



OECD Economics Department Working Papers No. 541

**Fiscal Relations Across
Levels of Government
in Australia**

**Vassiliki
Koutsogeorgopoulou**

<https://dx.doi.org/10.1787/316586754225>

Unclassified

ECO/WKP(2007)1

Organisation de Coopération et de Développement Economiques
Organisation for Economic Co-operation and Development

23-Jan-2007

English - Or. English

ECONOMICS DEPARTMENT

ECO/WKP(2007)1
Unclassified

FISCAL RELATIONS ACROSS LEVELS OF GOVERNMENT IN AUSTRALIA

ECONOMICS DEPARTMENT WORKING PAPERS No. 541

By Vassiliki Koutsogeorgopoulou

All Economics Department Working Papers are available through OECD's internet web site at:
www.oecd.org/eco/Working_papers

JT03220724

Document complet disponible sur OLIS dans son format d'origine
Complete document available on OLIS in its original format

English - Or. English

ABSTRACT/RESUME**Fiscal relations across levels of government in Australia**

Key areas of public service provision in Australia are subject to complex patterns of joint government involvement that can lead to inefficiencies. Clarifying government roles and responsibilities is likely to have a significant potential for improving public sector efficiency. Fragmentation of decision making and funding arrangements, particularly in the areas of hospital services and old-age care, creates incentives for cost and blame-shifting between government levels. A collaborative approach between government levels to overcome some of these problems, as recently initiated by the Council of Australian Governments, would help to develop better governance arrangements and improve spending assignments. A less complex system of inter-governmental transfers would also contribute to a more effective specification of spending responsibilities. Stronger revenue-raising capacity of the states, through a further improvement in the efficiency of the state tax system, would raise the ability of sub-national governments to meet expenditure responsibilities and be better prepared for coping with demographic change.

JEL classification: H1; H77

Keywords: Australia; fiscal federalism; vertical imbalance; horizontal equalization.

This Working Paper relates to the 2006 OECD Economic Survey of Australia (www.oecd.org/eco/surveys/australia).

Les relations budgétaires entre niveaux d'administration en Australie

La fourniture des principaux services publics en Australie fait intervenir des formules complexes de compétence partagée qui peuvent être source d'inefficience. Le secteur public pourrait sensiblement gagner en efficience si l'on clarifiait les missions et les compétences des différents niveaux d'administration. Le morcellement de la prise de décision et des dispositifs de financement, surtout pour les services hospitaliers et les soins aux personnes âgées, favorise les transferts de coûts et la déresponsabilisation dans les rapports entre niveaux d'administration. Une démarche fondée sur la coopération pour régler certains de ces problèmes, comme celle récemment engagée par le Conseil des gouvernements australiens, contribuerait à la mise en place de structures de gouvernance plus efficaces et à une meilleure affectation des dépenses. Un système moins complexe de transferts entre niveaux d'administration permettrait également de mieux préciser les responsabilités en matière de dépenses. Si les États avaient davantage de capacités de recettes, en améliorant encore l'efficience de leurs systèmes fiscaux, les autorités infranationales pourraient mieux faire face à leurs obligations de dépenses et seraient mieux préparées au changement démographique.

Classification JEL : H1 ; H77

Mots clés: Australie ; fédéralisme budgétaire ; déséquilibre budgétaire vertical ; peréquation budgétaire horizontale.

Ce Document de travail se rapporte à *l'Étude économique de l'OCDE de l'Australie 2006* (www.oecd.org/eco/etudes/australie).

Copyright OECD, 2007

**Application for permission to reproduce or translate all, or part of this material should be made to:
Head of Publications Service, OECD, 2 rue André-Pascal, 75775 Paris Cedex 16, France.**

TABLE OF CONTENTS

ABSTRACT/RESUME	2
FISCAL RELATIONS ACROSS LEVELS OF GOVERNMENT IN AUSTRALIA	5
Australian federalism: the main features.....	6
Issues concerning the allocation of spending responsibilities.....	16
Issues in funding arrangements for sub-national governments	21
Strategies to secure fiscal discipline	28
Concluding remarks and policy recommendations	30
Bibliography	32

Tables

1. Australian states: summary statistics	7
2. Mix of state and local government taxes.....	23

Figures

1. Indicators of decentralisation: an international comparison.....	9
2. Decomposition of public expenditure by function and government level	10
3. Sources of tax revenue	11
4. The vertical fiscal imbalance: a comparison with other federations.....	12
5. Australian Government payments to sub-national governments	14
6. Recurrent taxes on immovable property	24
7. The impact of horizontal fiscal equalisation	26

Boxes

Box 1. The division of powers	8
Box 2. The Goods and Services Tax: a Commonwealth or a state tax?.....	12
Box 3. Specific purpose payments	15
Box 4. Horizontal fiscal equalisation: main features	16
Box 5. Division of government responsibilities in health care, education and training.....	18
Box 6. The controversy over the vertical fiscal imbalance	21
Box 7. Horizontal fiscal equalisation and economic efficiency: main issues	28
Box 8. Australian Loan Council: main features and reforms.....	29
Box 9. Recommendations for improving fiscal relations across levels of government	31

FISCAL RELATIONS ACROSS LEVELS OF GOVERNMENT IN AUSTRALIA

by

Vassiliki Koutsogeorgopoulou ¹

1. The Australian federation was set up in 1901 and is among the world's oldest, after the United States (1789), Switzerland (1848) and Canada (1867). It is characterised by: *i*) widespread joint government involvement in most functional areas; *ii*) the presence of a vertical fiscal imbalance (*i.e.* disparities between the powers to raise revenue and to finance service delivery at different levels of government), which is addressed by federal transfers to the sub-central governments; *iii*) a comprehensive system of horizontal fiscal equalisation, aimed at eliminating disparities between the revenue-raising capacity and spending needs of the sub-central jurisdictions; and *iv*) a co-operative approach to fiscal management, with borrowing at all levels of government under the oversight of the Loan Council.

2. The relatively high degree of joint inter-governmental responsibilities in major functional areas, such as health care and education, makes co-operation among the different levels of government particularly vital for cost-effectiveness. Building on earlier arrangements, the Council of Australian Governments (COAG) has recently endorsed a National Reform Agenda that focuses not only on competition and regulatory issues, but also includes human capital issues (health, education and training and work incentives). Setting clearly-defined roles and responsibilities, especially in the key area of health care and related services where there is much overlap, is imperative for enhancing the accountability of the various government levels and improving service delivery. In relation to the physical infrastructure aspects of the National Reform Agenda, an unusual feature is that regulating network industries is often the joint responsibility of the states and Commonwealth. Much progress has been made in this area, but infrastructure issues have again come to the fore, with infrastructure bottlenecks allegedly holding back exports. Industrial relations are also guided by federal and state systems, though the recent WorkChoices legislation implies a move towards a simpler national system.²

3. The presence of vertical imbalances, with the states relying on transfers from the Commonwealth, leads to design issues concerning the inter-governmental transfer arrangements to bridge the vertical fiscal gap - although such imbalances are not, by themselves, indicative of a problem (Productivity Commission, 2005a). Concerns include the potential for: undermining accountability to taxpayers for expenditure decisions; creating duplication and overlap in the provision

1. The paper was originally produced for the 2006 OECD *Economic Survey of Australia*, published in July 2006 under the authority of the Economic and Development Review Committee of the OECD. The author is indebted to Val Koromzay, Andrew Dean, Jorgen Elmeskov, Peter Hoeller, David Turner, Isabelle Joumard, Christopher Heady, Hansjoerg Bloechliger, Douglas Sutherland as well as many researchers and officials at different levels of government in Australia for valuable comments and/or discussions. I am also grateful to Desney Erb for technical assistance and to Celia Rutkoski for secretarial assistance.

2. For a discussion, see the 2006 OECD *Economic Survey of Australia* Chapters 4 and 5.

of services; constraining beneficial tax competition across jurisdictions; and weakening incentives for tax and microeconomic reform. Raising the states' revenue mobilisation capacity would be a step towards reducing the vertical fiscal gap.

4. Horizontal balance issues raise questions regarding the appropriateness of the current equalisation mechanism in terms of the equity it achieves against the potential efficiency losses and the cost of institutional complexity it entails. Concerns arise about the usefulness of extensive interstate fiscal equalisation given the relatively low pre-equalisation disparities.

5. Finally, benefits would arise from the strengthening of government financial reporting and the further improvement of the existing benchmarking framework.

6. The need for an efficient delivery of government services is heightened by the growing spending needs associated with population ageing which are projected by the Productivity Commission (2005b) to add aggregate spending of around 6.5% of GDP by 2044/45, in the absence of policy changes. The bulk of this fiscal pressure is expected to fall on the Commonwealth which is the main provider of health and aged care services and of old-age pensions. But demographic changes will also put pressure on state expenditure in the area of health-related services, and in particular hospital services. The overall fiscal burden is projected to be less severe than for the Commonwealth, however, because the states provide education services where expenditure pressures should recede.³ Specific purpose payments (SPPs) are important in terms of how the future fiscal burden will be distributed among the government levels, with the Commonwealth's share being highest if SPPs grow with service needs.⁴

7. This paper discusses areas of fiscal relations across levels of government that warrant further reform efforts and lays out policy options for improvement. The issues identified are common to all federations and finding a solution is a difficult challenge. What characterises Australia is the relatively high level of co-operation through the Council of Australian Governments that provides a mechanism to deal with problems when they are perceived to be serious. The first section provides background information on the key features of Australian federalism. It focuses on revenue and expenditure assignment and inter-governmental fiscal relations. The following sections present the main issues related to current spending, funding assignments and instruments to secure fiscal discipline. The last section provides some concluding remarks and a set of policy recommendations.

Australian federalism: the main features

The structure of government and division of power

8. Australia's federal system is three-tiered. It comprises the central government (the Australian government, formerly referred to as the Commonwealth government), the states (six states and two territories with state-type powers)⁵ and local governments (currently around 720) (Table 1). The

3. In particular, with the Commonwealth being a major provider of funding of private schools -- which are growing more rapidly than state-funded public schools -- the states face less expenditure pressure in the context of a gradually declining share of the population of school age.

4. In its report, *The Economic Implications of an Ageing Australia*, the Productivity Commission projects that if SPPs grow with service needs, 90% (5.7% of GDP) of the total fiscal pressure (6.5% of GDP) will fall on the Commonwealth and the remainder on states. The Commonwealth's share falls to around 80% if SPPs grow with GDP and to 60% if SPPs grow with inflation and population (Productivity Commission, 2005b).

5. The term "states" is used in the chapter to encompass the activities of both states and territories.

Constitution recognises the Commonwealth and the states. Local governments, which are governed by state legislation, play a very small role relative to other OECD countries, confined to services such as waste management, town planning, water supply and local roads.

Table 1. Australian states: summary statistics

In per cent of total

	Population ¹	Land area	GDP per capita ²
New South Wales	33.3	10.4	103
Victoria	24.7	3.0	101
Queensland	19.6	22.5	92
South Australia	7.6	12.8	88
Western Australia	9.9	32.9	115
Tasmania	2.4	0.9	75
Northern Territory	1.0	17.5	117
Australian Capital Territory	1.6	0.03	128
Australia	100.0	100.0	100

1. Estimated resident population in 2005.
2. GDP for 2004/05 in current prices. The GDP of the states is known as gross state product (GSP) in Australia.

Source: ABS (2005), *Australian Demographic Statistics* (cat. No. 3101.0) and *Australian National Accounts: State Accounts 2004-05* (cat. No. 5220.0); ABS (2006), *Year Book Australia: 2006* (cat. No. 1301.0).

9. Throughout the history of the federation there has been a general trend towards greater centralisation. The constitutional powers and responsibilities of the central and state governments are presented in Box 3.1. The increase in responsibilities at the Commonwealth level resulted from High Court decisions (for example, upholding the ability of the federal government to make grants to states contingent on them not utilising their income taxing powers, and the ban on the states levying a sales tax),⁶ referenda (as on indigenous population affairs) and referral of state powers (as with corporations laws), as well as through the Commonwealth's constitutional right to make grants to the states conditional on its policy priorities and objectives. The creation of the modern welfare state by the central government,⁷ along with the more recent need to develop national approaches in response to greater competition arising from globalisation and the fact that the Constitution provides for the concurrent exercise -- rather than for a clear separation -- of powers between the states and the Commonwealth have also contributed to the drift towards a more centralised system (Keating and Wanna, 2000). These developments, and especially the growth in conditional transfers in response to the greater taxation power of the Commonwealth, have led to the emergence of major functional areas of joint government responsibility and a complex pattern of expenditure.

