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**Special Edition: State Funding Reform in the Australian Federation**

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# Fiscal equalisation and State incentive for policy reform

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## 1. FACILITATING STATE POLICY REFORM

Australia's approach to allocating Commonwealth untied grants to States and Territories (the States) has given their equitable allocation precedence over issues such as efficiency, revenue stability, regional asymmetric shocks, accountability and transparency<sup>2</sup>. In recent years, the Commonwealth has left the determination of what is an equitable allocation of untied grants to the Commonwealth Grants Commission (CGC) who advises it on their allocation. An explanation for this approach might be that while ever States cannot agree on an alternative, the Commonwealth is not motivated to impose a different fiscal equalisation methodology to that applied by the CGC. However, there is reason to expect that in the future the Commonwealth might take a different view as evidence grows of pressure for a rethinking of current grant arrangements. This evidence includes:

1. *Recommendation 108 of Australia's Future Tax System (AFTS 2009)* that: 'The Productivity Commission should examine the principles of public service delivery and the mechanisms that are available to governments to deliver public services and their implications for financial arrangements in the federation. The findings of this study should be considered by COAG'. <[http://www.taxreview.treasury.gov.au/content/downloads/final\\_report\\_part\\_1/00\\_AFTS\\_final\\_report\\_consolidated.pdf](http://www.taxreview.treasury.gov.au/content/downloads/final_report_part_1/00_AFTS_final_report_consolidated.pdf)>
2. *2010-11 Australian Government Budget Paper No. 3*. (11 May 2010): In the 2010-11 Budget, the Australian Government stated that: 'Horizontal fiscal equalisation does not guarantee that the States will provide a uniform standard of service – its aim is to equalise the capacity of each State to do so, while leaving each State free to determine the standard of service provision.....Under the *National Health and Hospitals Network*, Australian Government funding for public hospitals will be based on the efficient price of public hospital services, determined by an independent pricing authority.' (p7)
3. *The Treasury Incoming Government Brief - Red Book Part 1* (August 2010) statement that 'reforming State taxes also presents an opportunity to deliver[deleted 'y'] a significant increase in long term productivity' and that 'The fiscal

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<sup>2</sup> See Warren (2010a, 2010b) for an overview of the issue leading to this observation.

equalisation process does not promote reform' (p21).

<<http://www.treasury.gov.au/contentitem.asp?ContentID=1875&NavID>>

4. The holding of the current *Senate Select Committee on the Reform of the Australian Federation*  
<[http://www.aph.gov.au/Parliamentary\\_Business/Committees/Senate\\_Committees?url=reffed\\_ctte/index.htm](http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=reffed_ctte/index.htm)>
5. The recently announced (9 February 2011) House of Representatives Joint Committee of Public Accounts and Audit (JCPAA) *Inquiry into National Funding Agreements*  
<[http://www.aph.gov.au/Parliamentary\\_Business/Committees/House\\_of\\_Representatives\\_Committees?url=jcpaa/natagree/report.htm](http://www.aph.gov.au/Parliamentary_Business/Committees/House_of_Representatives_Committees?url=jcpaa/natagree/report.htm)>
6. Recent COAG discussion on health funding (13 February 2011) which saw considered a proposal for health specific purpose grants (specific purpose grant) and States own-source funded expenditure to be 'pooled' for redistribution amongst States using an activity based model and agreed levels of servicing  
<[http://www.coag.gov.au/coag\\_meeting\\_outcomes/2011-02-13](http://www.coag.gov.au/coag_meeting_outcomes/2011-02-13)>
7. Recently tabled (28 February 2011) Private Member's Bill *Auditor-General Amendment Bill 2011* which proposes amending the *Auditor-General Act 1997* to require amongst other things that the Commonwealth Auditor-General audit State agencies in receipt of Commonwealth grants<sup>3</sup>.  
<<http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22legislation/billhome/r4527%22>>
8. *Review of GST Distribution* (30 March 2011): When announcing the Review, Prime Minister Julia Gillard stated that 'Instead of States facing penalties for economic growth and rewards for economic underperformance, the GST distribution process should encourage economic reform and better delivery of services, and provide States with certainty.' Also that 'The review will lead to a simpler, fairer, more predictable and more efficient distribution of the GST to States and Territories.'<sup>4</sup>

Current intergovernmental fiscal arrangements are clearly under greater scrutiny by the Commonwealth Government and Parliament. The stimulus for this increased scrutiny appears to have two primary sources. Firstly, a perceived lack of transparency in current arrangements and what this has meant for State accountability for grant funded outcomes and secondly, for the incentive States have to embrace their own reforms or those funded through Commonwealth initiatives and delivered by States.

