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**VERTICAL FISCAL IMBALANCE IN AUSTRALIA:
A PROBLEM FOR TAX STRUCTURE, NOT FOR
REVENUE SHARING**

Bhajan Grewal

Centre for Strategic Economic Studies
Victoria University
Melbourne

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ABSTRACT

It is argued in this paper that vertical fiscal imbalance remains a serious problem for Australian federation. The paper shows that although by conventional measures vertical fiscal imbalance may have improved in recent years, judging by its impact on the States' tax structure it is clear that the situation has deteriorated. The unhappy legacy of revenue sharing arrangements over the past fifty years is discussed and it is shown that, despite numerous alterations in these arrangements, revenue sharing has failed as a solution for the problem of fiscal imbalance, and has resulted in loss of accountability and responsibility in government, and in institutional waste. The States' struggle for access to the field of income tax since the 1950s is outlined and the perceived impediments to such an access are considered in the light of the 1991 report of the Commonwealth-State officers' working party on tax powers.

The author is Deputy Director of the Centre for Strategic Economic Studies at Victoria University. As a former Director of Revenue and Grants Policy in the Victorian Treasury, he was also a member of the Commonwealth-State Treasury Officers Working Party on vertical fiscal imbalance which reported to the Special Premiers' Conference in October 1991. He wishes to thank Professors John Head, Russell Mathews and Peter Sheehan, and Mr Bruce Parr (of the Victorian Treasury) for providing valuable comments on an earlier draft of this paper. The normal disclaimer for any remaining errors applies.

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ABSTRACT¹

It is argued in this paper that vertical fiscal imbalance remains a serious problem for Australian federation. The paper shows that although by conventional measures vertical fiscal imbalance may have improved in recent years, judging by its impact on the States' tax structure it is clear that the situation has deteriorated. The unhappy legacy of revenue sharing arrangements over the past fifty years is discussed and it is shown that, despite numerous alterations in these arrangements, revenue sharing has failed as a solution for the problem of fiscal imbalance, and has resulted in loss of accountability and responsibility in government, and in institutional waste. The States' struggle for access to the field of income tax since the 1950s is outlined and the perceived impediments to such an access are considered in the light of the 1991 report of the Commonwealth-State officers' working party on tax powers.

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1. INTRODUCTION

The term vertical fiscal imbalance describes a chronic feature of Australian federalism namely, a highly centralised revenue-raising system enabling the Commonwealth Government to raise nearly 80 per cent of the national tax revenue, and a fairly decentralised system of public outlays which are shared almost equally between the Commonwealth and the States. Consequently, financial transfers from the Commonwealth to the States are a major source of financing public outlays of the States, accounting for an average of 44 per cent of the outlays of the States and the Territories during the ten years to 1989-90, although the figure is higher for the less populous States and the Northern Territory, and has been higher for the state sector during each of the previous two decades.

The heavy dependence of the State budgets on payments from the Commonwealth and the lack of viable alternative revenue sources for the States have remained a matter of concern and debate in Australia during most of the years since the second world war. During this period, some States challenged in the High Court the Commonwealth's exclusive right to income taxes. The imbalance has also been the subject of consideration at several Premiers' Conferences, official committees of review, Commonwealth-State Treasury officials' working parties, and academic conferences and seminars. A number of these reviews have recommended that a reduction in the degree of fiscal imbalance should be brought about by providing the States access to some of the broadly based taxes. Most recently, a working party of officials, which was asked by the Special Premiers' Conference in 1990 to examine the issue of vertical fiscal imbalance, reported in 1991 on several options, some of which would reduce the imbalance without increasing either the aggregate tax burden or the budgetary cost to the Commonwealth Government. These neutrality conditions would be achieved by virtue of the fact that the States' entry into income taxation would be accompanied by a corresponding reduction in Commonwealth grants to the States.

It is argued in this paper that the problems caused by vertical fiscal imbalance cannot be solved through revenue sharing. Instead, they must be recognised as problems of the States' taxation structure. The paper also shows conventional ratios often used for measuring the degree of fiscal imbalance divert attention from the qualitative aspects of the imbalance. A complementary measure is suggested that helps focus on the tax structure issues.

The paper is organised in the following manner. The level and significance of vertical fiscal imbalance are discussed in section 2, where a measure of broad-based tax structure is also introduced into the discussion; section 3 considers the legacy of revenue sharing over the past 50 years, including the issues of accountability, responsiveness, and institutional waste; the struggle of the States to regain entry into

the income tax field is outlined in section 4; the issues relevant to the restoration of the States' tax structure are discussed in section 5; the future role of the pay-roll tax is briefly touched on in section 6 in the context of its bearing on the States' tax structure; section 7 provides a brief summary of the main conclusions; and in the final section a few thoughts on the future outlook of the imbalance are offered.

2. THE LEVEL AND SIGNIFICANCE OF VERTICAL FISCAL IMBALANCE

The concept of vertical fiscal imbalance (VFI) is premised on the notion that in the ideal situation each level of government should be able to raise from its own sources all the revenue required to finance its expenditure. In an attempt to institutionalise this requirement for fiscal balance, the Commonwealth Government enunciated in 1926 a 'basic principle of national finance' according to which 'every government shall have the responsibility of raising the revenue which it is expending' (Prest 1974, p.188). But such a perfect balance remains only a benchmark, and has not been achieved in Australia since Federation. Even in its heyday, the leading economists, including Giblin and Mills, regarded the principle neither so basic nor so universal as its advocates claimed (Prest 1974, p. 189). At the same time, Giblin and Eggleston stressed, in the third report of the Grants Commission in 1936, the need to avoid excessive imbalance, observing that if a government raises less revenue than it needs its services are likely to be starved, but equally a government becomes extravagant if it has more money than it needs (Prest 1974). Reflecting the pragmatic nature of any solution to such an issue, Prest suggested that a ratio of tax revenue to outlays which is short of equality but well in excess of 50 per cent would be desirable (1974, p. 189).

Although some degree of VFI has always been a feature of Australian federation, the imbalance became serious after the States' exclusion from income taxation during the second world war and has remained a problem since. Several attempts have been made in the meantime to examine how the imbalance might be reduced. However, in spite of the transfer of pay-roll tax from the Commonwealth to the States in 1971, no lasting solution has yet been found.

As noted above, the most recent review of VFI was undertaken by the Working Party of Commonwealth-State Treasury officers in 1990-91. The Working Party defined vertical fiscal imbalance as "the difference between own source revenue and own purpose expenditure commitments of a level of government" (1991, p.6). Its report showed that for 1991-92, the ratios of own revenue and own purpose outlays stood at 1.36 for the Commonwealth, 0.54 for the States and Territories, and 0.63 for the local government (all figures are for the general government sector), and that the ratios for individual States and Territories varied from 0.23 for Northern Territory to 0.68 for New South Wales.

In an earlier study, the imbalance was measured by the Committee of Inquiry into Revenue Raising in Victoria by the ratio of Commonwealth grants to the States' outlays (Inquiry into Revenue Raising in Victoria 1983). Alternatively, the imbalance may also be measured by the ratio of own-source revenue of a Government to its total outlays. As compared with the Working Party's measure, this ratio

slightly underestimates the (VFI) ratio, as the denominator includes transfer payments to other Governments and to the public trading enterprises. In this paper, the ratios refer to the combined total of general government sector and public trading enterprises, as defined by the Australian Statistician.

As shown in Table 1, the figures suggest that the severity of VFI for Australian States has declined in recent years. Thus, for example, the States raised a larger percentage of their outlays from own sources of revenue in 1989-90 than in any previous period shown in this table except in 1975-76. Correspondingly, their dependence on Commonwealth grants has also declined to the lowest level since 1975-76. Furthermore, in 1989-90 a larger share of revenue was raised from taxes, fees and fines than in the previous periods

Table 1
Vertical Fiscal Imbalance in Selected Years

	<i>1969-70</i>	<i>1975-76</i>	<i>1980-81</i>	<i>1985-86</i>	<i>1989-90</i>
1. States' own source revenues as a percentage of States' Outlays	<u>36.1</u>	<u>35.2</u>	37.1	39.7	47.7
2. States' Taxes, Fees and Fines as a percentage of States' Outlays	26.8	29.3	29.3	30.3	36.4
3. Commonwealth Grants as a percentage of States' Outlays	45.4	58.6	57.0	55.2	48.4

Note: Unless otherwise indicated, the mention of States in this paper includes the Territories as well.
Source: Calculated by the author from ABS Catalogue No. 5501.0, various years.

Similarly, the figures in Table 2, which show the percentage of national taxation revenue raised at each level of Government, can be interpreted to suggest that, the plight of Australian States is not too dissimilar to their counterparts in Germany and the United States.

Table 2
Taxation Revenue by Level of Government in Major Federations 1991

	<i>Australia</i>	<i>Canada</i>	<i>Germany</i>	<i>USA</i>
Federal	77.5	49.4	70.9	68.2
State	18.5	34.1	20.5	18.8
Local	3.9	9.4	7.7	13.0

Source: OECD. (1992). *Revenue Statistics of OECD Member Countries, 1965/91*. Paris.