6. Examples include the High Court's decision in the second uniform income case (1957), effectively confirming the 1942 judgment that the Commonwealth's exclusive power over the income tax base (constitutionally a shared base) could continue after the war; and the Court's broad interpretation of "excise duties" to incorporate all taxes on manufacture, distribution, and sale of goods, barring states from levying taxes on the sales taxes of goods (although they retained their ability to tax services) (Keating and Wanna, 2000; Madden, 2002; and Williams, 2005a).
7. The Constitution was amended in 1946 to give the Commonwealth legislative power with respect to "pharmaceutical, sickness and hospital benefits, medical and dental service". The only Commonwealth power in relation to health prior to this amendment was over quarantine matters.

Box 1. The division of powers

The Constitution adopted in 1901 confers on the Commonwealth only a few *exclusive* powers, such as the power of setting the rates of customs and excise duties, and coinage. However, it provides for a large number of areas where the Commonwealth can exercise powers *concurrently* with the state governments, although the central government has legislative supremacy in the case of inconsistency. These powers include taxation, social welfare, postal services and telecommunications, banking and insurance and industrial disputes that extend over state borders.

The state governments have (exclusive) responsibility over all other service areas, including housing and urban development, law and order, energy, rail and road transport, and health care and education. However, the Commonwealth can be involved in areas of state responsibility through the granting of financial assistance on terms and conditions it deems appropriate, as, for instance, in the health care and education areas.

Source: Craig (1997); Productivity Commission (2005a).

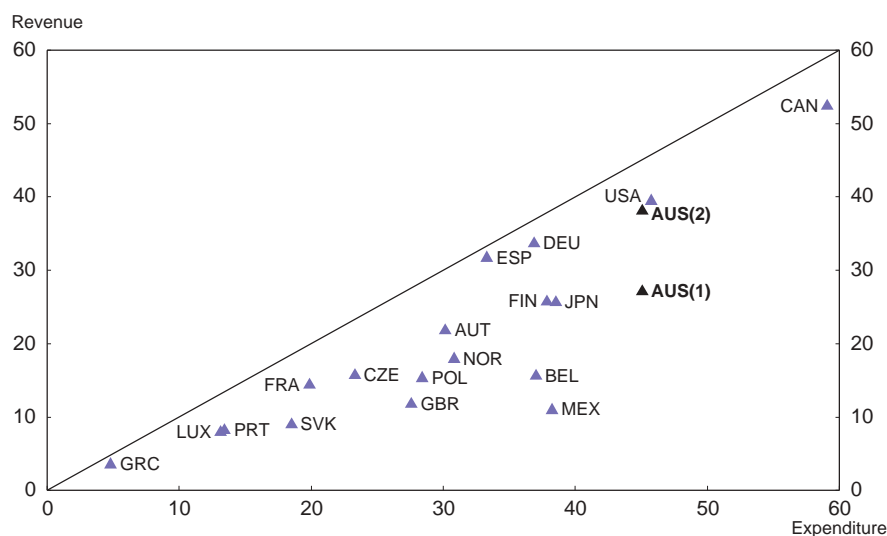
Spending and revenue assignments

10. Judged on the basis of their relative spending and revenue shares Australian sub-national governments are large in international comparison (Figure 1). They have considerable autonomy to set the level and composition of their expenditure, though there are some important exceptions,⁸ especially with regards to the matching requirements for tied grants (see below). Social and welfare spending is the largest Commonwealth own-purpose expenditure item (*i.e.* excluding earmarked grants to the sub-national governments), followed by health care and defence (Figure 2). The states have major responsibilities for education, accounting, along with health care, for over half of their spending. Local government outlays are concentrated on transport services, housing and community services, followed by general public services and recreational and cultural facilities, but amount to only 6% of public expenditure. The sub-national employment share is high, at approximately 84% of total public sector wage and salary earners and around 14% of all wage and salary earners, reflecting the state and local governments' responsibilities for service delivery in the areas of education, health care, transport and public order and safety (Australian Government, 2006).

8. In addition to the matching requirements for tied grants, these limitations arise from the Constitution itself (especially in relation to the federal government's role in defence and external affairs); state legislation (as it relates to defining the role of local government); and citizen's preferences with regard to public goods provided by the sub-national governments.

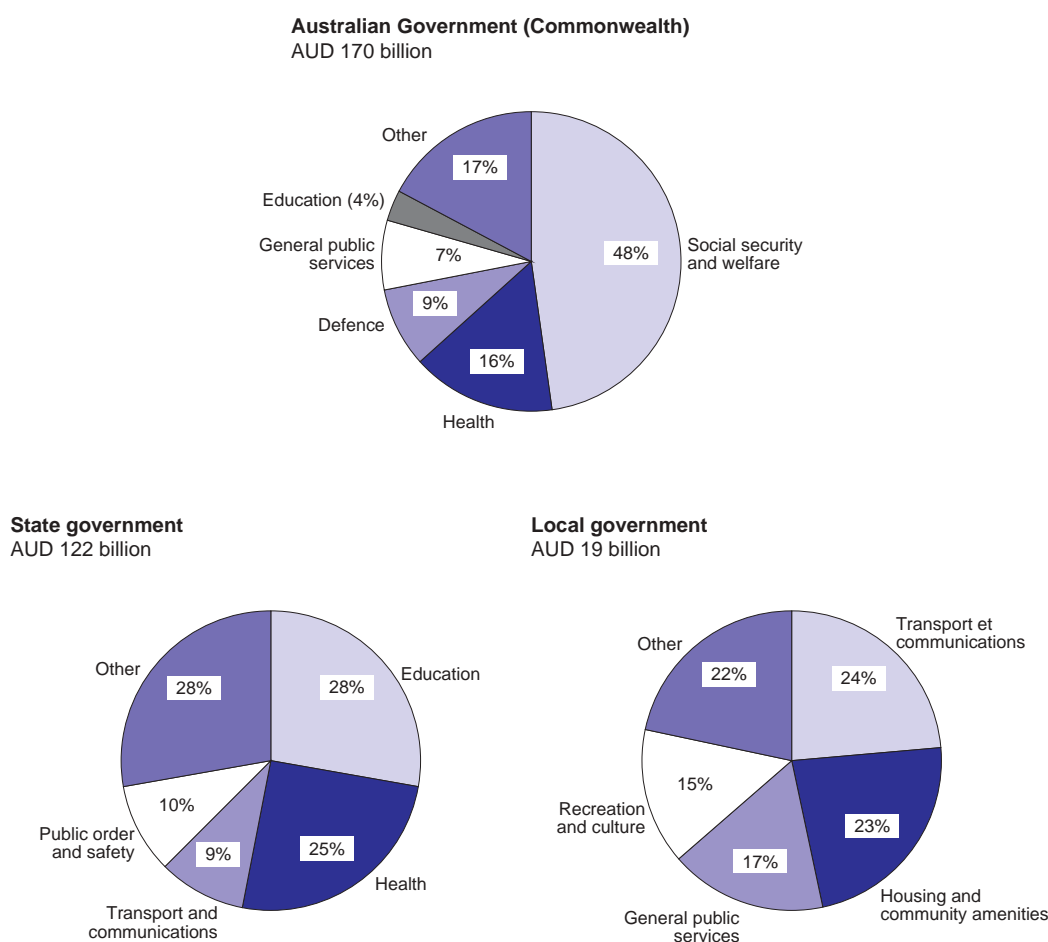
Figure 1. Indicators of decentralisation: an international comparison

Sub-national shares of revenue and expenditure in per cent of total general government, 2003 or 2004¹



1. 2002 for Mexico. Revenues include direct and indirect taxes as well as non-tax revenues received by regional and local governments. Transfers between government levels are netted out. The two data points for Australia show: 1) the Goods and Services Tax (GST) considered as a grant, and 2) GST considered as a state tax. For Norway data exclude revenues from oil production.

Source: OECD Annual National Accounts database, May 2006; Belgostat; Statistics Canada; Statistics Norway; US Bureau of Economic Analysis; ABS (2006), *Government Finance Statistics 2004-05* (cat. No. 5512.0).

Figure 2. Decomposition of public expenditure by function and government levelOwn purpose expenditure, 2004/05¹

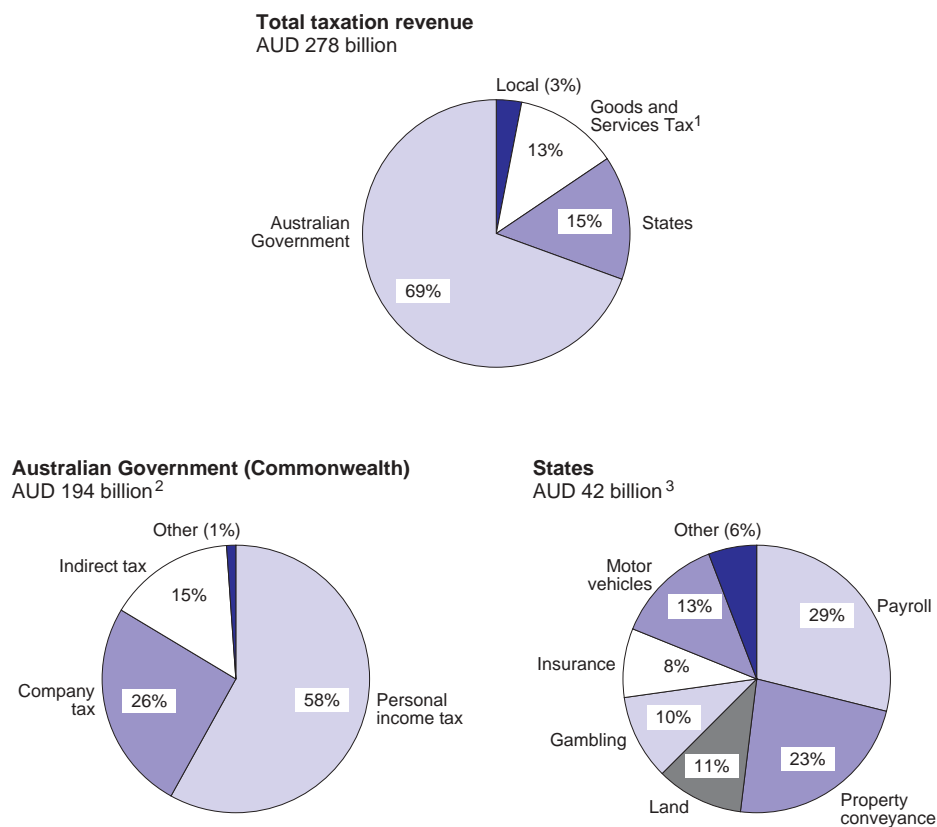
1. Australian Government excludes specific purpose payments (SPPs), state government includes SPPs to the states but excludes SPPs through the states to local government, local government includes SPPs.

Source: The Treasury, Australian Government and ABS (2006), *Government Finance Statistics 2004-05* (cat. No. 5512.0)

11. In contrast to the sharing of responsibilities on several spending categories, there is no co-occupancy of tax bases by the different levels of government. One exception is land property, a tax base which both the state and local governments share. The Commonwealth has control over some of the broadest tax bases, including personal and corporate income, customs and excises (Figure 3). It collects the revenue of the Goods and Services Tax (GST), implemented in July 2000, but transfers it entirely to the states. The statistical treatment of GST as a Commonwealth or state tax is therefore a matter of some controversy (Box 2). Sub-national governments have full autonomy to set their own tax rates and bases, with the major exception of the GST, for which changes in the base or rate require the unanimous support of the state governments, the endorsement of the Commonwealth and both houses of the Federal Parliament. Taxes on property (immovable property and financial and capital transactions) and payroll taxes account for a major share of total state tax revenue. At the local level, land taxes (known as rates) on property comprised around 40% of total revenue in 2003/04.

Figure 3. Sources of tax revenue

Per cent of total, 2004/05



1. All Goods and Services Tax (GST) revenue goes to the states to spend according to their own budgetary priorities. Whilst the GST is collected by the Australian Tax Office (ATO), it does so as an agent for the states with the states paying the ATO for the cost of collecting the GST.
2. Excluding GST revenue.
3. The GST raised AUD 35 billion in 2004/05, taking total state revenues to AUD 77 billion, but is excluded from this pie chart.