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<sup>3</sup> In particular, this is in response to the Auditor-General being 'limited with respect to money allocated to states and territories through national partnership agreements and other means, such as natural disaster payments or Building the Education Revolution payments. The Auditor-General is limited in jurisdiction in following the money trail and making sure that value for money and efficiency are being delivered.', Hansard, House of Representatives, Australian Parliament 28 February 2011, p17  
<[www.aph.gov.au](http://www.aph.gov.au)>

<sup>4</sup> See <<http://www.gstdistributionreview.gov.au/>>

This paper will examine whether there is an alternative grant design to that applied in Australia which is capable of better reflecting the lessons learnt in other countries with decentralised governments (Section 2). Attention will be focussed on how to design a grant structure which directly acknowledges how different approaches to allocating grants interact (Section 3) and potentially adversely impact on the incentives for States to embrace policy reform (Section 4). Focus will then be given to the policy areas of taxation (Section 5) and health (Section 6) and how a changed untied grant design could improve transparency, accountability and the incentive for States to undertake reforms.

## 2. LESSONS IN INTERGOVERNMENTAL GRANT DESIGN

In a recent review of fiscal federalism in twelve countries, a number of broad design lessons were identified as applicable to all decentralised governments. In particular, that:<sup>5</sup>

- (1) There be clear assignment of responsibilities;
- (2) Various levels of government have clear and agreed roles and limits on their authority;
- (3) Finance should follow function;
- (4) Governments face the financial consequences of their decisions;
- (5) Intergovernmental transfers strengthen (a) accountability, (b) competitiveness and (c) equity;
- (6) Accountability to citizens be achieved through transparent performance standards and redress mechanisms for citizens;
- (7) Institutional arrangements exist to manage intergovernmental conflicts; and there be
- (8) Periodic joint review of arrangements.

It is generally acknowledged in Australia that assignment of responsibilities across levels of government is unclear and confusing (1). Also accepted is that there is a lack of clarity as to the roles of and limits on the authority of the different levels, this being most apparent in the areas of health, education and the environment (2). With States raising just on 15% of all taxes but responsible for 41% of all government expenditure (in 2008-09), this substantial vertical fiscal imbalance means finance clearly does not follow function (3). The risk is that breaking the link between revenue and expenditure can result in each level of government not having to face the financial consequences of its decisions (4). In practice in Australia, this lesson is learnt as evidenced by the role of the Loan Council, the annual Loan Council Allocation and each State's own policies on budget transparency (Warren 2010b, pp27-28).

Failure to learn lessons (1) (2) and (3) has contributed to States sometimes claiming their inability to deliver the services demanded by the community is due largely to inadequate intergovernmental fiscal transfers. Here blame has been attributed by States to both the level of transfers from the Commonwealth and to their distribution between the States. A consequence is confusion by citizens as to who is accountable (5a) for policy outcomes – the Commonwealth or their State. This is not helped by

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<sup>5</sup> See the concluding lessons observed by the editors from the diverse experiences of the twelve federal countries reviewed in Shah (2007).

unclear performance standards for each level of government and unclear redress mechanisms for dissatisfied citizens (6).

Where Australia performs better is through its focus on achieving equity (5c) and having in place institutional arrangements designed to manage intergovernmental conflicts (7) through the Council of Australian Government (COAG) process. However, a weakness is with the apparent lack of readiness to periodically undertake joint reviews of arrangements (8). Rather, the Commonwealth Grants Commission which advises the Commonwealth on general (untied) grant allocation, is typically left to undertake periodic reviews – usually every five years – but not of a fundamental nature. While Australia appears to have learnt the lessons in (4) (5c) and (7), this could not be said for (1) (2) (3) (5a) (5b) (6) or (8).

The focus of this paper will be on the Australian federation's performance against international lessons (5) and (6) and how current intergovernmental transfer arrangements could be redesigned to provide States with an incentive to undertake policy reforms designed to improve efficiency and accountability.

Understanding how to simultaneously strengthen accountability, efficiency and equity of intergovernmental transfers requires an understanding of the conceptual issues guiding the development of different grant structures. Section 3 outlines how despite the complex grant design applied in Australia, it is in effect equivalent to a grant regime where all grants are pooled and allocated on horizontal fiscal equalisation principles. The effect is to compromise State accountability (5a) and efficiency (5b) as well as to make unclear from where a citizen's redress should be sought (6). As Section 4 will indicate, if Australia is to learn lessons (5) and (6), it must consider a fundamental re-examination of current grant design and distribution arrangements.

### 3. GRANT DESIGN AND FISCAL EQUALISATION

With decentralised government, it is almost inevitable that gaps will arise in the respective expenditure responsibilities and net revenue capacities both between and across levels of government. Typically, the national government is in a surplus revenue position while sub-national governments are revenue deficient. This arises from sub-national governments having access to often limited, small or weak own-tax bases or being 'crowded out' of a tax base by the actions of the national government. Even if each sub-national government could fund its activities from own-sources (so that there is no vertical fiscal gap<sup>6</sup>), asymmetries might exist between them as a result of their differing economic, social, political and demographic circumstances (resulting in a horizontal fiscal gap).