The apparent improvement in vertical balance shown in Table 1 has not occurred due to an expansion in the taxation powers of the States. It has occurred principally due to the decline in Commonwealth grants relative to State outlays. The

States have responded, in the absence of any broad-based taxes available to them, by increasing the utilisation of their existing taxes. This has meant that the States' reliance on the narrow-based and inefficient taxes has progressively increased in recent years. Unfortunately, this aspect of the situation is not captured by the simplistic ratios or percentages such as the ones depicted in Table 1. Similarly, what the figures in Table 2 do not show is that in Canada, Germany, and the United States, the middle level governments raise a much larger proportion of their revenue from broad-based taxes on incomes and consumption, in contrast with Australian States which are totally excluded from these two fields of revenue.

The Imbalance and the Tax Structure

In order to look beyond the simplistic ratios, where indeed the real nature of the problem of fiscal imbalance may be revealed, it is important, therefore to consider an additional measure that captures the relevant features of the structure of State revenue systems.

A useful additional measurement of fiscal imbalance may be the percentage of own source revenue raised by broad-based taxes. The following groups of taxes are taken in this paper to be broad-based for this purpose:

- Taxes on personal incomes
- General taxes on goods and services
- Taxes on pay-roll and workforce

Revenue raised from this group of taxes by the middle level of governments in Australia, Canada, Germany and the United States in 1991 is shown in Table 3. These figures show that by this measure the tax structure of Australian taxes is far inferior to those of their counterparts in the other federations.

Table 3
Composition of Tax Revenue of Middle Level Governments 1991
(percentage of total taxation receipts)

	<i>Australia</i>	<i>Canada</i>	<i>Germany</i>	<i>USA</i>
Broad-based Taxes				
Taxes on personal income	-	44	51	32
General taxes on goods & services	-	21	28	33
Taxes on pay-roll or workforce	28	-	-	-
Total Broad-based Taxes	28	65	79	65
Other Taxes				
On specific goods & services	14	15	2	16
On use of goods & services	26	9	5	8
On immovable property	10	3	6	2
On financial & capital transactions	21	-	2	-
Total Other Taxes	71	27	15	26

Source: OECD. (1992). *Revenue Statistics of OECD Member Countries, 1965/91*. Paris.

Figures in Table 4, show the changes in the structure of State taxation in selected years. It is clear that, while quantitatively vertical fiscal imbalance has declined since 1975, qualitatively, there has been a deterioration as the share of

revenue raised from narrow-based taxes has increased during this period. The share of revenue raised from pay-roll tax, the only broad-based tax available to the States at present, has also been declining. In its place, an increasing share of State revenue is now raised from taxes on financial and capital transactions, taxes on immovable property, and taxes on the use of goods and services (such as motor vehicles).

Table 4
Tax Structure of Australian States 1939, 1975, 1985, 1991
(percentage of Total Tax Receipts)

Australia				
	<i>1939</i>	<i>1975</i>	<i>1985</i>	<i>1991</i>
Broad-based Taxes				
Taxes on income	59	0	0	0
General taxes on goods & services	0	0	0	0
Taxes on pay-roll or workforce	0	35	31	27
Total Broad based Taxes	59	35	31	27
Other Taxes				
On specific goods & services	7.2	16	17	14
On use of goods & services	14	22	26	26
On immovable property	2.8	6	7	10
Financial & capital transactions	7	13	19	21
Net Wealth - recurrent				
Estate and inheritance taxes	10	7	--	--
Total Other Taxes	41	64	69	71

Source: Figures for 1939 are sourced from R.L. Mathews and W.R.C. Jay, (1972), *Federal Finance*, Melbourne: Thomas Nelson, p.152.

Figures for 1975, 1985, and 1991 are from OECD, (1992), *Revenue Statistics of OECD Member Countries, 1965/91*, Paris.

The structure of taxation of the States has been criticised by most observers and commentators. The Committee of Inquiry into Revenue Raising in Victoria (The Nieuwenhuysen Committee 1983) and the Collins Review of New South Wales Taxation (1988), both observed that the State taxation system is regressive and narrowly based. The Working Party of Commonwealth-State Treasury Officers examining vertical fiscal imbalance in 1991 also pointed out that:

- (a) income elasticity of State taxes is low and would require the States in the long run to increase tax rates in order to maintain their revenue as a proportion of gross domestic product;
- (b) Pay-roll tax is the most broad-based State tax at present, but being a tax on one input only (labour) the tax is often criticised for its possible distortion of resource allocation, although OECD studies suggest that the impact of the pay-roll tax is broadly similar to that of the income tax;
- (c) differences among the States in terms of exemption levels of pay-roll tax could lead to competitive erosion of the tax base, although the revenue benefits of standardising the exemptions did not appear to be substantial; and

- (d) there would also appear to be little scope for further increases in pay-roll tax, particularly in the light of the introduction of the Commonwealth Superannuation levy.

The Working Party considered that it would be possible for the States to raise between \$9.0 billion and \$13.0 billion from a surcharge on income tax, accompanied by a corresponding reduction in Commonwealth grants, without causing any problems for horizontal fiscal equalisation or management of the economy. In respect of the figures in Table 4, if \$10.0 billion was raised by the States from income tax, the share of broad-based revenue in total revenue would have increased to 50.7 per cent in 1991.

3. THE UNHAPPY LEGACY OF REVENUE SHARING

Loss of Accountability

Most commentators have singled out loss of accountability as a major drawback of the high degree of vertical fiscal imbalance in Australia. (see for example, Committee of Inquiry into State Revenue Raising 1983; Australian Constitutional Convention 1984; Working Party on Tax Powers 1991). Essentially, the accountability argument is that if a government does not raise all the revenue that it spends, it will not be fully accountable to its taxpayers, and its spending decisions are likely to be inefficient. Accountability in this sense refers to the need to explain, justify, convince or demonstrate to the taxpayers that the revenue is indeed necessary and that the funds raised will be spent responsibly. The odium or the political cost of revenue raising consists of these obligations on the part of the governments, and generally varies not only between taxation and intergovernmental grants, but also between different types of taxes and grants. Thus, in comparison with taxation, intergovernmental grants are likely to create the impression of zero political costs for the recipient government, and thereby result in a loss of accountability and efficiency. If, however, grants are given for specific purposes and carry with them at least some obligations towards the government which gives them, accountability is comparatively enhanced. Thus, on the criterion of accountability, specific purpose grants should be ranked higher than general revenue grants, which in turn are superior to taxation.

It is important to note that the accountability score of different types of taxes is also different and will depend upon the degree of discretionary change to tax rates or tax bases required for generating additional revenue. This point can be illustrated by contrasting two governments one of which (say, the Commonwealth Government) raises its revenue from progressive income taxation, and the other (say, a State Government) from pay-roll tax. In a period of high inflation accompanied by correspondingly high increases in money incomes, but little growth in employment, the former government would experience high and automatic growth in its tax revenue while the latter's revenue would remain static. Apart from the obvious difference in their revenue positions, the two governments would face different accountability constraints. In the case of the former an increasing amount of revenue can be raised without the government having to increase the rate of tax or broaden the tax base. On

the other hand, if the latter government wants to raise additional tax revenue, it would need to increase the rate of pay-roll tax, and be accountable to the taxpayers.

The two important propositions that emerge from this example are that (a) loss of accountability is not restricted to grants alone, and can occur even in the case of tax revenues, and (b) other things being equal, loss of accountability for taxation revenue would be higher for a government which raises a larger proportion of its revenue from non-discretionary growth of tax bases. The practical significance of these two propositions is that the Commonwealth Government's revenue structure has a much greater scope for the loss of accountability due to non-discretionary growth, than is the case with the State taxation. The loss of accountability caused by intergovernmental grants, on the other hand, can occur at both levels of government; the recipient being influenced by the lower political cost of the grant money, and the donor by being insensitive to the needs of the recipient.

Loss of Responsiveness

The concept of responsiveness refers to the ability of a government to respond meaningfully and effectively to specific demands and policy requirements of its electorate. In a federation, the concept is legitimised by the heterogeneity of preferences that defines the economic rationale for a federalised public sector (see Oates 1972; Grewal 1981). If preferences were homogeneous throughout a nation, or if the national government could provide heterogeneous outputs and policies, all public goods could be provided by the national government, through administrative delegation if necessary, and no need would exist for decentralised decision-making (which is the key to fiscal federalism). The case for fiscal federalism arises out of the inability of national governments, at a reasonable cost, to properly assess and respond to the unique needs of regional and local economies and societies.

In the context of intergovernmental grants, responsiveness means that Commonwealth Government is fully aware of and able to respond to the fiscal needs of the States, and the latter are able to spend the grants as warranted by the needs of their respective electorate. In other words, responsiveness means that the priorities to which a government is responding are its own priorities, not that of another government which may be involved in the financial arrangements. This does not rule out the cases of joint or shared responsibility between two or more government authorities when priorities must reflect the interests of all parties. It simply means that the coincidental involvement of a government through revenue sharing arrangements should not extend into the decision-making. This particular interpretation of responsiveness conflicts with acceptability and favours general purpose grants over specific purpose grants.

