal Finance*, pp. 95-6, 129-35, 229-32.

9 The likely implications of the High Court's decision of 1 April 1974 in *Dickenson's Arcade Pty Ltd* v. *Tasmania* are discussed towards the end of chapter 6.

10 Mathews and Jay, p. 289.

Chapter 3

1 'The Founding of the Federal Republic of Germany', p. 108.

2 R.L. Watts, *New Federations*, p. 197.

3 See R.A. Musgrave and A.M. Polinsky, 'Revenue Sharing: A Critical View', *Harvard Journal on Legislation*, Vol. 8, January 1971, p. 197.

[4] S.J. Mushkin and R.F. Adams, 'Emerging Patterns of Federalism', *National Tax Journal*, Vol. 19, No. 3, 1966, p. 242.

[5] See C.E. McLure, 'Revenue Sharing: Alternative to Rational Fiscal Federalism?', *Public Policy*, Summer 1971, pp. 465-6.

[6] Ibid., pp. 460-2; R.A. Musgrave, *The Theory of Public Finance*, pp. 5-6, 179-81; and C.M. Tiebout, 'A Pure Theory of Local Expenditures', *Journal of Political Economy*, Vol. 64, No. 5, 1956, pp. 416-24.

[7] This principle states that those who benefit from the output of a particular good should be the ones to pay for it. See M. Olson, 'The Principle of Fiscal Equivalence: The Division of Responsibility Among Different Levels of Government', *American Economic Review*, Vol. 59, No. 2, 1969, pp. 479-87.

[8] See G.F. Break, 'Revenue Sharing: Its Implications for Present and Future Intergovernmental Fiscal Systems: The Case For', *National Tax Journal*, Vol. 24, No. 3, 1971, p. 309.

[9] J.M. Buchanan, 'Federal Grants and Resource Allocation', *Journal of Political Economy*, Vol. 60, June 1952. An alternative method of securing interstate fiscal equalisation would be for the Federal Government to use taxes which discriminate between states or regions, but constitutional barriers prevent this in most federations, including Australia, the United States and West Germany.

[10] See A.D. Scott, 'The Economic Goals of Federal Finance', *Public Finance*, Vol. 19, No. 3, 1964, p. 259.

[11] See N. Bhargava, 'The Theory of Federal Finance', *Economic Journal*, Vol. 63, 1953, pp. 88-91.

[12] A.D. Scott, 'The Economic Goals of Federal Finance', p. 257.

[13] Quoted from U.K. Hicks, *Development Finance*, p. 109.

[14] The classic ideal may, indeed, be quite unstable. The case of Nigeria before the Civil War is cited by R.J. May in 'Intergovernmental Finance', *Public Administration*, Vol. 28, No. 1, March 1969, p. 59.

[15] These grants can be regarded as a means of countering a lack of perfect correspondence in the provision of public goods. Such a lack of perfect correspondence arises where people other than those who determine the output of the public good stand to benefit from a further extension of output — and these are presumably people who live outside the jurisdiction in question. See W.E. Oates, *Fiscal Federalism*, p. 71. The two main distinguishing characteristics of public as opposed to private goods are 'jointness' and external economies. See J.G. Head, 'Public Goods and Public Policy', *Public Finance*, Vol. 17, No. 3, 1962, pp. 197-219.

[16] W.E. Oates, *Fiscal Federalism*, pp. 75-8 and J.A. Wilde, 'The Expenditure Effects of Grant-in-Aid Programs', *National Tax Journal*, Vol. 21, September 1968, pp. 341-8.

[17] Matching grants can be open-ended or closed-ended. With open-ended grants there is no limit to federal matching. In most cases grants are not open-ended, i.e. federal matching ceases once a certain level of expenditure is reached.

[18] W.E. Oates, *Fiscal Federalism*, p. 76.

[19] Ibid., p. 13.

[20] 'Federalism: Problems of Scale', *Public Choice*, Vol. VI, Spring 1969.

[21] A good example relates to the New York Port Authority which provides a wide variety of transportation services on both the New York and New Jersey sides of the port of New York. See B.F. Davie and B.F. Duncombe, *Public Finance*, p. 461.

[22] *Fiscal Federalism*, p. 48.

[23] See, for example, J. Tinbergen, *On the Theory of Economic Policy*. A particular application of the eclectic approach is found in B.P. Herber, 'Vertical Intergovernmental Fiscal Relations in Australia: A Comparison with Canada and the United States', *Proceedings — National Tax Association*, 1969, pp. 269-99.

[24] See L. Thurow, 'The Theory of Grants-in-Aid', *National Tax Journal*, Vol. 19, December 1966, pp. 373-7.

[25] There are, of course, several other policy

instruments which can be used to correct for vertical intergovernmental fiscal imbalance, the choice depending on the fiscal structure of the particular federation. These include tax supplements and federal credits for taxes paid to lower levels of government. These are discussed in chapter 5.

26 M.D. Reagan, *The New Federalism*, pp. 3-13. See also M.J.C. Vile, *The Structure of American Federalism*, pp. 3, 65; M. Grodzins, *The American System;* R.L. Mathews in *Fiscal Federalism: Retrospect and Prospect;* and D.J. Elazar, *The American Partnership.*

Chapter 4

1 C.E. McLure, 'Revenue Sharing' pp. 458-9.

2 Ibid., p. 477.

3 R.L. Mathews and W.R.C. Jay, *Federal Finance*, p. 13.

4 This section is based on an article by the author on 'Vertical Intergovernmental Fiscal Imbalance: A Framework for Evaluation', *Finanzarchiv*, Vol. 32, No. 3, 1974, pp. 481-92.

5 See chapter 9.

6 See chapter 7.

7 For further details, see chapter 7; and *The National Finances 1973-74*, Canadian Tax Foundation, pp. 145-6.

8 See W.W. Heller, 'A Sympathetic Reappraisal of Revenue Sharing', in *Revenue Sharing and the City*, H.S. Perloff and R.P. Nathan eds., p. 13.

9 Royal Commission on Dominion-Provincial Relations, *Report*, Vol. II, p. 84. For a useful survey of the nature of federalism, including a reference to state financial autonomy, see *Report of the Ontario Committee on Taxation*, Vol. I, 1967, pp. 24-41.

10 This condition is unlikely to be met where states compete with each other and fail to adopt a common stand against centre intrusions.

Chapter 5

1 See V. Salyzyn, 'Federal-Provincial Tax Sharing Schemes', *Canadian Public Administration*, Vol. 10, No. 2, June 1967, p. 162.

2 Ibid.

3 In fact the Australian Government denies any connection between the two.

4 See J.H. Lynn, 'Federal-Provincial Fiscal Relations', p. 203.

5 See ibid.

6 See chapter 1.

7 U.K. Hicks, *Development Finance*, p. 123.

8 See A.H. Birch, 'Intergovernmental Financial Relations in the New Federations' in U.K. Hicks *et al.*, *Federalism and Economic Growth in Underdeveloped Countries*, pp. 125-7. The state share in income tax was raised progressively, following reports of the Finance Commission, from 60 per cent in 1957 to 80 per cent in 1974. This and related points are referred to by B.S. Grewal in *Fiscal Federalism in India*, pp. 23-4, 35-40.

9 The federal abatement was increased in steps from 1957 to 1966. An abatement has also applied to the corporation income tax. For details, see chapter 7.

10 *The National Finances 1972-73*, Canadian Tax Foundation, p. 54.

11 J.H. Lynn, 'Federal-Provincial Fiscal Relations', p. 204.

12 Such awareness is even greater in Quebec where separate returns are lodged for both the personal and corporation income taxes (and in Ontario for the corporation income tax).

13 Several US economists, as well as the Committee for Economic Development and the Advisory Commission on Intergovernmental Relations, have come out strongly in support of a system of tax credits. See M.D. Reagan, *The New Federalism*, pp. 134-5.

14 See J.F. Due and A.F. Friedlaender, *Government Finance: Economics of the Public Sector*, p. 503.

15 U.K. Hicks, *Development Finance*, p. 123.

16 See B.P. Herber, *Modern Public Finance: The Study of Public Sector Economics*, p. 456.

17 See for example B. Dixon, 'The Case for a

Marginal State Income Tax', *Economic Papers* (Economic Society of Aust. and N.Z.), No. 20, October 1965.

[18] 'The Search for a State Growth Tax' in *Intergovernmental Relations in Australia*, R.L. Mathews ed., p. 174.

[19] For details see next chapter.

[20] R.C. Gates, 'The Search for a State Growth Tax', p. 175.

[21] *Commonwealth Payments to or for the States, 1972-73*, p. 101.

[22] *The Swedish Budget 1974-75*, Ministry of Finance, Stockholm, 1974, pp. 105-6.

[23] *Federalism and Economic Growth*, p. 164.

[24] B. Hansen and W.W. Snyder, *Fiscal Policy in Seven Countries*, p. 343.

[25] Ibid., pp. 340-3.

[26] Calculations are based on data from *Commonwealth Income Tax Statistics*, Canberra 1971, table 3, pp. 6-7, and adjusted for the impact of inflation since 1969. 60 per cent of taxable income would cover those earning less than $6000 a year and would exclude those taxpayers earning less than $2000 a year.

Chapter 6

[1] See W. Prest, 'Federal-State Financial Relations', *Economic Papers* (Economic Society of Aust. & N.Z.), No. 20, October 1965, pp. 19-20.

[2] On this point, see H.W. Arndt, 'Judicial Review under Section 90 of the Constitution', *Australian Law Journal*, Vol. 25, 1952, pp. 676-7; and J. Dixon ed., *The Public Sector: Selected Readings*, p.270. Note the contrast with Canada (see chapter 7) where sales taxes now account for more than 40 per cent of provincial tax revenue.

[3] See G. Sawer, 'The Future of State Taxes: Constitutional Issues' in *Fiscal Federalism: Retrospect and Prospect*, R.L. Mathews ed., pp. 203-4.

[4] *Payments to or for the States, 1973-74*, 1973-74 Budget Papers, Canberra 1973, pp. 101-2; and R.L. Mathews and W.R.C. Jay, *Federal Finance*, p. 174. The uniform tax legislation consisted of four Acts, including the *Income Tax (Assessment) Act* 1942 which provided, for the war and one year thereafter, that Commonwealth income tax had a prior claim over any state income taxes, and the *Income Tax (Wartime Arrangements) Act* 1942 which provided for the compulsory transfer to the Commonwealth of tax records, staff, etc. from state tax offices.