This could require the national government to make grants designed to ensure sub-national governments are funded in such a way as to provide a similar level of service given a similar tax effort. In this case, the grant would be designed to equalise a sub-national government tax and/or service capacities resulting in an equitable outcome. Such an outcome can also be affected by removing the pressure for low tax capacity

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<sup>6</sup> There is an important distinction to be made between vertical fiscal imbalance (VFI) and vertical fiscal gap (VFG) in the literature. VFI is the difference between VFG and the actual level of funding from other governments designed to fund VFG. In effect, VFI relates to the under funding of VFG. See Shah (2006 p18), and Boadway and Hayashi (2004).

sub-national governments to impose higher tax rates to fund comparable service levels to other governments. Grants can also be designed to address shocks which have asymmetric impacts across sub-national governments due to their widely differing structures.

What is less often clear in practice is just how the different grants which are designed to achieve the objectives of equity, efficiency and stabilisation, can interact and potentially undermine the original intent of each grant. As observed by Bergvall *et al* 2006 (pp112-113): ‘An important cause of inefficiency in many countries is the use of the same grant for various purposes, for instance, subsidisation grants that simultaneously attempt to equalise, or financing grants that simultaneously attempt to subsidise.’ Inefficiencies can also arise when different grants are used to achieve a similar purpose, as with funding health both through specific purpose grants based on a particular objective and general purpose grants distributed on equalisation principles.

What can result is a lack of transparency as to how an objective is being met and with it an erosion of accountability and ultimately a compromising of equity objective in the allocation of all grants (Lesson 5). An important consequence of this lack of transparency might be to erode the willingness of sub-national governments to embrace policy reforms where there are uncertain benefits.

A possible solution is to make explicit the objectives and principles that underpin each type of grant and to identify and acknowledge how any interaction between different grants potentially compromises their respective objectives. Two basic strategies are possible in response: one is to identify and measure these interactions and the other is to prevent them. The difficulty with the former approach is that each grant could interact with and impact on other different grants. Even if in theory their interactions could be identified, in practice information asymmetries may result in advantages to some grant recipients which limits the scope for monitoring grant funded outcomes. The other option for limiting the unintended interaction between the different grants is to directly limit these between grant interactions.

To appreciate the nature of these interactions and how they might be limited in practice, Figure 1 presents schematically a simple *all* grant allocation framework. The schematic assumes that the national government has an available ‘pool’ of resources to address sub-national government funding objectives. This ‘pool’ can then be divided into general purpose grants (A in Figure 1) and specific purpose grants (B). While specific purpose grants are designed to address issues such as spillover effects from sub-national government expenditure or the effects of asymmetric shocks, general purpose grants are most often focussed on the objective addressing vertical fiscal gap and horizontal fiscal gap through applying fiscal equalisation principles.

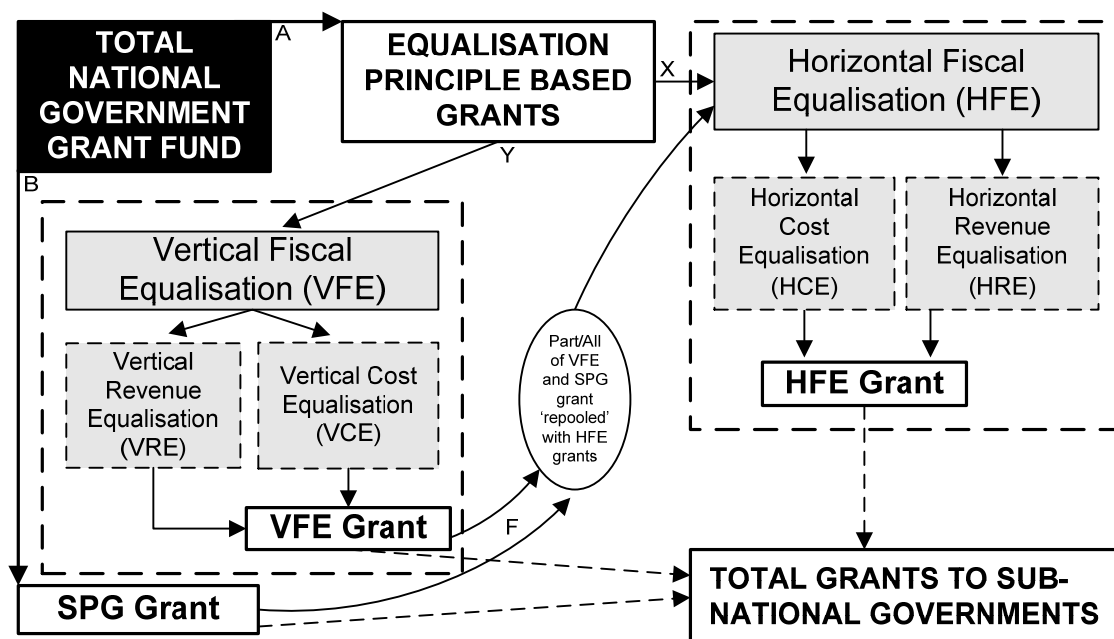
In practice, however, fiscal equalisation is implemented in many different ways across OECD countries<sup>7</sup>. This gives rise to the second distinction in Figure 1 which centres on how the available general purpose grant is distributed to sub-national governments. A distinction is made here between vertical fiscal equalisation (VFE) and horizontal