Source: ABS (2006), *Taxation Revenue Australia* (cat. No. 5506.0) and national authorities.

Box 2. The Goods and Services Tax: a Commonwealth or a state tax?

According to the Australian Bureau of Statistics, there are two broad treatments that could apply to Goods and Services Tax (GST) revenue according to the Government Finance Statistics (GFS) reporting framework, reflecting a “constitutional” or an “agency” approach.

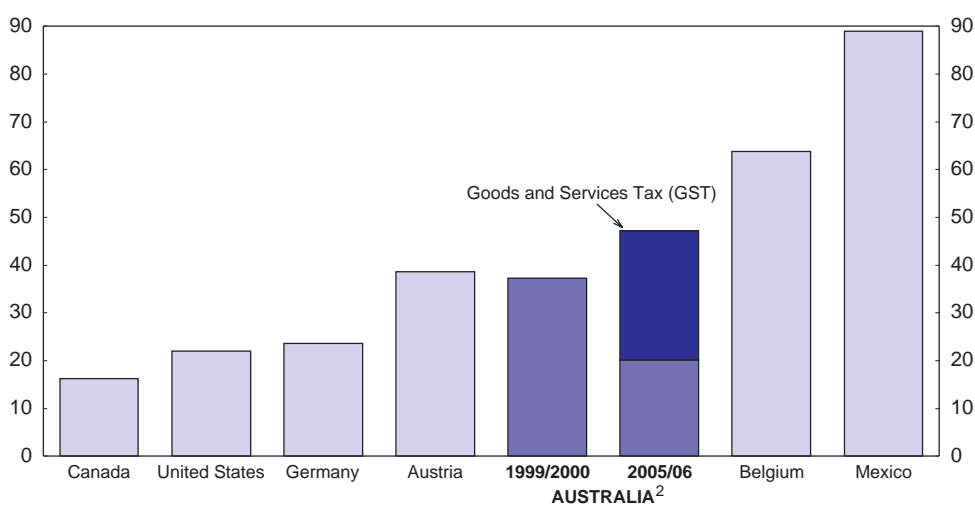
The Commonwealth considers the GST to be a state tax, as all its revenue is transferred to the states. The Commonwealth acts as a *collection agent* for the states, and the states reimburse the Commonwealth for the cost of collecting the GST. GST payments to the states are therefore not treated as a Commonwealth transfer. The Commonwealth also justifies its statistical treatment of GST revenue on the grounds that the tax base and rate cannot be changed without the unanimous support of the state governments, which implies that it is not a Commonwealth tax.

The Australian Bureau of Statistics (ABS, 2000), on the other hand, treats the GST as a Commonwealth tax because the Commonwealth exercises “... considerable influence and discretion over the setting of the GST and the distribution of its proceeds ... [and that] ... individually the states do not have sufficient influence or discretion over the setting of the GST and the distribution of its proceeds”. On these grounds, the ABS considers the distribution of GST to the states as a grant, treating its payment as Commonwealth spending.

As shown in Figure 3.4, the statistical treatment of GST has implications for the magnitude of the vertical fiscal imbalance (VFI), with the share of federal payments from the Commonwealth in state revenue having declined, in 2005/06, to approximately 20% or hovering around 47% -- compared with a pre-GST level of around 37% in 1999/2000 -- depending on whether the GST is treated as a state or federal tax.

Figure 4. The vertical fiscal imbalance: a comparison with other federations

In per cent of total sub-national revenue, 2003¹



1. Provincial government level only for Canada. The vertical fiscal imbalance (VFI) is defined as the total of federal payments to total sub-national revenue.
2. For Australia, VFI is the share of Commonwealth payments in total state revenue. The GST -- levied on a value added basis at a single rate of 10% -- was introduced in July 2000 and replaced the Commonwealth wholesale sales tax and a range of inefficient state taxes, including financial institutions duties, accommodation taxes, stamp duties on marketable securities and debit taxes. The states have further adjusted their gambling taxes to take account of the GST impact on gambling operators.

Source: International Monetary Fund (2005), *Government Finance Statistics Yearbook*; US Bureau of Economic Analysis; OECD (2005), *OECD Economic Surveys: Mexico*; Australian national authorities.

Inter-governmental financial arrangements

Financing fiscal imbalances

12. Because the largest tax bases are assigned to the Commonwealth, while expenditure responsibilities are significantly more decentralized, a vertical fiscal imbalance emerges in Australia's inter-governmental fiscal relations (Figure 4). The exact magnitude of the fiscal gap from 2000 onwards depends on the statistical treatment of GST as a state or a Commonwealth tax, as discussed above. But there also exist horizontal fiscal imbalances, reflecting differences in revenue raising capacity and delivery costs among the states. The Commonwealth Grants Commission (CGC) estimates that the revenue-raising capacity of the states ranges between 75 and 114% of the national average on a per capita basis, largely due to differences in tax bases. Cost differences are assessed to be within 10% of the national average, excluding the Northern Territory (Searle, 2002). Vertical and horizontal fiscal gaps also arise at the local government level, especially between rural and metropolitan councils.⁹

13. Bridging fiscal imbalances requires comprehensive inter-governmental revenue sharing through grants and transfers. Specific purpose payments (SPPs)¹⁰ to the states and local governments made up around 13% of Commonwealth expenditure in 2005/06 and cover a wide range of functions, especially health care and education (Figure 5). While most SPPs are paid to and spent by the states, SPPs are also assigned to some non-government bodies (for example, private schools) and to the local governments directly or through the states.¹¹ SPPs are granted in pursuit of the Commonwealth's own policy objectives on the basis of presumed deficiencies in service delivery (which may occur where part of the benefit of certain spending accrued outside a state border), as well as in response to demands for a national approach in key functional areas. Most SPPs therefore are "tied" – that is they are subject to conditions designed to ensure that national objectives are achieved (Box 3).

9. According to the authorities, many councils have inadequate financial governance or long-term financial planning practices. Many do not make adequate provision for depreciating infrastructure and do not borrow to replace infrastructure, while providing increased community services without ensuring that there are adequate resources to do so. Local government considers that its functions and responsibilities have increased and that it should be provided with a corresponding increase in financial resources, while the states and territories do not see the need for increased funding of local government.

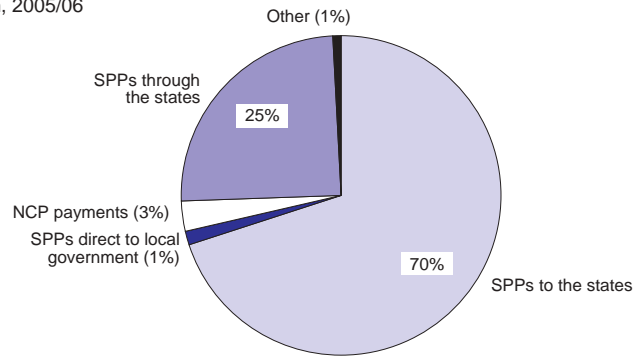
10. Since the early 1990s the federal government has used over 90 different SPPs to transfer funds to the states, although the total number of the programmes may surpass 500, if different sub-programmes are also taken into account (Searle, 2002).

11. These include financial assistance grants to local governments for roads and other services. Assistance is paid in the form of general purpose assistance and untied local road funding – both of which can be spent according to the priorities of local authorities. The annual increase in funding is granted on the basis of an escalation factor, determined by the Australian Treasurer with reference to population growth and the consumer price index (Australian Government, 2005).

Figure 5. Australian Government payments to sub-national governments¹

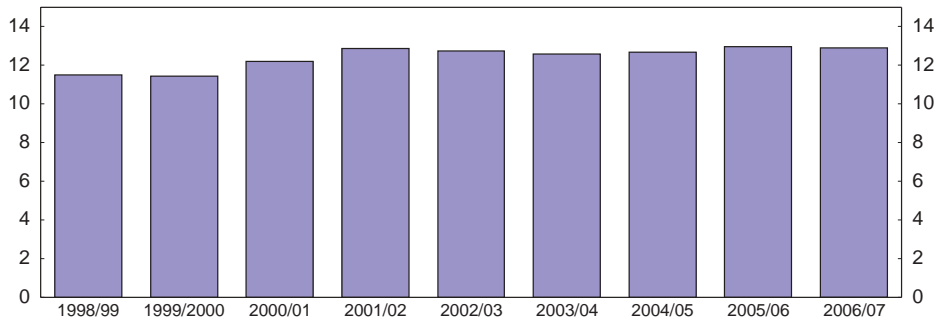
Composition of payments²

AUD 27.7 billion, 2005/06



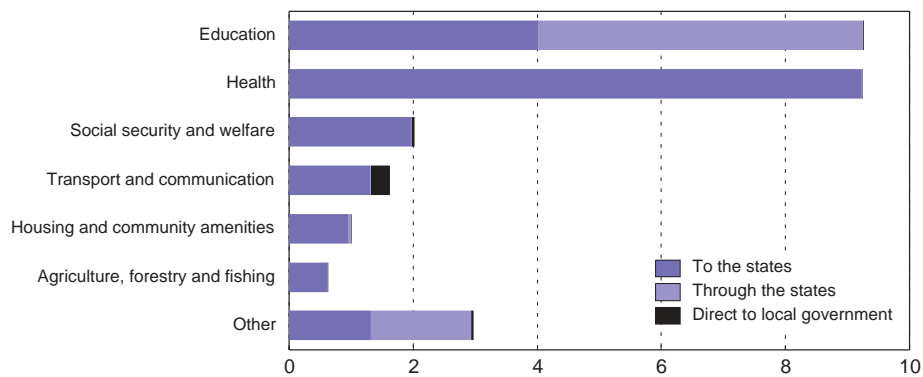
Evolution of SPPs³

In per cent of Commonwealth general government expenditure



Allocation of SPPs by functional area

In billion AUD, 2005/06



1. Data from 2005/06 onwards are estimates.
2. NCP: National competition policy.
3. Specific purpose payments (SPPs) for current and capital purposes.

Source: Australian Government (2006), *Budget Paper No. 3: Federal Financial Relations 2006-07* and *Final Budget Outcome* papers for earlier years, Australian Government, Canberra.

Box 3. Specific purpose payments

In general, the conditions attached to SPPs cover various different arrangements : *i*) general policy conditions (e.g. that the states provide free public hospital access for Medicare patients in return for funding under the Health Care Agreements); *ii*) expenditure conditions (e.g. SPPs for schools may be spent on teacher salaries and curriculum development); *iii*) input control requirements, in the form of “maintenance of effort” and “matching funding” arrangements (i.e. the states are required to maintain funding levels and/or match the federal funding in a programme area); *iv*) a requirement for states to report performance and financial information; and *v*) due recognition conditions (i.e. the states are required to publicly acknowledge the Commonwealth’s funding) (Australian Government, 2005).

Specific purpose payments are based on individual agreements between the Commonwealth and state governments. These agreements are not legally binding, but the recipients are required to demonstrate that allocations are spent in accordance with the agreement’s terms and conditions. Penalties and sanctions may apply for the untimely reporting of financial and performance information (as specified in the SPP agreement).

There are different indexation arrangements built into SPP agreements, based either on broad economy-wide indices (such as the various wage cost indices and the consumer price index), or population, or a combination of both. Moreover, in some cases funding increases according to the demand for the services provided by SPPs, while some SPPs have their own specific indexation arrangements (such as particular percentage growth rates).

14. There are also other grants. These include national competition policy payments (NCPPs) to the states in return for implementing National Competition Policy and related reforms, with the 2005/06 NCPPs being the final payments under the current arrangements.¹² The policy includes a commitment by the states to review legislation that restricts competition and to enact specific reforms in electricity, gas, water and road transport. The competition payments are assigned to the states on a per capita basis and are indexed annually to maintain their real value over time. Receipt of NCPPs is subject to recommendations from the National Competition Council’s assessment of progress in the implementation of reform commitments, with the potential for penalties to be recommended.¹³ The Australian government also considered, in 2005/06, for the first time, recommendations from the National Water Commission in relation to states’ progress on water reform (Australian Government, 2006). The actual amount of payments received by the states is determined by the Treasurer.¹⁴

The equalisation scheme

15. The distribution of GST revenue among the states is guided by horizontal fiscal equalisation (HFE), based on *per capita relativities* recommended by the Commonwealth Grants Commission, an

12. The Agreement to Implement the National Competition Policy and Related Reforms (1995) and the November 2000 COAG Communiqué (containing changes to the NCP arrangements) provided for the Australian Government to make competition policy payments to the states up to and including 2005/06. Hence, the 2005/06 NCPPs are the final payments under the current arrangements. As part of the new National Reform Agenda, agreed by COAG in February 2006, the Commonwealth will provide funding to the states and territories on a case-by-case basis, once specific implementation plans have been developed if funding is needed to ensure a fair sharing of the costs and benefits of reform (Australian Government, 2006).