[5] *Patterns of Australian Federalism*, p. 53.

[6] R.L. Mathews and W.R.C. Jay, *Federal Finance*, p. 175.

[7] J.A. Maxwell, *Commonwealth-State Financial Relations in Australia*, p. 11.

[8] According to Maxwell, 'the Commonwealth Treasury exercised great ingenuity in raising difficulties, and feeding them backstage to Under-Treasurers of states which were opposed or lukewarm to resumption'. See ibid., p. 12.

[9] *Payments to or for the States 1973-74*, p. 103.

[10] It is interesting that the court ruled *against* the validity of federal legislation which prohibited a taxpayer paying state income tax until the Commonwealth tax had been paid (this was, in effect, a reversal of the 1942 decision).

[11] See J.A. Maxwell, *Commonwealth-State Financial Relations in Australia*, p. 13.

[12] *Payments to or for the States 1973-74*, p. 105.

[13] 'The Financial Relationships of the Commonwealth and the States', *A Statement by the Premiers of all the States*, 19/1/70.

[14] Ibid., p. 28.

[15] *Payments to or for the States 1973-74*, p. 108.

[16] For a detailed account of the Loan Council's structure and its role in federal-state financial relations, see R.S. Gilbert, *The Australian Loan Council* and *The Future of the Australian Loan Council* with *An Annotation of the Financial Agreement 1927-1966*.

[17] Based on data in Budget Paper on *Commonwealth Securities on issue at 30/6/72*, Canberra, p. 25. Dependence on debt financing by states and local authorities (including semi-governmental authorities)

is considerably greater in Australia than in the United States or Canada. See B.P. Herber, 'Vertical Intergovernmental Fiscal Relations in Australia', pp. 294-5. The dramatic rise in the net debt of the states and the emergence, by 1970, of the Commonwealth as a net lender has been analysed by E.A. Boehm and P.B. Wade in 'The Anatomy of Australia's Public Debt', *Economic Record*, September 1971, pp. 315-37. See also R.L. Mathews and W.R.C. Jay, *Federal Finance*, pp. 204-5.

18 The debt burden on state budgets is related to loan expenditure on various public works from which no direct income is received (e.g. schools, hospitals) and also to business undertakings from which state treasuries recoup only a part of their debt charges. See *38th Report of the Commonwealth Grants Commission* 1971, p. 21.

19 W. Prest, 'Fiscal Adjustment in the Australian Federation — Vertical Balance', *Intergovernmental Relations in Australia*, R.L. Mathews ed., p. 195.

20 Federal road grants have been paid since 1922-24. Special grants, which are made on the basis of recommendations of the Grants Commission (see chapter 12), were first paid to Western Australia in 1910, to Tasmania in 1912 and to South Australia in 1929.

21 See R.L. Mathews and W.R.C. Jay, *Federal Finance*, table 14, p. 100 and pp. 151-2; and *Commonwealth Payments to or for the States 1971-72*, p. 91. For background material relating to the development of Commonwealth financial assistance and the state-by-state distribution of grants up to World War II, see R.J. May, 'Federalism and Fiscal Adjustment', pp. 57-63.

22 The budget difficulties of the states were accentuated by heavy state borrowing for development purposes. To meet this situation the Commonwealth Government (under the Financial Agreement of 1927) took over formal responsibility for the whole of the public debts of the states and agreed to make substantial contributions towards interest and sinking fund charges with respect to existing and future state debts. The Australian Loan Council, which had operated as a voluntary body since 1923, was also established to co-ordinate public borrowing. See E.J. Hanson, 'Federal-State Financial Relations in Australia', p. 11; R.C. Gates, 'The Search for a State Growth Tax', p. 160; and R.L. Mathews and W.R.C. Jay, *Federal Finance*, pp. 105-23.

23 As noted in the text, however, there is an indirect link in Australia between income tax collections and grants paid in the sense that if a state were to impose its own income tax (as it is legally entitled to do) the Commonwealth would cease paying general revenue grants (other than special grants) to that state.

24 The only real revenue sharing scheme, albeit not a very flexible one, employed in Australia was that which operated in the first ten years of federation, when revenue from customs and excise duties was shared between the Commonwealth and the states.

25 J.A. Maxwell, *Commonwealth-State Financial Relations in Australia*, p. 9.

26 *Payments to or for the States 1973-74*, p. 92.

27 This pattern was not affected by the supplementary grants, which took the form of *ad hoc* payments to supplement amounts yielded by the formula. The tax reimbursement grant received by Western Australia was, for example, nearly 15 per cent greater on a per capita basis than the tax reimbursement grant received by Victoria. This is in marked contrast to the position since 1958-59, when the maximum variation was well over 90 per cent.

28 *Payments to or for the States 1973-74*, p. 93.

29 R.J. May, *Federalism and Fiscal Adjustment*, pp. 63-4.

30 The suggestion for a tax sharing arrangement does not, of course, preclude the use of other means to reduce vertical imbalance. Several Australian economists have suggested either that the states have not fully exploited existing taxes or that

there are other taxes which they could impose. Gates ('The Search for a State Growth Tax', pp. 174-7) suggested, in addition to a marginal state income tax, a tax on net worth, a value-added tax, entertainment taxes and the abolition of federal estate duty (and its use by the states). Mathews, bearing in mind the need for a growth tax and experience in other countries, favoured a tax on retail turnover, arguing that 'it would be reasonable to hope that the High Court would treat the tax as a consumption and not an excise tax'. See R.L. Mathews, 'National Planning and Intergovernmental Relations: Commonwealth Grants to the States', *Public Administration*, Vol. 28, No. 1, March 1969, p. 85.

31 As noted earlier the main pressure for change came in the form of applications from Victoria and Queensland for special grants. It is also noteworthy that it was the Premier of Victoria (Henry Bolte) who at the end of 1967 used the impending introduction of a stamp duty on receipts (including receipts from wages and salaries) as a lever to seek a further review of intergovernmental fiscal arrangements. See *Payments to or for the States 1973-74*, p. 107, and R.J. May, *Financing the Small States in Australian Federalism*, pp. 115, 150.

32 J.A. Maxwell, *Commonwealth-State Financial Relations in Australia*, p. 20.

33 Ibid.

34 *Payments to or for the States 1973-74*, p. 94.

35 Apart from special grants (as recommended by the Grants Commission) and specific purpose grants, which fall into well-defined categories, these supplementary — and largely unconditional — payments were called 'additional assistance grants' in the early 1960s largely to help relieve unemployment and later became known as 'special revenue assistance' (being intended to help states combat drought and to meet budgetary difficulties). These supplementary payments amounted to $243m between 1961-62 and 1971-72. See *Commonwealth Payments to or for the States 1971-72*, pp. 25-7.

36 See W. Prest, 'Fiscal Adjustment in the Australian Federation — Vertical Balance', p. 191; and *A Statement by the Premiers of all the States*, pp. 21, 27-8.

37 Such problems can, however, be exaggerated. The Canadians appear to have had no difficulty in devising stabilisation arrangements to meet such problems. See chapter 7.

38 This amount was quite separate from special revenue assistance to the states which the Commonwealth made available in 1971-72.

39 See *Commonwealth Payments to or for the States 1972-73*, p. 18; and R.L. Mathews and W.R.C. Jay, *Federal Finance*, p. 252.

40 Ibid., p. 222. See also W.R.C. Jay in *Responsibility Sharing in a Federal System*, R.L. Mathews ed.

41 This has important implications for the task of planning in a federation. See Part IV.

42 R.J. May, *Federalism and Fiscal Adjustment*, p. 66.

43 R.L. Mathews, 'The Future of Government Finance', Centre for Research on Federal Financial Relations, *Reprint Series No. 1*, ANU, 1973, p. 12.

44 See *A Statement by the Premiers of all the States*, p. 29; and W. Prest, 'Fiscal Adjustment in the Australian Federation — Vertical Balance', p. 194.

45 *A Statement by the Premiers of all the States*, p. 4.

46 *Commonwealth Payments to or for the States 1973-74*, p. 43.

47 Ibid., p. 62.

48 Ibid., pp. 68-9.

49 *National Roads Bill* 1974, *Roads Grants Bill* 1974 and *Transport (Planning and Research) Bill* 1974.

50 Minister of Transport Second Reading Speech, *Hansard*, No. 7, 1st session, 1st period, 18/7/74, p. 385.

51 Senator P. Durack in *Hansard*, No. 12, 1st session, 1st period, 17/9/74, pp. 1126-7.

52 It should be stressed that the comments in

this paragraph (and to some extent those which appear in the next two paragraphs) are based on discussions with senior Treasury Officers in Canberra in 1972. The Treasury view may now be radically different!

53 On the basis of 1973-74 figures for specific purpose payments of a capital nature (which are dominated by road grants) NSW and Victoria received, on a per capita basis, considerably less than the four less populous states. See *Commonwealth Payments to or for the States 1973-74*, table 59, p. 100.

54 According to Wade, specific purpose payments for urban and regional development have 'brought to light an extraordinary number of eminent "bush lawyers" ... and ... has produced an amazing number of conferences and interstate journeys for both Federal and State officials'. See P.B. Wade, 'Recent Developments in Fiscal Federalism in Australia, with Special Reference to Revenue Sharing and Fiscal Equalisation' in *Fiscal Federalism: Retrospect and Prospect*, pp. 58-9.

55 On this point, see W.R. Lane, 'The Case for Interstate Fiscal Equalisation', ANZAAS, Adelaide, August 1969, pp. 4, 8-9; and Mathews 'National Planning and Intergovernmental Relations', p. 90.

56 See *Commonwealth Payments to or for the States 1973-74*, p. 25. Interest-free capital grants must be distinguished from interest payments and sinking fund contributions under the 1927 Financial Agreement and the new grants for easing state debt charges, both of which are classified as specific purpose payments.

