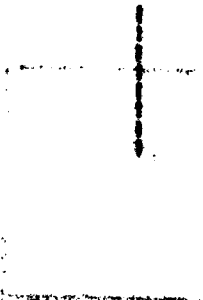


PRINCIPLES OF FEDERAL GRANTS

With Particular Reference to the
Australian Federation



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INTRODUCTION

The purpose of this essay is to examine the different possible bases upon which grants may be made from the Federal Government to the several State Governments in a Federation. The basic concept of federalism is sufficiently clear for general principles to be developed which will be applicable to any Federation. Nevertheless there are quite important differences between the main Federations of the present time. Each has evolved gradually and its form has been influenced by varied historical developments.

It would be true to say that although general principles which will be valid for all Federations may be discovered, the application of those principles may differ in particular detail. Consequently, the examination which follows has been made with direct reference to conditions in the Australian Federation. Australian terminology will be used, and at a later stage an examination will be made of the various types of grants made by the Federal Government in the Australian Federation. Despite the limitation of the analysis to a particular Federation, it is felt that the examination could be extended along the same lines to include the other major Federations.

The examination will be divided into three parts. The first will establish alternative principles upon which federal grants could be made, and from the alternatives establish the principle which would give the most beneficial results. The second will analyse existing practice in Australia in the light of the principles which have emerged, and the third will draw conclusions as to possible lines of future development.

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PART 1.

ESTABLISHMENT OF PRINCIPLES

FOR THE

DETERMINATION OF GRANTS

FROM THE

FEDERAL GOVERNMENT TO THE

STATE GOVERNMENTS

IN A FEDERATION.

CHAPTER 1

The Nature of the Financial Problem in a Federation

Historically the basic form of government has been the unitary state. This state has had clearly defined boundaries and within these boundaries one person or body, autocrat or popularly elected parliament, has had absolute control. Unions of such states have arisen from time to time, but in the majority of these cases they were formed by one state stronger than the rest and this one inevitably dominated.

The essential difference between the unitary and the federal forms of government is that in the unitary state there is only one body to control all affairs of state. In the federal form there are several authorities each exercising control of domestic matters in a particular region or State and a federal authority controlling matters which affect all States.

An eminent authority on Federalism, E. C. Sheare,¹ has defined the federal principle of government as a "method of dividing powers so that the general and regional governments are each, within a sphere, co-ordinate and independent." In the Australian Federation, the general government is the Federal Parliament, and this has power to function in certain defined spheres. The regional governments are the State Governments with power over domestic matters in their own territories.

A federation thus comprises a group of States with their own form of parliamentary government, and a Federal Government with a separate field of authority. It is a union of governments to their mutual advantage. Before Federation, the States were completely separate entities with their own political, social and economic organisations. There may have been no common factor between them, but it may be assumed that in order for them to wish to join together in even a loose form of union, there will have been

1. E. C. Sheare - "Federal Government" p 11.

some aspect of community or economic life which is common to each. It may have been a common language, racial origin, allegiance or even colour. Again, it may have been a similarity in economic resources or natural conditions. It is not even necessary that the regions forming the federation should comprise a compact area. They could conceivably be scattered over a wide area, interspersed with other States which remain outside the Federation. However, it can be conceded that conditions are more conducive to the formation of a federation if the boundaries of the several regions are concurrent.

The reasons why the several States consider it desirable to form a federation may be many and varied. It can be assumed, however, that all realise that there is some benefit to be derived from the formation of the federation. Foremost is the possibility that defence preparations may be more effective when carried out on a large scale than if undertaken by each State individually. Again, it may be possible for the States, when acting in combination, to arrange reciprocal tariff agreements with other nations. Such arrangements would be impossible, or at least more cumbersome, when entered into by each State separately. Trade and travel between States would be facilitated, and inevitably as a result of federation, customs barriers between States would disappear. This would enable internal trade to flow freely to the advantage of all States, whereas previously tariff barriers between the States may have hampered interstate trade.²

At the formation of the federation it will be necessary to institute a central authority to administer those functions which impinge on all parts of the federation irrespective of State boundaries. Foremost amongst these will be such functions as the administration of defence and overseas relationships, both political and economic. This federal authority will be formed by

