

**THE NEGLIGIBLE IMPACT OF SPECIFIC PURPOSE
PAYMENTS AND AUSTRALIA'S "NEW FEDERALISM"**

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Discussion Paper No. 26, July 1991

Views expressed in this paper are those of the author, and do not necessarily reflect the opinions of the Department of the Prime Minister and Cabinet of which he is an officer (Editor).

ISSN 1030 2190

ISBN 0 7315 1244 8

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Abstract

The operational key to intergovernmental relations in Australia's federal system of governance is the nature of the financial relations between the different levels of government. Integral to these relations are Specific Purpose Payments (SPPs) transfers. This paper argues that, in most cases, SPPs have similar effects on the pattern of expenditure by States and Territories as have unconditional Financial Assistance Grants.

The theory of intergovernmental grants suggests that tied grants with matching conditions attached, and non-matching tied grants that force recipient governments to provide the assisted function at a level above its preference, induce substitution effects upon the recipient government, and so should impinge on their spending options. In Australia, however, this constraint has been removed because of the role of the Commonwealth Grants Commission. The Commission is required to calculate the distributional relativities for the States and Territories according to the principle of fiscal equalisation. In deriving these relativities, the Commission treats SPPs by the so-called inclusion method. This ensures that any intended matching effects of SPPs (explicit or otherwise) are largely compensated for over the period being reviewed. Theoretical and statistical evidence is provided to support these arguments.

Hence, with the exception of two special cases, there is no real benefit, and almost certainly real costs (because of the larger bureaucracies associated with the administration of SPPs), to the community in the Commonwealth generally retaining Specific Purpose Payments.

Australia's intergovernmental fiscal arrangements, including the relatively high incidence of Specific Purpose Payments, prevent the community from fully enjoying the perceived benefits of the federal system of government. In particular, they fail to act as an effective constraint on the expansionist tendencies of government. Sustainable reform of fiscal imbalance, however, may be difficult to attain because of the effects caused by the interrelationships between Sections 51, 90 and 96 of the Constitution.

1. INTRODUCTION

The operational key to intergovernmental relations in Australia's federal system of governance is the nature of the financial relations between different levels of government. Given that revenue collection in Australia is highly centralized (relative to other federations), these relationships necessarily stem from the Commonwealth Government out to the States and Territories, and thence, to local government. An integral part of these intergovernmental financial relations are Specific Purpose Payments (SPPs). Hitherto it has been widely accepted that SPPs shape State governments' policy choices and fiscal behaviour (see, for example, Mathews, 1983 (a)). This paper seeks to correct that misconception, arguing that SPPs usually have no more such effects than do general revenue grants such as Financial Assistance Grants.

Specific Purpose Payments are Commonwealth payments to the States under Section 96 of the Constitution, which provides that "the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit" (Constitution of Australia, 1986, p. 29). They now comprise half of all Commonwealth transfers to the States and Territories.

Specific Purpose Payments have been the vehicle by which the Commonwealth has entered many fields of public action ostensibly falling within the powers of the States. Being such an integral part of the overall flow of funds between levels of government, it is imperative that any agenda for reform of Australia's federal institutions includes Specific Purpose Payments. Their impact on actual government decision-making and intergovernmental relations needs to be fully understood before any effective reforms of major policy areas such as social welfare, roads, education, and so on can be devised. Otherwise, those reforms may prove ineffectual.

What has been remarkable about much of the debate surrounding the Prime Minister's "New Federalism" initiative has been the apparent lack of official awareness about what is the real impact of Specific Purpose Payments upon the behaviour of the recipient State Governments. This

paper attempts to rectify this situation; this is in the hope that doing so will clarify the real interests of some of the participants in the debates.

In the October 1990 Special Premiers' Conference Communique, it was stated that:

"leaders and representatives recognised that a major concern of the States is how to achieve greater flexibility in the management of their budgets. A substantial factor contributing to that concern is the extent of tied grants - Specific Purpose Payments from the Commonwealth to which detailed conditions are attached in many cases - and the substantial growth in those grants in the post-war period. Leaders have decided that this trend must be reversed; that the goal should be a substantial reduction of tied grants as a proportion of total Commonwealth grants"

(1990, p.2).

In pursuit of this objective, a committee of expert officials was established to review all aspects of fiscal federalism, including Specific Purpose Payments. It was required to report back to the forthcoming Conference on:

1. the classification of Specific Purpose Payments;
2. the incidence of matching requirements in larger programs;
3. proposals for eliminating or modifying conditions attached to tied grants.

(cf. Special Premier's Conference Communique, 1990, Attachment 1: 2)

This paper investigates possible reasons for the widespread prevalence of Specific Purpose Payments, and considers the action necessary to reduce the level of these payments. I argue that, in the Australian context, tied grants exercise little influence on the broad direction of State expenditure. Moreover, benefits - including reduced administrative costs and improved transparency of program accountability - would accrue to the community from abolishing Specific Purpose Payments in favour of greater Financial Assistance (unconditional) Grants or broad program "block" grants.

The structure of the paper is as follows:

Part 2 - the broad statistical picture is presented to provide a context within which to place the ensuing theoretical discussion;

Part 3 - the theory of intergovernmental grants is outlined;

Part 4 - this theory is placed into the Australian context; in particular, the impact of the Commonwealth Grants Commission's "inclusion" method for treating Specific Purpose Payments in deriving States' general funding relativities is considered;

Part 5 - these hypotheses are then related to the Australian data;

Part 6 - possible explanations for why Specific Purpose Payments have continued to grow, despite their apparent inability to affect States' broad policy choices, are discussed. A test for justifying the use of tied grants is proposed;

Part 7 - these arguments are synthesized in the final comments, which use a constitutional framework to highlight the peculiarly Australian factors involved and point to the reforms required for effective change to occur.

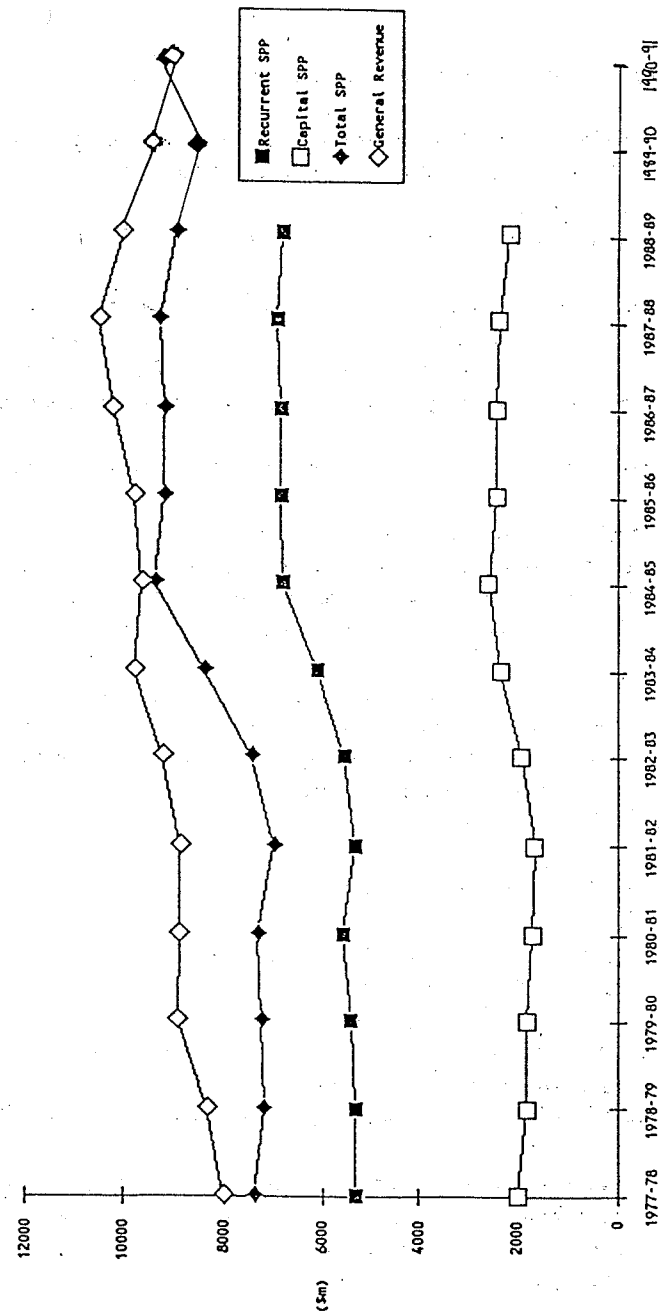
2. STATISTICAL BACKGROUND

Diagram 1 below shows the distribution of Commonwealth grants, in real terms, for the period 1977-78 to 1990-91.