57 *Proceedings of the Conference of Commonwealth and State Ministers*, Canberra, 25/26 June 1970, p. 2. See also R.J. May, 'Government Borrowing and the Public Debt', *Intergovernmental Relations in Australia*, R.L. Mathews ed., p. 252.

58 *Commonwealth Payments to or for the States*, 1971-72, p. 18.

59 W. Prest, 'Fiscal Adjustment in the Australian Federation — Vertical Balance', p. 197.

60 *Australian Law Journal*, March 1974, p. 97.

61 Ibid.

62 *Australian Financial Review*, 18/6/74, pp. 1, 4.

63 104 CLR 529.

64 Barwick, C.J. as reported in *Australian Law Journal*, March 1974, p. 97.

65 See *Business Franchise Licences (Petroleum) Bill, Second Reading*, NSW *Hansard*, Forty-Fourth Parliament, 17/9/74, pp. 1071-2.

66 Ibid., pp. 1072-4.

67 *Business Franchise (Petroleum) Act*, No. 8, 1974 and *Business Franchise (Tobacco) Act*, No. 118, 1974. Both Bills were passed by the South Australian Parliament on 28 November 1974.

68 *SA Hansard*, No. 17, 41st Parliament, 3rd session, p. 2358.

69 Data from Treasury Information Bulletin Supplements: *National Accounting Estimates of Public Authority Receipts and Expenditure*.

Chapter 7

1 Royal Commission on Dominion-Provincial Relations, *Report*, Queen's Printer, Ottawa, 1940.

2 D.V. Smiley, 'The Rowell-Sirois Report, Provincial Autonomy, and Post War Canadian Federalism' in *Canadian Federalism: Myth or Reality*, p. 65.

3 See R.J. May, *Federalism and Fiscal Adjustment*, pp. 69-72. Horizontal fiscal equalisation is dealt with in Part III.

4 See J. Sirois *et al.*, 'The Rowell-Sirois Views on Canadian Tax Policy' in *Public Finance in Canada: Selected Readings*, p. 104. However, the case for such centralised or joint control is much less persuasive in Canada because of a much larger reservoir of domestic loanable funds upon which to call and a much more accessible external market. See Mackintosh, 'Federal Finance', p. 88.

5 US Advisory Commission on Intergovernmental Relations, *In Search of Balance — Canada's Intergovernmental*

Experience, Report M-68, September 1971, pp. 3-4.

6 D.V. Smiley, 'The Rowell-Sirois Report', p. 67.

7 Ibid. Emphasis added.

8 For a discussion of the meaning of financial independence, financial responsibility and financial autonomy, see R. Dehem and J.N. Wolfe, 'The Principles of Federal Finance and the Canadian Case', p. 124.

9 *Report*, Book II, pp. 69, 79, noted in D.V. Smiley, 'The Rowell-Sirois Report'.

10 Financial arrangements before 1941 are set out in M. Moore and J.H. Perry, 'Financing Canadian Federation: The Federal-Provincial Tax Agreements', *Canadian Tax Paper*, No. 6, March 1953, Canadian Tax Foundation, pp. 5-21.

11 Ibid., p. 12. Provincial corporation and personal income taxes were levied by several provinces before World War I but it was not until the 1930s that most provinces levied these taxes. See J.H. Perry, *Taxation in Canada*, pp. 170-1.

12 *Report of the Ontario Committee on Taxation*, 1967, Vol. III, para 54, p. 38.

13 These percentages are taken from G.E. Carter, 'Canadian Conditional Grants Since World War II', *Canadian Tax Paper*, No. 54, November 1971, Canadian Tax Foundation, Table A-5, p. 118.

14 See J.F. Graham, *Fiscal Adjustment and Economic Development*, pp. 36-7.

15 On this point see D.V. Smiley, *The Canadian Political Identity*, p. 52; and D.C. Corbett, 'Partners in Taxation: The Relevance to Australia of Canadian Federal Finance', Paper delivered at 11th Annual Conference of the Australian Political Studies Association, University of Sydney, 28/30 August 1969, p. 3.

16 Smiley, 'The Rowell-Sirois Report', p. 70; and W.A. Mackintosh, 'Federal Finance', p. 92.

17 Newfoundland entered the federation in 1949 and signed the tax rental agreement for a 3-year period.

18 M. Moore and J.H. Perry, 'Financing Canadian Federation', pp. 37-8.

19 The foregoing calculations are based on data from *National Accounts Income and Expenditure, 1926-1956*, tables 36 and 37, Dominion Bureau of Statistics, Queen's Printer, Ottawa, 1962, pp. 74-7.

20 See G.E. Carter, 'Canadian Conditional Grants Since World War II', p. 4.

21 See R. Dehem and J.N. Wolfe, 'The Principles of Federal Finance and the Canadian Case', p. 128; Advisory Commission on Intergovernmental Relations, 'In Search of Balance — Canada's Intergovernmental Experience', pp. 3-4; and W.C. Hood, 'Economic Policy in our Federal State' in *The Future of Canadian Federalism*, P.A. Crepeau and C.B. Macpherson eds., p. 64.

22 Advisory Commission on Intergovernmental Relations, 'In Search of Balance — Canada's Intergovernmental Experience'. There have also been suggestions that the growing interest of the provinces in regional planning and economic development was linked with the Federal Government's failure to achieve full employment and an acceptable rate of economic growth. See, for example, G.E. Carter, 'Canadian Conditional Grants', p. 4.

23 *Provincial and Municipal Finances, 1971*, Canadian Tax Foundation, p. 59; see also M. Moore and J.H. Perry, 'Financing Canadian Federation', pp. 41-3, 64.

24 G. Sawer, *Modern Federalism*, p. 96.

25 *Fiscal Adjustment and Economic Development*, p. 39.

26 See *The National Finances 1971-72*, p. 164; also W.C. Hood, 'Economic Policy in our Federal State', p. 66 and J.A. Maxwell 'Federal Grants in Canada and Australia', *Economic Record*, September 1969, pp. 442-3.

27 Advisory Commission on Intergovernmental Relations, 'In Search of Balance — Canada's Intergovernmental Experience', pp. 5, 13.

28 The purport of the equalisation payments was to enable all provinces, whatever their tax base, to provide a reasonable level of public services without an unduly high burden of taxation. This topic is covered in detail in Part III. Special grants to the

Atlantic provinces were also introduced in 1958-59 — the total payment being $25m a year for four years.

29 T.K. Shoyama, 'The New Federal-Provincial Fiscal Arrangements', Notes for a discussion before the Ottawa Chapter, Canadian Political Science Association, 22/11/1966, p. 6.

30 These taxes were levied by authority of the *Federal-Provincial Fiscal Arrangements Act* 1962.

31 The basic federal rates were those set out in section 32 (1) of the *Federal Income Tax Act*.

32 An equalised payment was made to bring the per capita yield from the abatement points specified for each program up to the average per capita yield of the same number of points in the top two provinces. See *The National Finances 1971-72*, p. 168.

33 Ibid., pp. 167-8.

34 See G.E. Carter, 'Canadian Conditional Grants Since World War II', p. 118.

35 Advisory Commission on Intergovernmental Relations, 'In Search of Balance — Canada's Intergovernmental Experience', p. 4.

36 Alberta, largely because of its oil revenue, is the only province not to have imposed a retail sales tax. See J.F. Due, 'Development of Retail Sales Taxes in the 1960's and 1970's', *Canadian Tax Journal*, Vol. 19, No. 6, 1971, p. 545.

37 Statement by the Minister of Finance to the Federal-Provincial Tax Structure Committee, Ottawa, 14/9/66, p. 25.

38 The sole constitutional limitation is with respect to indirect taxes which may impair interstate trade or interfere with international commerce.

39 Statement by the Minister of Finance, 14/9/66, p. 26; see also T.K. Shoyama 'The New Federal-Provincial Fiscal Arrangements', pp. 4-5.

40 Ibid., p. 4.

41 *The National Finances 1971-72*, p. 169. A 1973 amendment to the *Federal-Provincial Fiscal Arrangements Act* 1972 extended the post-secondary education financing arrangements for an additional three years. See *Canadian Tax Journal*, Vol. 22, No. 1, 1974, p. 78.

42 *The National Finances 1970-71*, p. 43.

43 W. Darcy McKeough, *Ontario's 1971 Budget*, Government Printer, Toronto, 26/4/71, p. 9.

44 See *The National Finances 1973-74*, p. 70.

45 For details of these proposals, see *The National Finances 1971-72*, pp. 33-46.

46 Ibid., p. 48.

47 See *The National Finances*, *1973-74*, p. 59; and D.H. Clark, 'Federal-Provincial Fiscal Arrangements for the 1972-1976 Fiscal Period', *Canadian Tax Foundation Panel Discussion*, Vancouver, 17/11/71, pp. 3-4.

48 E.J. Benson, Statement on Federal-Provincial Taxation Arrangements by the Federal Finance Minister at the Federal-Provincial Conference of First Ministers, Ottawa, 16/11/71, p. 5.

49 Clark 'Federal-Provincial Fiscal Arrangements, for the 1972-1976 Fiscal Period', p. 4.

50 On 2 April 1972 Alberta announced plans to terminate its agreement with Ottawa for federal collection of the provincial corporate income tax. See 'Tax Memo,' No. 54, July 1974, Canadian Tax Foundation, p. 17. In 1974, Alberta advised the Federal Government that it proposed, after termination of the corporation income tax agreement, to institute a provincial-administered business taxation and incentive system. It is expected that the new system will take several years to develop. See Canadian Tax Foundation, *Provincial and Municipal Finances 1975*, Toronto, 1975, p. 74.