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<sup>7</sup> See OECD *Working Papers* 1 to 12 prepared for the OECD *Fiscal Federalism Network* by the OECD Centre for Tax Policy and Administration at [http://www.oecd.org/findDocument/0,3770,en\\_2649\\_35929024\\_1\\_119684\\_1\\_1\\_1,00.html](http://www.oecd.org/findDocument/0,3770,en_2649_35929024_1_119684_1_1_1,00.html) and Warren (2011)

fiscal equalisation (HFE). VFE is designed to allocate the general purpose grant between sub-national governments on criteria such as disparities in expenditure needs or fiscal capacity, to achieve some national government specified desired outcome such as *minimum* expenditure or a guaranteed average fiscal capacity. It is not unusual to have such grants earmarked, matching, or performance related. In contrast, strict HFE is about having sub-national governments with higher-than-average tax capacity and lower cost structures contributing to an equalisation fund from which sub-national governments with lower-than-average tax capacity or higher cost structures can benefit.

Figure 1 Grant Allocation and Fiscal Equalisation



Source: Based on Figure 1 in Warren (2012)

The methodology adopted in determining VFE and HFE grant allocations may in practice be very similar – differing only in how it is applied. For example, vertical revenue equalisation (VRE) and horizontal revenue equalisation (HRE) could both be based on the assessed revenue measured as the average national tax rate applied to their share of the base of a particular tax (defined as revenue from a Representative Tax System). A general purpose grant distributed on VRE principles, for example, could then fund a particular sub-national government to ensure it received at a *minimum*, assessed revenue equal to the average national per capita assessed revenue from various revenue sources. In contrast, HRE would fund those below the average national per capita assessed revenue through a *redistribution* from those sub-national governments with above the average national per capita assessed revenue. Similarly, a particular expenditure could be funded through vertical cost equalisation (VCE) to ensure *minimum* national average per capita assessed expenditure after taking into account cost disabilities in delivering services across sub-national governments. In contrast, horizontal cost equalisation (HCE) would be focussed on those sub-national governments with below national average per capita assessed expenditure *contributing* to those with above national average per capita assessed expenditure.

While Figure 1 is not definitive in terms of all possibilities, it does represent the most common approaches to national governments allocation of the total grant 'pool' to sub-national governments. Two facts are clear from this Figure: firstly, that specific purpose grants cannot be considered in isolation from general purpose grants and secondly, that general purpose grants can, like specific purpose grants, be distributed according to a multiplicity of principles. Combined, this might result in the ultimate impact of the allocation of the total grant pool being neither transparent nor able to ensure accountability, let alone result in efficiency and equity improving outcomes.

The remainder of this paper will focus on the Australian grant allocation framework, the implications of such inter-grant interactions and whether any policy disincentives effects which might arise could be minimised by restructuring the current approach.

#### 4. INCENTIVISING STATE POLICY REFORM

In Australia, the CGC, when advising the Commonwealth on how to allocate general purpose grants based on HFE principles, adopts a 'five pillars' approach (Warren, 2010a):

Pillar 1 a State's *financial capacities*, not its performance or outcomes;

Pillar 2 what States collectively do (on average);

Pillar 3 *policy neutrality* or a State's own policies or choices should not directly influence its grant;

Pillar 4 *practicality*; and

Pillar 5 *contemporaneity*, delivering relativities most appropriate to the application year.

An important outcome of this CGC approach is to effectively pool specific purpose grants and general purpose grants and allocate this pool on HFE principles (Warren 2012, 2010a). This is most simply represented by F in Figure 1, which is the proportion of specific purpose and VFE allocated grants added directly to a State's fiscal capacity when determining the allocation of general grants distributed on HFE principles.

A direct consequence of this approach is that, through the interaction of these different grants, the original objective of the specific purpose and VFE grants is undermined. So too is any attempt to encourage policy reform through these grants. By treating specific purpose and VFE grants as just another funding source when allocating general grants on HFE principles, any outcomes sought from these grants will be overridden through the allocation of general purpose grants. Complicating this result is the fact that most of the benefit arising from State policy reform will flow through to both other States (through its impact on HFE grants) and to the Commonwealth through increased revenue (Warren 2010a).