It highlights the rising significance of Specific Purpose Payments, particularly between 1981-82 and 1984-85. General revenue payments, on the other hand, have been declining in importance since 1987-88.

Table 1, below, verifies these apparent trends. It shows that there has been a dramatic rise in the relative importance of Specific Purpose Payments since 1969-70. These rises have been almost exclusively in the periods of Labor government (1972-75 and 1983 to present).

DIAGRAM 1: TOTAL COMMONWEALTH GRANT LEVELS ADJUSTED FOR PRICE VARIATIONS (1984-85 values)



Source: Commonwealth Grants Commission and Commonwealth Treasury.

TABLE 1: COMMONWEALTH TRANSFERS TO THE STATES, BY TYPE AS A PERCENTAGE OF TOTAL TRANSFERS

Year	General revenue funding	Specific Purpose Payments
1969-70	72.7	27.3
1972-73	70.1	29.9
1975-76	50.7	49.3
1978-79	56.6	43.4
1981-82	66.3	33.7
1984-85	51.1	48.9
1987-88	61.7	38.3
1990-91	49.3	50.7

Sources: Commonwealth Treasury and Russell L. Mathews (1983)

In 1990-91, the States received \$28.1 billion from the Commonwealth, of which \$14.1 billion was in tied grants, and \$14.0 billion in general purpose payments. The breakdown of Specific Purpose Payments by function for 1990-91 is shown in Table 2 below.

Some Specific Purpose Payments merely pass through State Treasuries on their way to other organisations. These agency arrangements are to satisfy legal and constitutional requirements. These payments are not available to States for use in budget formulation in the same way that regular grants are. Payments "through States" include grants for higher education, local government, and non-government schools. They accounted for 35 percent of all tied grants in 1990-91 (\$4.8 billion).

It seems appropriate, therefore, to adjust the data on Commonwealth transfers to States to discount "agency" payments. Diagram 2, below, breaks down Commonwealth grants in this way for the period 1980-81 to 1990-91. It shows that the payments available for use by States have fallen sharply in real terms - by over 15 percent - since the funding peak of 1984-85. This is clear evidence of how much State funding has been

TABLE 2: SPECIFIC PURPOSE PAYMENTS, BY FUNCTION, 1990-91 (\$ BILLION)

Function	\$ Billion
Hospitals	3.70
Higher Education	2.70
Government Schools	1.05
Non-government Schools	0.87
Commonwealth-State Housing Agreement	1.04
Roads	1.60
Local Government	0.71
Others	2.41
TOTAL	14.08

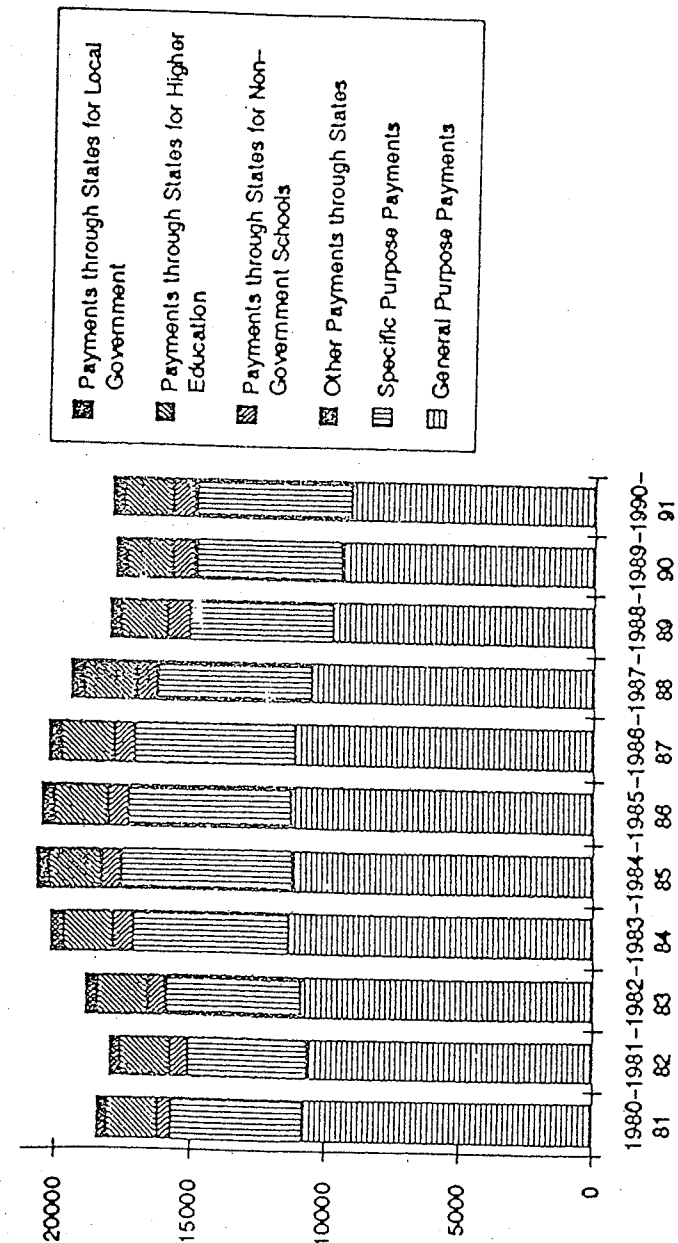
Source: Commonwealth Treasury

slashed in the wake of the Commonwealth fiscal tightening in the late 1980s. In association with the recent collapse in State revenue from stamp duty and other pro-cyclical sources, this decline has put a tight lid on State budgets. These factors fueled the impetus for States to call for reform of federal fiscal arrangements.

The first concrete response to these complaints by the Commonwealth occurred at the recent financial Premiers' Conference, where it honoured a commitment given last year to maintain general revenue funding in real terms. That notwithstanding, Specific Purpose Payments are set to continue growing more quickly than Financial Assistance Grants. Hence, it appears that no real reform has, as yet, occurred.

An important factor contributing to States' concerns with Specific Purpose Payments is the extent to which detailed conditions are attached. Among the most significant are matching conditions, which have the apparent effect of reducing the amount of fungible resources available to States for program delivery (the countervailing effect of the

DIAGRAM 2: PAYMENTS TO AND THROUGH THE STATES, 1980-81 TO 1990-91 (\$ million, 1984-85 prices)



Source: Commonwealth-State Relations Secretariat using Commonwealth Budget papers.

Commonwealth Grants Commission's fiscal equalization procedures is not considered until Section 4).

Matching conditions applied to 34 of the 87 Specific Purpose Payments operating in 1990-91. This amounted to only \$1.73 billion (12 percent of all tied grants), however, as most of the larger Specific Purpose Payments do not carry matching conditions. Overall, the States and Territories are required to contribute about a similar amount.

There are three types of matching arrangement: formal set funding ratios, such as dollar-for-dollar (26 programs); agreement to maintain real funding levels by the States (1 program); and informal arrangements (7 programs).

Other conditions attached to Specific Purpose Payments are largely to ensure that Commonwealth policy objectives, or jointly agreed policy objectives, are being met. Commonwealth departments are required to account to Parliament for the use of funds spent through tied grants against the objectives for which they were provided (1).

These conditions may be quite detailed and include:

1. specification of where or for what purpose the funds are to be used;
2. conditions concerning the delivery and administration of the program;
3. a requirement to provide statistical and qualitative information on the program's performance.