13. These penalties may take the form of a permanent deduction, specific suspension (until pre-determined conditions are met) and pool suspension (applying to a range of outstanding legislation review and reform compliance failure, which are reassessed in subsequent assessments).

14. On the basis of the 2006/07 Budget, the Australian Government decided to deduct permanently AUD 40.7 million and suspend AUD 32.9 million of the estimated maximum level of payments of AUD 777.9 million in 2005/06, and reimburse AUD 100.5 million of 2004/05 suspensions. The National Competition Council indicated that it would recommend the lifting or reduction of 2005/06 suspensions subject to the satisfactory assessment of implementation of reform commitments in 2007 (Australian Government, 2006).

independent advisory body established in 1933 (Box 4).¹⁵ The assignment of general purpose assistance to local government is also guided by horizontal equalisation. Each state government maintains a separate grants commission to determine the allocation of these grants to the councils within their jurisdiction.

Box 4. Horizontal fiscal equalisation: main features

In applying horizontal fiscal equalisation, the Commonwealth Grants Commission (CGC) distributes the GST pool (GST revenue and Health Care Grants) to the states such that, "if each state made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the *capacity* to provide public services at the same standard" (CGC, 2004).

Equalisation rests on "three pillars": *i*) the fiscal capacity of the states, rather than the performance or outcomes they achieve, are equalised - the CGCs recommendations pertain to untied general revenue grants, so that each state may spend its GST revenue according to its own priorities; *ii*) the states are equalised to average standard - no judgment is made by the Commission on the level of service that might be appropriate or about appropriate benchmarks; and *iii*) equalisation is "policy neutral" - a state's own policies or choices should not directly influence its share of GST revenue.

The assessment procedures by the CGC are based on a complex methodology that takes account of differences in per capita revenue-raising capacity and differences in spending "needs" (*i.e.* the per capita amounts required to be spent by the states in providing an average standard of government services). The procedure culminates in the calculation of the "relativities": an index of relative needs which, when weighted by the population in each state, provides a basis for the distribution of the GST pool.* The CGC updates the relativities each financial year, and undertakes broader reviews of its methodology every five years. The next major review is currently underway, and is due to report in early 2010. In assessing a state's relative needs, and thereby the allocation of the GST revenue, the CGC takes into account only factors that are beyond a state's control (referred to as "disabilities"), including population size and structure, wages, rental and electricity costs, and tax bases (such as payroll tax). If actual spending and revenue were used instead, a state could influence its share in GST revenue through its policy choices.

Since the CGC is responsible for taking account of all sources of state revenue in its equalisation procedure, specific purpose payment (SPP) receipts need to be treated as revenue when calculating the relativities. However, some SPPs are "quarantined" by the Commonwealth in its terms of reference given to the Commission, and are not taken into account. Others are considered "out of scope" by the CGC (that is, they are not relevant because they do not fund state services or they do not have a direct impact on state budgets), whereas all the remaining SPPs are "treated by inclusion", reducing a state's need for GST funds. The inclusion of SPPs in the equalisation process is an issue of debate, as discussed later.

* The national average relativity is set to one. The states assessed to have relativities above one require more than the national average per capita amount of the GST pool to deliver services at the national average level, while the opposite is true for those with a relativity below one (CGC, 2006).

Source: Craig (1997); Australian Government (1999, 2005); CGC (2004, 2006); Garnaut and FitzGerald (2002a); Webb (2002a) and Williams (2005a, 2005b).

Issues concerning the allocation of spending responsibilities

Joint government involvement in key functional areas

16. The Commonwealth and the states are involved in almost every functional spending area. The Commonwealth justifies its involvement on the grounds of promoting national standards, ensuring policy coordination and attainment of national objectives, achieving economies of scale and scope, and dealing with inter-jurisdictional spillovers. However, shared responsibilities can pose difficulties, including on how to avoid the inefficiencies which may emerge -- as a result, usually, of a blurring of government responsibilities -- from cost and blame-shifting among government levels, wasteful

15. According to the CGC's terminology, a relativity is defined as "a *per capita* weight assessed by the Commission for use by the Australian Treasury in calculating the share of the GST pool that a state requires to achieve horizontal fiscal equalisation" (CGC, 2006). The decisions of the CGC are not legally binding. The federal government, however, usually implements its recommendations.

duplication of effort or under-provision of services, and a lack of effective policy co-ordination. Some overlap arising from vertical competition may be beneficial, however, if it provides greater choice or better services (Australian Government, 2005; Productivity Commission, 2005a).

17. There is little evidence on the extent of overlap, duplication and cost-shifting. But the complexity of the underlying arrangements for joint provision of health care and related services (Box 5), in particular in the areas of hospital services and care for the elderly, creates incentives for cost and blame-shifting¹⁶ between government levels (Productivity Commission, 2005c). With the states having responsibility for funding public hospitals, and the Commonwealth for subsidising private medical services under Medicare, there is an incentive for public hospitals to refer patients being discharged to their general practitioner (GP), rather than providing post-hospital services directly. On the other hand, difficulties in accessing GPs may cause patients to resort to emergency wards of public hospitals for primary care services. Moreover, in areas where there are shortages in Commonwealth-funded nursing homes, public hospital beds may be unnecessarily occupied on a long-term basis by patients requiring old-age care (Garnaut and FitzGerald, 2002a; Allen Consulting, 2004; Williams, 2005b).

18. The health and old-age care systems were a key agenda item in the June 2005 meeting of the Council of Australian Governments – which recognised the need for clarifying government roles and responsibilities to improve their functioning. The Productivity Commission (2005c) estimated that an efficiency improvement of 10% in the health care sector service delivery would provide cost savings equivalent to around 1% of GDP at present and 2% by 2050. The Hogan review for aged care (Hogan, 2004) recommended longer-term options for improving consumer choice and competition, including the establishment of a contracting agency to act on behalf of the federal government to negotiate prices and conditions for residents. The Commonwealth indicated that it would consult widely on these proposals.¹⁷

19. The potential for cost and blame-shifting between government levels seems to be lower in the education than in the health care sector (Productivity Commission, 2005c) due to a generally less complex institutional framework in the former sector (Box 5). There are areas however where a more co-ordinated approach is needed. Concerning vocational education and training (VET), in particular, COAG pointed out that “there is scope for further whole-of-government actions”, arguing that the creation of a “genuinely” national approach to apprenticeships and training is vital to reduce skill shortages. Issues also arise at the tertiary education level, relating, for instance, to the cross-jurisdictional variations in the recognition of universities and accreditation courses and providers,¹⁸ and to differences in funding arrangements for VET, which is mainly state-funded, and universities, which are funded almost exclusively by the Commonwealth. The fact that students enrolled in the VET sector cannot defer payment of tuition charges but undergraduate university students are able to do so, even though VET tuition fees are lower than those of universities, may distort student choice. Costs and other inefficiencies also arise due to differences in schooling among the states (*e.g.* entry and minimum leaving age, curriculum design), although there are plans for introducing a common entry age across jurisdictions by 2010 and an Australian Certificate of Education for grade 12 (Banks, 2005; Productivity Commission, 2005c).

16. When responsibilities of various government levels overlap, as for example in the case of health care, each level of government can blame the other for not doing its part, leading to under-provision of some services and poor cost-efficiency of public expenditure programmes (Joumard, 2005).

17. The Australian government addressed all of the immediate, and most of the medium-term recommendations in the Hogan Review, providing AUD 2.2 billion for various initiatives.

18. Recent debate has focused on the possibility of rationalising responsibilities for universities. While the Commonwealth has significant financial and policy responsibility for higher education, the states retain major legislative responsibilities.

Box 5. Division of government responsibilities in health care, education and training

Health care

Spending on health care reached 9.7% of GDP in 2003/04, with public expenditure accounting for 68% of the total. Approximately two-thirds of public expenditure on health care is funded by the Commonwealth, and the remainder by the states. The main features of the current funding arrangements are as follows:

- Under the Medicare system, the Commonwealth provides access to medical, pharmaceutical and hospital services for all Australians through: *i)* The *Medicare Benefits Scheme* rebates for listed medical services; *ii)* the *Pharmaceutical Benefits Scheme* of subsidies for listed prescription drugs; and *iii)* the *Australian Health Care Agreements* with the states, ensuring access to free public hospital services based on clinical need. Moreover, the Commonwealth provides a rebate of between 30 to 40% for private health insurance holders.
- The largest source of funds for residential and community old-age care comes from the Commonwealth, which also has responsibility for regulating residential old-age care.
- The states are responsible for most acute and psychiatric hospital services. They also provide and fund the majority of community health care services and public health care activities, including school dental services, child and maternal health care services, disability support, disease control and various inspection functions.
- Local governments may also provide residential and community old-age care services, home care and personal preventive services, such as pre-school immunisation clinics.
- Private providers deliver a significant proportion of primary, specialist and allied health care through general practitioners, specialists, pharmacists, physiotherapists and dentists. They are funded by a combination of user charges, Medicare and private health insurance.

Education and training sector

Public expenditure on education was approximately 5.4% of GDP in 2003/04, with states accounting for the most part. Private expenditure on education stood at around 1.6% of GDP.

The states' responsibilities include:

- Providing schooling to all children of school age.
- Providing major funding for government school education and contributing funds to non-government schools.
- Regulating school activities and policies, and setting curricula, course accreditation, student assessment and awards for both government and non-government schools.
- Administering and providing major funding for vocational education and training (VET).
- Regulating and accreditation of higher-education courses.

The Commonwealth's responsibilities include:

- Providing the majority of funding for non-government schools and being principally responsible for the funding of higher education institutions.
- Providing supplementary funding for government schools and VET. Starting in 2006, 25 federally-funded Australian Technical Colleges will be located in regions suffering from skill shortages and high unemployment.
- Providing financial assistance for specific educational programmes and categories of students.
- Promoting national consistency and coherence in the provision of education and training.

Both government levels are responsible for planning and monitoring the performance of education services and evaluating outcomes.

Recent cooperative efforts

20. A broad range of inter-governmental agreements have been put in place since the early 1990s, including the harmonisation of regulations, the adoption of national standards and the re-assessment of roles and responsibilities. These were driven by pressure to improve the international competitiveness of the economy, as well as to deal with inter-jurisdictional spillovers and ensure effective policy outcomes in key functional areas (Productivity Commission, 2005a). The option of ceding responsibility to one level of government would provide a permanent boundary between the functions of each tier of government, establishing clearer lines of accountability. However, it would be very difficult to implement in practice as the states or the Commonwealth would have to cede responsibilities and it would call for a reform of the existing funding arrangements. There are also benefits arising from joint government involvement. The Australian government has a clear role in national aspects, but the state/local governments are best situated to respond to local needs (Allen Consulting, 2004). Enhanced co-operation, however, unavoidably raises issues about clarification of roles and responsibilities and the appropriate mechanisms for collaboration, and for monitoring policy implementation and performance.

21. In February 2006, COAG agreed to collaborate on the implementation of a new National Reform Agenda to enhance productivity and labour force participation so that Australia is better placed to meet rising demographic pressures and intensified international competition. The reform agenda is broad-based. Its main innovation is the inclusion of a human capital agenda (health, education and training and work incentives), in addition to the traditional areas of competition and regulatory reform. The focus in the health care area is on preventing chronic disease, integrating delivery and ensuring that the incentives created by payment structures are consistent with better health outcomes. In education, the focus is on early childhood development and on improving the transition from school to work or further study, with apprenticeship and vocational training playing significant roles. A new organisation, the COAG Reform Council,¹⁹ will monitor the progress in implementing the agreed programmes and report annually to COAG.

22. The COAG process represents a step towards clarifying the allocation of roles and responsibilities between government levels in the health and aged care sectors. An agreement has been reached that health SPPs will be reviewed prior to renegotiation to determine whether elements could be changed to contribute to better health outcomes, and for implementing the key recommendations of the Productivity Commission in the *Australia's Health Workforce* Report, calling for a reform of the overly complex funding and payment regime underpinning the system in order to improve workforce performance and health quality and outcomes (Productivity Commission, 2006).