2. This was particularly evident in trade between the free-trade Colony of N. S. W. and protectionist Victoria before Federation in Australia.

representatives of all member States of the federation. Whether it shall be a body elected by universal franchise, appointed by the legislatures of the several States or an advisory body only,³ is a matter to be decided by the States themselves at the time of the formation of the Federation. However, it would appear that if the Federation is to function adequately, the Federal Government should be given absolute authority in its allotted spheres of activity. If this were not done, there would be danger of deadlocks should the legislatures of some States be unwilling to adopt unequivocally the recommendations of an advisory body.

The keystone of a Federation is its Constitution. This will be devised and agreed to by the representatives of all the States and will contain the provisions which will govern the actions of both the Federal and State Governments. It will set out the fields in which each may operate, and to be completely effective, will probably need to be subject to alteration only upon the passing of a referendum of all members of the Federation. This is an aspect of federalism which is the subject of some controversy but it lies outside the scope of this enquiry.⁴ The rigidity of a Constitution in a Federation prevents the correction of any mistakes which may have been made at the outset and of deficiencies which arise through the passage of time and changing conditions. However, a certain amount of rigidity will be necessary in order that the Federal and State Parliaments may be free to operate in their respective spheres without fear of amendment to the provisions under which they operate unless there is some pressing need for change.

The determination of the extent of the respective spheres of activity of the Federal Government on the one hand and the several State Governments on the other, will be decided at the time of the formation of the Federation. This is one of the major constitutional problems and will probably give rise to perhaps the

3. The Australian experience was that a voluntary body with powers to make recommendations only was unsatisfactory. The Federal Council of Australasia, which existed from 1885 to 1899 was quite ineffective.

4.

greatest, or at least the most difficult problem for which a solution must be found. That is the financial problem which is the main subject for consideration in this Chapter.

There are certain functions which obviously fall within the province of the Federal Government, and others which will equally obviously be the province of the State Governments. The primary test will be whether the function encompasses the whole of the Federation. If it is national in character, it is a field in which the Federal Government should operate. If it is purely local in character, it is a function which can be performed adequately by the State Governments.

This is not a matter upon which it is possible to generalise with any conviction. Apart from the fact that there is no clear line of division between a function which is national in its scope and one which is purely regional, the character of functions will differ in their importance in different countries. A function which is rightly considered to be of national importance in one Federation might, with equal justification, be regarded as of only local importance in another. However, for purposes of illustration, the division between the Federal and State Governments in the Australian Federation may be taken as indicative of the type of division which will be made.

The functions which are as wide as the Federation and which have been given to the Federal Government, include the power to conduct the defence of the nation, external relations of a political nature, the imposition of tariffs on international trade and the provision of services which overlap the boundaries of several States. On the other hand, functions which are purely local in character and are thus best suited for administration by the several State Governments include the provision of health services, education facilities and the preservation of law, order and public safety. Indeed it would probably be detrimental to their successful and efficient administration if they became a function of the Federal Government.

This raises the question of the desirability or otherwise of introducing a third level of government below the level of State government. The States themselves will probably be reasonably large in area, if for no other reason than to justify the formation of a Federation in preference to a unitary form of government. If they are large, it may be in the interests of efficiency to introduce a third, local government, level to function in fields which are too narrow for the Governments of the States to administer successfully. It is thought, however, that the distribution of powers between three levels of government would surrender, through loss of efficiency, all the advantage that would be gained by localisation of functions. Rather, the whole problem is simplified if, as in Australia, the distribution is limited to the Federal Government and the several State Governments with one of the functions of State Governments to organise local government within the geographical boundaries of each State.

It would then be possible for a State to establish a local government organisation and delegate some of its powers. In this way administration would be kept as close as possible to the place where the functions are performed, and yet the difficulties which would arise if the Federal Constitution had to deal with the distribution of powers between three levels of government would be avoided. The extent of these difficulties will become more apparent after consideration has been given to the financial problem which will arise between the Federal and State Governments.