Often though, the conditions only relate to general policy guidelines or Commonwealth involvement in the program's development.

(1) Although the recent Commonwealth Auditor-General's report into Specific Purpose Payments found evidence of glaring deficiencies in the reporting and accounting of program outcomes and performance (Commonwealth Auditor-General [J. N. Taylor], 1991).

3. THEORY OF INTER-GOVERNMENTAL GRANTS

The standard theory on the impact of grants on recipient governments presented here is based on the path-breaking article by Scott (1952).

Scott noted that the particular virtue claimed for (matching) conditional grants is that the central government retains the responsibility for spending its taxes, in accordance with the principles that governments must justify to their legislature the use of the funds raised by taxation. Conditional grants interfered, however, with the right of the lower level of government to decide for itself what services it shall provide.

Scott used indifference curve analysis to prove his argument. Indifference curves make the assumption that as more of two given services are enjoyed by a State, total satisfaction will rise. This, to Scott (1952, p. 386), seemed a fairly realistic attitude to the receipt of governmental services.

Indifference curve analysis cannot make similar assumptions, however, about the payment of these services. It may well be that the imposition of additional taxes are so distasteful to the community that having more services and paying for them may cause a loss in total satisfaction. Hence, to ascertain the total level of services demanded by the community alternative forms of analysis such as Wicksell's (1896) value-countervalue model should be used (see Musgrave, 1961). Having deduced that figure, Scott's indifference curve approach is suitable for assessing the distribution of services, at a given level of taxation revenue for the lower level of government.

Diagrams 3 to 5 show these effects on the budgetary options of recipient governments. The diagrams depict a given state's spending options on two public activities, A and B. A may be viewed as a particular program, and B all other expenditure functions carried out by that government.

Without financial assistance from the central government, the state is constrained by the fiscal capacity of its own revenue instruments to the budget line BL₁. Indifference curve IC₁ includes the spending preference which maximizes the state's utility (as assessed by the present regime) for the two activities: A₁ and B₁.

Diagram 3 shows that if the central government provides an unconditional grant to the state, then its spending options will expand by the value of the grant to the new budget line, BL_2 . The state will then choose a new public expenditure mix - A_2 and B_2 - which reflects its policy priorities. The grant only has an income effect on the state's budgetary position. Of course, the state could also, if it wished, maintain expenditure at pre-grant levels and reduce its own revenue efforts by the value of the grant. Again, there has only been an income effect on the state.

But if funding is provided by way of a tied grant with matching conditions, then there is a substitution effect as well. In Diagram 4, activity A is subsidised by the central government with a dollar-for-dollar tied grant. This swings the state's budget line out, enabling it to reach the higher indifference curve IC_3 . If the funding had been unconditional, however, the state could have provided, to it, a more preferable spending mix, as indicated by the higher indifference curve IC_2 . It has been forced to give up funding some more preferable programs for activity A. A loss in utility has occurred, according to the state's assessment. The dead weight loss associated with being pushed back to the lower level of utility by the matching grant is the area LMN in Diagram 4. M represents the point at which the recipient is constrained from providing its preferred funding mix (Stiglitz, 1988, p. 646).

Diagram 5 shows the effect of tied grants, provided without matching conditions, on the state's spending options. The tied grant, on activity A to the value of A_0 , only acts as a brake on the state's choices if it prefers to fund activity A at a level below A_0 . At any point above that, the result of the tied grant has a similar effect to unconditional funding: the state is not constrained in its choice.

For example, if IC_2 represents the maximizing indifference curve for the state's budget line (BL_2'), then it is free to provide its favoured mix of activities: A_2 and B_2 . But if the state's maximizing indifference curve is IC_3 , then there would be a constraint. It could only provide the two activities at A_0 and B_0 , and not in its favoured mix (A_3 and B_3). The section YZ of the budget line has been removed from the state's range of spending options. This area is referred to as "the corner solution", and a

DIAGRAM 3: THE EFFECT OF FINANCIAL ASSISTANCE GRANTS ON RECIPIENT GOVERNMENTS' SPENDING OPTIONS

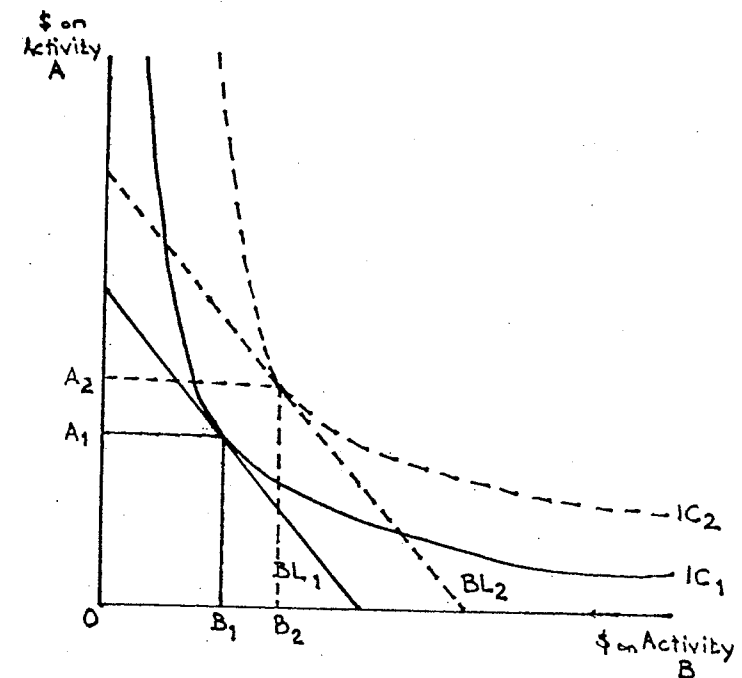


DIAGRAM 4: THE EFFECT OF SPECIFIC PURPOSE PAYMENTS WITH MATCHING CONDITIONS ON RECIPIENT GOVERNMENTS' SPENDING OPTIONS

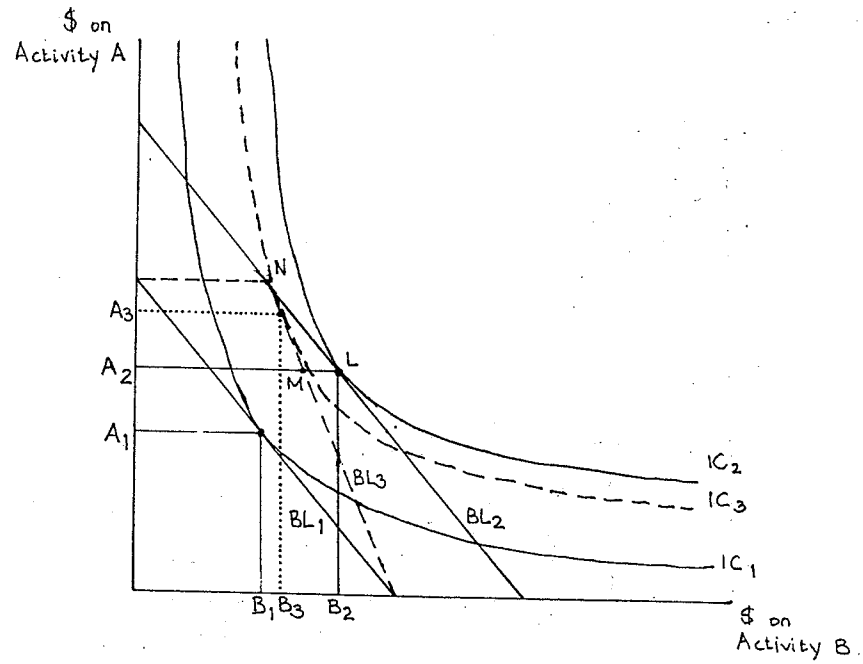
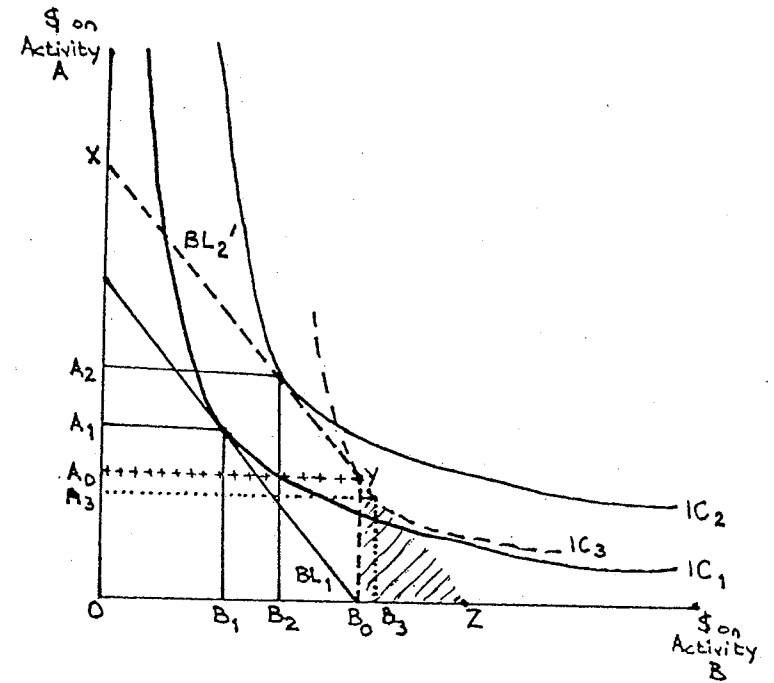