A possible strategy to address this outcome is to quarantine specific purpose and VFE grants from general purpose grants allocated using HFE principles (by setting  $F=0$  in Figure 1). In effect this would ensure the current CGC approach to 'repooling' all Commonwealth grants is replaced with an approach which ensures 'depooled' grants are independent (and therefore 'depooled') from general grants allocated on HFE principles.



An advantage of quarantining the allocation of different grants in the 'pool' from each other is that it enables one to 'see through' the grant (as an input) directly to the outcome (or output). What results is a simpler and more transparent approach which would improve accountability by ensuring any individual grant in the 'pool' designed to achieve some outcome/output performance conditions can be more readily monitored and assessed. By limiting the interaction between different types of grants, unintended consequences can also be minimised, such as when specific purpose grants or the benefits from reforms are redistributed away from the State because of how general purpose grants are allocated. It could also enable more of the benefits of reform to accrue to the reforming State.

As Blöchliger and Charbit 2008 (p9) observed, 'the amount of equalisation grants a State loses if it increases its own tax revenue varies considerably across countries; however, on average sub-national jurisdictions have to dedicate more than 70% of additional tax revenue to equalisation'. Such high rates are a significant disincentive to government effort to increase their revenue base (Wurzel 2003).

In fact, assuming tax capitalisation, there could arise an incentive for some States to increase their tax rates to reduce their tax base and subsequently obtain higher equalisation grants (for Australia: Dahlby and Warren, 2003; for Canada: Smart, 2007, for Germany: Büttner, 2006). Also, if the grant allocation was based on an equalisation formula which was not comprehensive, States could 'avoid taxes that enter the formula and select taxes that do not, resulting in a distorted sub-national tax structure. Lenient tax effort, especially if tax administration is under sub-national control, may also be a result of high equalisation rates' (Blöchliger and Charbit 2008, p9).

Grant interactions may also result in a development trap for poor regions. Policy reforms designed to grow their economy with any downside-risk would be unattractive since any gains would confront a 100% marginal equalisation tax rate until they pass the floor or some minimum entitlement (Baretti, Huber and Lichtblau 2000, Garnaut and Fitzgerald 2002). One solution proffered is to exclude taxes strongly related to development from the equalisation formula – as with taxes on resources in Canada which are designed to encourage resource development in poorer (Atlantic) provinces. A risk with this approach is that it could result in strategic tax setting by those regions. However, this could be overcome by making some grant entitlements related to policy results such as certain sectoral growth performance, rather than wealth creation. It is also reasonable to expect that the incentive a State has to grow its economy and yield greater benefits to the State will provide an overwhelming incentive to States to continue to grow their economies despite the loss in grants through the equalisation tax (Schneider 2002).

Nonetheless, the benefits from (inefficient) State 'strategic behaviour' designed to maximise its grant share should be minimised. Here, adopting comprehensive approaches to revenue and cost equalisation or by adopting measures which are independent of State actions<sup>8</sup> is important. However, any adverse consequences of comprehensiveness must be minimised. It is here that the Australian approach to

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<sup>8</sup> For a discussion of these issues see Blöchliger and Charbit (2008) and Bergvall, Charbit, Kraan and Merk (2006).

allocating the total grant pool has come under challenge for failing to ensure that governments face the financial consequences of their decisions (Lesson 4); for weakening not strengthening accountability, competition and equity (Lesson 5); and for undermining accountability through a lack of transparent (and simple) performance standards with redress mechanisms for citizens (Lesson 6).

If history is any lesson, introducing the approach outlined above could confront political resistance across the States. However, the inertia against change can be overstated. As highlighted in Section 1, there is a growing recognition that change is necessary to current intergovernmental fiscal arrangements. This is also clear in the commentary by States such as New South Wales, Victoria and Western Australia in their submissions to various CGC Reviews. It is also clear from inquiries in various States<sup>9</sup> and recommendations by business groups<sup>10</sup>.

In the following two sections, the scope for the framework outlined above to facilitate reform in the areas of income taxation and health will be examined.

## 5. INCOME TAX BASE SHARING

Despite Australian States having the power to impose income taxes, they have not imposed such taxes since the Commonwealth introduction of the uniform income tax legislation in 1942 as a war measure with States compensated through the provision of grants. Post-war, States proposed reintroducing income taxes but were subsequently threatened with the loss of these grants on a dollar-for-dollar basis for any tax revenue raised. In the late 1970s and 1980s, the Commonwealth moved to allow States to impose surcharges on the Commonwealth personal income tax but opted not to. AFTS(2009)<sup>11</sup> supported such an approach on the proviso that the Commonwealth 'make room' for States which it would not do when this option was previously available to States.