There will inevitably be some functions on the borderline between those which are purely national and those which are purely local in character. To prohibit the State Governments from functioning in these fields would be incompatible with their retaining the maximum of independence. On the other hand, it would probably be in the best interests of the nation if the Federal Government were given some voice in the administration of these particular functions. When such functions are being considered at the time of the formation of the Constitution, a case

may be made out for the Federal and State Governments to share responsibility.

Experience has shown in Australia that when responsibility is shared in the form of concurrent powers of government, the power has tended to be appropriated by the Federal Government. This was particularly evident in the case of concurrent powers to impose income taxation. It is through the agency of concurrent powers that the potentially stronger of the two types of government can expand at the expense of the other. It is therefore essential that if it is found necessary to give the Federal and State Governments concurrent powers in certain fields, the Constitution should contain adequate provisions against the usurpation of those powers by one at the expense of the other.

It is obviously impossible to enumerate and allocate every possible type of function which may be distributed between the Governments in the Constitution. However, it is probable, and indeed desirable, that the more important should be specifically mentioned and allocated. This will leave a wide field of activity which will not be specifically considered. The alternatives open are to permit both types of government to function in this residual field, or limit the field completely to one or the other. In the interests of preserving the essentials of federalism - retention as far as possible of the independence of the member States - it is desirable that such residual powers should be retained completely by the State Governments. Power should only be given to the Federal Government where it is essential in the interests of the Federation as a whole that certain functions should be performed on behalf of the States in order to obtain uniformity or co-ordination of policy. If a certain function is regarded as lacking sufficient importance to be specifically allocated by the Constitution, it would almost certainly fall outside this group of functions.

Difficulty may arise at some future time if a function which by all tests is the province of the Federal Government, was not of sufficient importance at the time of the

formation of the Constitution to warrant specific transfer to the Federal Government. It may be a function developed since the time when the Constitution was formed.⁵ In this case, if all residual powers are left in the hands of the State Governments, the Federal Government will be constitutionally prevented from assuming control. This can be overcome by amendment to the Constitution or by giving the Governments of the States authority to transfer any power to the Federal Government if they so desire. This however, is a problem of political science and does not materially affect the financial problem.

It can be seen that the distribution of functional powers should follow some definite pattern which will be determined by the nature of those powers. It is absolutely essential to the proper functioning of the Federation that the distribution of powers be made according to this principle. If functions which are essentially local in character are given to the Federal Government, a certain amount of inefficiency will result and dissatisfaction will follow if those affected are geographically remote from the seat of administration. Thus the distribution of functional powers should be determined by the nature of the Federation.

The powers referred to in the preceding paragraphs have been called functional powers. By this has been meant the power to perform some act of administration. It could be interpreted as power to spend money on certain functions. Distinct from this group is another set of powers which can be referred to as financial powers. These are mainly powers to raise revenue. As with the distribution of functional powers, there may also be some automatic distribution of financial powers. For example, it may be considered essential for the Federal Government to be given power to control international and interstate trade. If this is so, it will automatically carry with it the financial power to impose and collect customs duty. Similarly, the provision of certain services

5. For example, in Australia control of air traffic was sufficiently unimportant to be ignored at the time of the formation of the Federation. When the necessity for control arose, it was a residual power and hence a function of the State Governments

may be national in character and hence become a function of the Federal Government.

The Federal Government may also be given direct financial powers. For example, at the outset of Federation it may be decided that it is in the interests of the Federation as a whole that taxes on incomes should be uniform in all parts of the Federation and that this can best be achieved by the transfer of the powers to tax incomes to the Federal Government to the exclusion of the State Governments. These are three examples of the types of revenue which the Federal Government may receive as the result of the allocation of powers at the time of the formation of the Federation. There will be others of lesser or greater importance, but undoubtedly the Federal Government will be given some power to collect revenue by taxation or by the imposition of duties.

The assumption of certain powers to collect revenue by the Federal Government will mean the loss of those revenue fields to the member States. The retention of certain functional powers will mean that the State Governments will receive some revenue, if only as a corollary to the retention of those functional powers. They may also be allotted power to levy taxation in certain fields by the Constitution. This would be, in effect, merely a continuation of the practice which existed before the Federation was formed. More probably the allocation of powers, both functional and financial, will leave a residual field of revenue available to the States thus ensuring that they receive some revenue. The alternative is that the Federal and State Governments share certain revenue raising fields.