DIAGRAM 5: THE EFFECT OF SPECIFIC PURPOSE PAYMENTS WITHOUT MATCHING CONDITIONS ON RECIPIENT GOVERNMENTS' SPENDING OPTIONS



loss of utility ensues if a state is prevented from choosing a policy menu within these bounds.

The existence of spillover effects may lead a state to seek to provide a non-private good at a low level within this corner solution. An efficient level of service delivery, however, may not occur if this situation remains unchecked. A matching grant could help move the state towards a more Pareto-optimal resource allocation by subsidising the positive spillover, thereby raising the level of output. There are two types of spillover relevant in this regard: a non-private good that has been allocated to its "proper" justification, but for which there are externalities extending beyond that frontier; or else an appropriate jurisdictional level does not exist for a particular non-private good, and hence it is not the explicit responsibility of any particular level of government. As a consequence, joint program delivery is co-ordinated through the device of a tied grant.

This analysis assumes, however, that tastes are homogeneous. If they are not, Pareto optimality can only be fully achieved by the use of individual grants. Given the extreme difficulties in devising a politically feasible method for distributing individual grants, tied grants to lower levels of government are viewed in this context as a reasonable "second best" solution. (see Breton, 1965; and Commonwealth Grants Commission, 1990). Buchanan (1950) argues, however, that grants for fiscal equalisation purposes should not be on an individual basis, but on a governmental basis as this enables each recipient government to be capable of providing the same balance between tax contributions made and the average value of services provided ("fiscal residuum") to each taxpayer.

A number of the other strict assumptions made may lead some to think that this analysis lacks empirical relevance. These assumptions include:

1. governments are able to accurately gauge the public goods preferences of the community, and reflects those preferences in their policy choices and intergovernmental fiscal relations;

2. the services being provided are "non-private", that is, the amount available to each citizen does not reduce that available to others by an equivalent amount;
3. the state collects revenue only through taxation to fund a common spending pool, and does not impose any benefit taxes or user charges;
4. the pre-existing division of functions between levels of government is fixed;
5. there are no costs associated with the delivery of governmental services.

Relaxing these assumptions does not, however, alter the thrust of the argument: that only in special circumstances should tied grants without matching conditions affect a recipient government's budgetary options; and that a donor government should use tied grants with matching conditions if it wishes to cause a change in the policy behaviour of lower levels of government. The remainder of this section canvasses developments in this field since Scott's article.

Goetz and McKnew (1972) argue, on the basis of a median voter perspective, that unless an individual possesses the median desired mix of public and private goods, under both matching and unconditional grants, the indifference curves of the standard account must be redrawn to reflect the change in the tax-price of the particular public good being subsidised. While this point seems valid, the argument relies on an assumption (the median voter theory) with little apparent empirical veracity, and on the government being able to relate taxpayers' willingness to provide revenue for the provision of a given public good in a consolidated funding framework. To be able to make such calculations, programs should be earmarked: that is, specific expenditures should be financed by specific taxes, so that citizens can properly assess the level of services they are willing to pay for through their tax contributions (2). Goetz and McKnew's model, however, is in a consolidated fund format.

(2) The classic contribution on the theory that the provision of public services should on the basis of benefit taxation, or as he puts it "the principle of value-countervalue", is Knut WICKSELL (1896). For a recent detailed discussion of the perceived benefits of earmarking, including why the tax should be complementary, see Geoffrey BRENNAN and James M. BUCHANAN (1980, pp. 137-155).

There is evidence in the United States to suggest that, contrary to the standard model, non-matching tied grants do have an apparent effect on state's budgetary options. One explanation for this is the "flypaper effect" (money sticks where it hits). Stiglitz (1988, pp. 647-648) puts forward three reasons for this effect:

1. voters do not perceive the true marginal price of public expenditures when non-matching tied grants are present. This argument is analogous to Galligan and Walsh's (1990) "60 cent dollars" hypothesis for explaining the reluctance of the States and Territories to take effective action against vertical fiscal imbalance in Australia;
2. bureaucrats have discretion over their program budgets, at least in the short-term when voters are not aware of the additional funds at their disposal. Hence, state functional departments will look to their federal colleagues for grants to increase their budget;
3. federal administrators can ensure that funds are spent in an incremental manner. They often can withdraw a grant if they feel it is being used to replace revenue from state taxes.

The second reason is not a strong argument for the flypaper effect. It is based on the idea that bureaucrats have the capacity to avoid the opprobrium of the ballot box or central agencies. But the flypaper effect is about states being constrained. This, on the contrary, involves states using a device to avoid constraint.

Brennan and Pincus (1990) suggest that the flypaper effect may arise from implicit conditions being attached to ostensibly non-matching tied grants. Most of the standard arguments for inter-governmental grants depend on the claim that certain expenditures, if assigned to lower levels of government, generate positive interjurisdictional spillovers. Hence, if there is no corrective action, such as tied grants, by the central government, those services will tend to be undersupplied. The tied grants change the level of services supplied by changing the relative prices of local public goods for the recipient government. But tied grants without any matching condition do not change relative prices. Only matching tied grants achieve this desired substitution effect. Brennan and Pincus contend, therefore, that the standard theory for grants concerning the existence of positive interjurisdictional spillovers is weak, unless

non-matching grants do induce a substitution effect. This would be the case if those grants had implicit conditions attached to them, such that their actual impact was no different than that of a tied grant with matching conditions.

If the grant is in any way contingent on the recipient's behaviour, Brennan and Pincus argue that it will induce behavioural responses. These contingency effects are likely to be implicit when the number of agents party to the transaction is small, or when they do not relate solely through market-like institutions (for example, an intergovernmental committee). They point out that the standard presumptions of mainstream economics suggest that it is likely both that transfers from donor to recipient will reflect some measure of quid pro quo, and that the donor's ends will impinge in some fashion on the recipient government's spending patterns.

Zampelli (1986), on the other hand, postulates that the flypaper effect may be the result of variable mis-specification. He says that more appropriate specification of intergovernmental financial relations yields little evidence for it in the American context. He argues that it is tenuous to assume that a recipient government's budget constraint will be altered because of a grant's conditions.

When conditional aid is intended to cause an increase in the recipient government's public output beyond current levels, the recipient can:

1. reduce their own normal funding of the subsidised program;
2. use a project which was going to be undertaken anyway to secure the grant;
3. redefine budget categories;
4. reallocate running costs to make the grant fungible.