51 Further problems caused by the international oil crisis are discussed in chapter 18.

Chapter 8

1 A great deal has been written on this subject in a relatively short time. The most persuasive argument for federal revenue sharing has been put by the Advisory Commission on Intergovernmental Relations, *Revenue Sharing — An Idea*

Whose Time Has Come, Information Report, M-54, Washington, December 1970. See also W.W. Heller, *New Dimensions of Political Economy*; J.A. Pechman, 'Money for the States', *New Republic*, Vol. 156, 8/4/67, pp. 15-17; M.E. Levy and J. de Torres, *Federal Revenue Sharing with the States: Problems and Promises*; C.L. Harriss, *Federal Revenue Sharing: A New Appraisal*; E.R. Fried *et al.*, 'General Revenue Sharing', in *Setting National Priorities: The 1974 Budget* (chap. 7); G.F. Break, 'Revenue Sharing: Its Implications for Present and Future Intergovernmental Fiscal Systems: The Case For', *National Tax Journal*, Vol. 24, No. 3, September 1971; C.E. McLure, 'Revenue Sharing: Alternative to Rational Fiscal Federalism?'; J.A. Pechamn, 'Fiscal Federalism for the 1970's', *National Tax Journal*, Vol. 24, No. 3, September 1971; R.A. Musgrave and A.M. Polinsky, 'Revenue Sharing: A Critical View', and M.L. Weidenbaum and R.L. Joss, 'Alternative Approaches to Revenue Sharing: A Description and Framework for Evaluation', *National Tax Journal*, Vol. 23, No. 1, March 1970.

2 See next chapter.

3 'Revenue Sharing — An Idea Whose Time Has Come', p. 17.

4 *The State and Local Fiscal Assistance Act* of 1972.

5 This chapter leans heavily on the work of the Advisory Commission on Intergovernmental Relations and on two key reference sources: B.P. Herber, 'Revenue Sharing and Fiscal Equalisation in Canada and the United States' in *Fiscal Federalism: Retrospect and Prospect*, R.L. Mathews ed., and R.A. and P.B. Musgrave, *Public Finance in Theory and Practice*, pp. 635-46.

6 See W.W. Heller, 'A Sympathetic Reappraisal of Revenue Sharing', pp. 14-16.

7 'Revenue Sharing — An Idea Whose Time Has Come', p. 9.

8 This calcualtion is based on information from *Facts and Figures on Government Finance*, Tax Foundation Inc., New York, 17th ed., 1973.

9 B.P. Herber 'Revenue Sharing and Fiscal Equalisation in Canada and the United States', p. 24.

10 For further detail, see ibid, pp. 22-3.

11 Fried *et al.*, 'General Revenue Sharing', p. 280.

12 Ibid.

13 Ibid., p. 281.

14 Ibid., p. 282.

15 B.F. Davie and B.F. Duncombe, *Public Finance*, p. 477.

16 See Advisory Commission on Intergovernmental Relations, *Revenue Sharing — An Idea Whose Time Has Come'*, p. 14.

17 See O. Oldman, 'Objectives in Fixing Revenue and Expenditure Responsibilities with Particular Emphasis on Federally Motivated State Tax Reform', *National Tax Journal*, Vol. 29, No. 3, September 1971, pp. 294-5.

18 R.A. Musgrave and A.M. Polinsky, 'Revenue-Sharing: A Critical View', pp. 201-3.

19 D.L. Raiff and R.M. Young, 'Budget Surpluses for State and Local Governments: Undercutting Uncle Sam's Fiscal Stance?', *Federal Reserve Bank of Philadelphia Business Review*, March 1973.

20 Ibid., pp. 21-2.

21 Ibid., p. 22. By the end of 1973 about $10b had been paid out in revenue-sharing cheques to about 38,000 separate governmental units. For about half the recipient governments, revenue sharing has permitted a measure of tax relief; for the other half it has generated new spending or reduced reliance on debt financing. See U.S. Department of Commerce, *Survey of Current Business*, October 1973, pp. 2-3.

22 See M.L. Weidenbaum and R.L. Joss, 'Alternative Approaches to Revenue Sharing', pp. 6-7.

23 This suggestion bears some similarity to the German system. In Germany 75 per cent of the state share of value-added tax revenue is distributed on a population basis and the remaining 25 per cent is available to states with below-average taxable capacities. See next chapter.

[24] See R.A. Musgrave and A.M. Polinsky, 'Revenue Sharing'; and O. Oldman, 'Objectives in Fixing Revenue' p. 294.
[25] C.E. McLure, 'Revenue Sharing', p. 477.
[26] G.F. Break, 'Revenue Sharing', pp. 308-9.

Chapter 9

[1] The Basic Law (*Grundgesetz*) of the Federal Republic of Germany was promulgated by the Parliamentary Council on 23rd May 1949. The Basic Law or Constitution (as amended up to and including 31/8/73) is divided into eleven sections which embrace: basic rights; the federation and the states; the legislature — *Bundestag* and *Bundesrat*; committees of the Federal Government; the Federal President; legislative powers of the federation; the joint tasks; the administration of justice; finance; defence; and transitional and concluding provisions.
[2] H.J. Gumpel, *Taxation in the Federal Republic of Germany*, p. 422.
[3] J.F. Golay, *The Founding of the Federal Republic of Germany*, pp. 86, 108.
[4] These are capital levies, computed from the date of the 1948 Currency Reform, which are paid into a fund that is used to equalise burdens resulting from differential war damage. The levies continue until 1979. See H.J. Gumpel, *Taxation in the Federal Republic of Germany*, pp. 578-81.
[5] Finance Reform emerged as a result of a comprehensive inquiry by an expert body — the Troeger Commission — into various aspects of federal-state-municipal finance. The Commission was appointed in 1964 and its *Report* was released in 1968. The new Finance Reform Law, based on the Commission's recommendations, was approved in April 1969. See *Gutachten ueber die Finanzreform in der Bundesrepublik Deutschland*, Kommission fuer die Finanzreform, Kohlhammer, 1966.
[6] The decision to give municipalities a growth tax was influenced by a belief that municipal finances were too heavily dependent on revenues from the trade tax. For various reasons the Federal Government pressed for a gradual phasing out of the trade tax and hence for a lessened dependence of municipalities on the tax (before 1970 about 80 per cent of all municipal revenues was derived from the trade tax). As part of the finance reform proposals it was therefore agreed that 40 per cent of the proceeds from the trade taxes levied by municipalities should be paid to the Federal Government and the states in return for the right of the municipalities to receive a share of income taxes. For details on the nature and impact of the trade tax, see H. Kolms, *Finanzwissenschaft III Besondere Steuerlehre*, pp. 83-6; N. v.d. Nahmer, *Lehrbuch der Finanzwissenschaft*, II, pp. 94-8; and H.J. Gumpel, *Taxation in the Federal Republic of Germany*, chapter 15.
[7] For Germany, statistics on state outlays and indebtedness have been obtained from the *Finanzbericht* (1971 to 1974). Data on state indebtedness also appear in the *Monthly Report of the Deutsche Bundesbank*, Vol. 22, No. 8, August 1970, p. 15 and Vol. 23, No. 12, December 1971 (table VII, p. 56). For Australia calculations are based on data in 'National Accounting Estimates of Public Authority Receipts and Expenditure', *Supplement to the Treasury Information Bulletin.*
[8] The techniques used for redistributing tax revenues from financially strong to financially weak states are described in chapter 13.
[9] Most of these grants are of the specific purpose variety and are made on a systematic basis as part of the machinery for joint planning and financing between the federal and state governments. See chapter 19.
[10] See chapter 2.
[11] For details, see chapter 19.
[12] In 1970 the municipalities also participated (for the first time) in the revenue from the wage and assessed income tax. See table 9-2.
[13] H.J. Gumpel, *Taxation in the Federal Republic of Germany*, p. 425. Before 1970

the share of income taxes could be varied in this way. Since 1970, it is only the share of the value-added tax which may be varied by Federal Statute.

14 See *Monthly Report of the Deutsche Bundesbank*, Vol. 23, No. 12, December 1971, p. 25 and *Finanzbericht*, 1974, p. 63.

15 *Finanzbericht*, 1970, p. 167.

16 Ibid., p. 170.

17 The deficits of the municipalities are financed mainly by longer-term borrowing under state supervision; a large part of this borrowing takes the form of credits through city savings banks. See *Deutsche Bundesbank, Monthly Bulletin*, VII, December 1970, p. 56.

18 There was, however, some loss of state revenues by virtue of the transfer to the Federal Government of several 'bagatelle' taxes. See footnote†, table 9-3.

19 Under Article 106 (7) of the Constitution, states are required to provide municipalities with 'adequate' finance — and state allocations to local authorities have increased significantly since 1968. However, the actual percentage of state revenues to be allocated to municipalities is regulated by state law and hence may differ from state to state. Information from the Federal Ministry of Finance in Bonn suggests a range of 16 to 22 per cent.

20 Taxes shared between the three levels of government.

21 *Gutachten der Steuerreformkommission* 1971, Vol. III, Section XII, p. 51.

22 See ibid., p. 52.

23 Ibid., pp. 52-4.

24 The Tax Reform Commission is also on record as favouring an increase in open-ended grants by states to local authorities since this would leave greater scope for freedom of action by local authorities as to the way in which funds are spent. See ibid., Vol. III, Section VIII, pp. 8-10.

25 See chapter 19.

26 Report of Troeger Commission, para 229, p. 58 and para 425, p. 110.

27 Ibid., para 532, p. 151.

28 See, for example, 'Receipts of the Central, Regional and Local Authorities', *Monthly Report of the Deutsche Bundesbank*, Vol. 23, No. 8, August 1971, p. 18.

29 Open-ended, or unconditional, grants are comparatively rare in Germany. The same is broadly true of Canada if the equalisation grants are excluded.

Chapter 10

1 See chapter 19.

2 The interstate distribution of financial assistance grants is, however, greatly influenced by *ad hoc* decisions of the Federal Government. Unlike the US system, there is no 'pass-through' provision to local authorities, there is no favourable allowance for areas with high population densities, there is no tax effort element as such, and the transfers are not specifically linked with the taxable incomes of individuals. Moreover, the tax effort component in US revenue sharing serves as a revenue condition, thereby making the transfer more like a conditional or specific purpose grant.

3 See W. Prest, 'Commentary on Revenue Sharing and Fiscal Equalisation' in *Fiscal Federalism: Retrospect and Prospect*, Research Monograph No. 7, Centre for Research on Federal Financial Relations, p. 77.; and US Advisory Commission on Intergovernmental Relations, *General Revenue Sharing: An ACIR Re-evaluation*, Report A-48, October 1974, pp. 5-7.

4 See W.W. Heller *et al.*, *Fiscal Policy for a Balanced Economy: Experience, Problems and Prospects*, pp. 42-8.

5 'Economic Policy in our Federal State', pp. 71-2.