This is the practice which was adopted in the Australian Constitution with respect to powers to impose taxation and experience has now shown that it can be unsatisfactory. Inevitably one or the other of the two levels of government must be given prior right to collect the tax and this may lead to the eventual exclusion of the other form of government from the particular field. The formation of concurrent financial powers will mean in

effect the virtual allocation of the power to the authority with priority of collection. As in the case of concurrent functional powers considered earlier, it is in the interests of the Federation as a whole that when it necessary to institute such concurrent powers, it is equally necessary to ensure that they remain divided between the two types of government. This safeguard should be inserted in the Constitution.

After the adoption of the federal principle there will thus be two levels of Government. On the one hand it will have created a Federal Government and on the other it will have retained the legislative and administrative organisations of the regions which have now become member States of the Federation. The Constitution, agreed to by at least a majority, will have allocated powers both functional and financial between the two types of government. This distribution will have been determined, not by any arbitrary method, but by the needs of the Federation. That is, the distribution will have been made in such a way that the best interests of the nation as a whole will be served.

As a result, it is inevitable that there will be no designed relationship between the functional powers and the financial powers of both the Federal Government and the State Governments. That is, the distribution of the functional powers will be determined in such a way as to produce the most satisfactory results. Generally, financial powers are of secondary consideration, and will follow almost automatically from the allocation of functional powers. It can therefore be expected that little attention will be paid, or should be paid, to the degree of balance which will be achieved between the two sets of powers. For example, it may be that the allocation of functional powers to the States carries with it revenue raising powers far in excess of their needs while the Federal Government has certain functions to perform but lacks the power to raise revenue to meet all revenue requirements. Conversely, the Federal Government might find itself with power to raise revenue greater than the amount necessary for it to perform

its proper functions, while the revenue raising power of the State Governments is far below their requirements. For the purposes of this analysis, the revenue requirements of a government in a Federation may be taken as the amounts of revenue which it must receive to permit it to carry out the functions allotted to it by the Constitution. In the latter case mentioned above, the revenue requirements of the State Governments are greater than their potential revenue.

It is not inconceivable that at a point in time the distribution of functional and financial powers between the two types of government will be roughly in balance. That is, the Federal Government will have power to raise just sufficient revenue to meet its requirements. Similarly with the State Governments. However, should this position arise accidentally it is almost certain that before long the relative significance of certain functional or financial powers will change, and hence the balance will be disturbed. If the required balance has been ingeniously engineered, it may have been at the expense of the optimum allocation of powers which is expected to produce the best and most beneficial results in the Federation. If this is so, it will probably not be long before some change takes place which will cause some disparity, and if it is desired to maintain the original balance, this can only be achieved by further manipulation of functional or financial powers. Apart from the difficulties associated with the periodic amendment of the Constitution to maintain this balance, if it becomes necessary to re-distribute the functional powers, the new distribution will probably ^{vary} be from the optimum distribution.

The degree to which the disparity between the cost of the function which each type of administration is required to carry out and the financial resources available to each will vary according to the fundamental basis of the particular Federation. That is, the distribution of functional powers in any Federation will be determined by such diverse factors as the geographical pattern, the distribution of the population, the financial resources of each

community, and so on. The complicated pattern will, if the distribution of powers is aimed at producing the best possible result determine the degree of disparity between the cost of functional powers and the revenue which can be obtained by the exercise of financial powers. The extent of the disparity can vary between two possible extremes. At the one end it is possible to visualise the Federal Government with limited functional powers but with absolute financial powers. In other words, at the time when the Constitution was being framed it was found necessary to give all revenue raising powers to the Federal Government but it was desirable to transfer only limited functional powers to that authority. In this case, the State Governments will find themselves virtually devoid of income and yet be involved in considerable expenditure in order to carry out their allotted functions.