Zampelli's econometric approach pays little credence to indifference curves. This is a major flaw. He fails to recognise that just because there is a point where the unconditional grant budget line and matching grant budget line cross, that point is not necessarily a joint utility maximizing point. Diagram 4 shows this. N is the point where the unconditional and matching grant budget lines BL₂ and BL₃ cross, but it is

not the utility maximizing point for the unconditional grant budget line BL₂. L is that point.

Zampelli also assumes that the state will be able to adjust its budget to negate any implied matching effects of a non-matching grant, without penalty from the donor government. This appears to be a reasonable characterisation of the Australian situation, but not for the reasons Zampelli puts forward. This is because of the impact of the Commonwealth Grants Commission's fiscal equalization procedures (discussed below).

Nevertheless, these caveats aside, Zampelli shows that for local government in the United States, up to 70 per cent of federal aid is converted into fungible resources and that therefore, conditional grants might as well be consolidated under general revenue programs.

4. THE IMPACT OF THE COMMONWEALTH GRANTS COMMISSION

The analytical waters of government grants are extensively muddled in Australia because of the Commonwealth Grants Commission. Its role is to advise the Commonwealth Government on the distribution arrangements for Financial Assistance Grants to the States and Territories. It does this according to the principle of fiscal equalization (3), which is

"that each State is entitled to receive a share of Financial Assistance Grants sufficient for it to provide a standard level of governmental services, without having to impose higher taxes and charges than the other States".

The Commonwealth Grants Commission is also required to pay regard to principles of economic efficiency and administrative simplicity. The Commission's "Standard Budget" brings these elements together. In a perfect world, it would include all State functions other than those wholly funded by the Commonwealth, and all State own-source revenue. This eliminates from the calculations Specific Purpose Payments

(3) A stout defence of the principles underlying fiscal equalization by James M. BUCHANAN (1950) provides more cogent arguments than those offered by the COMMONWEALTH GRANTS COMMISSION (1990, pp. 99-100).

"through States" to other agencies such as for local government and higher education.

Data problems and interactions between types of transactions, however, limit the Standard Budget's coverage. Most Specific Purpose Payments, nevertheless, are included - the main exceptions being roads and capital payments. By including Specific Purpose Payments in the equalization formula, States' diverging expenditure needs are more comprehensively accounted for than if they were excluded. It ensures that Specific Purpose Payments not funded in a way consistent with the Commission's assessment of a State's fiscal capabilities will be fully compensated for in that State's general revenue share over the review period (presently five years) (4).

Even matching tied grants effectively become fungible within State budgets, unless the level of services required because of the matching condition is above the Commission's Standard Budget assessment. If this occurs, the effect is as depicted in Diagram 4 for the above-standard funding component only.

The Commonwealth Grants Commission's relativity assessment, therefore, "over-rides" the distribution arrangements for any Specific Purpose Payment included in the Standard Budget. Diagram 6 below illustrates this, using the example of a state that declines a Specific Purpose Payment in favour of general funding. In the diagram:

TFAR_i is the state's total financial assistance requirement, after comparison of its fiscal capabilities with the standard budget; O_i is the value of Specific Purpose Payments paid to that state; G_i is the value of general revenue funding provided to that state; and D_i is the state's deficit after receiving these grants (nil for the illustration).

(4) If a Specific Purpose Payment is distributed on a basis that encompasses all relative disabilities between States, then the grant payments and States' expenditure on that program are deducted from the standard budget.

DIAGRAM 6: ILLUSTRATION OF HOW A STATE WHICH MAKES A LOWER EFFORT TO ATTRACT A SPECIFIC PURPOSE PAYMENT RECEIVES ITS ASSISTANCE AS GENERAL REVENUE ASSISTANCE

This argument can be illustrated using the inclusion example (example 1)

(i) Inclusion Method (both States accept the SPP).

States	TFAR _i	O _i	G _i	G _i + O _i	D _i	Total Grants Received
A	100	40	60	100	0	100
B	100	20	80	100	0	100
Total	200	60	140	200	0	200

(ii) Inclusion Method (only State A accepts the SPP).

States	TFAR _i	O _i	G _i	G _i + O _i	D _i	Total Grants Received
A	90	40	50	90	0	90
B	90	0	90	90	0	90
Total	180	40	140	180	0	180

(iii) Inclusion Method (only State A accepts the SPP, the Commonwealth shifts the refused SPP into the pool).

States	TFAR _i	O _i	G _i	G _i + O _i	D _i	Total Grants Received
A	100	40	60	100	0	100
B	100	0	100	100	0	100
Total	200	40	160	200	0	200

Source: Commonwealth Grants Commission (1990, Appendix J, p. 176).

The examples show that the level of general revenue funding is a residual, calculated after deducting all relevant tied grants from a state's financing requirement. Hence, if a state gets relatively less assistance through Specific Purpose Payments, it receives relatively more general revenue assistance (compare examples (ii) and (iii) to (i)).

The effects of this methodology are salient. The constraint that matching tied grants are expected to exercise over recipient governments has been largely removed. The only Specific Purpose Payments that are going to affect States' broad budgetary choices are those that force them to provide a given service at a level above that which would be freely chosen (that is, those within the corner solution of Diagram 5), and those matching grants that result in a level of service provision above the Commonwealth Grants Commission's assessed standard.

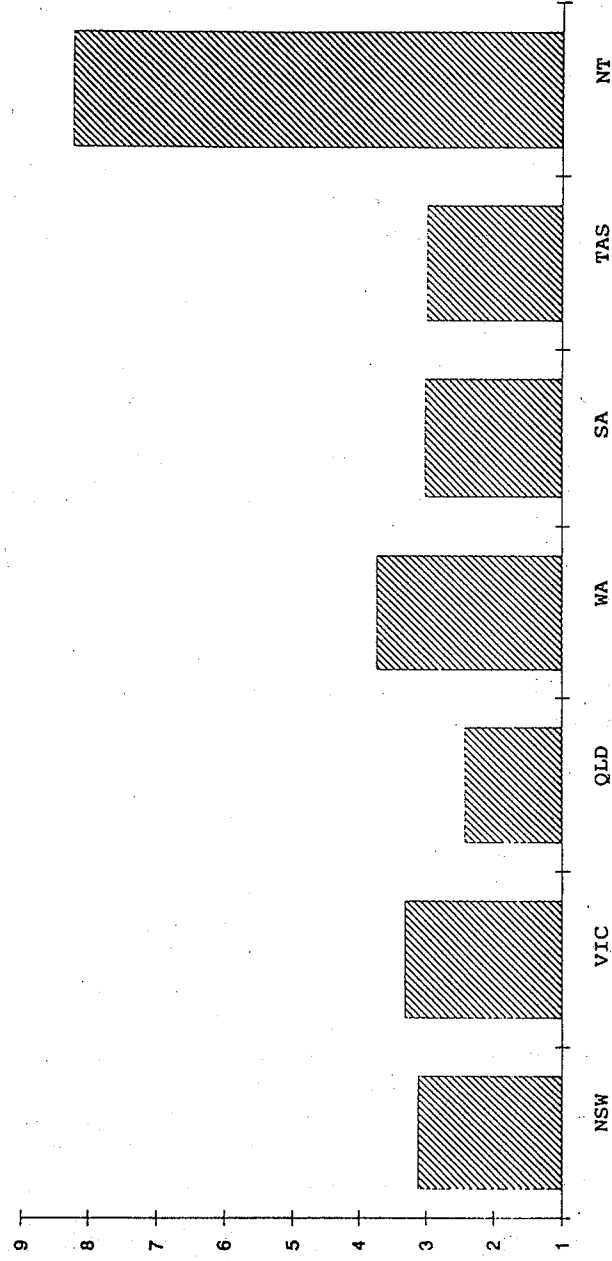
This is not to say that the other conditions attached to Specific Purpose Payments covering detailed administrative and statistical requirements have no impact on States. They raise the cost of producing public services, and hence, are likely to reduce the level of service delivery to the community.