Chapter 11

1 See pp. 22-3.

2 In the USA, which has a strong tradition for conditional grants-in-aid, the method (prior to revenue sharing in 1972) was to rely almost exclusively on variable grant formulas to determine the scale of conditional grants for particular services.

Under these formulas grants vary in inverse ratio to per capita income, the main idea being to ensure that funds are channelled into areas that serve the national interest. See A.H. Birch, 'Intergovernmental Financial Relations in New Federations', p. 118.

3 J.F. Graham, 'Fiscal Adjustment in a Federal Country', *Canadian Tax Papers*, No. 40, December 1964, Canadian Tax Foundation, p. 9.

4 See R.A. Musgrave, *The Theory of Public Finance*, p. 526, and chapter 3.

5 See A.D. Scott, 'A Note on Grants in Federal Countries', *Economica*, Vol. 17, November 1950, p. 419.

6 J.M. Buchanan, 'Federalism and Fiscal Equity', *American Economic Review*, September, 1950, p. 587. See also J.F. Graham, 'Fiscal Adjustment', p. 9.

7 See D.H. Clark, 'Fiscal Need and Revenue Equalisation Grants', *Canadian Tax Papers*, No. 49, September 1969, Canadian Tax Foundation, pp. 8-9.

8 Similarly situated in the sense of facing the same economic circumstances with respect to income (including rent, dividends, etc.), property, age and size of family.

9 J.M. Buchanan, 'Federalism and Fiscal Equity', p. 588. Adherence to this 'fiscal residuum' principle requires that benefits from public services must be imputed to individuals. If this can be done, the equalising function of the central budget does not induce fiscal irresponsibility. See R.A. Musgrave, 'The Theory of Public Finance', p. 182.

10 It was because grants tend to be equated in popular thinking with subsidies that Buchanan favoured action by the central government to vary income tax rates from state to state so as to offset differences in state fiscal capacities. However, in so far as the constitution requires central taxes to be uniform, this method cannot be used. See J.M. Buchanan, 'Federalism and Fiscal Equity, p. 595, and A.D. Scott, 'The Economic Goals of Federal Finance', *Public Finance*, Vol. 19, No. 3, 1964, p. 253.

11 J.F. Graham, 'Fiscal Adjustment in a Federal Country,' p. 11. See also Graham, *Fiscal Adjustment and Economic Development*', pp. 176-8. There are many combinations of taxes and benefits that produce a given fiscal residuum (A.D. Scott, The Economic Goals of Federal Finance' p. 254).

12 Graham 'Fiscal Adjustment', on p. 15.

13 J.M. Buchanan, 'Federal Grants and Resource Allocation', *Journal of Political Economy*, Vol. 60, June 1952; J.F. Graham, 'Fiscal Adjustment in a Federal Country', p. 10; and 'Fiscal Adjustment and Economic Development', p. 180; and J.M. Buchanan and R.E. Wagner, 'An Efficiency Basis for Federal Fiscal Equalisation' in *The Analysis of Public Output*, J. Margolis ed., pp. 139-62.

14 For the various objections to the payment of equalisation grants, including the possible adverse effect on resource allocation, see D.H. Clark, 'Fiscal Need and Revenue Equalisation Grants', pp. 9-13.

15 On this point, see W.R. Lane 'The Case for Interstate Fiscal Equalisation', p. 4.

16 See A.D. Scott, 'The Economic Goals of Federal Finance', p. 268.

17 General revenue grants do, for the most part, leave states free to spend according to their own priorities and assessment of need. However, the method followed by the Grants Commission before 1974 of making adjustments to modified budget results of the claimant states came in for criticism on the ground that it encouraged an undue growth of expenditure by claimant states in the unadjusted categories. See R.L. Mathews, 'National Planning and Intergovernmental Relations', pp. 86-7. With the new method of assessing special grants adopted in 1974 (see next chapter), this particular problem is much less evident. C.E. McLure argues convincingly that unconditional grants are an extremely clumsy way of achieving minimum service standards (see 'Revenue Sharing: Alternative to Rational Fiscal Federalism', p. 475). See also A.D. Scott, The Economic

Goals of Federal Finance'. p. 254; and R.A. Musgrave, 'Theories of Fiscal Federalism, *Public Finance*, Vol. 24, No. 4, 1969, p. 527.

[18] D.H. Clark, 'Fiscal Need and Revenue Equalisation Grants', p. 12.

[19] For a discussion of the 'external' benefits of education, see B.A. Weisbrod, *External Benefits of Public Education: An Economic Analysis*, pp. 24-35.

[20] See, in particular, A.D. Scott, 'A Note on Grants in Federal Countries', p. 419; J.H. Lynn, 'Federal-Provincial Fiscal Relations', p. 200; A.H. Birch, 'Intergovernmental Financial Relations in New Federations', pp. 116-17; C.E. McLure, 'Revenue Sharing' p. 474; R.L. Watts, *New Federations,* p. 197; J.F. Graham, 'Fiscal Adjustment in a Federal Country', pp. 15-19; and J.M. Buchanan, 'Federal Grants and Resource Allocation'.

[21] A.D. Scott, 'A Note on Grants in Federal Countries'.

[22] J.M. Buchanan, 'Federal Grants and Resource Allocation'.

[23] Ibid., pp. 208-9.

[24] Ibid., pp. 211-12.

[25] Ibid., pp. 212-13, 215.

[26] A.D. Scott, 'Federal Grants and Resource Allocation', *Journal of Political Economy*, Vol. 60, December 1952, p. 535.

[27] On this point, see S.J. Mushkin, 'Federal Grants and Federal Expenditures', *National Tax Journal*, Vol. 10, No. 3, 1957, p. 198.

[28] Ibid., p. 199.

[29] Thus according to Eapen, 'the very fact that a number of states decide to form a federal polity . . . implies that the people of these states want to retain a fair measure of freedom to determine their social choices more or less independently of one another. A.T. Eapen, 'Federalism and Fiscal Equity Reconsidered', *National Tax Journal*, Vol. 19, No. 3, 1966, p. 327.

[30] See comment by M.S. Feldstein on article by J.M. Buchanan and R.E. Wagner, 'An Efficiency Basis', pp. 161-2. Feldstein argues convincingly that large grants to urban areas (which are sub-optimal in terms of the Buchanan-Wagner model) would in fact assist mainly the very poor areas (and especially those with predominantly black populations). Although these are areas of high population density (and may include areas of high per capita income), this is clearly not because of the lavish provision of public goods (which is implied in the Buchanan-Wagner model). According to Feldstein, considerations of equity, and perhaps long run efficiency imply public programs far in excess of the financial capacity of the local urban areas.

Chapter 12

[1] Equal per capita grants have an 'equalising' effect in the sense that, when there are differences in state taxable capacities, the poorer states would have to increase tax rates more than the wealthier states in order to generate enough revenue to replace the grants. See W.R. Lane, 'The Case for Interstate Fiscal Equalisation', p. 3.

[2] From 1937 to 1960 New South Wales, Victoria and Queensland served as the standard states; in 1961 the Commission adopted a two-state standard (New South Wales and Victoria) and this basis was continued until 1967 when the Commission announced its intention to switch to a four-state standard. However, this step was not taken and the two-state standard has continued to be used. See *28th Report*, paras 50-70; *29th Report*, paras 50-74; *38th Report*, pp. 43-7; and *41st Report*, pp. 3-4. The choice of New South Wales and Victoria was a more stable standard than one based on all four non-claimant states, but with frequent changes in the number of claimant states since 1959 it is debatable whether that choice was really appropriate. It seems legitimate to question why the Commission did not opt for a national average standard, as in Canada. The Commission has justified its selection of the two-state standard partly on the ground that the standards in terms of

services provided and capacity to raise revenue are highest in New South Wales and Victoria. This standard therefore appears likely to best serve the long-term interests of the claimant states as members of the federation. See *28th Report*, para 64.

[3] To counter moves by the states to use semi-governmental authorities as a substitute source of loan money and hence negate to some extent the effective control over total governmental borrowing by the Loan Council, an Agreement (the so-called 'Gentlemen's Agreement') was reached in 1936 by which the Loan Council was to approve borrowing programs of larger semi-governmental authorities (i.e. borrowing of $200,000 p.a. or more). The borrowing limit was raised to $300,000 in 1967-68, to $400,000 in 1973-74, to $500,000 in 1974-75 and to $700,000 in 1975-76. See R.L. Mathews and W.R.C. Jay, *Federal Finance,* p. 151; and *Payments to or for the States and Local Government Authorities 1975-76.*

[4] Other writers have dealt with the topic in greater detail. The following survey of the Commission's methods and procedures is designed to give the reader a broad picture of the Commission's role in influencing horizontal fiscal equalisation in Australia. Such an overall view is needed to enable comparisons to be made with the methods employed in West Germany, USA and Canada. The work of the Grants Commission has been covered in considerable detail by J.G. Head, 'Financial Equality in a Federation: A Study of the Commonwealth Grants Commission in Australia', *Finanzarchiv*, Vol. 26, No. 3, December 1967; and by R.L. Mathews in 'Fiscal Equalisation in Australia: The Methodology of the Grants Commission', *Finanzarchiv*, Vol. 34, No. 1, 1975. See also E.J. Hanson, 'Australian Commonwealth Grants Commission: A Quarter Century of Fiscal Judgement', *Canadian Tax Paper*, No. 20, September 1960, Canadian Tax Foundation; R.J. May, 'Financing the Small States in Australian Federalism'; J.A. Maxwell, 'Commonwealth-State Financial Relations in Australia'; R.L. Mathews and W.R.C. Jay, *Federal Finance*, pp. 153-6, 215-21, 255-60; R.L. Mathews, 'Horizontal Balance in the Australian Federation: The Reduction of Inequalities', Address to the Committee for Economic Development of Australia Forum, Sydney, June 1970 and excerpts in J. Dixon ed., *The Public Sector*, pp. 314-39. Extracts of the last article appear in 'Grants Criteria for Equalisation Grants', *Fiscal Equalisation in a Federal System*, R.L. Mathews ed., pp. 1-11.

[5] Grants Commission, *41st Report (1974) on Special Assistance for States*, pp. 1, 30-1.