However, even if the Commonwealth was to 'make room' for States, the application of HFE principles by the CGC when allocating general purpose grants would remove any real incentive for States to countenance such a proposal (Warren 2010a). In essence, this is because the marginal equalisation rate is excessively high.

In response, Warren (2010a) proposed five options to remove this HFE 'trip' to economically efficient State tax reforms:

- (1) Quarantine additional revenue from selected State tax reforms;
- (2) Quarantine any Australian Government tax reform incentive grants;
- (3) Limit CGC redistribution of any agreed fiscal dividend through backcasting<sup>12</sup>;

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<sup>9</sup> For example, New South Wales Government in IPART (2008), Victoria (2010), and was a motivating factor for Tasmania (2011) and the Garnaut and FitzGerald (2002) Review sponsored by NSW, Victoria and Western Australia.

<sup>10</sup> For example, see Business Council of Australia (2007) and NSW Business Chamber (2008).

<sup>11</sup> AFTS 2009, Pt 2, Vol 2, p675.

<[http://www.taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs\\_reports.htm](http://www.taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm)>

<sup>12</sup> Major changes to methodology, policies and data are responded to by the CGC through using a process described as backcasting, where the changes in any one year are applied *as if* they were in operation in earlier years across which the State relativities are being estimated. The impact of the change occurs on

- (4) Institutionalise compensation; and
- (5) Adopt a flexible Pillar 2 through a partial move to ‘what States ought to do’ rather than ‘what States do’ on taxation.

It is (5) that the UK government is soon to introduce as part of its recently revised funding arrangements with Scotland. Here, ten percentage points of the UK Personal Income Tax basic and higher rates on the Scots is attributed to Scotland whether or not it decides to set that rate above or below ten percentage points (Warren 2010c). In effect, this is an application of VRE principles with ‘average’ and imputed rather than actual rate and where higher (or lower) than the ‘average’ rate is effectively ignored and to the benefit (or cost) of the State. In Canada, VRE is applied through a province’s per capita equalisation entitlement being equal to the amount by which their fiscal capacity is below the average fiscal capacity of all provinces – known as the ‘10 province standard’. Those provinces with above average fiscal capacity receive no equalisation entitlement<sup>13</sup>.

At present in Australia, States with a tax capacity (or tax base) below the per capita national average receive transfers from States with an average per capita above the national average. States are therefore assumed to impose the tax at the national average tax rate. If a State increases its rate above the average, the CGC assumes in Pillar 3 that it will benefit wholly from any revenue above the average. In practice, however, Pillar 3 is not independent of ‘what States do’. While small changes in rates will only infra-marginally impact grant entitlements, this is not so with substantial rate increases or major tax reforms (as noted in Warren 2010a).

If instead an approach was taken which operated on the VRE principle with the average set at ‘what ought to be’, then a State would have no reason not to impose the minimum and every reason to increase their rate above the average – since this would not be subject to equalisation. In Canada, such an arrangement effectively applies to natural resource revenues. Provinces receive a grant equal to the greater of either the amount they would otherwise receive by fully excluding natural resource revenues, or by excluding 50% of natural resource revenues. This adjustment to equalisation ensures that provinces receiving revenue from natural resources receive a net fiscal benefit from their resources equivalent to half the per capita resource revenues of the receiving provinces<sup>14</sup>. This is a conceptual approach which Western Australia has long argued for to the CGC in relation to its resource royalties revenue.

With VRE, each State has a clear incentive both to grow its economy (due to a potentially zero marginal equalisation tax rate) and to impose rates greater than ‘what ought to be’. States would then have real and significant discretionary fiscal powers through their access to substantial revenue sources such as through access to a broad based personal income tax.

However, if this new substantial tax and related VRE pool were treated as just another revenue source when determining general purpose grant shares using HFE principles,

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a one-off basis with any transitional arrangements relating being excluded from the CGC process through quarantining any one-off compensation. See discussion in Warren(2010, p316).

<sup>13</sup>See <<http://www.fin.gc.ca/fedprov/eqp-eng.asp>> and discussion in <<http://www.eqtf-pfft.ca/english/EQTreasury/annex04-1.asp>>

<sup>14</sup>ibid

then these benefits would be undone. For this reason, the VRE pool and related tax would need to be quarantined and accompanied by complementary adjustments to the coverage of expenditure when applying HFE principles.

While it could be argued that a State might have an incentive to retain a tax base disability, this is unlikely to be the case with taxation as far more is to be gained from growing the economy than just the loss of the Commonwealth disability compensation. In this case, VRE would be equitable, efficient and transparent.

VRE need not replace HFE principles when allocating the general purpose grant pool. Rather, VRE principles could be applied to part of the 'pool' with the objective of providing the framework in which incentives are made available to States to encourage their adoption of major tax reforms such as a State income tax. A significant benefit also would be the attention such an approach draws to the benefits of reform and the scope to reduce vertical fiscal gap and minimise the inefficiencies arising from the redistributive effects of addressing horizontal fiscal gap.