Vertical fiscal imbalance, particularly at the level it exists in Australia, also undermines the concept of responsiveness if it degenerates into unilateral decisions such as those taken by the Commonwealth; it exercised its fiscal supremacy and made decisions without due regard for the possible effects on the States' finances. Fiscal resources of the Commonwealth Government are far in excess of its direct expenditure responsibilities. It has been noted that a large part of its revenue is generated in the absence of discretionary changes to tax rates or bases. Abundance of revenue and

relative lack of taxpayer accountability have often provided a potent mixture for fiscal adventurism: for example in the late 1960s, when the States slid into increasing indebtedness while the Commonwealth used its surplus revenue for repaying its debt and became a net creditor; or in the early 1970s when the Commonwealth launched massive spending programs financed through the multitude of specific purpose grants to the States; or in the 1980s when the Commonwealth caused fiscal starvation of the States so that it could not only reduce its budget deficit but achieve a surplus. These are all examples of how the revenue supremacy of the Commonwealth took the States through a fiscal roller-coaster over the past two decades.

The observation made by the Grants Commission in 1936 (noted above) that surplus revenue is likely to result in extravagant behaviour sounds rather profound against this background. So also does the following comment of Russell Mathews:

‘if equity and diversity in service provisions are the great strengths of Australian federal fiscal arrangements, the overriding weakness is that of lack of fiscal responsibility and accountability at both levels of government—as a result of the fact no level of government is responsible for the essential budgetary process of linking revenue-raising and spending decisions’.
(1985, p.21)

Under normal circumstances, the States could assess the potential damage of a specific-purpose program and refuse to accept a grant if there is a high risk of distortion of priorities. However, not having many alternative sources of revenue of their own, States have seldom been in a position where rejection of Commonwealth funds is a realistic option for them.

The ascendancy of fiscal centralisation in Australia that has resulted from the high degree of VFI is in stark contrast to the directions proposed in the United States of America in recent years by leading fiscal experts. In a recent book *Reviving the American Dream: The Economy, the States and the Federal Government*, which addresses the key questions facing the US economy including declining productivity, Rivlin (1992) has proposed that the role of the American States in national economic policy-making should be strengthened and their revenue capabilities enhanced with a shared national tax, ideally a national VAT. Rivlin’s proposal involves entrusting the States with the entire productivity agenda including provision of infrastructure, education and skill formation. In a separate comment on the dangers of fiscal centralisation Wallace Oates, another renowned expert on fiscal federalism also stresses that: ‘there surely are strong reasons, in principle, to believe that policies formulated for the provision of infrastructure and even human capital that are sensitive to regional or local conditions are likely to be more effective in encouraging economic development than centrally determined policies that ignore these geographic differences’ (Oates 1993).

As these perspectives suggest, centralised policy-making runs the risk of loss of efficiency by imposing uniform policies and solutions on issues that require responses specifically designed for local conditions. Additionally, however, when centralised control is exercised through the vehicle of financial transfers instead of direct provision of services, the lines of responsibility for each level of Government are blurred. As

pointed out by Mathews and Jay more than twenty years ago no government then discharges 'the vital role of government, arbitrating between the taxpayer and those who call for more expenditure on government services' (1972). The States are able to take the view that they would be happy to provide the additional services if only the Commonwealth, on the other hand, is able to assert that adequate or even generous funds have been made available to the States and it is entirely up to them to determine the priorities for allocation.

Institutional Waste

In the past fifty years, vertical fiscal imbalance in Australia has been treated as a problem of revenue sharing, not one of taxation structure. Several factors may have contributed to this view of the problem. First, the current degree of centralisation of taxation revenue is often regarded as largely the inevitable outcome of Constitutional constraints (such as the exclusion of the States from excise duties, coupled with the High Court's interpretations of section 90 of the Constitution which have extended this prohibition to most forms of sales taxation) about which not a great deal may be possibly done, at least in the short run. Secondly, some have justified the highly centralised revenue structure by arguing that it is essential for the Commonwealth Government's ability to manage the national economy. Thirdly, there is the argument, never fully demonstrated for its validity but always implicit in the debates on States' access to some broad-based taxation, that vertical fiscal imbalance enables the Commonwealth Government to safeguard the interests of the less populous States through horizontal fiscal equalisation. Finally, in the absence of a generalised normative theory of tax decentralisation (except the public choice perspective which still remains inextricably tied to its assumption of the exploitative behaviour of all Governments at all times), there has been a reluctance in Australia to adopt those models of joint utilisation of tax bases which have worked well in other federations. Accordingly, annual Commonwealth grants to the States have been accepted by many as a natural and permanent feature of Australian fiscal federalism. The following statement by Mr Paul Keating, made in his capacity of an ALP backbencher, in an address to the National Press Club on 23 October 1991 makes a forceful argument for the status quo:

Economic management has had to develop from the Commonwealth's power over revenue and the creation of a monetary authority. The national perspective dominates Australian political life because the national government dominates revenue raising, and only because the national government dominates revenue raising. (Keating 1991)

At the same time Australia's experience also shows without doubt that revenue sharing is a poor means of closing the vertical fiscal imbalance. Apart from the loss of accountability and responsiveness noted above, revenue sharing has resulted in enormous waste of the potentially useful institutions such as the Premiers Conference and Australian Loan Council. Instead of addressing the critical issues of policy coordination across a range of issues of national importance, in which intergovernmental externalities or the need for developing a genuine national perspective are important, these institutions continue to waste their energies on making annual variations to Commonwealth grants or loans to the States (for more on this

theme see Grewal 1989). Table 5 shows the frequency of ad hoc alterations made to the arrangements of general purpose revenue grants to the States in the last fifty years. It is clear from the Table that a stable and a viable system of revenue sharing has not emerged from these experimental variations.

The Fiscal Powers Sub-committee of Australian Constitutional Convention (1984), noted another aspect of the institutional waste resulting from revenue sharing when it stated that there is also the worrying indication that prolonged reliance on grants may have lulled the States into fiscal submission to the Commonwealth, and made them insensitive to the requirements of accountability to the taxpayers. If this were the case, although the States' enthusiasm for participation in a national personal income tax during the 1991 review by the Special Premiers' Conference suggested otherwise, the vested interests of both levels of Government may have locked the country into a patently inferior fiscal framework.

Table 5	
Major Alterations Made To Revenue Sharing Arrangements: 1942-92	
1942-3 to 1945-6	Tax reimbursement grants for income tax and entertainment tax, primary purpose being compensation for loss of tax revenue.
1946-7 to 1947-8	Tax reimbursement grants increased beyond initial loss of tax revenue.
1948-9 to 1956-7	Method of determining aggregate total of grants changed and linked to growth of population and wages.
1957-8 to 1958-9	Aggregate total of tax reimbursement grants linked to 'adjusted' population.
1959-60 to 1964-5	Tax reimbursement grants replaced by financial assistance grants; aggregate total determined by formula.
1965-6 to 1969-70	Formula for financial assistance grants changed, inter alia to include a betterment factor.
1970-1	Financial assistance grants continue but additional amounts added to base grants and additional revenue assistance given to cope with budget deficits.
1971-2 to 1974-5	Betterment factor increased, grants given to meet debt charges. Special revenue assistance given to ease the effect of wage increases. A permanent increase of \$112 million made to the base grants in 1972-3. Special/additional revenue assistance in each of the final two years.
1975-6	Further permanent additions to the lease of financial assistance grants. Betterment factor increased.
1976-7	Financial assistance grants abolished in favour of tax sharing grants at 33.6 per cent of personal income tax collections in that year.

1977-8 to 1980-1	The basis for tax sharing grants changed to 38.97 of previous year's tax collections. A guarantee given to ensure that no State would lose in comparison with the previous arrangements.
1981-2	An interim year in which the grants simply maintained at the real level of the previous year.
1982-3 to 1984-5	The basis for tax sharing grants changed to 20.72 per cent of previous year's total tax collections. A guarantee of 2 per cent real increase in 1982-83 and 1 per cent real increase in 1983-84 and 1984-85.
1985-6	Tax sharing grants discontinued and replaced with financial assistance grants for the triennium 1985-6 to 1987-8. Financial assistance grants maintained at previous year's level in real terms.
1986-7	Previous year's grant increased by the legislated guarantee of 2 per cent real growth.
1987-8	Contrary to the guaranteed 2 per cent real increase, grants determined by maintaining the previous year's level in real terms .
1988-9	Grants determined by reducing the forward estimates by \$650 million.
1989-90	Grants determined again for one year by reducing the forward estimates by \$550 million and another \$45 million to fund special assistance to NT.
1990-1	Grants determined for one year by reducing the forward estimates by \$400 million, and another \$50 million to fund special assistance to the NT.
1991-2	1990-91 grants maintained at the previous year's real level.