[6] U.K. Hicks, 'Memorandum for the Consideration of the Fifth Finance Commission', Reprint from *Monthly Commentary on Indian Economic Conditions*, Vol. X, No. 3, p. 3.

[7] *41st Report* (1974), para 1.8, p. 4.

[8] Ibid., para 3.62, p. 45. In 1975, the latter requirement was also dropped, so that the recommended grants became pure equalisation grants.

[9] U.K. Hicks, 'Current Problems of Federal Finance in India and some Comparisons with Australia', *Public Finance*, Vol. 23, No. 3, 1968, p. 225.

[10] *3rd Report* (1936), para 9.

[11] J.G. Head, 'Financial Equality in a Federation', p. 476.

[12] *3rd Report*, para 9 (italics added). The stress on *minimum* financial needs occurred again in the *25th Report* (1958), p. 45.

[13] Ibid., para 164 (italics added).

[14] *22nd Report* (1955), pp. 21-2.

[15] R.L. Mathews, 'Fiscal Equalisation Models' in *Fiscal Equalisation in a Federal System*, R.L. Mathews ed. p. 31.

[16] J.G. Head, 'Financial Equality in a Federation', p. 512.

[17] See K.V.S. Sastri, comment on paper by A.H. Birch: 'Intergovernmental Financial Relations in New Federations', in U.K. Hicks *et al.*, *Federalism and Economic Growth in Underdeveloped Countries*, p. 134.

[18] See R.J. May, *Financing the Small States*

in Australian Federalism, p. 86.

19 A full discussion of the nature and causes of financial inequalities between the Australian states (including the below-standard fiscal capacity of the claimant states) is set forth in the *38th Report* (1971), pp. 13-22.

20 See *31st Report* (1964), paras 59-68.

21 Several allowances were, however, made to reflect differential costs as between states in providing various services. Thus, Western Australia in 1965 was able to obtain a favourable adjustment to reflect the higher school commencing age in that state on the ground that costs of providing education were lower than in other states. Tasmania, on the other hand, incurred an unfavourable adjustment on the same reasoning by virtue of its above-average school leaving age. For further details on the methods used by the Commission in making its calculations, see *34th Report* (1967), pp. 72-9. For comments by the Australian Treasury on the new method and the need in its view to take into account the degree of utilisation of particular services, see R.J. May, *Financing the Small States in Australian Federalism*, pp. 91-3; and Grants Commission, *38th Report* (1971), pp. 52-6. For a general discussion of the use of the unit-cost method, see J.A. Maxwell, *Commonwealth-State Financial Relations in Australia*, pp. 30-3.

22 See *40th Report* (1973), para 4.41.

23 *41st Report* (1974), para 4.105.

24 Ibid., para 4.104.

25 See *40th Report* (1973), paras 4.48-4.57, and *39th Report* (1972), para 4.59.

26 *40th Report* (1973), paras 4.6-4.12.

27 Ibid., para 4.30.

28 Ibid., para 4.31.

29 *41st Report* (1974), pp. 66-9.

30 Ibid., para 4.98.

31 Ibid., pp. 86-7.

32 Ibid., para 4.173.

33 Ibid.

34 *38th Report* (1971), para 4.36.

35 *41st Report* (1974), para 3.22

36 See *38th Report* (1971), pp. 32-3, especially para 2.53.

37 *Special Report* (1972), pp. 9-10.

38 Ibid.

39 See *41st Report*, para 3.30.

40 *Special Report* (1972), p. 10.

41 Ibid., p. 15.

42 R.L. Mathews, 'Horizontal Balance in the Australian Federation', pp. 314-39.

43 Ibid., p. 335.

44 *41st Report*, para 3.24.

45 Ibid., para 3.27.

46 For an expansion of the basic formula and comparison with a formula which illustrates the old method of assessing special grants, see ibid., pp. 35-7. The old and new methodologies are also contrasted in R.L. Mathews, 'Fiscal Equalisation in Australia'.

47 In 1955 the Commission argued that special grants should continue because of relatively high costs of a variety of services and development projects in the financially weak states. See *22nd Report* (1955), p. 22. In 1961, as justification for its continued existence, the Commission stressed the importance of special grants as payments to claimant states at the margin for purposes of budgetary balance. See *28th Report* (1961), para 45 and J. Dixon, 'The Changing Role of the Australian Commonwealth Grants Commission', *Public Finance*, Vol. 26, 1971, p. 479.

48 See chapter 6.

49 *Commonwealth Payments to or for the States 1971-72*, p. 94.

50 Ibid., p. 97.

51 Ibid., pp. 14, 99.

52 J. Dixon, 'The Changing Role of the Australian Commonwealth Grants Commission', p. 472.

53 *Proceedings of the Conference of Commonwealth and State Ministers*, 25 June 1970, Commonwealth Govt Printer, Canberra, 1971, pp. 5-6. See also *Commonwealth Payments to or for the States, 1970-71*, p. 17 and R.J. May, *Financing the Small States in Australian Federalism*, p. 154.

54 *Commonwealth Payments to or for the States, 1971-72*, p. 14.

55 Proceedings, p. 22.

56 In the Autumn Session of 1973 the Aus-

tralian Parliament enacted the *Grants Commission Act* 1973 (No. 54 of 1973), which repealed earlier legislation relating to the Commission. The Act provided for the Commission to inquire into and report upon applications by approved regional organisations of local governing bodies for financial assistance. See Grants Commission, *First Report (1974) on Financial Assistance for Local Government*, pp. 3-5; and *Payments to or for the States and Local Government Authorities*, 1974-75, pp. 115-17.

57 A degree of fiscal equalisation at the local level has, however, been achieved by Grants Commissions which operate in New South Wales and Western Australia. The creation of the Local Government Assistance Fund in New South Wales stemmed from a recommendation of a Royal Commission under the chairmanship of Mr Justice R. Else-Mitchell. See *Report of the Royal Commission of Inquiry into Rating, Valuation and Local Government Finance*, Sydney, 1967, p. 166. By 1975 the total resources of this fund had been increased to $10m p.a. The fund constitutes the only source of untied financial assistance to local authorities by the New South Wales Government.

58 For an examination of the problems likely to face the Grants Commission in its new role, see R.L. Mathews, 'Fiscal Equalisation for Local Government', The G.L. Wood Memorial Lecture, University or Melbourne, 2/10/73, published in *Economic Record*, September 1974 (pp. 329-45) and reproduced in *Fiscal Equalisation in a Federal System*, pp. 113-38.

59 *First Report on Financial Assistance for Local Government*, p. 17.

60 Ibid., para 3.37.

61 Ibid., para 3.39.

Chapter 13

1 *Report of the Royal Commission on Dominion-Provincial Relations*, 1940, Book II, p. 83.

2 See M. Moore and J.H. Perry, 'Financing Canadian Federation', pp. 18-19.

3 Ibid., pp. 36-7.

4 'Fiscal Need and Revenue Equalisation Grants', p. 35.

5 There are several federal programs which are designed to benefit low income regions, such as the Maritime Freight Rates Subsidy and the Atlantic Province Power Development Program. Against this, there are other programs, such as assistance to housing, which provide a relatively greater benefit to high income regions. See D.H. Clark 'Fiscal need and Revenue Equalisation Grants', pp. 36-7. The point is that the equalisation arrangements take no account of the impact of these programs (except indirectly in so far as the programs affect taxable capacities) or of the relatively greater expenditure needs in low income regions. The formula for calculation of equalisation grants takes account of revenue capacity, not expenditure need. Low income regions have also derived considerable benefits from the hospital insurance and medicare programs.

6 See W.C. Hood, 'Economic Policy in our Federal State', p. 67.

7 T.K. Shoyama, 'The New Federal-Provincial Fiscal Arrangements', p. 20.

8 This statement should be qualified to the extent that the stabilisation provisions of the Act ensured that no province could receive in the current year an amount which was less than 95 per cent of the previous year's revenue (from all sources) at the tax rates ruling in that year. See *The National Finances 1968-69*, p. 143.

9 This method was devised by the US Advisory Commission on Intergovernmental Relations in its 1962 study, *Measures of State and Local Fiscal Capacity and Tax Effort*. All major provincial revenues were included, except federal grants and borrowing. See D.H. Clark, 'Fiscal Need and Revenue Equalisation Grants', p. 39.

10 The given uniform rate of tax is, in fact, the national average tax rate since the

national average is the equalisation yardstick. Thus, for retail sales taxes, the rate to be applied to the tax base of any province would be the total revenue from retail sales taxes in all provinces divided by the value of retail sales in all provinces.

[11] See Advisory Commission on Intergovernmental Relations, *Measuring the Fiscal Capacity and Effort of State and Local Areas*, p. 38.

[12] This method seems to have been adopted because of a belief that lack of data and problems of estimation would make it difficult to measure differences in expenditure needs between provinces. According to D.H. Clark ('Fiscal Need and Revenue Equalisation Grants', p. 50) an estimation of expenditure need 'would require numerous assumptions and the exercise of much judgement'. Another writer defended the existing arrangements on the grounds that 'no one has yet devised a method of measuring expenditure requirements on a comparable basis as between provinces'. See J.H. Lynn, 'Provincial Revenue Equalisation Payments', paper presented to a Seminar on Federal-Provincial Tax Proposals, Acadia University, Nova Scotia, 18/19 May 1967, pp. 12-13.

[13] The number of revenue sources incorporated in the equalisation arrangements had increased from sixteen in 1967 to twenty-two by 1975.

[14] See R.W. Collins, 'Equalised Unhappiness', *Canadian Tax Journal*, Vol. 14, No. 6, 1966, p. 532.

[15] D.H. Clark, 'Fiscal Need and Revenue Equalisation Grants', p. 53.

[16] *Provincial and Municipal Finances*, 1973, Canadian Tax Foundation, p. 127.

[17] D.B. Perry, 'Federal-Provincial Fiscal Relations: The Last Six Years and the the Next Five', *Canadian Tax Journal*, Vol. 20, No. 4, 1972, pp. 356-7.

[18] *Canadian Tax Journal*, Vol. 21, No. 2, 1973, p. 167.

[19] *Canadian Tax Journal*, Vol. 22, No. 6, 1974, p. 611.