## 6. HEALTH FUNDING REFORMS

While there might not as yet be an active public debate directly on the issue of funding the federation, there is in effect an active debate on the need to improve State public service delivery. It was in fact just this debate which motivated the health reform discussion at the 13 February 2011 COAG meeting. In the eleven-page communiqué following the meeting (*Heads of Agreement – National Health Reform*), 'transparency' was mentioned fourteen times and 'performance' fifteen times<sup>15</sup>. The issue is that health is both a State and a Commonwealth priority and funded by States through own-source revenue, and by the Commonwealth through specific purpose grants and by States allocating a proportion of their general purpose grants to health.

In the case of health specific purpose grants, three basic principles find application: equal per capita (EPC); vertical cost equalisation (VCE) and horizontal cost equalisation (HCE). EPC is where grants are based on population shares, VCE is where funding is for those States with *below* some average level of service provision given cost disabilities, and HCE is where funding enables States to achieve some average level of service provision given cost disabilities.

VCE is the most common approach across OECD countries for allocating grants to fund expenditure (Blöchliger and Charbit 2008). In Australia, all three approaches find application. Health specific purpose payments (SPP) are allocated on an EPC basis and national partnership payments (NPP) for health are allocated on a needs/cost basis and reflective of Commonwealth priorities and are in effect allocated on VCE principles. The general purpose grants (equal to the GST revenue) are then allocated on HFE principles which are underpinned in the case of the expenditure side, by HCE principles.

The trade-off with cost equalisation is that it can create inefficiencies (disincentives) through leading States to influence their needs (and disadvantage) with the goal of increasing their equalisation grant. This is possible because the cost of service

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<sup>15</sup> See <[http://www.coag.gov.au/coag\\_meeting\\_outcomes/2011-02-13/docs/communique\\_attachmentA-heads\\_of\\_agreement-national\\_health\\_reform.rtf](http://www.coag.gov.au/coag_meeting_outcomes/2011-02-13/docs/communique_attachmentA-heads_of_agreement-national_health_reform.rtf)>

delivery is far more complex than revenue capacity issues and therefore more open to abuse. This complexity can therefore lead to rent seeking and pressure from special interests for particular grants.

One solution has been to earmark cost equalisation grants but this can be inefficient as grant entitlements are most often input rather than output- or outcome-based. As Blöchliger and Charbit (2008, p16) noted:

Earmarking reduces sub-national choice and can lead to distorted sub-national budget allocation, especially if grants cover many small budget items. Moreover, if earmarked grants are matching sub-national spending – so-called matching grants – their equalising effect is likely to be weak or even negligible. If national government is to retain control over the proper use of equalisation funds, it can do better through appropriate public service regulation such as minimum standards or output and performance indicators, while leaving operation and management of fiscal resources at the discretion of local and regional governments.

Earmarking grants also only weakly assists regional disparities. The evidence shows that poor regions are less willing or able to respond to Commonwealth matching grants while wealthy regions tend to reduce their own expenditure when receiving such grants. An alternative to earmarking grants is to link equalisation general purpose grants with regulations such as minimum standards or output and performance indicators.

Inefficiencies can also arise from the interaction between grants. The CGC is, for example, aware (Morris 2002, pp322-23) that by offsetting (unquarantined) Commonwealth specific purpose grants received by each State against that State's 'Total Requirement for Financial Assistance', the CGC methodology effectively undoes the intended specific purpose grant distribution arising from any special negotiations between the Commonwealth and the States. In effect, what the CGC does is add back (or repools) specific purpose grants into the general purpose grant 'pool' ( $F=1$  in Figure 1). The key issue is that regardless of how the health specific purpose grant is allocated (EPC, VCE or HCE) or not (when general purpose grant is increased accordingly), if it is assumed that  $F=1$  then the final distribution of the total grant 'pool' (general purpose grant and specific purpose grant) will remain unchanged. If, however, the health specific purpose grants are allocated on EPC or VCE principles and then quarantined ( $F=0$ ), the original intent of these grants is maintained. This is because quarantining both the specific purpose grant and the related assessed health expenditure removes them from consideration when determining the relativities applied when allocating general purpose grants.

If it happened that the health assessed expenditure was on an EPC basis, then it would not matter if health specific purpose grants were allocated on an EPC basis. In this case, including or excluding health specific purpose grants and related expenditure would be of no consequence to relativities. However, this is an exceptional case.

As a general rule, only quarantining a specific purpose grant and related expenditure will maintain the original distribution of the specific purpose grant. However, while this ensures States spend their specific purpose grant on the designated expenditure, if the specific purpose grant was without matching conditions, the State could still reduce that States own-source revenue allocated to health expenditure. In this case

there is no reason why States would not change their total level of actual health expenditure and therefore total assessed health expenditure. A remedy is for the Commonwealth to replace its input focussed specific purpose grants with matching conditions or outcomes/outputs performance conditions. In the latter case, States would be indirectly forced to match specific purpose grants so as to achieve Commonwealth specified outcomes/outputs and benefit from any reward regimes (or not be impacted adversely by penalties for non-performance).