In spite of this long and varied experimentation with revenue sharing, no viable long-term solution has been found for closing the vertical fiscal imbalance. Instead, the current system of revenue sharing has produced a situation in which:

- (a) the Commonwealth Government appears to believe that centralisation of economic and fiscal decisions is necessary for the achievement of national economic objectives, and that Commonwealth grants to the States are an indispensable instrument of centralisation;
- (b) the Commonwealth has on occasions used the blunt instrument of Commonwealth grants to starve the States financially in order to achieve their agreement on specific issues;
- (c) the States have shown, except on a few occasions when the tax powers were pursued with unanimous support, generally a preference for Commonwealth

grants, and have been opposed mainly to conditions attached to specific purpose grants;

- (d) the States have often been content with blaming the Commonwealth for not giving them enough funds, instead of going seriously for additional tax powers; and
- (e) the institutions of fiscal federalism largely waste their time and effort on the determination of the level, the distribution and the composition of Commonwealth grants, instead of playing a constructive role in policy development and coordination.

It will be difficult to claim that over the past half a century, revenue sharing has helped create a vibrant federation in Australia in which diversity and competition have been nurtured as dynamic features of the public sector. Instead, the current situation can only be supported, as noted above, if fiscal centralisation is accepted as a means of effective government.

4. THE STRUGGLE FOR BROAD-BASED TAXATION

The First Big Push of the 1950s

It is a part of Australia's fiscal history that the States vigorously resisted the introduction of the uniform income tax by rejecting Commonwealth proposals twice before the latter passed the legislation unilaterally. The States then challenged the Constitutional validity of the legislation in the High Court but lost. Even after the war was over, their attempts to re-enter the field of income tax were resisted by the Commonwealth as it wanted to exercise its legal right to uniform income tax, validated by the High Court in the first uniform income tax case. The legal power of the Commonwealth in this context related to its power to cease tax reimbursement grants to a State which entered the income tax field without the Commonwealth's agreement. The Commonwealth had also introduced a uniform entertainment tax in 1942 and paid compensatory grants to the States for the loss of revenue from this source. The entertainment tax was, however, returned to the States in 1953-54, but the return of the income tax has not happened so far.

The revenue raised by the Commonwealth from income tax increased rapidly during and after the war and constituted nearly 44 per cent of national taxation revenue in 1948-49 as compared with 21 per cent in 1938-39. The VFI ratio for the States declined to 0.21 in 1948-49. Their dependency on the Commonwealth had correspondingly increased, as 35 per cent of their total expenditure was now funded from Commonwealth grants. By 1948-49 the loss of income tax had already adversely affected the States' finances as Mathews and Jay explain:

By 1948-49, however, the States were facing intense budgetary difficulties. Deterioration in the finances of their business undertakings, the need to make good the wartime back log of works and deferred mainstream expenditures, and rapidly rising costs of government had somehow to be accommodated within the financial limits imposed by the Commonwealth, and such increases

as the States were able to achieve in the yields of taxes still under their control. (1972, p. 197)

Led by Victoria, the States again raised the question of their re-entry into the income tax field at the Premiers' Conferences of September 1950 and August 1951. Victoria took out a writ in the High Court in October 1952 to challenge some parts of the uniform tax legislation, but did not pursue the challenge. In July 1952, the Commonwealth Government informed the States that it was prepared to discuss with them the question of their access to income tax. In February 1953, the Premiers' Conference considered a report prepared by the Commonwealth-State Treasury officers on the technical issues of this matter. The officers reported that it would be feasible for a single tax administration to be maintained under the Commonwealth, while allowing the States to nominate a percentage addition to the income tax collected by the Commonwealth (Mathews and Jay 1972, p. 214).

At the February 1953 Premiers' Conference, the officers were asked to prepare a further report as a basis for discussion on the extent to which the Commonwealth Government might vacate the income tax field. This report was received at a subsequent Premiers' Conference in August 1953, together with a report on the special problems facing Queensland in the event of a return to income tax by the States. However, due to lack of enthusiasm among some of the States, particularly the less populous ones, no agreement could be reached on the proposal.

The failure of the States to successfully pursue their return to income taxation in 1950-53 was partly due to the fact that there was no agreement on the part of the Commonwealth to correspondingly reduce its rates of tax so as to make a tax room for the States' percentage additions. Some years later, a similar arrangement involving a tax room would enable the Canadian provinces to return to income taxation, a field they had also vacated in favour of the national government during the Second World War.

In addition, the lack of enthusiasm on the part of the less populous States also demonstrated that horizontal fiscal imbalance and vertical fiscal imbalance were not entirely separate issues but were interrelated. The less populous States were apprehensive that the gap between them and the larger States would increase if income taxation became a source of State revenue. This apprehension has remained an important factor in the smaller States' attitude towards vertical fiscal imbalance ever since, and was reflected in the terms of reference given to the Commonwealth State Treasury Officers' Working Party in 1991. The Working Party came to the conclusion that the concerns of the less populous States could be addressed by the current system of horizontal fiscal equalisation which need not be disrupted by the States' gaining access to personal income tax. This should never have been in doubt even in the 1950s as the Grants Commission's procedures for special grants to the claimant States were in place and could have easily accommodated the differential fiscal effects of the States' entry into income taxation. Instead of encouraging the States' re-entry into income taxation by removing this apprehension, the Commonwealth Government appeared, during this period, to be using it as a means of maintaining the status quo.

In December 1955, Victoria proceeded with a High Court challenge to the Commonwealth's uniform income tax legislation. In November 1956, the New South Wales Government intervened in support of Victoria's challenge. In August 1957, the Court unanimously upheld the vital sections of the legislation, which had made the tax reimbursement grants to a State conditional on it not imposing an income tax.

A special Premiers' Conference was convened in March 1959 when Victoria and Queensland took the unprecedented step of applying to the Commonwealth Grants Commission for special grants. The issue of States' access to income tax was again discussed but could not be resolved. Instead, the Conference agreed to make significant changes to the tax reimbursement grants, including their replacement with 'financial assistance grants' (see Table 6).

Fiscal Crisis of the States

Not satisfied with the fiscal outcome of the new arrangements, Victoria approached the Commonwealth in 1964 with a proposal to impose a marginal income tax on Victorian residents, which it wanted the Commonwealth to collect on its behalf. Under the legal provisions in place at the time, Victoria would have had to forgo financial assistance grants, presumably by the amount equivalent to the revenue raised by the proposed income tax. But the Commonwealth rejected the request, arguing that the uniform tax arrangements could be changed only if they were supported by all States, if the changes adequately safeguarded the interests of taxpayers and did not upset the sound basis for future financial relations between the Commonwealth and each of the States.

The Victorian Government indicated that it did not favour setting up the machinery for the administration and collection of its own income tax but in June 1965, again raised the question of income tax at the Premiers' Conference. As there was no support from the other States for the idea of a 'marginal' State tax the proposal went no further.

In the meantime, the search by the States for alternative sources of revenue continued, and in 1966-67 Western Australia imposed a receipts duty on payments of wages and salaries. The following year Victoria imposed a similar duty. The Commonwealth Government informed the States at the June 1968 Premiers' Conference that it regarded a duty on wages and salaries to be similar to an income tax and therefore in breach of the provisions of the uniform income tax legislation. It warned the States that if the duty continued by 1970 when the 1965 grants arrangements were due to be reviewed, it would take action to reduce the grants of the guilty States. The Commonwealth also told the States that it did not favour the States levying a pay-roll tax. Victoria removed the duty as it applied to wages and salaries in July 1970 and Western Australia followed suit in January 1971.

Another blow to the already weak fiscal position of the States during this period, which made vertical fiscal imbalance worse, came with the invalidation of the States' receipts duty by the High Court in 1970, on the ground that it was an excise duty. The receipts duty had been described by Prest (1974) as the 'biggest find' of the

States in recent years which would have raised some \$60 million in 1970-71 (compared with \$77 million raised in 1969-70 from land taxes).

In search of new sources of tax revenue, Victoria proposed in its 1971-72 budget a 10 per cent tax on charges for transient accommodation in hotels, motels, and other such places. However, following strong protests from the industry, the proposal was dropped in October 1971. Similarly, the Tasmanian Government first proposed to introduce in its 1971-72 budget a tax on admissions to entertainments, but later abandoned it.

The pressure on State revenues continued during this period and was reflected in a range of increases in tax rates as well as base-broadening measures applied by the States to existing taxes in fields such as racing, stamp duties, and motor taxation. Some States also ventured into new areas of non-tax revenue raising. For example, Victoria introduced statutory corporation payments for the State Electricity Commission and the Gas and Fuel Corporation in this period. New South Wales introduced a tax on poker machines. But growth in current expenditures of the States far outstripped the increase in taxation revenue. Despite a tight restraint on gross capital formation by the State and local authorities, the shortfall in revenues resulted in a sharp increase in the net indebtedness of the States. Thus, outstanding Commonwealth Government loans to the States increased from \$733.9 million at 30 June 1960 to \$2057 million at 30 June 1970, an increase of 180 per cent. Total Commonwealth Government net payments to the States, including Loan Council borrowings, increased by 121 per cent over the same period. The net debt of the State budget sector increased from \$3952 million at 30 June 1960 to \$7379 million at 30 June 1970 (McAuley, 1980).