Earmarked grants

23. The current SPP arrangements, and in particular the conditions attached to such payments, are often criticised by the states for constraining budget flexibility; imposing restrictive input controls, *via* effort conditions and matching requirements, rather than focusing on outputs; and creating duplication and administrative costs, especially when federal funds are provided to the states through a large number of "small" SPPs (State and Territory Treasuries, 1999; Garnaut and FitzGerald, 2002a). On the other hand, there are some benefits arising from conditionality, including, in the federal government's view, increased accountability of state spending and the potential for enhancing cost-efficiency in situations where grants are provided to deal with inter-jurisdictional spillovers or to set national standards.

19. The Reform Council will be an independent body, which will replace the National Competition Council that has played a vital role in implementing the NCP reforms since 1996 (COAG, 2006).

24. The state treasuries have developed a set of *Best Practices*, aimed at overcoming some of the problems outlined above.²⁰ While not endorsing these principles, the Commonwealth has indicated its willingness to move towards a new framework for SPP accountability that involves the clarification of objectives and assignment of responsibilities for SPPs, and reporting by the states on agreed financial information and performance indicators. This approach has been progressively adopted as SPPs have been renegotiated. A positive initiative in this respect is the requirement that state governments have to meet a number of new performance conditions in order to obtain federal funding for education over the period 2005-08. While the new approach represents a step towards an outcome accountability framework, funding for SPPs will continue to be input-based as, in the Commonwealth's view, input controls remain the best way to protect the federal government against financial risks associated with service delivery, which is the responsibility of the states. Input controls are further seen by the Commonwealth as a means of ensuring that state sub-national governments do not shift responsibility for service provision over time to the central level.

25. Benefits could arise, however, from funding SPPs on an outcome/output rather than an input basis. These include an improved use of state resources, through granting states greater flexibility on the allocation of federal funds, and incentives to service providers to raise efficiency. Moreover, a focus on outcomes could enhance transparency and accountability. Nevertheless, drawing on the experience of the United Kingdom, which is at the forefront of applying quantitative outcome-focussed performance targets in the public sector, the targets should be simple to quantify and audit, if they are to enhance operational efficiency. In the Australian context, as a step on the way to an ultimate move towards the funding of SPPs on an outcome/output basis, further effort could be put into developing outcome/output performance and reporting frameworks, where the challenge is to develop measures of service delivery that are clearly defined, measurable and enforceable. Progress will be easier with some SPPs than others. For example, targets for educational achievement would provide better performance indicators for learning outcomes than clinical outcomes would do for health care, given the measuring difficulties and depth of information required for the latter. Nevertheless, even in cases where there is sufficient information for the government to set outcome targets, these can be implemented effectively only if they provide performance incentives (OECD, 2004). Financial incentives, for example in the form of rewards for early achievement of the targets, could motivate service providers. That said, it would also be advisable to impose financial penalties, or adopt a "naming and shaming approach",²¹ for non-compliance. In a different context, competition payments played a very important role in the implementation of National Competition Policy reforms, and demonstrate the potential for financial incentives to underpin progress of the new national reform agenda (Productivity Commission, 2005c).

26. The use of broad-banding, where a number of small SPPs are combined into a larger pool, should be considered, as it is likely to have the potential for enhancing the efficiency of funding through increased flexibility and reduced administrative costs – although such an approach could hamper the objectives of the SPPs, insofar as these are aimed at internalising spillover effects associated with individual policy areas. In their 2002 Review of *Commonwealth-State Funding* (commissioned by New South Wales, Victoria and Western Australia), Garnaut and FitzGerald recommended that SPPs be rationalised into three major programmes: a health and aged care programme, an education and training programme (both to be administered by the states), and an

20. The key principles include: simple administrative accounting and reporting arrangements; an outcome/output focus; non-legalistic wording and the use only of those provisions that give effect to the main policy intent; flexibility to allow the states and territories to decide delivery mechanisms; and clearly defined allocation of funds, processes and dates for renewal.

21. This could be achieved through the publication of reports by the overseeing authority which set out details of how a state had failed to comply.

indigenous population programme (to be administered by the Commonwealth). This proposal received no support from the Commonwealth. It saw disadvantages including the loss of control over how its money is spent by the states, resulting in possible under-spending on capital programmes, and the difficulty of monitoring states' financial contributions across several functions. Reviewing the funding arrangements prior to their renegotiation, as recently agreed by COAG for health care payments, is a welcome initiative. Finally, a more rules based approach for setting SPPs would ensure greater transparency.

Issues in funding arrangements for sub-national governments

27. Given the significant spending responsibilities of the sub-national governments, an important challenge on the funding side is to provide lower-tier governments with sufficient revenue-raising autonomy to make them accountable to local citizens.

Vertical fiscal imbalances

28. The question of whether it is desirable to reduce vertical imbalances remains open (Box 6). The presence of a vertical imbalance is not, by itself, necessarily indicating a problem. However, specific features of the transfer system to fill the vertical fiscal gap have given rise to a number of concerns (Productivity Commission, 2005a). There has been growing attention over Australia's VFI since the 2000 reforms, in view of the replacement of taxes over which the states had full control by the GST (Collins, 2001 and 2004; Searle, 2002). The outcome of this debate should depend on the assessment of the economies of scale that can be exploited in centralising tax collection and the costs associated with increased co-ordination and the loss of the capacity by the lower tiers of the government to engage in efficiency-enhancing horizontal competition.

Box 6. The controversy over the vertical fiscal imbalance

Critics often consider VFI as the root cause of the problems in the inter-governmental relations, including reduced accountability, duplication and overlap in the provision of services, excessive conditionality of federal transfers, distortion of public expenditure towards items that receive earmarked grants ("fly-paper" effect),¹ and the creation of "fiscal illusion", as governments and voters fail to consider more than the own-revenue costs of state government spending. Moreover, VFI is often regarded as reducing the scope for beneficial tax competition across jurisdictions and weakening the incentives for tax and microeconomic reforms (Madden, 2002).

The case against VFI is by no means uncontroversial. The scope for "fly-paper" and "fiscal illusion" effects has been called into question by some commentators.² As for interstate tax competition, evidence by the Productivity Commission (1996) suggests that this often involves special exemptions and concessions on businesses to attract labour and capital, thus questioning positive effects from competition. Some fiscal gap could also be considered beneficial on the ground that it: *i*) provides leverage for the Commonwealth to undertake important national reforms that require state government involvement; and *ii*) helps smoothing economic cycles by enabling the central government to influence the allocation of resources in the economy through its spending and revenue decision. In addition it is possible that some vertical fiscal imbalance may constrain the size of government as the central government is exposed to the political costs associated with increasing taxes. This cost is only partially offset by the political benefits of expenditure programmes given that many of these are funded by the central government, but delivered by sub-national governments.

1. The flypaper effect – described as "money sticks where it hits" – refers to situations where grants tend to be used by the recipient government for service provision, and will not be passed to taxpayers in the form of lower taxes. This is likely to lead to over-provision.
2. For a discussion see Hancock and Smith (2001). In particular, the authors question the existence of failed public choice mechanisms as the empirical evidence is not conclusive.

29. The debate over VFI raises the question of which taxing responsibilities should be assigned to different levels of government. This is a complex issue and no consensus has so far been reached. Major changes in the taxing powers of the states seem unlikely as the High Court has precluded the

states from introducing broad-based consumption taxes, such as the GST. One option for increasing the revenue-capacity of the sub-national governments would be to allow them to “piggyback” on the personal income tax levied by the Commonwealth. This would call for the centre to make “tax room” by lowering its personal income tax so that the states can impose a surcharge on the federal personal income tax. Each state could be allowed to set the surcharge rate and, for the reform to be revenue-neutral, they would be required to give up part of the federal transfers received.²² This option would encourage tax competition among the states. An advantage of the personal income tax surcharge option is that it would not significantly raise tax administration costs, if the tax base is unchanged and identical across the states and with the Commonwealth, since it would still be administered and collected by the Commonwealth. However, a difficulty with this option is that its introduction would require a fundamental adjustment of Commonwealth-state financial arrangements which would require agreement of all jurisdictions.

The existing state tax mix

30. The most direct solution if some increase in the revenue-raising capacity of the states to meet their expenditure responsibilities were considered warranted would involve broadening the states’ land property and payroll tax bases. In any event, the efficiency of the state tax system should be raised (Table 2). There is no doubt that the 1999 *Intergovernmental Agreement (IGA) on the Reform of Commonwealth-State Financial Relations* created more efficient tax arrangements by replacing a number of narrowly-based, distorting indirect taxes and the Financial Assistance Grants by the GST. But the remaining distortionary state stamp duties should also be abolished. As a positive step the Australian government has now reached agreement with all states on a schedule for the abolition of most taxes listed for review in the IGA, including stamp duty on mortgages, leases, and credit and rental arrangements. The abolition of these taxes is estimated by the government to save taxpayers approximately AUD 4.4 billion over the four years from 1 July 2006 (Australian Government, 2006). If the land tax were to be broadened, consideration should be given to the abolition of conveyances duties on the transfer of real property – though the abolition of the business conveyancing duty is to be considered in the future.²³

22. For a discussion of this option see Collins (2004). Going back, the Commonwealth passed legislation, in 1978, to allow the states to impose an income tax surcharge, but the initiative failed partly because the Commonwealth government did not make “tax room” by cutting personal tax rates. If a state government wanted to levy an income tax surcharge, it would have had to impose that on top of the existing federal rates, which none was willing to do. Moreover the surcharge was portrayed in a number of states as double taxation, while states are also quite comfortable receiving grants from the Commonwealth, rather than raising revenues on their own (James, 1997).

23. Unlike stamp duty on business conveyances of real property, the abolition of which is to be considered in the future, stamp duty on residential conveyances was not listed in the Intergovernmental Agreement and has therefore not been a part of this agreement between the Australian government and the states.

Table 2. Mix of state and local government taxes¹
In per cent of total tax revenue, 2004/05

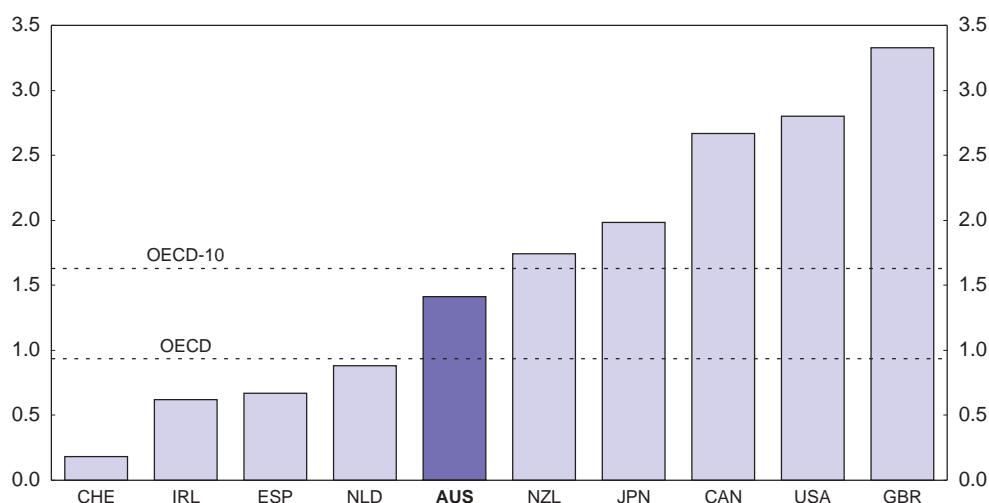
	New South Wales	Victoria	Queensland	South Australia	Western Australia	Tasmania	Northern Territory	Australian Capital Territory	Total
On employers payroll	27	24	19	20	24	21	30	26	24
On property	46	46	53	50	55	51	40	50	49
Immovable property	24	25	26	30	26	30	16	26	25
Land	9	7	5	7	6	5	..	8	7
Municipal rates (local government)	14	17	18	20	16	23	16	0	16
Financial and capital transactions	22	21	27	20	29	20	25	24	23
Stamp duties on conveyances	18	19	20	15	26	15	20	21	19
On the provision of goods and services	16	19	14	19	8	15	19	12	16
Gambling	8	11	9	11	3	9	13	7	9
Insurance	8	8	4	8	6	6	6	5	7
On use of goods and performance of activities	11	10	13	10	13	14	10	12	12
Motor vehicles	10	10	12	10	13	14	10	12	11
<i>Memorandum items:</i>									
Total tax receipts (billion AUD)	17.9	12.6	8.6	3.7	5.2	0.9	0.4	0.7	49.8
Per capita (thousand AUD)	2.6	2.5	2.2	2.4	2.6	1.8	1.8	2.2	2.5

1. Excluding revenue from the Goods and Services Tax.

Source: ABS (2006), *Taxation Revenue, Australia 2004-05* (cat. No. 5506.0).