5. THE IMPACT OF SPECIFIC PURPOSE PAYMENTS ON STATE BUDGETARY CHOICES

This section relates the above discussion to the Australian data. Diagrams 7 to 9 below show the ratio of State discretionary expenditure - comprised of expenditure from own-source revenue and Financial Assistance Grants, plus Specific Purpose Payments without matching conditions - to Specific Purpose Payments without matching conditions for each State and the Northern Territory in three broad expenditure categories - health, education, and industry assistance - for 1988-89.

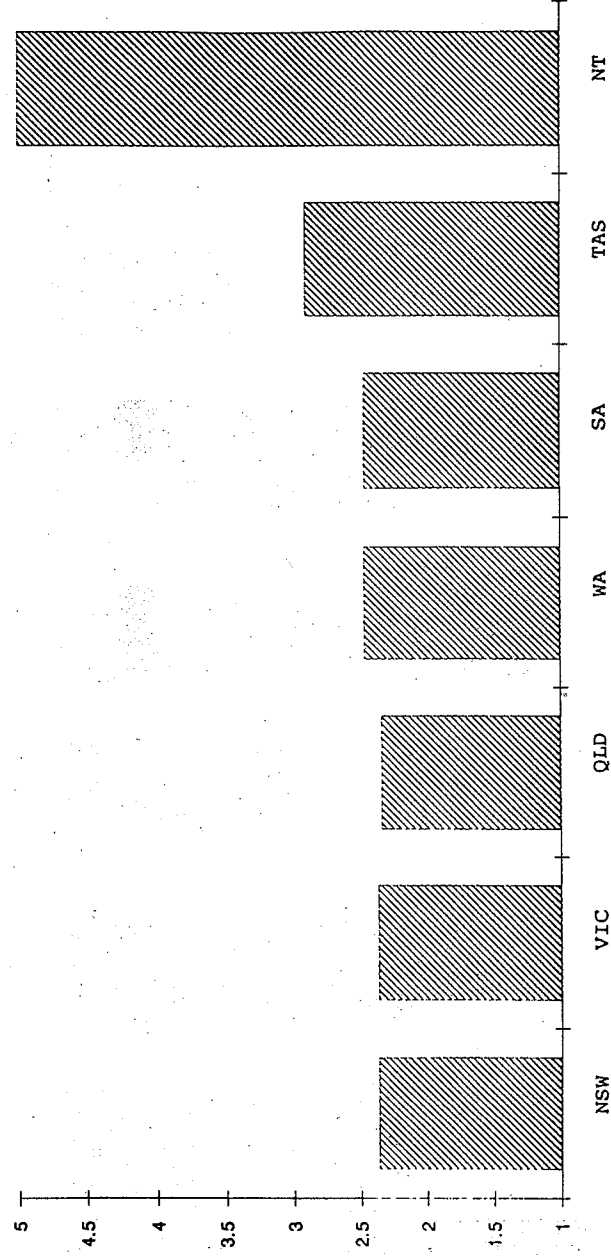
Although fiscal equalization means that matching tied grants are also effectively fungible, they have been excluded from the analysis (both the value of the grants and the States' matching contributions). A more intensive focus on the issue of whether States' budgetary choices are being constrained can be accomplished by concentrating on Specific

DIAGRAM 7: RATIO OF STATE DISCRETIONARY EXPENDITURE AND UNMATCHED SPECIFIC PURPOSE PAYMENTS TO UNMATCHED SPECIFIC PURPOSE PAYMENTS, HEALTH, 1988-89



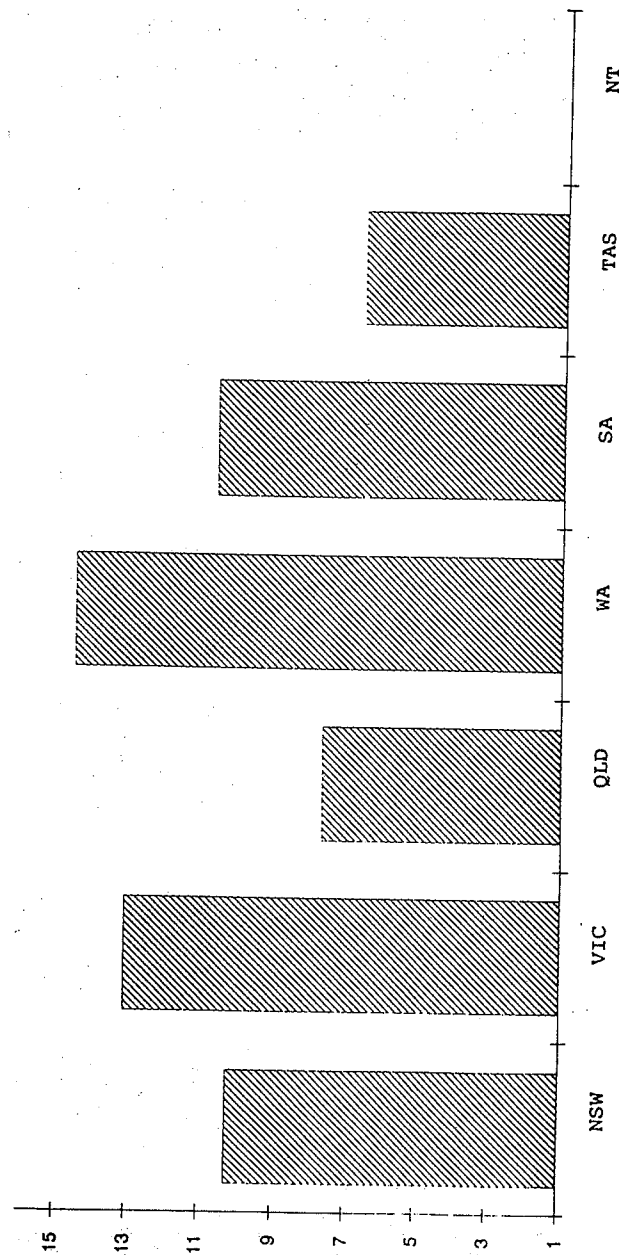
Source: Commonwealth Grants Commission (1990); State and Commonwealth Budget papers.

DIAGRAM 8: RATIO OF STATE DISCRETIONARY EXPENDITURE AND UNMATCHED SPECIFIC PURPOSE PAYMENTS TO UNMATCHED SPECIFIC PURPOSE PAYMENTS, EDUCATION, 1988-89



Source: Commonwealth Grants Commission (1990); State and Commonwealth Budget papers.

DIAGRAM 9: RATIO OF STATE DISCRETIONARY EXPENDITURE AND UNMATCHED SPECIFIC PURPOSE PAYMENTS TO UNMATCHED SPECIFIC PURPOSE PAYMENTS, INDUSTRY ASSISTANCE, 1988-89



Source: Commonwealth Grants Commission (1990); State and Commonwealth Budget papers.

Purpose Payments without matching conditions. Also, the relative importance of matching tied grants is quite small.

The diagrams do not support claims that the States' budgetary priorities are being forcibly altered. Put another way, there is no evidence to suggest that States' expenditure in these program areas would fall below the levels demanded by the community, if funding was via unconditional grants rather than Specific Purpose Payments. This assumes that the Commonwealth has accurately measured community demand in deciding the level of tied funding for these program areas.

To sustain an argument for retaining tied funding in these broad areas, the ratio of expenditure would need to be, a priori, in the range 1:1 to 1.5:1. The only instance of that is in respect of industry assistance for the Northern Territory. This is due to the pervasive influence of the Power and Water Authority grants, which have been recently scaled down. In all other instances, the discretionary expenditure ratio is at least 2:1. The diagrams also suggest wide variability in funding choices between States.