In contrast, the Commonwealth enjoyed a healthy growth in taxation revenues during this decade. Income tax revenue increased at the average annual rate exceeding 11 per cent. Total taxation revenue increased by an average annual rate of ?? per cent. The net surplus of the Commonwealth budget sector increased from \$1653 million at 30 June 1960 to \$6308 million ten years later (McAuley 1980). As a result, the Commonwealth was able to pay off its debt and become a net creditor by 1969.

This situation was the focal point of criticism by the State Premiers in their Statement to the Commonwealth in 1970: *The Financial Relationships of the Commonwealth and the States*, in which they summed up their plight in the following terms:

The Australian States alone among developed countries have not been in a position to finance a substantial proportion of their non-reproductive capital works out of revenue. At the same time the Commonwealth has been able to finance out of revenue, and at better standards, the whole of its non-reproductive capital works and even the whole of its fully productive capital works, and also rapidly eliminate its outstanding debt. (p. 13)

The observations made by Wilfred Prest, a leading public finance economist at the time, about the consequences of vertical fiscal imbalance bear repetition:

Apart from the possible effects of this continuing imbalance on the level of governmental responsibility, it clearly creates a climate of political discord and generates a high frequency of acrimonious debate among the various governments. More frequently, it almost certainly distorts the allocation of economic resources—spending on some services being lower, and that on others higher than would be dictated by the preferences of the community... It is surely extra-ordinary that for over twenty years the provision by the States of schools, hospitals and even sewage works has had a lower priority than the repayment of Commonwealth debt, most of it carrying low interest rates and half of which, in real terms, would have been wiped out by inflation anyway. *In this Alice-in-Wonderland world, Commonwealth revenue surpluses have not gone into the provision of community services. Instead these services have been saddled with debts which it has incurred on behalf of viable commercial undertakings like Qantas and Trans-Australia Airlines.* (Prest 1974, p. 197, emphasis added)

The need for a re-examination of the distribution of responsibilities in the Australian federation was also felt outside the State government circles during this period. In 1971, the Social Science Research Council of Australia (later called the Academy of Social Sciences in Australia) invited a group of social scientists, political leaders and public servants from all levels of government to take part in a seminar on Intergovernmental Relations which was held at the Australian National University in November 1971 (Mathews 1974). The invitation sent to the participants elegantly summed up the fiscal problem of Australian fiscal federalism in the following terms:

The system of government which had evolved since federation was seen as having unfortunate political, economic and social consequences, due in large part to an illogical and unworkable division of powers and responsibilities between the Commonwealth and the States... and, As a result of Commonwealth domination of the Loan Council, uniform income taxes and High Court decisions which had the effect of severely restricting State indirect taxation, the Commonwealth Government had come to command financial resources well in excess of its expenditure need while the independent revenue sources available to the States had become quite inadequate to enable them to discharge the functions for which they were responsible under the Constitution. In principle, financial balance could be restored by means of intergovernmental grants while leaving responsibilities unchanged. In practice, however, grants arrangements in Australia increasingly, involved major shifts in responsibilities among governments as a consequence of Commonwealth decisions about the level and rate of growth of grants (affecting vertical balance), changes in the relative indebtedness of the different levels of government (affecting the structure and burden of State and local debt), the distribution of grants among State governments (affecting horizontal balance) and the attachment of conditions to grants (affecting the autonomy of States to determine their own expenditure priorities). (Mathews 1974, p. 2)

In their joint statement entitled: *The Financial Relationships of the Commonwealth and the States*, presented to the 1970 Premiers' Conference, Premiers

of all States argued for a partial replacement of financial assistance grants by State income taxes, and requested that the Commonwealth and State Treasury officers be instructed to devise a scheme for the States' entry into the income tax field broadly along the lines of the system operating in Canada, but adapted to the recognised needs of the less populous States. The last point was given further prominence in the document which, *inter alia*, asked that the financial equalisation provisions currently available to the less populous States should be preserved. The Premiers' demand went further and asked that the States should be given the possibility of securing access to wider revenue fields presently under control of the Commonwealth, as well as to income tax (Commonwealth of Australia 1975, p. 164).

The Prime Minister, Mr Gorton rejected the States' proposal, giving the following four reasons:

- (i) the income tax revenue was subject to annual fluctuations, whereas financial assistance grants formula could be modified to provide greater stability;
- (ii) the taxpayers had grown accustomed to uniform income tax scheme for over 30 years;
- (iii) in the absence of uniform income taxation, the Commonwealth's task of managing the economy would become more difficult; and
- (iv) it would be difficult to make satisfactory equalisation grants to the smaller States or work out a universally acceptable method of distribution.

A contemporary observer commented that the fourth argument about the potential risk to the less populous States 'really killed the idea' of resumption of taxation of incomes by the States (Jay 1974). Lack of strong support from New South Wales also left Victoria as the only State with a real enthusiasm for the scheme.

In June 1971, the Commonwealth announced that pay-roll tax was to be transferred to the States from 1 September 1971, with corresponding adjustment to financial assistance grants. At the time, the Commonwealth's rate of pay-roll tax was 2.5 per cent. The States immediately announced that the rate would be increased to 3.5 per cent. To some, the transfer of pay-roll tax might have appeared to be the end of the States' search for a growth tax. The tax has indeed been developed by the States into their single most important source of tax revenue. However, even at the time, some observers doubted whether this would be the answer to the problem of vertical fiscal imbalance. Prest sounded the warning in 1974 saying '... the transfer of pay-roll tax to the States [was] no more likely to satisfy the States' demand for a growth tax than it [was] to remove the imbalance between revenue and functions' (1974, p. 189). His argument was that unlike the income tax, pay-roll tax is a proportional tax and that, in the absence of rate increases, revenue from it would not increase at sufficiently high rate to solve the longer term financial problems of the States.

Reversal Of The Roles: Changed Attitudes To Income Tax

The availability of pay-roll tax as a new and broad-based source of revenue, and the massive expansion of Commonwealth grants to the States during the Whitlam years caused a quick transformation in the fiscal concerns of the States which now

shifted from tax powers to the size and composition of Commonwealth grants. In May 1975, the Premiers released a statement entitled *The General Revenue Arrangements Between the Commonwealth and The States*, in which they asked that the general revenue grants arrangements be based on the principle that they were to compensate the States for their lack of access to income tax. They also proposed that the average wages element in the grants formula be replaced with a 'progression' factor equal to 1.5 times the increase in average wages each year. Significantly the Premiers did not ask for access to income tax in this statement.

Perhaps unexpectedly for the Premiers, the next initiative for State tax powers came from the Commonwealth, in 1976 as a part of the newly-elected Prime Minister, Malcolm Fraser's 'New Federalism' policy. It has been suggested that Mr. Fraser came to power owing a great deal to the State branches of the Liberal Party and that the new federalism policy reflected this reliance on the States (Sharman 1993). The tax sharing arrangements introduced in 1976 by the newly elected Commonwealth Government were a central part of the Coalition Parties 'New Federalism' policy issued in September 1975.

Under this proposal, the income tax sharing arrangements with the States were to be introduced in two stages. Under Stage 1, which came into operation in 1976-77, the Commonwealth continued to be the sole Government imposing income taxation but the States were to receive a fixed proportion of the net personal income tax collections. The arrangements for this stage were legislated in the *States (Personal Income Tax Sharing) Act 1976*. Stage 2 was initially scheduled to come into effect from 1977-78, and the enabling legislation - the *Income Tax (Arrangements with the States) Bill 1977* - was introduced into the Parliament in the Autumn 1977 session. Under this stage, each State would have the right to impose, on top of the Commonwealth tax, a surcharge or grant a rebate for its residents. Any additional taxes so imposed by the States would be collected by the Commonwealth on behalf of the States concerned. It was understood that minimal changes would be required in relation to the tax forms to accommodate State surcharges or rebates. Assessment notices would also be changed and would provide information to taxpayers on the disposition of Commonwealth tax to States (Commonwealth of Australia 1977, p. 16). The *Income Tax (Arrangements with the States) Bill 1977* was not proceeded with immediately as the States needed time for proper consideration and informed debate. The Bill, however, lapsed as the Commonwealth Parliament was dissolved on 10 November 1977 for new elections. A revised Bill, incorporating some changes including technical and machinery matters, was passed by the Commonwealth Parliament in Autumn 1978 session and became the *Income Tax (Arrangements with the States) Act 1978*. Legally, the ground was now clear for a State to re-enter the income tax field. The position remained so until the Labor Government repealed this legislation in 1988. But throughout this period, none of the States took up the opportunity.

In February 1981, the Premiers of all States presented a joint statement to the Prime Minister entitled *Review of Personal Income Tax Sharing Arrangements Between the Commonwealth and the States*. In this statement the Premiers complained about the shortcomings of Stage 2 of the existing tax sharing arrangements under which the States had been receiving each year between 1976-77 and 1980-81, 39.87

per cent of previous year's income tax collections. The February 1981 statement of the Premiers again did not seek access to income taxation; it only sought improvements in arrangements for tax sharing grants.