Property taxation

31. The ratio of property tax revenue to GDP is above the OECD average. However, there is still scope for greater reliance on this tax base (Figure 6). The land property tax base could be broadened. This would require addressing administrative issues, including the need to keep property valuations up to date, and reducing exemptions, which are estimated to reduce the potential tax base by at least 50% (Freebairn, 2002). Owner-occupied residential land constitutes the main exemption, with others including primary production land and land held by charities and religious bodies. Moreover, tax free thresholds apply to small and low value holdings of land used for industrial and commercial purposes and for rental houses, exempting them from paying land tax. The current exemptions may encourage land to be devoted to activities that are exempted, leading to efficiency losses. The different treatment of land property for owner-occupied housing, as opposed to rental, provides a clear example. The existence of an exemption threshold, in the cases mentioned above, may also provide an incentive to landholders to sub-divide their property to reduce the tax liability (Gabbittas and Eldridge, 1998; Freebairn, 2002). If the land tax were to be broadened, for example to include owner-occupied housing, then consideration should be given to the abolition of the conveyance duties levied on the transfer of real property. Reduced reliance on conveyance fees (levied on the sale or transfer of title of business and residential property) would be welcome as this tax is both inefficient and inequitable.

Figure 6. Recurrent taxes on immovable property¹In per cent of GDP, 2004²

1. Taxes levied regularly on proprietors and tenants in respect of the use or ownership of land and buildings.
2. Provisional data, 2003 for Australia. The OECD aggregates are unweighted averages; the OECD-10 are the ten countries shown in the chart and are chosen because they have a similar overall level of aggregate tax pressure to Australia.

Source: OECD (2005), *Revenue Statistics*.

Payroll taxation

32. Australia is among the few OECD countries (along with Austria, Canada and Mexico) that have a payroll tax at the sub-national level. The main advantages of payroll taxes are their relatively broad and stable base, and low administrative costs. However, the payroll tax base has been narrowed over time, reflecting the increased use of exemptions by the states, with a resulting loss of efficiency. Approximately half of the potential tax base lies outside the tax net due to the small firm exemption (Freebairn, 2002). There are also exemptions for firms engaged in particular activities (such as charitable and other non-for-profit organisations), as well as those granted by the states to specific firms to attract them to set up operations in their jurisdiction. The Productivity Commission further sees ample room for reducing the high compliance costs through an increased harmonisation among the states (Gabbitas and Eldridge, 1998). Additional inefficiencies associated with the payroll tax arise from its incomplete coverage of all forms of remuneration,²⁴ as well as its potential discouragement effects on innovation (by imposing a heavy burden on newly-created companies with little or no profits), and by adding to the cost of hiring workers. The payroll tax may, however, be at least partly shifted onto wages, thus mitigating these last two disadvantages.

Tax competition

33. The tax mix varies noticeably between the Australian jurisdictions. To some extent, this variation is the result of tax competition across the states, often originated from the smaller states, in

24. The legal incidence of payroll tax is on employers, and is based on wages paid or payable to employees (which in most states includes non-cash fringe benefits). Labour income paid by the federal and local government, as well as that earned by the self-employed are untaxed. Moreover, the tax base does not include sub-contractors and certain types of fringe benefits, and in two states - Queensland and the Northern Territory - employer superannuation contributions (Gabbitas and Eldridge, 1998).

an attempt to “compensate” for natural or institutional weaknesses not apparent in the larger states.²⁵ According to the Productivity Commission, tax competition seems to have spread to “less obvious forms” in recent years, having taken increasingly the form of *specific* exemptions, and to a lesser extent, *general* exemptions (Gabbitas and Eldridge, 1998). Predatory tax competition²⁶ among the states is unlikely to be sustainable, as the associated revenue losses need to be balanced against other fiscal priorities, such as maintaining a balanced budget in the longer term. As a step towards mitigating this problem, an agreement was signed recently by the states (except Queensland) to restrict the use of selective assistance to attract investment.

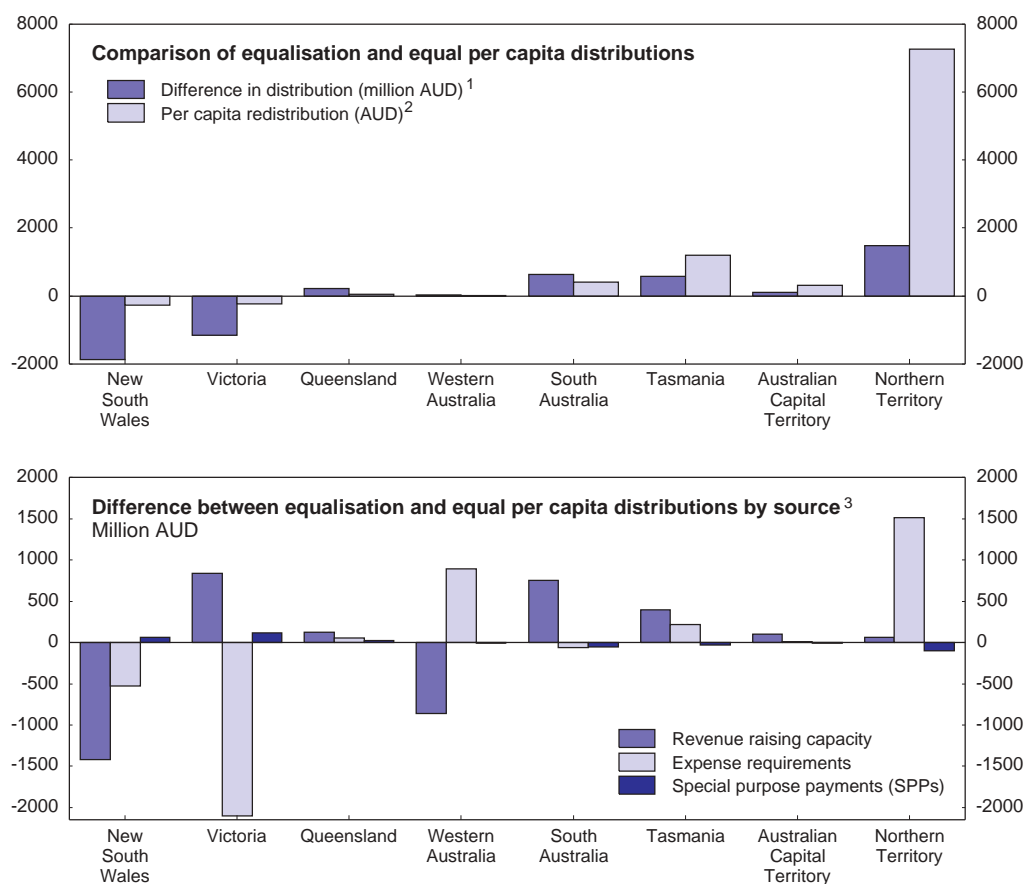
Horizontal fiscal equalisation

34. Horizontal fiscal equalisation results in a redistribution of funds away from the larger states (New South Wales and Victoria), benefiting mainly South Australia, Tasmania and the Northern Territory (Figure 3.7). This reflects the Commonwealth Grants Commission’s assessment²⁷ that “donor” states have greater revenue capacities and/or less significant expenditure disabilities than other states. Expenditure assessments, in total, redistribute more than revenue assessments. Australia stands out as the only country in Pelouquin and Chong’s (2002) set of federations that attempts to fully equalise the revenue-raising capacity and expenditure needs of its states, despite having the lowest pre-equalisation fiscal disparities.²⁷

-
25. In addition to horizontal tax competition, the observed variation in the state tax mix also reflects differences in the ability of the states to raise revenue from a particular tax base and interstate differences in abolishing outdated and inefficient taxes. Historically, the abolition of other taxes has been led by the larger states, with the other states following suit (Gabbitas and Eldridge, 1998).
26. The elimination of death duties is often cited as an example. In particular, its abolition, by Queensland, in 1976, induced the migration of more affluent elderly people to the state, forcing the other states to do the same. As a result, all states lost this revenue source. In the Productivity Commission’s view, however, it is debatable whether this was destructive or constructive competition, with the answer depending on whether death duties should be included or not in an efficient mix of tax bases (Productivity Commission, 2005a).
27. The Pelouquin and Chong sample includes Canada, Germany, Switzerland and the United States as well as Australia. On the basis of the findings, Germany is the next most egalitarian federation after Australia.

Figure 7. The impact of horizontal fiscal equalisation

2005/06



1. Difference between a state's distribution of the Goods and Services Tax (GST) revenue/health care grants pool using the Commonwealth Grants Commission's relativities with a notional distribution on a per capita basis.
2. Difference in distribution divided by population.
3. Negative amounts indicate that a state has an above average capacity to raise revenue for its own sources, or below average costs for providing services, or that it receives above average per capita amounts of SPPs from the Australian Government.

Source: Australian Government (2006), *Report on State Revenue Sharing Relativities: 2006 Update*, Commonwealth Grants Commission, Australian Government, Canberra.

35. The appropriateness of the extent of interstate fiscal equalisation, in light of the relatively small pre-equalisation disparities, has been questioned by Garnaut and FitzGerald (2002a). The authors consider, in particular, the current system as being “too comprehensive”, arguing for equalising access solely to education, health care, and indigenous community development. In contrast, the defenders of the current system believe that the comprehensive approach to equalisation is a reflection of the desire to ensure that each state has the capacity to provide a standard level of services to its citizens.

36. The equalisation principle employed by the Commonwealth Grants Commission (CGC) has come under great scrutiny. The debate focuses on the measures used in the CGC’s calculation of

per capita relativities,²⁸ which are often criticized for being based on a complex methodology, with the CGC sometimes lacking the data needed. Another issue of controversy arises from the inclusion of specific purpose payments in state revenues, unless “quarantined” by the Commonwealth, which reduces the state’s implied share of the GST revenue pool. As such, the CGC methodology could reduce the incentive for the states to enter into agreements with the Commonwealth for transfers in the form of SPPs. However, it is also argued that the consequences of the SPP treatment on the distribution of the pool of GST revenue come through with a time lag, because of the averaging provisions used in calculating the allocation of the pool to the states (Williams, 2005b).

37. The debate over whether the equalisation system discourages efficient resource allocation is inconclusive (Box 7). Empirical evidence suggests that the impact on efficiency is not large. Dixon *et al.* (2005) concluded that the welfare gain from changing the current framework and distributing the GST on an equal per capita basis would be about 0.3% of total federal payments to the states.²⁹ Moreover, estimates by Ramakrishnan and Cerisola (2004) suggest that the structure of federal transfers to the states did not have a significant impact on output growth across states in the 1990s, although empirical analysis of the dynamic efficiency disadvantages could be affected by a reverse causality between growth and equalisation payments, in addition to major difficulties regarding unmeasurable counterfactuals.

38. The main elements of the present equalisation system are unlikely to undergo radical changes. But this does not preclude incremental reforms to maintain the relevance and responsiveness of the system. The next major review, due to be implemented in early 2010, will include proposals for simplification of the methodology used by the CGC to determine the GST relativities. It should be currently easier to pursue reforms, as the larger states are all bunched around one on their relativity, with only Tasmania and the Northern Territory way above. In addition to enhancing transparency, greater methodological simplicity would reduce the set of information required from the states. More generally, the debate about the desirability and sustainability of the equalisation system usually tends to lead to extreme suggestions: either no reform or the phasing out of the current equalisation system, at least for the large states – as recently proposed by New South Wales.

28. In November 2001, New South Wales, Victoria and Western Australia — who argue that the HFE methodology disadvantages them — commissioned a Review of Commonwealth-State Funding to examine the methods used to distribute federal grants among the states including the application of HFE (Webb, 2002a). For the final report of this review, see Garnaut and FitzGerald (2002a).

29. A similar conclusion about the size of the impact of the principle of fiscal equalisation on the efficient allocation was derived by the CGC in its 1988 report on General Grant Relativities, which assessed the effects as not being serious enough to justify a change in equalisation procedures. Looking at the issue of whether or not to include location-specific costs, the CGC concluded that there was no evidence that fiscal equalisation influenced location decisions (Williams, 2005b).