This apparent variability in funding choices among program areas is more clearly demonstrated in Table 3 below. The co-efficient of variance for the broad categories (which cover the full gambit of State general government activity) are quite high. Even the large categories of health and education show a wide disparity on average spending per capita across the States. Queensland spends only \$462 and \$590 per capita respectively on education and health, whereas Victoria chose to spend \$714 and \$647 per capita on these items. Both policy areas are covered by a plethora of Specific Purpose Payments. They have not hampered Queensland in any discernible way from offering below-average levels of services. This emphasizes the fact that the breadth and format of Specific Purpose Payments do not impede States from offering divergent policy menus. The policy over-riding nature of the Commonwealth Grants Commission's fiscal equalization procedures at the aggregate level is confirmed by this table.

Gerritsen (1988) has analysed State Budget outcomes in another context (to assess Stevenson's staple theory approach to explaining regional differences in Australia). His results, nevertheless, are interesting as they lend support to this paper's hypothesis. He showed that fiscal

**TABLE 3: STATE NET EXPENDITURE BY CATEGORY, 1988-89
(IN AGGREGATE AND PER CAPITA TERMS)**

Category	State NSW	VIC	QLD	WA	SA	TAS	Co-effic. of variance
Pop'n ('000)	5,735.3	4,289.5	2,785.1	1,568.4	1,416.0	449.4	
Aggregate expenditure (\$ million):							
Education	3,462.3	3,061.6	1,641.9	1,030.6	952.6	329.5	
Culture and Recreation	195.9	125.5	94.1	86.6	84.7	28.8	
Health	3,538.6	2,773.3	1,287.2	1,097.7	911.8	284.8	
Welfare svcs	457.3	400.9	178.6	197.2	144.8	44.4	
Law and order	1,117.2	771.5	467.7	381.7	298.0	91.2	
Other	1,864.1	1,580.0	772.1	814.5	715.2	237.5	
Total	10,636.0	8,712.8	4,441.6	3,608.3	3,107.1	1,016.2	
Per capita expenditure:							
Education	603.7	713.7	589.5	657.1	672.7	733.2	9.3%
Culture and Recreation	34.2	29.3	33.8	55.2	59.8	64.1	46.8%
Health	617.0	646.5	462.2	699.9	643.9	633.7	13.5%
Welfare svcs	79.7	93.5	64.1	125.7	102.3	98.8	25.2%
Law and order	194.8	179.9	167.9	243.4	210.5	202.9	14.3%
Other	325.1	368.3	277.2	519.3	505.1	528.5	33.7%
Total	1,854.5	2,031.2	1,594.8	2,300.6	2,194.3	2,261.2	15.1%

Note: Northern Territory has been excluded, because its very high per capita costs due to the sparseness of its small population severely bias the results. The A.C.T. has been excluded, because it is not yet included in the relativities assessments of the Commonwealth Grants Commission. Weighted averages have been used throughout.

Source: Commonwealth Grants Commission (1990, Appendix K).

centralisation has not encouraged inter-state uniformity, and that the States are not as homogeneous to the extent assumed by some observers (e.g., see Self, 1989, pp. 76-77). Gerritsen considers four possible sets of explanation for the differences he observes in State Budget outcomes: socio-economic structure, issue cycles, political partisanship, and the system of fiscal federalism. He presents a strong case for the fourth reason - fiscal federalism - being the biggest factor.

Of course, there may be particular programs where the level of discretionary expenditure in some States beyond that funded through the relevant Specific Purpose Payment is quite minimal. If so, the Specific Purpose Payment may be justified if it can be shown that the value of that grant is the minimum necessary for ensuring that the service is provided at the level the community demands. Otherwise, there is no economic rationale for tied funding.

So, why do Specific Purpose Payments persist?

6. SOME POSSIBLE EXPLANATIONS FOR THE PERSISTENCE OF SPECIFIC PURPOSE PAYMENTS

This section considers three possible explanations for the persistence of tied grants. These are:

1. governments seek to minimize the competitive pressures that federalism is designed to promote;
2. the impact of costs in the governmental decision process;
3. Beer's notion of functional federalism.

These explanations converge on the notion that government can have the capacity to behave in a way analogous to that of a self-interested maximizer. Its motives may not necessarily be congruent with those of the electorate. In this context, widespread use of tied grants may be construed as evidence that the polity is pursuing its own objectives, rather than those of the wider community. In this endeavour, politicians and bureaucrats may be involved in mutually advantageous partnerships with political or departmental clients, or pressure groups. Such arrangements, if aimed at securing benefits for the traders at the expense

of the non-traders (in this case, the voters), point to dangers not unlike those associated with "logrolling" (See Riker and Brams, 1973).

In the tradition of Hobbes (1651, pp. 250-264), Brennan and Buchanan (1980, pp. 137-141) argue that, unless constrained by constitutional rules and the normal electoral processes, "leviathan" monopoly government will seek to maximize taxation revenue for its own ends, rather than for providing governmental services to the citizenry. Politicians and bureaucrats are perceived as having similar motives in this regard. Accordingly, Brennan and Buchanan see great danger in unrestrained majoritarian rule. The following equations reflect their position:

$$Y_k = R - G \quad (1)$$

$$Y_k = (1 - @) R \quad (2)$$

where R is total tax revenue, @ is the proportion of that revenue spent on the public services G, and Y_k is the surplus available for the polity.

Through its dispersal of political authority, federalism is an indirect means of imposing constraints on the potential fiscal exploitation of leviathan government. This potential varies inversely with the number of competing governmental units at each subnational level. The more jurisdictions the better, because citizens will have wider choice, and greater opportunity for migrating to their preferred jurisdiction (as migration costs will be reduced vis-a-vis the fiscal surplus Y_k).

Gerritsen (1990) turns this argument around to argue that, because of the great distance between Australia's major population centres, citizens may use the different levels of jurisdiction to "shop" for policy choices, rather than choose horizontally between jurisdictions at the same level.

In this world of leviathan government, intergovernmental grants are a negative factor, with the exception of those grants for equalization purposes. Their objective is to increase the capacity for government to avoid the competitive element federalism is supposed to provide. Traditional justifications for intergovernmental grants, such as spillovers and economies of scale in tax administration, are rejected because they "presume government is a benevolent despot". Brennan and Buchanan (1980, pp. 180-185) instead contend that there will be constant pressure by competitive subnational governments to secure institutional

arrangements, such as tied grants, that moderate these pressures. Uniform taxation across all jurisdictions is highly prized by the lower levels of government because it removes one major element of the governmental process. This eliminates the possibility of services being provided in an earmarked benefit tax format, making it easier for government to cloud the true cost of services from the electorate. The normative implications are clear. Revenue sharing in any form is undesirable, because it subverts the primary purpose of federalism: to created competition between jurisdictions.

It has been suggested that the Australian Constitution was deliberately framed in a manner aimed at minimizing tax competition between States. Shapiro and Petchey (1991, p. 5) claim, on the basis of their reading of the Constitution and conventions, that the colonies were quite aware of the effective constraint tax competition exercised over their activity. By handing over to the Commonwealth in 1901, what was the major revenue instrument (customs and tariffs) in exclusivity, and the other taxation powers on a concurrent basis, the States formed a "fiscal cartel" in return for an appropriate share of the additional revenue raised. The Constitutional guarantee that three-quarters of customs revenue would be transferred back to the States for the first ten years of federation may be positively interpreted in this context, as could the 1927 Loan Council agreement.

Secondly, there is the question of the costs of providing public services. This is alluded to in Brennan and Buchanan's analysis through their notion of the fiscal surplus. This surplus includes maintenance of the administrative machinery. A more explicit consideration of costs in the delivery of governmental services in a federal context is that of Breton and Scott (1978, pp. 7-12). There are organisational (supply) and demand costs:

1. the supply costs are imposed by government: administration costs internal to a bureaucracy, and co-ordination costs between bureaucracies (5);

(5) For an authoritative account of the critical need for effective co-ordination of inter-governmental programs, see Jeffrey L. PRESSMAN and Aaron WILDAVSKY (1979).

2. the demand costs are incurred by citizens: signalling costs such as participating in pressure groups and making political representations, and mobility costs (6).