Another Half-hearted Stab at Tax Powers

In May 1985, the Victorian Government again raised the question of the tax powers of the States at the Premiers' Conference. Recognising that the high degree of vertical fiscal imbalance was not conducive to the efficiency and responsiveness of the public sector as a whole, the Premiers' Conference in May 1985 agreed that, after the Commonwealth's tax reforms had been finalised, a Working Group of Commonwealth-State Heads of Treasury would be asked to examine the practical options of bringing about a redistribution of tax powers between the two levels of government. The Working Group was to be required to report having regard to two objectives: the first was consistency with the respective roles of each level of government in respect of macroeconomic stabilisation, income redistribution, and efficient community needs; and the second was the condition that any redistribution of tax powers must not in itself lead to an increase in the overall tax burden in Australia, but should facilitate the restoration of a reasonable degree of vertical fiscal balance (Victorian Government 1985, pp. 104-5).

The timing of this demand for tax powers had to do with a number of factors including the strong possibility that, as a part of its proposed wide-ranging tax reforms, the Commonwealth might introduce a retail tax on goods and services, which would encroach upon some of the States' own taxes on selective goods such as tobacco and petrol. Also, in 1983, the High Court had declared Victoria's pipeline license fee unconstitutional. In 1981, Victoria imposed a licence fee on Esso and BHP pipelines from Longford to Western Bay. But the Court declared that the fee was a tax on the production of gas or petroleum and was therefore an excise (*Haematite Petroleum Pty Ltd v. Victoria* (1983) 57 ALJR 591). Although directly the decision only affected Victoria, its message about the constitutional uncertainty of some of their major sources of revenue was not lost on the other States.

At about the same time as the High Court's decision on the pipeline fee, two other independent committees had criticised the vertical fiscal imbalance as being the source of major problems for the States' tax structure. The Committee of Inquiry into Revenue Raising in Victoria (the Nieuwenhuysen Committee 1983), had drawn attention to the undesirability of the State's reliance on narrow-based taxes which were inefficient and inequitable. The report of this inquiry, which was the first major and systematic review of taxation at the State level, considered at length the issues of allocation of tax powers in Australia, constitutional constraints on States' taxing powers and comparisons of the Australian experience with other comparable federations.

The Committee concluded that the existing degree of VFI constituted a serious problem as it placed the States' taxation systems on a very narrow-footing. It noted that when the States search for additional tax revenue, new taxes 'must be discovered within the very considerable existing constraints', they are 'comparatively rare, and are unlikely to be ruled out simply because they overlap with another tax imposed by the

Commonwealth or for some other reason place an inequitable burden on the taxpayer' (p. 95). While acknowledging that the highly centralised taxation system of Australia had the advantages of a limited scope for 'wasteful competition among State and local governments' in taxation, and allowed central control for the pursuit of macroeconomic management policies, the Committee concluded that the existing high degree of VFI 'detrimentally affect[ed] the responsibility of State governments and parliaments and entrench[ed] State dependence on Commonwealth grants' (p. 95). It noted that while some intergovernmental fiscal transfers were inevitable in a modern federation, the extent of such transfers in Australia was unparalleled in other comparable federal countries (p. 95).

In 1984, support for broadening the States' tax base also came from the Fiscal Powers Sub-Committee of the Australian Constitutional Convention which examined the issue of vertical fiscal imbalance in its Report to the Standing Committee. In this report the sub-committee argued that the principle 'that each unit of government in a federal system should have revenue raising powers that are roughly commensurate with its expenditure obligations' is 'central to both the theories of responsible government and federation' (Australian Constitutional Government 1984, p. 12). The sub-committee argued that as the taxes which were at the disposal of the States were narrowly based, cumbersome and artificial, increasing reliance on these created problems for the taxation structure of the country as a whole, affecting the mix of taxation.

In some of the submissions received by the sub-committee, it had been argued that the States could utilise more fully the taxation powers already available to them but that they had chosen not to do so. The sub-committee considered this to be the symptom of a serious problem for the Australian federation, namely that the State Governments were not prepared to take political responsibility for levying taxes which were necessary for funding their spending decisions (p. 15).

Following the remit from the May 1985 Premiers' Conference noted above, the State Treasury officers prepared a draft report for consideration of the Commonwealth Treasury officers. However, partly due to their preoccupation with the Commonwealth tax reforms, and partly due to the deterioration in the Commonwealth's budgetary position at that time, the joint report was not finalised. In the meantime, the support among the States for tax powers also weakened and the proposal gradually faded away behind new concerns about the level of financial assistance grants.

The 1990-91 Review of Distribution of Tax Powers

In July 1990, the Prime Minister proposed the Special Premiers' Conference process for the reform of intergovernmental relations designed to form a closer partnership between different levels of Government. The objective of this process was to examine, in a cooperative way, the scope for altering the current distribution of functions between the levels of government to enhance national efficiency and international competitiveness, and to improve the delivery and quality of the services provided by the governments.

A review of intergovernmental financial relations was to be a part of this reform process. The Prime Minister's statement of 19 July 1990 did not, however, mention vertical fiscal imbalance as an issue for this review; it only mentioned tied grants to be reviewed in order to reduce duplication and improve program delivery. In the end, and at the insistence of the States, review of vertical fiscal imbalance was added to the agenda of the Brisbane meeting of the Special Premiers' Conference held on 30-31 October 1990.

The State Premiers' return to the issue of tax powers after many years reflected their unhappy experience with the financial assistance grants arrangements, particularly since the abandonment by the Commonwealth of tax sharing agreement in 1985-86. Thanks to the cuts applied unilaterally by the Commonwealth to the growth of financial assistance grants, net Commonwealth payments to the States had declined in real terms in each of the years between 1985-86 to 1988-89. For some initial period, the impact of these cuts was cushioned by the healthy rates of growth in State revenues, particularly from stamp duties, which benefited from the boom conditions in equity and real estate markets. But as these conditions changed for the worse after the share market crash of October 1987, the pressure on the State's financial position increased and was reflected in the low growth rates in current outlays and quite severe cuts in capital outlays, as shown in Table 6.

Table 6
Financial Aggregates: State Government Sector
(real % change)

	<i>1984-85</i>	<i>1985-86</i>	<i>1986-87</i>	<i>1987-88</i>	<i>1988-89</i>	<i>1984-89</i>
Current outlays (a)	6.8	3.8	2.7	1.7	0.2	3.0
Capital outlays (a)	-4.9	1.9	3.0	-16.8	-13.3	-6.0
Total outlays (a)	3.7	3.3	2.1	-2.7	-2.5	0.9
Own source revenues (b)	10.7	7.3	3.5	8.8	7.7	7.7
Net Commonwealth Payments	2.7	-0.7	-1.1	-4.4	-7.0	-2.1

Notes:

(a) Payments to other levels of government are included in capital and current outlays.

(b) Includes the increase in provisions (including for depreciation and superannuation).

Source: Commonwealth of Australia. (1990). *Budget Paper No. 4: Commonwealth Financial Relations with other levels of Government 1990-91*. Table 5. Canberra: Australian Government Publishing Service.

The terms of reference of the Working Party required that, *inter alia*, the following matters be addressed particularly:

- the range of taxes currently available to Commonwealth and State Governments;
- the impact of the current taxation arrangements on government accountability and macroeconomic management; and

- options of reform of the distribution of Commonwealth-State tax powers taking account of: constitutional legal and administrative considerations the appropriate balance between the Commonwealth and State Governments' revenue raising capacity.

In examining these matters the Working Party was to be guided by a set of principles which mainly included the following:

- (a) to strengthen the Australian federal structure so as to enable meaningful expressions of diversity consistent with the need to maintain the essentially unifying features of the Australian economy and the achievement of national objectives and aspirations;
- (b) to enable each level of government to have access to reliable sources of revenue which are, so far as possible, commensurate with expenditure responsibilities and national responsibilities for macroeconomic management, including the level and incidence of taxation and public sector borrowing being primarily determined at national level;
- (c) to ensure a rational allocation of revenue powers between levels of government that further improves the efficiency, effectiveness, equity and simplicity of the Australian taxation system;
- (d) to maintain revenue neutrality on a national basis (any assessment of revenue powers and expenditure responsibilities should be based on the premise that the overall national level of taxation should not increase); and
- (e) acceptance of the principle of fiscal equalisation.

The working Party reported in October 1991. Its report was to have been considered by the Special Premiers' Conference at 20-21 November 1991. However, as the Commonwealth had by now adopted the position that vertical fiscal imbalance was not a central issue for the proposed reforms, a strong disagreement emerged between the Commonwealth and the States about the purpose of the November 1991 Conference and this meeting did not take place. Instead, the State Premiers and the Territory Chief Ministers met in Adelaide in the absence of the Commonwealth and passed a resolution restating that they regarded the issue of vertical fiscal imbalance as critical to the reform of intergovernmental relations in other areas, and that they favoured a return by the States to the income taxation field in such a way that:

- The States should be allowed to impose an identifiable component of a national income tax on personal incomes;
- The States' component could be imposed at the rate of 6 per cent of taxable income, as defined by Commonwealth legislation;
- a corresponding adjustment in financial assistance grants would ensure that for an initial period of three years, the overall burden of taxation on taxpayers would remain unchanged;

- the collection and administration of income tax would remain uniform throughout Australia and would be handled by the Australian Commissioner of Taxation; and
- by and in itself the proposal would be revenue neutral for the Commonwealth, the States, as well as the taxpayers and would not involve double taxation of incomes.