Box 7. Horizontal fiscal equalisation and economic efficiency: main issues

The debate over the impact of equalisation payments on economic efficiency revolves around the following main issues.

Some authors argue that horizontal equalisation transfers may *discourage labour from moving to jurisdictions where its marginal product is highest*. Such criticism arises mainly from equalisation on the cost side, and in particular, with regards to the location-specific disabilities (including factors such as scale of delivery, urban transit and population dispersion), which tend to lead to a redistribution of revenue in favour of the less populous states.

Critics further argue that, by focusing on average levels of service, the CGC methodology creates *disincentive for state governments to improve efficiency*. States embarking on cost-reducing reforms are “penalised”, while inefficient states are “rewarded” for under-performance. As a result, heavily subsidised states may undertake spending initiatives with low payoffs. In addition, the current equalization arrangements may hamper growth-enhancing reforms, if the states anticipate that the gains from reforms will be equalised away. As Webb (2002b) points out, however, there is no agreement on how to integrate incentives that reward efficiency into equalisation assessments.

Moreover, it has been suggested that the current system of inter-governmental transfers creates *deadweight losses* estimated at AUD 150-280 million per year (Garnaut and FitzGerald, 2002b). These are static costs. The authors also express the view that the dynamic efficiency costs are potentially higher, but difficult to quantify.

Opponents of the argument, that equalising transfers may *discourage labour* from moving to jurisdictions where its marginal product is highest, contend that fiscal equalisation can correct for the inefficiencies arising, for example, from interstate differences in the distribution of capital returns, fiscal incentives (that is, differences in state taxes, service levels and costs), congestion and demographic factors. It is further argued that equalisation simply brings decentralised fiscal outcomes closer to those that would prevail under unitary decision-making. Within-boundaries equalisation is already practiced by the Commonwealth and the states, as they do not impose higher taxes in higher-cost areas or provide a lower level of services in remote areas. Hence, if equalisation among the states was reduced or even eliminated, the effect would be felt state-wide and not just in high-cost remote areas. In other words, there would be an incentive to move from the rural areas or smaller state capitals to the already large metropolitan areas of Sydney and Melbourne, with no clear gains derived in a highly urbanised society as Australia.

In its latest report, the CGC counters criticisms that its practices undermine efficiency (or even penalise it) on the grounds that differences in efficiency across states play no role in the derivation of relative needs of the states (as these are calculated on the basis of average expenses and revenues, adjusted for influences beyond state government control), and hence in the calculation of the grant shares. In this context, CGC points out that states that are more efficient than average can use the proceeds as they see appropriate, while those below average must compensate for the difference by a lower quality of services, higher taxes or an increase in borrowing, all of which might induce such states to seek efficiency improvements.

Source: Craig (1997); Rye and Searle (1997); Collins (2004); CGC (2006); Dixon *et al.* (2005); Garnaut and FitzGerald (2002a, 2002b); Madden (2002); McLean (2002); Ramakrishnan and Cerisola (2004); Webb (2002a).

Strategies to secure fiscal discipline

39. The Australian government does not impose fiscal rules on the states. The Australian Loan Council is the means by which public-sector borrowing is co-ordinated and monitored. This co-operative approach offers several advantages, including the creation of a political forum for discussions. It also has the potential for strengthening political commitments, and hence fiscal discipline, through consensus-building, and for raising local awareness of the macroeconomic implications of policy choices. On the other hand, this approach requires agreement on common fiscal policy targets, which may be difficult to secure, and lacks adequate mechanisms for enforcement (Joumard and Kongsrud, 2003).

The Loan Council

40. The Loan Council is made up of representatives of central and sub-central governments. It reviews borrowing plans, taking into consideration each jurisdiction’s fiscal position and infrastructure requirements. Jurisdictions may be requested to make adjustments, if their policies are perceived as

being at odds with the Council's macroeconomic objectives. The Council publishes each jurisdiction's agreed financing requirement and can request jurisdictions to provide an explanation for breaching a tolerance limit (Sutherland *et al.*, 2005).

41. The Loan Council has undergone a number of significant changes over time (Box 8). The current arrangements focus on fostering transparency and accountability. Emphasis has been put on setting credible budgetary processes and facilitating financial market scrutiny over proposed borrowing through uniform and more comprehensive information reporting requirements. These arrangements have not been put to the test, as yet, since the Loan Council has operated through a period of improving state finances, with continuing operating surpluses and sharp declines in debt, and also at a time when the federal government has accumulated large budget surpluses.

Box 8. Australian Loan Council: main features and reforms

The Loan Council was set up informally in 1923 and given formal status in 1927, under the Financial Agreement between the Commonwealth and the states. It has undergone a number of significant reforms over time. Under the initial arrangements, state borrowing was controlled by the Commonwealth, with the states being only able to borrow from overseas markets with unanimous Loan Council approval. The states have always been free to determine how borrowed funds would be used. These arrangements worked well until the 1970s, when the states began to use non-conventional borrowing instruments, such as leasing and deferred payment schemes, circumventing the effective control of the Council. Financial de-regulation in the 1980s also reduced the Council's ability to effectively control sub-central borrowing. The *Global Borrowing Limits Approach* of 1984 constrained the level of new borrowing (conventional and unconventional) by the Commonwealth and the state governments. Though successful at the start, by 1993/94 it had become apparent that these arrangements did not reflect the total impact of public sector financing on financial markets, as it did not take into account reserves, and that borrowing did not necessarily mirror the needs or fiscal positions of the states, as the limits were based on historical amounts. This led to the implementation of the current arrangements. By focusing on net, rather than global, borrowing, the current arrangements removed the Commonwealth's explicit power to borrow on behalf of the states and allowed them to issue their own securities.

The current system requires nominations by the states jurisdictions for their total call on financial markets with no requirement for specific project details. Emphasis is put on credible budgetary processes and more comprehensive data reporting requirements to make governments more accountable to the market. Specifically, the Commonwealth and each state government are required to submit to the Loan Council their net financing requirements for the coming year. These so-called *Loan Council Allocations* comprise estimates of the sum of general government and public non-financial corporations' surplus or deficit, net cash flows from investment in financial assets for policy purposes and some memorandum items.

The Loan Council considers a state jurisdiction's nomination with regard to the jurisdiction's fiscal position, infrastructure needs and the macroeconomic implications of borrowing. If the submission of a particular jurisdiction raises concern, the Council has the right to request comprehensive justification for the nomination, as well as an amendment of the fiscal strategy, if needed. However, there has been little controversy or dispute arising from Loan Council decisions. To ensure that credible nominations are put forward, each jurisdiction is subject to a 2% tolerance limit for deviations. In the event that this limit is exceeded, a jurisdiction is required to publicly report the breach.

Source: National submission; Craig (1997); Institute on Governance (1998); Webb (2002b).

42. Complementing the role of the Loan Council, financial markets and rating agencies seem to have been effective in disciplining sub-central fiscal behaviour. The experience of Victoria in the 1990s is instructive. Following a period of deficits and rising debt and a subsequent rating agency downgrade, the Victorian government set an explicit long-term objective to reduce debt and debt-servicing ratios to levels consistent with restoration of the state's former triple A credit rating. Maintaining an AAA credit rating is currently an explicit objective of the fiscal strategy in a number of states.

Improving transparency

43. The strengthening of government financial reporting would enhance fiscal policy transparency. The current reporting system entails multiple sets of financial statements, which differ across jurisdictions, reducing comparability.³⁰ Efforts underway to harmonise the existing requirements and presentation framework are welcome, given the potential implications of such a reform in assessing fiscal policy outcomes.³¹

44. There is also scope for further improving the existing benchmarking frameworks, published annually in the *Report on Government Services*, through completing the process of developing indicators and establishing relevant data sets.³² This would facilitate comparisons of equity, cost-effectiveness and efficiency in service delivery across jurisdictions. The focus of the recent COAG-agreed National Reform Agenda on long-term outcomes and measures underlines the need to improve the assessment of relative performance across jurisdictions.

Concluding remarks and policy recommendations

45. The Australian federal system has evolved considerably over time, moving towards a model where the Commonwealth and the states have joint responsibility for a large number of functions and governments collaborate in key policy areas. The states, however, have considerable room to set the level and composition of their expenditure, although there are some important limitations. The current pattern of widespread shared government involvement increases the necessity to clearly define roles and responsibilities, and for a simpler and more flexible system of SPP arrangements to minimise duplication and cost shifting, particularly in key areas such as health and related services. The recently-endorsed COAG National Reform Agenda -- focusing on human capital issues, in addition to the traditional areas of competition and regulation -- is a welcome step towards achieving a more effective delivery of public services. A close co-operation among the Commonwealth and states for the timely implementation of the COAG reform agenda is imperative, especially in light of pressures arising from demographic changes.

46. The presence of vertical and horizontal imbalances also raises issues. Whereas there is little agreement over the desirable degree of governmental centralisation, the states' reliance on revenue transfers from the Commonwealth draws attention to the design of the inter-governmental transfer arrangements needed to bridge the fiscal gap. Important in this context is a further improvement in the state tax mix, with a broadening of the base of more efficient taxes as compensation for the abolition of the remaining stamp duties. As for the current comprehensive horizontal fiscal equalisation

30. Currently, six of the eight jurisdictions base their primary budget Statements on Government Finance Statistics (GFS), and two base their budgets on Generally Accepted Accounting Principles (GAAP), while the Australian Government provides its budget Statements according to both GAAP and GFS.

31. The Financial Reporting Council set the Australian Accounting Standards Board the task of harmonising the GFS and GAAP frameworks in order to enable the development of an Australian Accounting Standard which makes it possible to prepare a single set of government reports which are auditable, comparable between jurisdictions and in which the outcome Statements are directly comparable with the relevant budget Statements. Revisions to the uniform presentation framework of financial data were agreed by the Australian Loan Council in March 2002 and March 2003.

32. For example, an examination of the Report on Government Services -- which applies a common overarching reporting framework to 14 areas of government service provision (such as education health management, aged care) -- indicated that this report could be improved as a benchmarking exercise. In particular, the Steering Committee concluded that there are a number of areas where indicators have yet to be developed, for which data have not been collected, or where incomplete or non-comparable data are used.

mechanism, conflicts between the long-term “donor” states and “recipient” states in a pool-based equalisation system are to be expected. However, consideration could be given to implementing the simplification of the overly complex and detailed CGC methodology even earlier than 2010 – the year targeted by the current reform programme. Finally, benefits would arise, in terms of ensuring fiscal discipline across government levels, from further enhancing the transparency of public spending through an improvement in the reporting and benchmarking frameworks. Ongoing efforts towards this direction are welcome.

Box 9. Recommendations for improving fiscal relations across levels of government

The allocation of spending responsibilities:

- The complex patterns of joint government involvement in key areas of public service provision should be simplified, through a clarification of government roles and responsibilities, to reduce cost and blame-shifting, and duplication or gaps in service delivery. Emphasis should be put on effectively clarifying spending assignments in the health care and related services, and in particular in the areas of hospital services and aged care.
- The specific-purpose payments should become less complex and inflexible. A first step would be to develop an outcome/output performance and reporting framework for each SPP. This is an ambitious task as outcome/output measures of service delivery are difficult to clearly define, measure and enforce in a robust way. Nevertheless, such frameworks could ultimately lead to a move towards the funding of such payments on an outcome/output basis in certain areas, such as education.
- The Commonwealth and state governments should co-operate closely to ensure the timely implementation of the 2006 COAG National Reform Agenda, focusing not only on competition and regulation, but also on human capital issues (health care, education, and training and work incentives).

Funding arrangements for sub-national governments:

- Broaden the land property tax base through addressing administrative issues such as keeping property valuations up to date, and reducing exemptions, in particular that of land property for owner-occupied housing.
- Further improve the efficiency of the existing state tax mix, by implementing rigorously the agreed schedule for the abolition of most business stamp duties. If the land tax were to be broadened, for example to include owner-occupied housing, then consideration should be given to the abolition of the conveyance duties levied on the transfer of real property.
- Broaden the base of the current narrowly-based payroll tax system (mainly by extending it to smaller firms), and streamline compliance procedures.
- If some increase in the revenue-raising capacity of the states to meet their expenditure responsibilities were considered warranted, a less direct option would be to allow states to “piggyback” on the personal income tax levied by the Commonwealth, with the centre making “tax room” by lowering its personal income tax. A difficulty with this option is that its introduction would require a fundamental adjustment of Commonwealth-state financial arrangements which would require agreement of all jurisdictions.
- Consider simplifying the overly complicated and detailed system of horizontal equalisation, even before the year 2010 targeted by the current reform programme.