[20] 'Revenue-Sharing and Fiscal Equalization in Canada and the United States', table 2, p. 15.

[21] B.F. Davie and B.F. Duncombe, *Public Finance*, p. 474.

[22] Advisory Commission on Intergovernmental Relations, *Measuring the Fiscal Capacity and Effort of State and Local Areas'*, p. 35.

[23] Walter Heller looked on equalisation as a major justification for revenue sharing. See *New Dimensions of Political Economy*, p. 154; and 'A Sympathetic Reappraisal of Revenue-Sharing', pp. 25-6.

[24] See H.M. Hardy 'The Nixon Plan in Canada', *Canadian Tax Journal*, Vol. 20, No. 6, 1972, pp. 549-57; and B.P. Herber, 'Revenue Sharing and Fiscal Equalization in Canada and the United States', pp. 31-3.

[25] *Finanzbericht*, 1970, p. 169. The financial arrangements with West Berlin contain complicated equalisation elements which are not discussed in the following text.

[26] These are multipliers which municipalities can apply, subject to state law, to their trade, property and pay-roll tax revenue for which uniform federal tax rates are set. Since *Hebesaetze* vary considerably from state to state and bear no necessary relation to financial capacities, it was decided to employ uniform *Hebesaetze* for purposes of the interstate financial settlement. See, for example, H. Wick, 'Die Regelung des Finanzausgleichs unter den Laendern', *Deutsche Rentenversicherung*, 1969, p. 263.

[27] These states, with the initial support of the Lower House, wanted all the joint tax revenues (income and value-added taxes) to be distributed on the basis of need criteria. Had this proposal been accepted, the state horizontal settlement would have been merged with the vertical (federal-state) settlement. Most writers in Germany believe that the adoption of such a proposal would have been a retrograde step since it would have imposed further limitations on the independent budgeting of the states. See, for example, H. Wick, 'Die Regelung des Finanzausgleichs', p. 266. According to Seeger the financial

autonomy of the states and the stability of the federal system rest on the principle of derivation (distribution according to local receipts); and related to this is the separation of the vertical from the horizontal settlement. See J. Seeger, 'Der Grosse Steuerverbund', *Finanzpolitik*, Wirtschaftsdienst I, 1969, p. 7.

28 The difficulty of distributing value-added tax revenue according to local receipts stems from the fact that the tax is, for the most part, passed on the buyer. Receipts in a state have no necessary connection with productive capacity of the state.

29 These supplementary allocations date back to 1965. They were not strictly part of the financial settlement and the amounts have been relatively small. See *Finanzbericht*, 1970, p. 173.

30 Ibid., p. 175.

Chapter 14

1 Since 1965 Queensland's base grant has been progressively raised by $2m each year in recognition of Queensland's large area and relatively small population. See *Commonwealth Payments to or for the States, 1971-72*, p. 12.

2 The interests of claimant states are, in any event, protected by the Grants Commission which takes account, *inter alia*, of the interstate distribution of general revenue grants.

3 See J.A. Maxwell, *Commonwealth-State Financial Relations in Australia*, pp. 68, 84-7; R.L. Mathews, 'National Planning and Intergovernmental Relations: Commonwealth Grants to the States', p. 83; and R.J. May, 'Government Borrowing and the Public Debt', pp. 254-5.

4 Based on discussions which the author had with Queensland Treasury officials in May 1972.

5 Based on information in table II of J.A. Maxwell 'The New 1971 Federal-Provincial Fiscal Arrangements Act in Canada', *Economic Record*, June 1973, p. 307.

6 The maritime provinces have tended to be the heaviest per capita borrowers. See A.W. Johnson and J.M. Andrews, 'The Basis and Effects of Provincial-Municipal Fiscal Decisions', *Canadian Tax Paper*, No. 40, Canadian Tax Foundation, December 1964, pp. 39-40.

7 As noted by D.H. Clark, 'Federal-Provincial Fiscal Arrangements', p. 6.

8 There are, however, considerable differences in per capita public expenditures between the seven provinces which qualify for equalisation (compare, for example, Manitoba's $731 with Newfoundland's $1037). Data from *Provincial and Municipal Finances 1973,* Canandian Tax Foundation, p. 30.

9 Average per capita public expenditure (current and capital) of the seven low income provinces compared with average per capita public expenditure of Ontario, Alberta and British Columbia.

10 R.A. Musgrave and P.B. Musgrave, *Public Finance in Theory and Practice,* p. 643. Categorical grants are specific purpose grants.

11 R.E. Wagner, *The Fiscal Organisation of American Federalism*, p. 98. See also J.A. Maxwell, 'The Equalising Effects of Federal Grants', *Journal of Finance*, May 1954, pp. 209-15; G.F. Break, *Intergovernmental Fiscal Relations in the United States*, p. 127; and D. Netzer, *State-Local Finance and Intergovernmental Fiscal Relations*, p. 60.

12 *Measuring the Fiscal Capacity and Effort of State and Local Areas,* p. 35.

13 Advisory Commission on Intergovernmental Relations, *General Revenue Sharing: An ACIR Re-evaluation*, p. 3.

14 See study by R.A. Musgrave and A.M. Polinsky, 'Revenue Sharing: A Critical View'. It is interesting to note that New York, which is among the more affluent states, received a higher per capita revenue-sharing grant than three of the poorest states (Alabama, South Carolina and Arkansas). California also received a higher per capita grant than Alabama and about as large as South Carolina. See B.P. Herber, 'Revenue Sharing and Fiscal

Equalisation in Canada and the United States', pp. 26-7.

[15] It has been argued that the budget appropriations in respect of the financial settlement transfers are more likely to be assured of a smooth passage in the state parliaments of the financially strong states if the amounts can be kept down to a level regarded as reasonable. See H. Wick, 'Die Regelung des Finanzausgleichs', p. 270.

[16] It is probable that financial settlement transfers in 1970 were cut by about 50 per cent as a result of the new system. On this and related points see J.S.H. Hunter, 'Inter-State Fiscal Equalisation in the Federal Republic of Germany and Comparisons with Australia and Canada'.

[17] Data from *Statistisches Jahrbuch*, 1971, p. 25; 1972, p. 519.

Chapter 15

[1] On this point, see D.H. Clark, 'Fiscal Need and Revenue Equalisation Grants', p. 48.

[2] See, for example, M. Moore and J.H. Perry, 'Financing Canadian Federation', p. 71.

[3] The reasons for this bias are set out in various reports of the Commonwealth Grants Commission. See, for example, *38th Report* (1971), para 2.6, p. 14.

[4] R.L. Mathews, 'Horizontal Balance in the Australian Federation', p. 334.

[5] As an example, the grant to Western Australia to compensate for its withdrawal from claimancy was reduced by $3m p.a. commencing with the year 1970-71, because of the apparent improvement in the relative capacity of that state to finance its budget expenditure. Increased per capita payments have from time to time been made to various states in an *ad hoc* fashion and without explicit reference to guiding principles or overall policy goals.

[6] M. Moore and J.H. Perry, 'Financing Canadian Federation', pp. 71-2.

[7] Since 1973, municipal taxes imposed for local school purposes have been included in the comparisons.

[8] *41st Report* (1974), pp. 50-1.

[9] Ibid., para 4.45.

[10] *38th Report*, p. 14.

[11] The comparisons include, for each country, both current and capital expenditures — for state, semi-governmental and local authorities. In Australia, a weighted average has been used on the assumption that New South Wales/Victoria are the standard states — they do not receive equalisation payments. Data are from CBCS, *Public Authority Finance: State and Local Authorities 1972-73*. In Canada, seven provinces receive equalisation payments. Data are from *Provincial and Municipal Finances*, *1973*, Canadian Tax Foundation, p. 30. In Germany five states receive equalisation payments. Data are from *Statistisches Jahrbuch*, 1972.

[12] W. Prest, 'Commentary on Revenue Sharing and Fiscal Equalisation', p. 77.

[13] R.W. Collins, 'Equalised Unhappiness', p. 530.

[14] R.L. Mathews, 'Fiscal Adjustment in the Australian Federation: Horizontal Balance,' p. 14.

[15] According to an analysis undertaken by Professor Mathews in 1970, differential per capita payments were too large to be attributed to differences in need. See 'Horizontal Balance in the Australian Federation', in J. Dixon ed., pp. 314-39.

[16] Remarks of Prime Minister (J.G. Gorton) at Conference of Commonwealth and State ministers, *Proceedings of the Conference*, Canberra, 25/26 June 1970, p. 5.

[17] R.L. Mathews, 'Fiscal Adjustment in the Australian Federation', pp. 14-15.

Chapter 16

[1] A.D. Scott, 'The Economic Goals of Federal Finance', p. 282.

[2] 'Emerging Patterns of Federalism', p. 244. On the same point, see M.D. Reagan, *The New Federalism*, pp. 3-13.

[3] 'Intergovernmental Finance', p. 54.

Chapter 17

[1] 'The Financial Relationships of the Commonwealth and the States', *A Statement by the Premiers of all the States*, Canberra, 19/1/70.

[2] This sudden outburst of Commonwealth generosity may have been triggered off by the High Court's ruling in February 1970 that receipts duties (relating to goods and services) imposed by the states were in conflict with the Commonwealth's exclusive power over excise duties. Moreover, the arrangement whereby the Federal Government agreed to collect receipts duty on behalf of the states was defeated in the Senate in September 1970.

[3] P. Blazey, *Bolte: A Political Biography*, p. 209. This confrontation was heightened by the introduction of receipts duties on wages and salaries in Western Australia and Victoria; but this move was effectively blocked by the Commonwealth in 1969.

[4] Ibid., p. 206.

[5] 'The Search for a State Growth Tax', p. 164.

[6] Ibid., p. 168.

[7] R.L. Mathews and W.R.C. Jay, *Federal Finance*, p. 204.

[8] R.S. Parker, 'Federalism — Australian Brand' in *Australian Politics: A Second Reader*, H. Mayer ed., p. 61.

[9] On this point, see R.L. Mathews, 'The Future of Government Finance', p. 14; and R.J. May, 'Intergovernmental Finance', pp. 16-18.

[10] D.B Copland, 'The Impact of Federalism on Public Administration' in *Federalism: An Australian Jubilee Study*, G. Sawer ed., pp. 142-4.