The Commonwealth did not entertain this or any other proposal for reducing vertical fiscal imbalance.

5. RESTORING THE TAX STRUCTURE

The Working Party Report

The Working Party did not consider that revenue sharing, whereby the States would receive a specified share of the revenue from one or more nominated Commonwealth taxes, would achieve the primary objective of matching more closely the responsibility and accountability for revenue raised by each level of government with its expenditure obligations.

It considered that income tax power would provide the States with an elastic revenue base, but that there would be substantial administrative and compliance costs if State income taxes were not imposed on the same base as the Commonwealth income tax. On the other hand, the States' reliance on Commonwealth tax base would reduce, to some degree, the accountability of the States for the tax they impose. The Report concluded that in principle, State personal income tax could be applied to:

- total income, or
- taxable income, or
- tax payable as defined by the Commonwealth tax legislation.

The States could impose a flat rate tax, introduce their own tax scale, or impose a surcharge on the tax payable to the Commonwealth. A flat rate tax imposed by the States would apply to all income taxpayers and, as a result, would not need to be at a high rate. This would minimise its impact on the progressivity of the national tax system. Irrespective of the option adopted by the States, it was considered that there is a clear need for the States to be held accountable for any tax of this nature.

5.2 Principles of Tax Assignment in Federations

The following principles, developed by Richard Musgrave (1983) are generally used in the theory of fiscal federalism for guidance in the assignment of taxing powers to different levels of government in a federation:

- (1) benefit taxes and user charges are appropriate at all levels;
- (2) taxes suitable for the purpose of stabilisation policy should be central, while lower-level taxes should be cyclically stable;

- (3) progressive taxation, designed to secure redistributive objectives, should be primarily central;
- (4) middle and especially lower-level jurisdictions should tax those bases which have low interjurisdictional mobility;
- (5) personal taxes with progressive rates should be used by those jurisdictions within which a global base can be implemented most efficiently; and
- (6) tax bases which are distributed highly unequally among sub-national jurisdictions should be imposed centrally.

It is clear that the current distribution of tax powers in Australia is not consistent with the above principles. There is no theoretical reason for the States not to impose proportional income taxes, or destination type taxes on sales provided that the jurisdictions are large enough to discourage tax avoidance through shopping trips to neighbouring areas. Nor is there any theoretical reason for assigning exclusive rights of taxation to one level or another; provided that administrative and compliance costs are kept low, joint utilisation of a tax base does not violate any of the above principles.

The major constraints on sub-national taxation in the above approach arise out of the potential for flight of taxpayers or tax bases into jurisdictions with lower taxes or higher income support. This view is based on the assumption, often implicit in much of this literature, that mobility between jurisdictions is not only unrestricted but is also free in the sense of being costless, so that even small differences in taxation burdens would trigger immediate migration. This proposition also requires a further assumption that all jurisdictions are identical except for differences in relative tax burden. The plausibility of these assumptions is not universally shared and has been questioned by some (see Grewal 1981, Grewal and Mathews 1983 and references cited therein). Despite this, however, the threat of mobility remains a major constraint on sub-national taxation. Indeed, due to the increasing international mobility of capital and the use of computerised transactions in capital markets, taxation of capital is becoming increasingly difficult even for national governments (Gordon 1992). This suggests that the heavy reliance of the Australian States on taxes on capital transactions such as stamp duties and other financial transactions is likely to leave them in a vulnerable position in the future.

The States' tax structure also does not satisfy the second principle as revenue from some of their taxes, eg. stamp duties, fluctuates along with the phases of every economic cycle. Once again this would not occur to the same degree if the States raised a larger proportion of their revenue from broad-based taxes.

Situation in Other Federations

As noted earlier, vertical fiscal imbalance in each of the United States, Canada, and Germany is much lower than in Australia. In the United States, the States have

virtually unlimited taxing powers, and are precluded from imposing only taxes on international transactions and discriminatory taxes on interstate commerce. In Canada, income taxation (both individuals and corporate) is a major source of revenue for the Federal and the Provincial Governments. The Federal Government collects personal income tax for nine provinces and corporate income tax for seven provinces under tax collection agreements. In each case, the Provincial Governments have the right to determine basic personal income tax rate as a percentage of the basic Federal tax. The Provincial corporate income tax is applied directly to taxable corporate income. Quebec operates its own personal income tax system. Provinces also impose retail sales taxes, along with the a broad-based, multi-stage national sales tax introduced by the Federal Government from 1 January 1991.

In Germany, the shares of each level of Government in income tax are set out in the Constitution. The value added tax shares are specified in the Federal legislation and cannot be varied without the approval of the Bundesrat. The approval of the Bundesrat is also required before the rates of these taxes can be varied. Intergovernmental negotiation is therefore a key requirement in the matters of taxation policy. The shares of revenue for each level of government, along with the revenue it raises from its own taxes, has been generally sufficient to meet its expenditure responsibilities. In this sense, the problem of vertical fiscal imbalance has been avoided. Horizontal fiscal equalisation has been implemented in Germany along with a low degree of vertical imbalance.

The Bogey of Tax Competition

In the theory of fiscal federalism, there is ample support for the competitive behaviour of sub-national governments due to its beneficial effect on efficiency. A sizeable literature has grown on this subject since the development of the Tiebout hypothesis in mid-1950s (see Tiebout 1956, Grewal et al. 1980, Oates 1981 and references cited therein).

The issue of tax competition in a federation has two dimensions; competition among the governments at the same level of hierarchy such as the States or the local authorities; and competition between governments at different levels, such as between the Commonwealth and the States or between the States and local authorities. Both types of competition are relevant in a discussion of vertical fiscal imbalance, although in Australia the attention is often focused only on the competition among the States. It is often overlooked that the main issue is whether the Commonwealth Government should continue to have a monopoly power in relation to the major sources of taxation revenue. In the case of customs duties and excise duties, the Commonwealth Constitution has sanctioned the monopoly of the Commonwealth. In the case of sales taxation, the High Court's interpretations of a sales tax as being a possible excise duty have effectively excluded the States from this field of taxation, although the States have attempted, with mixed success, to get around this constraint in various ways. In the case of income taxation, the Commonwealth's monopoly power now derives from section 96 of the Constitution, which empowered it to make general revenue grants to the States conditional on their exclusion from income tax.

It is commonly argued that one of the advantages of centralisation of tax powers in Australia is that it avoids the problems associated with multiplicity of tax rates, and possible competition among the States (see for example *Report of the Committee into Revenue Raising in Victoria*, 1983). The example of tax competition which resulted in the abolition of death and estate duties in the 1970s is often cited in support of such pronouncements. And yet, both the theoretical and the empirical bases of such an argument are open to question.

It is beyond question that wasteful competition among sub-national jurisdictions needs to be avoided, and that the abolition of death duties and estate duties in the 1970s when all other States followed the unilateral decision of the Queensland government, is a constant reminder of such wastefulness. However, there are other examples in the Australian fiscal history which provide strong evidence to the contrary. Pay-roll tax was transferred by the Commonwealth in 1971 to the States and has since been developed by them into the largest single source of revenue; raising on average more than a third of their taxation revenue. This has been achieved by progressive increases in the rates of the tax. Similarly, the States have developed in recent years gambling taxation, business franchise fees and financial institutions duties as major sources of revenue. In each case, a State has not shied away from making a choice different from the rest of the States. But this has not meant that the structure of taxation has fallen towards the lowest rates or the highest exemptions. For example, Queensland's decision not to impose a business franchise fee on petroleum products has not stood in the way of progressive increases in the rate of duty in the other States. Queensland's rate of business franchise fee on tobacco remained much lower until 1989-90, but did not deter the other States from relying on this source of revenue. A.C.T. still does not impose a financial institutions duty despite the fact that such a duty exists in every other jurisdiction. These differences in tax rates and tax instruments are evidence of diversity and confidence on the part of the States that making a different choice is not always suicidal.

Significantly, the Report of the Officers' Working Party (1991) was also supportive of healthy competition among jurisdictions and considered it to be an integral part of a properly functioning federal system, and a restraint on excessive utilisation of particular taxes by just one level of government which happens to have a monopoly over them.

The Imaginary Threat to Fiscal Equalisation

The differences in the fiscal positions of the less populous States on the one hand and the larger States (New South Wales and Victoria) on the other hand have been a major factor in weakening the resolve of the former group of States for gaining tax powers in exchange for Commonwealth grants. This horizontal imbalance appears to have been an important consideration in the Commonwealth and State Treasury Officers' reports prepared in 1951 and 1952 on the question of States' access to income taxation (Mathews and Jay 1972). It certainly was one of the stumbling blocks for the States' case in 1970 when the support for income tax powers fizzled out largely due to lack of enthusiasm from the less populous States.