Ensuring fiscal discipline:

- Improve the transparency of fiscal policy through the strengthening of government financial reporting. Efforts towards harmonising the existing frameworks and preparing a single set of government reports are welcome and should continue.
- Further enhance the existing benchmarking framework by completing the process of developing indicators and establishing relevant data sets for those indicators.

Bibliography

- ABS (Australian Bureau of Statistics) (2000), “Accruals-based Government Finance Statistics”, *Information Paper*, cat. No. 5517.0, ABS, Canberra.
- Allen Consulting (2004), *Governments Working Together: A Better Future for Australians*, The Allen Consulting Group, Melbourne, May.
- Australian Government (1999), *Budget Paper No. 3: Federal Financial Relations 1999-2000*, Australian Government, Canberra, May.
- Australian Government (2005), *Budget Papers*, Budget 2005-06, Australian Government, Canberra, May, www.budget.gov.au/2005-06.
- Australian Government (2006), *Budget Papers*, Budget 2006-07, Australian Government, Canberra, May, www.budget.gov.au.
- Banks, G. (2005), “Comparing School Systems Across Australia”, speech to the ANZSOG Conference, “Schooling in the 21st Century: Unlocking Human Potential”, Sydney, 28 September.
- CGC (Commonwealth Grants Commission) (2004), *Report on State Revenue Sharing relativities 2004 Review*, Australian Government, Canberra.
- CGC (2006), *Relative Fiscal Capacities of the States 2006*, Australian Government, Canberra.
- COAG (Council of Australian Governments) (2006), “Meeting 10 February 2006, Communique”, www.coag.gov.au.
- Collins, D.J. (2001), “The 2000 Reform of Intergovernmental Fiscal Arrangements in Australia”, paper prepared for the International Symposium on Fiscal Imbalance, Quebec, 13-14 September.
- Collins, D.J. (2004), “The GST and Federal-State Financial Relations: A Personal Assessment After Four Years Operation of the Intergovernmental Agreement”, *Opinion Piece*, No. 1, Australian Tax Research Foundation, August.
- Craig, J. (1997), “Australia”, in *Fiscal Federalism in Theory and Practice*, T. Ter-Minassian (ed.), International Monetary Fund, Washington DC.
- Dixon, P.B., M.R. Picton and M.T. Rimmer (2005), “Efficiency Effects of Changes in Commonwealth Grants to the States: A CGE Analysis”, *Australian Economic Papers*, Vol. 44, No. 1, Blackwell Publishing.
- Freebairn, J. (2002), “Opportunities to Reform State Taxes”, *The Australian Economic Review*, Vol. 35, No. 4, Blackwell Publishing.
- Gabbittas, O. and D. Eldridge (1998), “Directions for State Tax Reform”, *Staff Research Paper*, Productivity Commission, Canberra, June.

- Garnaut, R. and V. FitzGerald (2002a), *Review of Commonwealth-State Funding: Final Report*, Committee for the Review of Commonwealth–State Funding, August, www.treasury.nsw.gov.au/int_gov/finalrep.pdf.
- Garnaut, R. and V. FitzGerald (2002b), “Issues in Commonwealth-State Funding”, *The Australian Economic Review*, Vol. 35, No. 3, Blackwell Publishing.
- Hancock, J. and J. Smith (2001), “Financing the Federation”, The South Australian Centre For Economic Studies, Adelaide and Flinders Universities, September.
- Hogan, W.P. (2004), *Review of Pricing Arrangements in Residential Aged Care: Final Report*, Aged Care Price Review Taskforce, Canberra.
- Institute on Governance (1998), “Intergovernmental Fiscal Relationships: An International Perspective”, Institute on Governance, Ottawa.
- James, D. (1997), “Federal and State Taxation: A Comparison of the Australian, German and Canadian Systems”, *Current Issues Brief*, No. 5, 1997-98, Department of the Parliamentary Library.
- Joumard, I. (2005), “Getting the Most Out of Public Sector Decentralisation in Mexico”, *Economics Department Working Papers*, No. 453, OECD, Paris, www.oecd.org/eco/working_papers.
- Joumard, I. and P.M. Kongsrud (2003), “Fiscal Relations across Government Levels”, *OECD Economic Studies*, Vol. 1, No. 36, OECD, Paris.
- Keating, M. and J. Wanna (2000), “Remaking Federalism?”, in *Institutions on the Edge?: Capacity for Governance*, Allen & Unwin, Sydney.
- Madden, J.R. (2002), “Australian Federalism Reforms and Global Integration”, *Working Paper*, No. 148, Center for Research on Economic Development and Policy Reform, Stanford University, August.
- McLean, I. (2002), “Fiscal Federalism in Australia”, *Public Administration*, Vol. 82, No. 1, Blackwell Publishing, March.
- OECD (2004), *OECD Economic Surveys: United Kingdom*, No. 3, OECD, Paris.
- Peloquin, D. and A. Chong (2002), “A Comparison of Fiscal Disparities and Equalisation Regimes in Selected Federations”, paper presented at the Conference of Australian Economists, October, Adelaide.
- Productivity Commission (1996), *State, Territory and Local Assistance to Industry*, Report No. 55, IC Inquiry Report, Australian Government Publishing Service, Canberra.
- Productivity Commission (2005a), *Annual Report 2004-05*, Annual Report Series, Productivity Commission, Canberra, October.
- Productivity Commission (2005b), *The Economic Implications of an Ageing Australia*, Research Report, Productivity Commission, Canberra, March.

- Productivity Commission (2005c), *Review of National Competition Policy Reforms*, Inquiry Report, No. 33, Productivity Commission, Canberra, February.
- Productivity Commission (2006), *Australia's Health Workforce*, Research Report, Productivity Commission, Canberra, January.
- Ramakrishnan, U. and M. Cerisola (2004), "Regional Economics Disparities in Australia", *IMF Working Paper*, WP/04/144, International Monetary Fund, Washington, August.
- Rye, C.R. and B. Searle (1997). "The Fiscal Transfer System in Australia" in E. Ahmad (ed.), *Financing Decentralized Expenditures: An International Comparison of Grants*, National University Press, Canberra.
- Searle, B. (2002), "Federal Fiscal Relations in Australia – 2001", *ICER Working Papers*, No. 01-2002, International Centre for Economic Research, Turin.
- State and Territory Treasuries (1999), "Specific Purpose Payments", Discussion Paper, July, www.dtf.wa.gov.au/cms/uploadedFiles/SPP_Discussion_July_99.pdf.
- Sutherland, D., R. Price and I. Joumard (2005), "Fiscal Rules for Sub-central Governments: Design and Impact", *Economics Department Working Papers*, No. 465, OECD, Paris, www.oecd.org/eco/working_papers.
- Webb, R. (2002a), "Horizontal Fiscal Equalisation", *Research Note*, No. 1, 2002-03, Department of the Parliamentary Library, Parliament of Australia, August.
- Webb, R. (2002b), "The Australian Loan Council", *Research Note*, No. 43, 2001-02, Department of the Parliamentary Library, Parliament of Australia, June.
- Williams, R. (2005a), "Federal-State Financial Relations in Australia: the Role of the Commonwealth Grants Commission", *The Australian Economic Review*, Vol. 38, No. 1, Blackwell Publishing.
- Williams, R. (2005b), "Fiscal Federalism: Aims, Instruments, and Outcomes", *The Australian Economic Review*, Vol. 38, No. 4, Blackwell Publishing.

WORKING PAPERS

The full series of Economics Department Working Papers can be consulted at www.oecd.org/eco/Working_Papers/

- 540. *Russian manufacturing and the threat of 'Dutch Disease': A comparison of competitiveness developments in Russia and Ukrainian industry* by Rudiger Ahrend, Donato de Rosa and William Tompson
- 539. *Stimulating innovation in Russia: The role of institutions and policies* by Christian Gianella and William Tompson
- 538. *Healthcare reform in Russia: problems and prospects* by William Tompson
- 537. *A golden rule for Russia? How a rule-based fiscal policy can allow a smooth adjustment to the new terms of trade* by Christian Gianella
- 536. *From "clientelism" to a "client-centred orientation"? The challenge of public administration reform in Russia* by William Tompson
- 535. *Has the rise in debt made households more vulnerable?*
(December 2006) Nathalie Girouard, Mike Kennedy and Christophe Andr
- 534. *Social security reform in Brazil: Achievements and remaining challenges*
(December 2006) Fabio Giambiagi and Luiz de Mello
- 533. *Improving labour utilisation in Brazil*
(December 2006) Luiz de Mello, Naércio Menezes Filho and Luiz G. Scorzafave
- 532. *Boosting innovation performance in Brazil*
(December 2006) Carlos H. de Brito Cruz and Luiz de Mello
- 531. *Consolidating macroeconomic adjustment in Brazil*
(December 2006) Luiz de Mello and Diego Moccerro
- 530. *Product market regulation in the non-manufacturing sectors of OECD countries: Measurement and highlights*
(December 2006) Paul Conway and Giuseppe Nicoletti
- 529. *The Turkish pension system: further reforms to help solve the informality problem*
(November 2006) Anne-Marie Brook and Edward Whitehouse
- 528. *Policies to improve Turkey's resilience to financial market shocks*
(November 2006) Anne-Marie Brook.
- 527. *Upgrading Japan's innovation system to sustain economic growth*
(November 2006) Randall S. Jones and Tadashi Yokoyama
- 526. *Strengthening the integration of Japan in the world economy to benefit more fully from globalisation*
(November 2006) Randall S. Jones and Taesik Yoon
- 525. *OECD's FDI regulatory restrictiveness index: Revision and extension to more economies*
(November 2006) Sven Blöndal and Alain de Serres
- 524. *Globalisation and inflation in the OECD economies*
(November 2006) Nigel Pain, Isabell Koske and Marte Sollie
- 523. *Identifying determinants of Germany's international price competitiveness – A structural VAR approach*

- (November 2006) Martin Meurers
522. *Short-term pain for long-term gain: the impact of structural reform on fiscal outcomes in EMU*
(November 2006) Paul van den Noord and Boris Cournède
521. *Interactions between monetary and fiscal policy: How monetary conditions affect fiscal consolidation*
(November 2006) Rudiger Ahrend, Pietro Catte and Robert Price
520. *Restoring fiscal sustainability in the Euro Area: raise taxes or curb spending?*
(October 2006) Boris Cournède and Frédéric Gonand
519. *Should Measures of Fiscal Stance be Adjusted for Terms of Trade Effects*
(October 2006) David Turner
518. *Monetary policy and inflation expectations in Latin America: Long-run effects and volatility spillovers*
(October 2006) Luiz de Mello and Diego Moccero
517. *Social safety nets and structural adjustment*
(September 2006) Paul van den Noord, Nathalie Girouard and Christophe André
516. *Adapting the Icelandic education system to a changing environment*
(September 2006) Hannes Suppanz
515. *Forecasting monthly GDP for Canada*
(September 2006) Annabelle Mourougane
514. *Finland's housing market: reducing risks and improving policies*
(September 2006) Laura Vartia
513. *The Danish housing market: Less subsidy and more flexibility*
(September 2006) Espen Erlandsen, Jens Lundsgaard and Felix Huefner
512. *Labour market reform in Germany: How to improve effectiveness*
(September 2006) Eckhard Wurzel
511. *Removing obstacles to employment for women in Ireland*
(September 2006) Boris Cournède
510. *Assessing Russia's non-fuel trade elasticities: Does the Russian economy react "normally" to exchange rate movements?*
(September 2006) Christian Gianella and Corinne Chanteloup
509. *Regulation, competition and productivity convergence*
(September 2006) Paul Conway, Donato De Rosa, Giuseppe Nicoletti and Faye Steiner
508. *Improving education achievement and attainment in Luxembourg to compete in the labour market*
(September 2006) David Carey and Ekkehard Ernst
507. *Raising economic performance by fostering product market competition in Germany*
(August 2006) Andrés Fuentes, Eckhard Wurzel and Andreas Reindl
506. *Regulation of financial systems and economic growth*
(August 2006) Alain de Serres, Shuji Kobayakawa, Torsten Sløk and Laura Vartia
505. *Enhancing Portugal's human capital*
(August 2006) Bénédicte Larre and Stéphanie Guichard