These costs are incurred because of economies of scale in the delivery of public services, and because these services display the characteristics of non-private goods which, on occasion, involve spillover effects. The demand costs reflect the fact that it takes time, effort and money for citizens to register their views with government. Nevertheless, it is these activities that act to constrain government in its policy implementation from avoiding the will of the public, and usurping the fiscal surplus.

Breton and Scott (1978, pp. 142-151) interpret grants as a means of matching assigned revenue and allocation functions. Unlike Brennan and Buchanan, they see efficiency advantages in, at least, some revenue collection being centralised to capture economies of scale. In this context, grants can be regarded as "contractual tax disbursements". This, however, only explains the existence of grants, *per se*, not tied grants.

Breton and Scott go further, suggesting that if the focus is shifted to the assignment of expenditure functions and, if cost minimization dictates centralized revenue collection, then grants could be interpreted as "contractual payments for implementing expenditure policies" - irrespective of whether they be tied or unconditional. Programs with high co-ordination costs will tend to be centralized, and those with low co-ordination costs will be decentralized. The crucial point is that it is the nature of the revenue arrangements, based on apparently reasonable economic grounds, which are the driving force behind the formulation of expenditure arrangements. The revenue-rich central government can "trade" in expenditure functions through tied grants. It can buy functions from lower levels of government, causing the delivery of those programs to be at levels it prefers.

The form of payment preference will not be strong among the donor politicians. But given that organisational arrangements form the basis of

(6) This cost reflects the fact that the notion of shifting to another jurisdiction to attain a more preferable mix of governmental and private goods and services is not costless. The notion of "voting with the feet" originates from the seminal article by Charles M. TIEBOUT (1956).

bureaucrat's income and power (Niskanen, 1971), central government bureaucrats will prefer the payment to be in a conditional form, as this presents greater scope for expanding the administrative components of the budget.

Recipient politicians, on the other hand, generally prefer the payments to be unconditional, as this provides greater budget flexibility. Again, however, their bureaucrats - especially those in functional agencies - will prefer conditional grants because of their greater administrative requirements.

In contrast to Brennan and Buchanan, Breton and Scott do perceive differences in the motives of politicians and bureaucrats. The underlying principle, nevertheless, is similar: there are forces inherent within the structure of government institutions that, if unchecked, may seek to advance interests inimical to those of the community at large.

Beer (1977, pp. 30-33) suggests that the ascendancy of the technocracy has resulted in a marked shift of influence away from the private sector of politics - voters, pressure groups, and political parties - towards the public sector itself - politicians and bureaucrats. Again, the flavour of his remarks is that the underlying philosophy of federal democracy is being subverted.

He states that central government draws heavily upon the vast specialized and technical knowledge within its bureaucratic ranks for conceiving and executing new programs. These programs may, on occasion, be administered via tied grants. The presence of professional civil servants is not exclusive to the central government; however. The state bureaucracies are also staffed by technocrats. Strong vertical connections develop between bureaucratic colleagues across levels of government, which is not surprising given that they "talk the same language". Beer calls this trend "functional federalism". The traditional concept of autonomy between levels of government breaks down in the face of these powerful cross-jurisdictional alliances. Federal and state bureaucrats use fiscal instruments like tied grants to institutionalize their relations, and, to that extent, enable themselves to avoid the inquisitive eye of their respective governments' central agencies and the

electoral and constitutional rules designed to constrain such collusive behaviour.

These hypotheses picture tied grants as a tool for maximizing the ability of government agencies to increase their domain by virtue of the expanded administrative and co-ordination activity intergovernmental programs offer. Such activity is, of course, at the expense of the community, as there will be less tax revenue available for actual service delivery. The Commonwealth Grants Commission (1990, p. xix) estimates that about \$50 million in administrative savings are available from collapsing Specific Purpose Payments into block grants or Financial Assistance Grants - with no discernible impact on States' capacity to deliver governmental services to the public.

The existence of spillover effects is not, of itself, sufficient to justify providing tied grants. An effective way of demonstrating the need for a particular tied grant would be to reformulate Wicksell's (1896) value-countervalue theory for deciding the level of public services into an intergovernmental grant context, such as :

- if the net benefits to be gained from providing a tied grant to States - that is, the benefits in terms of more appropriate levels of service provision by States less the additional running costs incurred by the Commonwealth in administering the program - are greater than

- the net benefits of providing the funds through Financial Assistance Grants, which have no marginal administrative costs, and provide benefits at levels commensurate with States' individual priorities.

7. CONCLUSION: PLACING THIS ANALYSIS IN A CONSTITUTIONAL FRAMEWORK

This essay has presented some theoretical insights into the likely effects of Specific Purpose Payments, and the impact of the Commonwealth Grants Commission's "inclusion" method for treating these payments in calculating States' general revenue funding relativities. Three broad conclusions can be deduced from these arguments:

1. Specific Purpose Payments generally have little effect on State's spending priorities, because of the interaction between their effects on these spending options and the Commonwealth Grants Commission's fiscal equalization procedures.
2. There are two categories of Specific Purpose Payment where there may be some impact on State's funding choices: those that raise a program's provision level above that of "the corner solution" and Specific Purpose Payments with matching conditions that raise a program's provision level above the Commonwealth Grants Commission's Standard Budget assessment. Continuation of these Specific Purpose Payments is only justified if it can be proven that the Commonwealth knows better than the States how much of a given service is being demanded by the community (say, because of interjurisdictional spillovers), and can provide - through the use of tied funding - greater net benefits to the community than those available through general revenue funding.
3. There are likely to be real benefits available both to the community and the Commonwealth budget from abolishing Specific Purpose Payments in favour of greater general revenue funding or, if you agree with Brennan and Buchanan, passing some taxation powers back to the States to reduce vertical fiscal imbalance.

These conclusions, and the theoretical discussion from which they were derived, do not address the question of the constitutional influence in shaping the structure of Australia's fiscal federalism - including the prominence of Specific Purpose Payments. The earlier reference to Shapiro and Petchey's (1991) interpretation of Section 90 of the Constitution alluded to this, however, and is the starting point for my final remarks.

If their interpretation is correct (that is, the colonies moved to unite partly for the purpose of forming a fiscal cartel to reduce tax competition among themselves), then the question arises as to what has been the real purpose of Section 96?

Before answering this, however, there is another constitutional factor that needs to be reviewed. Section 51 of the Constitution lists the joint, or concurrent, powers of the Commonwealth and States (in which the Commonwealth takes precedence in the event of policy conflicts), and Sections 52 and 90 list most of the Commonwealth's exclusive powers. Galligan and Uhr (1990, pp. 314-315) contend that this division of powers has three important consequences for understanding Australian federalism:

1. the powers of the Commonwealth and States are formally and directly interrelated, notwithstanding the contrary impact of the High Court's strictly legalistic interpretative method of reading the Constitution;
2. because of the concurrent nature of the Section 51 powers, the actual balance of power between the Commonwealth and the States depends on how active the Commonwealth is in pursuing its concurrent powers;
3. the Australian federal system is one of shared and overlapping powers.

Bringing Section 90 together with the various constitutional powers to interpret Section 96 places it in a different light to the traditional view. Section 96 could have been framed to provide a vehicle for the Commonwealth to continue to share revenue from the fiscal cartel, after the original ten year constitutional customs arrangement terminated. These new arrangements would be capable of being organised in such a manner that the Commonwealth could use Section 96 to "buy" responsibility for certain concurrent functions off the States. This would relieve the States not only of unwanted tax competition, but also of relatively unwanted policy functions. This could enable States to expand programs of greater interest to themselves.

Tied grants provide the framework for lower levels of government to expand their operations, at little apparent cost to themselves, and for revenue-rich central governments to "shop" for new policy functions in which to be involved.

If this constitutional interpretation is reasonable, then there is cause to ponder the real level of constraining influence written into Australia's

federal constitution - as opposed to the idealized models of Brennan and Buchanan and others. It may be that for effective reform of federal fiscal relations to occur in Australia, the constitution may need to be altered to ensure that revenue and expenditure powers at each level of government are approximately matched or, at a minimum, that formal revenue sharing arrangements are included in the constitutional contract.

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