A benefit of this particular approach for the Commonwealth is to force actual and assessed State health expenditure to become aligned since 'what States do' would become 'what States ought to do' according to the Commonwealth. With such an outcome, debate over whether to quarantine the health specific purpose grant and related expenditure might be unimportant if the general purpose grant methodology adopted to determine assessed health expenditure aligns with the Commonwealth desired outputs/outcomes. However, if States opt to fund health at levels above 'what ought to be', then a general purpose grant allocation methodology based on 'what is' could act to redistribute the health specific purpose grant. In practice, the simplest and least controversial approach would be to quarantine the health specific purpose grant from the HFE principles-based allocation of general purpose grants, thus removing any scope for the specific purpose grant allocation to impact on the general purpose grant. In essence, that the specific purpose grants be defined as an earmarked matching quarantined grant accompanied by output/outcome performance conditions (such that  $F=0$  in Figure 1 and related expenditure removed from consideration in HFE).

The 13 February 2011 Commonwealth-State proposal on health went one step further than this recommendation, effectively defining the specific purpose grant 'pool' as total health expenditure, whether funded from a specific purpose grant, general purpose grant or State own-revenue<sup>16</sup>. This health 'pool' was to be determined based on an agreed volume of activity and an efficient price. States would then be funded from this pool to deliver an agreed volume of services at an efficient price. If the State's cost of delivery is below the efficient price, the State can retain the savings. If it is above, they can either increase their funding of health from own-sources or provide less service. An incentive therefore exists to deliver services at the efficient price.

The health funding proposal is therefore conceptually similar to the VCE principle in Figure 1. However, if the proposed VCE grants and associated health expenditure are not quarantined ( $F=1$ ) from inclusion in the CGC HFE methodology, the CGC's advice to the Treasurer on the allocation of general purpose grants amongst States has the potential to undo the original intention of the COAG health proposal, since 'what States ought to do' will differ from 'what States do' (Pillar 2). This is particularly important since the COAG proposal is about outcome and outputs (through performance requirements) whereas the CGC approach is all about expenditure (costs and needs) and therefore inputs. Ensuring the VCE principle is maintained would require the health grant and related expenditure to be removed ( $F=0$ ) from consideration when the CGC estimates how to allocate general purpose grants. This

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<sup>16</sup>See <[http://www.coag.gov.au/coag\\_meeting\\_outcomes/2011-02-13/docs/communique\\_attachmentA-heads\\_of\\_agreement-national\\_health\\_reform.pdf](http://www.coag.gov.au/coag_meeting_outcomes/2011-02-13/docs/communique_attachmentA-heads_of_agreement-national_health_reform.pdf)>

quarantining would also need to extend to any rewards or penalties relating to performance. Not to do so would work to remove any desired behavioural response by individual States (which is why current performance payments under current health NPPs are quarantined as explained previously).

The VCE approach to health also has the advantage of addressing an ongoing criticism of the CGC HFE methodology that Pillar 2 rewards disability, doing nothing to encourage States to reduce it – an accusation most commonly made of States with large indigenous populations<sup>17</sup>. If VCE grants fund ‘what States ought to do’, have attached performance conditions, and are quarantined from consideration when allocating general purpose grants, then addressing disability is unavoidable. What results from applying the VCE principle in Figure 1 where  $F=0$  is an outcome which aligns with agreed objectives (such as equity and efficiency outcomes) which are transparent (in being readily understood) and ensure accountability (through outcome performance monitoring).

## 7. CONCLUSION

The objective of this paper has been to highlight how greater attention given to the interaction between the various intergovernmental grants could make clearer the currently blurred roles and responsibilities within the Australian federation. This is especially problematic where there is not only shared funding of programs, but shared delivery. What could result from a better understanding of these interactions is better performance against the desirable criteria of accountability and transparency at the sub-national level of government.

It was also shown that through grant design which explicitly acknowledges the interaction between grants with State policies, major reforms in the area of income tax base sharing and health reforms could become potentially more attractive for sub-national governments. Complementing this knowledge with action to ensure the integrity of any agreed reward/penalty arrangements and to limit any apparent disincentive effects, would do much to encourage States to embrace reform which is in both their and the national interest.

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<sup>17</sup> Warren (2010a) also argues the CGC methodology is best suited to a steady-state evaluation and not well suited to periods of major reform because the fiscal equalisation mechanism can work against change and only with direct Commonwealth involvement (through changing the CGC TOR and supplemental funding for States) can these limitations of fiscal equalisation be overcome.

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