[11] K.W. Knight, 'Federalism and Administrative Efficiency' in *Intergovernmental Relations in Australia*, R.L. Mathews ed., p. 50.

[12] W. Prest, 'Federalism in Australia: The Role of the Commonwealth Grants Commission', *Journal of Commonwealth Political Studies*, Vol. V, No. 1, March 1967, pp. 5-6. Professor Sawer cites an agreement by the seven governments in 1967-68 in relation to the regulation and control of off-shore oil and gas exploration as 'a particularly important exercise of co-operative federalism'. See G. Sawer, *Australian Government Today*, p. 28. In more recent years, however, the Australian Government has endeavoured to assert its legislative sovereignty in this area while the states have countered by seeking a High Court ruling as to the validity of the federal legislation.

[13] W. Prest, p. 7.

[14] K.W. Knight 'Federalism and Administrative Efficiency', p. 52.

[15] E.G. Whitlam, 'A New Federalism', *Australian Quarterly*, Vol. 43, No. 3, September 1971.

[16] Department of Urban and Regional Development, *First Annual Report*, Canberra, 1973, p. 7.

[17] Ibid.

[18] Ibid.

[19] Ibid., p. 8. Italics added.

[20] *Second Annual Report*, 1973-74, pp. 29-31.

[21] Ibid., pp. 35-6.

[22] *First Annual Report*, p. 23 and *Second Annual Report*, pp. 16-18. This has relevance to legislation passed in June 1973 to give local government access to the Grants Commission.

Chapter 18

[1] E.W. Weidner, 'Decision-Making in a Federal System' in *Federalism, Mature and Emergent*, A.W. Macmahon ed., p. 369.

[2] Ibid., p. 370.

[3] Canada has an Institute of Intergovernmental Relations at Queen's University (Kingston, Ontario). The institute is a research body and was established in 1965. The Canadian Tax Foundation has also promoted research in the area of intergovernmental relations. In Australia, a Centre for Research on Federal Financial Relations was established at the Australian National University in Canberra towards the end of 1972. The centre is concerned with research into all aspects of inter-

governmental financial relations. In the United States there are several independent bodies, besides ACIR, which conduct research into intergovernmental and related problems. Examples are the Brookings Institution, the National Tax Association, and the Tax Institute of America. There is a Centre for the Study of Federalism at Temple University, Philadelphia, and similar centres are to be found at many other American universities.

4 *Revenue-Sharing — An Idea Whose Time Has Come,* US Government Printing Office, Washington, 1970.
5 S.J. Mushkin and R.F. Adams, 'Emerging Patterns of Federalism', pp. 230-1.
6 Ibid., p. 231.
7 Ibid., p. 233.
8 Ibid., pp. 233-5.
9 *Revenue Sharing — An Idea Whose Time Has Come*', p. 9.
10 Institute of Intergovernmental Relations, *Report: Intergovernmental Liaison on Fiscal and Economic Matters*, p. 17.
11 Ibid., p. 18.
12 See ibid., pp. 33-4; and A.R. Kear, 'Co-operative Federalism: A Study of the Federal-Provincial Continuing Committee on Fiscal and Economic Matters' reprinted in J.P. Meekison ed., pp. 310-14.
13 *Report of the Royal Commission of Inquiry on Constitutional Matters* (Quebec), Queen's Printer, 1956, Vol. 3, Book 2, p. 301.
14 *Report of the Institute of Intergovernmental Relations*, pp. 38, 112, 198.
15 *The National Finances, 1972-73,* Canadian Tax Foundation, p. 115.
16 Economic Council of Canada, 'Towards Sustained and Balanced Economic Growth', *Second Annual Review*, Queen's Printer, December 1965, p. 189.
17 *Third Annual Review*, November 1966, p. 178.
18 *Communiqué*, Federal-Provincial Conference, Ottawa, November 15/17 1971, p. 2.
19 *Report of the Institute of Intergovernmental Relations*, pp. 46-9, 119-20.
20 Ibid., p. 120.
21 See *Economist*, 23/11/74, p. 97.
22 *Economist*, 30/11/74, p. 94.
23 See R.D. Brown, 'The Fight over Resource Profits', *Canadian Tax Journal*, Vol. 22, No. 4, 1974, pp. 315-37.
24 *Canadian Tax Journal*, Vol. 22, No. 1, 1974, p. 78.

Chapter 19

1 *Das Gesetz zur Foerderung der Stabilitaet und des Wachstums der Wirtschaft*, Federal Ministry of Economics, 3rd ed., Bonn, May 1970.
2 B. Hansen and W.W. Snyder, *Fiscal Policy in Seven Countries, 1955-1965*, pp. 212-13.
3 This is specifically provided for under Article 109 (2) of the Constitution.
4 Under Article 109 (4) (i) of the Constitution a federal law can, with the approval of the Council of States, and in order to avoid a disturbance to total economic equilibrium, regulate the maximum amounts, conditions and time periods for borrowing by governments and governmental bodies.
5 Article 109 (4) (ii) of the Constitution.
6 On this and related points, the author is grateful for assistance from Dr E. Neuthinger of the Federal Finance Ministry in Bonn.
7 See *Monthly Report of the Deutsche Bundesbank*, Vol. 25, No. 11, November 1973, pp. 21-2.
8 B. Hansen and W.W. Snyder, *Fiscal Policy*, p. 227 n.
9 Under the Act governing its duties and powers, the Deutsche Bundesbank (West German Central Bank) is required to co-operate with the Federal Government and to support the general economic policy of the government. However, in exercising the powers conferred upon it by the Act, the bank is independent of instructions from the Federal Government. The Central Bank Council (the supreme body of the Deutsche Bundesbank) is, like its American counterpart (the Federal Reserve Board in Washington), much more independent than are the central banks in

Australia or Canada. See Deutsche Bundesbank, *Instruments of Monetary Policy in the Federal Republic of Germany,* July 1971, pp. 5-6, 69.

10 See 'Finanzreformgesetz', *White Paper on Finance Reform*, Federal Ministry of Finance, Bonn, 21/5/69, pp. 6-7, 16-17.

11 See K. Stadler, 'Die Neue Finanzverfassung', *Bayerische Verwaltungsblaetter*, September 1969, p. 298.

12 *Finanzbericht*, 1972, pp. 179-81.

13 K. Stadler, 'Die Neue Finanzverfassung', p. 299.

14 Ibid., p. 301; White Paper, op. cit., p. 7; *Finanzbericht,* 1971, pp. 163-4 and 1972, pp. 181-3.

15 H. Haller, 'Changes in the Problems of Federative Public Economies', *German Economic Review*, Vol. 8, No. 3, 1970, p. 181.

16 Ibid., p. 183.

17 Ibid., p. 182.

18 For a discussion of the work of the Council and its growing influence, see W. Kasper, 'Formation and Co-ordination of Economic Policy: Possible Models for Australia', *Discussion Paper for the Royal Commission on Australian Government Administration*, Australian Government Publishing Service, Canberra, 1975, pp. 66-73; and H.C. Wallich 'The American Council of Economic Advisers and the German Sachverständigenrat: A Study in the Economics of Advice', *Quarterly Journal of Economics*, Vol. LXXXII, No. 3,1968.

19 B. Hansen and W.W. Snyder, *Fiscal Policy*, p. 222.

Chapter 20

1 R. Blough, 'Fiscal Aspects of Federalism' in *Federalism, Mature and Emergent*, A.W. Macmahon ed., p. 404.

2 C.P. Harris 'Social Planning and Regionalism in Australia', p. 14.

3 Ibid., p. 15.

4 R.J. May, 'Intergovernmental Finance', p. 47.

5 G. Sawer, *Modern Federalism*, p. 127.

6 Quoted by T.S. Monks in *Sydney Morning Herald*, 22 November 1973, p. 6.

7 See G. Thimmaiah, 'Planning and Federal Finance', *Eastern Economist*, 29/8/69, pp. 391-3.

8 'Excerpts from the Report of the Committee of Economic Enquiry' reprinted in *The Public Sector: Selected Readings*, J. Dixon ed., p. 298.

9 This proposal reflected the Committee's view that there was a need in Australia for a body (similar to the Economic Council of Canada) which could make a continuing assessment of medium and long-term trends. See *Report of the Committee of Economic Enquiry*, Vol. I, Canberra, May 1965, pp. 450-4.

10 D.A. Dunstan, 'A View from the States', reprinted in J. Dixon (ed.) *The Public Sector: Selected Readings*, pp. 290, 294. Italics added.

11 Ibid., p. 295.

12 See E.G. Whitlam, 'A New Federalism', p. 12.

13 R.L. Mathews, 'National Planning and Intergovernmental Relations', p. 83.

14 These calculations are made after adjusting both specific purpose and general purpose capital payments for the new housing finance arrangements. Since 1971-72 the housing component was no longer nominated by the states out of the approved Loan Council program.

15 R.J. May, 'Intergovernmental Finance', pp. 47-8.

16 J. Dixon, 'The Changing Role of the Australian Commonwealth Grants' Commission', pp. 480-1.

17 Such a Council could build on existing institutions or planning agencies, such as the Priorities Review Staff.

18 'Grants Criteria for Equalisation Grants', p. 11.

Chapter 21

1 See T.M. Russell, 'Intergovernmental Fiscal Relations in Canada: A Provincial

Viewpoint', *Proceedings of the Sixty-Sixth Annual Conference on Taxation*, National Tax Association and Tax Institute of America, Toronto, 9/13 September 1973, pp. 275-7.

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- (i) 'In Search of Balance — Canada's Intergovernmental Experience', *Report M-68*, Washington, September 1961
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- (iv) 'Measuring the Fiscal Capacity and Efforts of State and Local Areas', *Information Report M-58*, Washington, March 1971
- (v) 'Federal-State-Local Finances: Significant Features of Fiscal Federalism', *Report M-69*, Washington, February 1974
- (vi) 'General Revenue Sharing: An ACIR Re-evaluation', *Report A-48*, Washington, October 1974.

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Text set in 10 point Century and printed on
100 gsm. woodfree paper by Colorcraft Ltd., Hong Kong

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Jacket design by
ANU Graphic Design/Adrian Young
Printed in Hong Kong