By now, important parameters of the situation have changed as compared to the earlier periods. Whilst in the 1970s the less populous States relied on Special Grants assessed by the Commonwealth Grants Commission in response to a formal application for such support, since 1981, distribution of the entire general revenue assistance has been based upon the principle of fiscal equalisation. Secondly, because of the change just noted, the burden of fiscal equalisation is now directly borne by New South Wales and Victoria whereas before 1981, Special Grants were funded by the Commonwealth Government. The importance of these changes lies in the fact that the principle of fiscal equalisation is now much more firmly established than was the case before 1981.

It also means that a commitment on the part of New South Wales and Victoria to adhere to the principle of fiscal equalisation is an important pre-requisite in any future case for States' access to new tax powers. Such an understanding existed among the States in 1991 and was a source of the strength of their case. The Treasury Officers' Working Party was able to demonstrate that if the States gained access to income tax powers, and were able to raise between \$9.0 billion to \$13.0 billion of revenue (1990 prices), the Commonwealth would still be able to finance the required amount of equalisation grants and the process of fiscal equalisation would not be threatened.

In spite of the fact that a sort of consensus existed among them in 1991, the divisive power of this issue continues to exist as a potential threat to the States' effectiveness in regard to their joint stand against the Commonwealth's monopoly over income taxation. A visiting Canadian expert on federalism recently made the following observation:

When the Commonwealth Grants Commission (CGC) released its new set of revenue grant relativities in early this year {1993}, every State levied a broadside against the results. But this is playing Canberra's game. The CGC exercise is all about the distribution of a given pie. This is a zero-sum exercise for the aggregate States. The States' game is, or ought to be, finding common causes and pressing not only for a large pie but as well a reduction in the aversion to devolving broad-based taxation to the States, there must be amusement if not joy in the corridors of Canberra in witnessing the States unloading their canons at precisely the wrong target. (Courchene 1993, p. 37)

The Smoke-screen of Macroeconomic Management

In addition to fiscal equalisation, the Commonwealth's responsibility for macroeconomic management had been often cited as a major reason for maintaining the high degree of vertical fiscal imbalance. In spite of its repeated use as an argument, there is no support for extreme centralisation of revenues as a necessary condition for successful macroeconomic management either in theory or in the experience of other federations. As noted above, macroeconomic management in each of Canada, Germany, and the United States is conducted in the presence of highly decentralised revenue systems. In considering this issue, the Officers' Working Party noted that:

...changes in taxation arrangements to reduce the extent of vertical fiscal imbalance may lessen the flexibility of the Commonwealth to achieve its macroeconomic policy objectives, especially in relation to fiscal policy. However, the more medium term focus of macroeconomic policy suggests that changes to taxation arrangements could be manageable depending on the specific options and the arrangements in place to address concerns about the fiscal responsibility of the States and the coordination of fiscal policy. (1991, para. 8.36)

It went on to add that:

...in arriving at this judgement, account was taken of the continuing effectiveness of the existing arrangements relating to the Global Limits as well as the scope for reform to borrowing arrangements to assist in overall fiscal coordination. There may also be scope in the context of the Financial Premiers' Conference/Loan Council to continue consultation and coordination on changes to taxes and charges. (1991, para. 8.37)

6. THE FUTURE ROLE OF PAY-ROLL TAX

Pay-roll tax is one and the only broad-based tax available to the States at present. In recent years, however, pay-roll tax has come under attack for being a perceived impediment to growth in employment. Its abolition was a part of the package of policies announced by the Liberal-Country Parties Coalition in its famous, but since abandoned, policy document the '*Fightback!*' released in November 1991. The package of measures announced in that document included the proposal to abolish pay-roll tax, with compensatory grants to the States. A more recent example of criticism of pay-roll tax is the proposal put by the Parliamentary Democratic Party Senators in March 1994 to the Federal Treasurer in relation to the 1994-95 Commonwealth Budget (Australian Financial Review, 21 March 1994, p. 1). The proposal involved the granting of a pay-roll tax rebate to employers as an incentive for creating employment. As this would not be possible without the States' agreement, financial compensation for them was also proposed.

Proposals like these can be discussed from two different viewpoints: one in terms of the theoretical or empirical validity of the underlying arguments; and two in terms of the merits of such proposals for vertical fiscal imbalance. The first approach has been adopted by John Head, among others, who has argued that essentially the economic effects of pay-roll tax are not different from those of income tax (Head 1991). This raises the obvious question: if the States reduce the use of pay-roll tax but are correspondingly given access to income tax, would such a change result in a net improvement in the overall tax structure?

The second perspective suggests immediately that a reduction in pay-roll tax accompanied by an increase in Commonwealth grants to the States will clearly worsen the vertical fiscal imbalance. All the familiar criticisms about the loss of accountability and responsiveness would become relevant to the new situation, with even greater force.

7. SUMMARY OF CONCLUSIONS

The main conclusions of the above discussion may now be drawn together. Factually, Australia has had, for the last fifty years, a level of vertical fiscal imbalance at the State level that is much too high in comparison with the pre-war situation in Australia, and the current situation in other industrialised federations.

There is no support in the theoretical literature for creating or maintaining such a high degree of vertical fiscal imbalance, either as a means of macroeconomic management, economic development, or income redistribution. Nor is there any theoretical support for assigning powers for taxing incomes or consumption exclusively to one level of Government in a federation.

Conventional ratios used in measuring the imbalance suggest that in recent years the severity of the imbalance has declined. As these ratios do not measure the qualitative impact on the tax structure of the States, however, it is not generally recognised that a larger proportion of State revenue is now being raised from taxes that have been repeatedly described as narrow-based, inefficient and regressive.

Throughout the last fifty years, the imbalance has been addressed by the Commonwealth as though it were a problem about the level of Commonwealth grants to the States. The determination of these grants has gone through numerous changes during this period. These experiments with revenue sharing have failed to find a lasting solution to the imbalance, and the grant arrangements have virtually become ad hoc adjunct of Commonwealth's budgetary policy. As the budgetary priorities of the Commonwealth changed so did the role of revenue sharing

On several occasions, the States have sought to regain access to a broad-based tax (in particular income taxation) so as to reduce their dependence on Commonwealth grants. Their attempts were unsuccessful due as much to their own half-heartedness (which at times was based on the fears of the less populous States that they might lose the support of fiscal equalisation grants), as to the Commonwealth's determination to retain exclusive control of income taxation (arguing that this was necessary for discharging its responsibility for macroeconomic management and income redistribution).

The latest investigation into the question of States' tax powers by the Working Party of Commonwealth and State Treasury Officers in 1991 has confirmed the views of the expert committees and other observers who had argued in the past that giving the States an access to broad-based taxation such as income tax was desirable. The Working Party went further in concluding that such a reform would not undermine the Commonwealth Government's ability for macroeconomic management or the interests of the less populous States in respect of fiscal equalisation. It also concluded that revenue sharing is not the appropriate solution for the imbalance as it does not address the problems of accountability and responsiveness in government

8. FUTURE OUTLOOK

It is difficult to make a prediction about the future of vertical fiscal imbalance in Australia. The historical record shows that there has been a twenty-year cycle of the States' desire for gaining access to wider tax powers; their first serious assault on this issue was in 1950-51, the second in 1970 and the third in 1990-91. If this history were to repeat itself, the States' next serious campaign for income tax should be expected in 2010. However, some important signs suggest that the States may not wait that long this time. These signs include the following:

the demonstration in the 1991 report of the Working Party that neither management of the economy nor the fiscal interests of the less populous States need to be threatened if the States were to gain access to the income tax field;

the movement towards international economic integration which puts a premium on policies and strategies that are specific to regions and therefore emphasises the role of decentralisation of decision-making and local and regional leadership; and

the precarious fiscal plight of the States which, having borne the brunt of the Commonwealth's spending cuts since the mid 1980s, appear, in the mid-1990s, to have exhausted their fiscal margins and are likely to find it increasingly difficult to meet the challenges of the next decade from within their current taxing powers.

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In 1983, the Committee of Inquiry into Revenue Raising in Victoria had stressed that the States' tax structure should be broadly-based (1983, ch. 3). The New South Wales Tax Task Force reinforced that view when it noted that:

A frequent criticism of the States' tax bases has been that they are too narrow ie. the spread of tax collections across the various categories is uneven, relying heavily on just a few taxes for the majority of revenue. (1988, p. 28)

**Revenue and Expenditure of Government Authorities by Level of Government
1938-39, 1948-49, 1958-59, and 1969-70**

Authorities

	<i>Commonwealth</i>	<i>State & Local</i>
1938-39		
Total Taxation	151.4	104.0
Total Expenditure	135.0	260.8
VFI Ratio	(1.12)	(0.39)
1948-49		
Total Taxation	948.5	126.2
Total Expenditure	639.6	604.7
VFI Ratio	(1.48)	(0.21)
1958-59		
Total Taxation	2265.0	465.0
Total Expenditure	1640.0	1725.0
VFI Ratio	(1.38)	(0.27)
1969-70		
Total Taxation	6382.0	1342.0
Total Expenditure	4346.0	4681.0
VFI ratio	(1.47)	(0.29)

Source: Calculated from R.L. Mathews and W.R.C. Jay, (1972), *Federal Finance*, Melbourne: Thomas Nelson, various Tables.