At the other extreme, the Federal Government may be given certain functions to perform and yet have no assured source of revenue. In this case, the State Governments will have certain administrative functions to perform and their sources of revenue will be potentially greater than their revenue requirements. In practice it will probably be found that the actual distribution which is adopted will bring forth a situation somewhere between these two extremes. Either the Federal or State Governments will be found to have revenue resources in excess of their requirements. It follows that the other authority will have less revenue than it needs.

It is of course, conceivable that in absolute terms both authorities may have potential sources of revenue in excess of or less than their requirements. For the Federation as a whole, however, the financial resources and revenue requirements will balance. If they should be temporarily out of balance, then on the occasions when financial resources exceed requirements, taxation up to the full potential will not be necessary. When revenue requirements exceed the revenue potential, some reduction of expenditure will be found necessary. Over the Federation as a whole, when revenue and expenditure are equated, it can be assumed that there will still

be disparity between the functional and financial powers of both the Federal Government and the Governments of the several member States of the Federation.

This disparity gives rise to the major financial problem of a Federation. If one authority has more revenue than the adequate performance of its allotted functions requires and the other authority has less than its requirements, and if it is impossible or impracticable to transfer either functional or financial powers from one authority to the other, then recourse must be had to the transfer of revenue from the authority which is in a position to produce surplus revenue to the authority which has insufficient revenue to meet necessary expenditure. Either the Federal or State Governments may be the authority enjoying the position of financial superiority. The determination of which it shall be and the degree of the disparity will result from the interaction of all the forces which caused the Federation to come into being. Whichever authority happens to be in the position of enjoying surplus revenue, there will be a financial problem which will vary according to which authority is in this position.

In the case where the State Governments can raise more revenue than they require, the problem of redistribution which will have to be solved will not be very great. They will raise a certain amount of revenue and portion of this income will be used to meet necessary expenditure on the administration of the functional powers allotted to them under the Constitution. Any surplus revenue can then be paid to the Federal Government to be added to its other sources of income in order to meet its expenditure requirements. the main problem here is to ensure that there will be sufficient surplus revenue after the State Governments have met their necessary expenditure to permit the Federal Government to function effectively.

The position may arise that although the State Governments have a revenue potential sufficient to meet their own and the Federal Government's financial needs, they may be unwilling to raise the revenue necessary to produce the surplus for transfer

to the Federal Government. In such a situation it would be advisable to have some legislative or constitutional provision which would compel the governments of the States to transfer sufficient revenue to the Federal Government. It would be difficult, and indeed inadvisable, for the Constitution to provide that the a stated amount, or proportion of the total income of each State should be handed annually to the Federal Government. If the appropriate amount were correctly determined at the beginning, in the first year of Federation, it would soon become more than or less than adequate. Perhaps the best method would be the establishment of a Commission or similar body of experts to determine the necessary amounts from time to time. It would then be mandatory for each State Government to subscribe the determined amount to the finances of the Federal Government.

If, under these circumstances, both the Federal Government and the member States of the Federation have been allotted fields in which to raise revenue, and the State Governments are unwilling to tax with severity sufficient to produce the revenue necessary to give a surplus which is to be available for transfer to the Federal Government, then the Federal Government may, if the taxation field allotted to each are supplementary - that is, they fall on the same person - increase the rates of taxation in the fields open to it in order to correct the deficiency. However, if this could be done, it could be said that the fields of taxation were such that they could be manipulated to produce a permanent balance between functional and financial powers. There may possibly be other solutions which will produce the desired result with equal adequacy.

The alternative case of disparity between functional and financial powers which may arise, is the situation where the Federal Government is given potential revenue raising powers in excess of its requirements. In the analysis which follows, attention will be concentrated on the correction of a disparity of this nature. The exclusion of the possibility of the other alternative situation arising can be justified on two grounds.

The first is that in the major Federations which now exist the Federal Government is financially the stronger. In the United States of America, the Dominion of Canada and the Commonwealth of Australia, the Federal Governments regularly make grants to the member States of each Federation in order that they may adequately perform their allotted functions.

Secondly, the nature of the functional powers which would reasonably be allotted to a Federal Government are such that they carry with them considerable revenue raising power. It can be expected that control of tariff measures associated with international trade will be one of the functions of the Federal Government, and this will automatically carry with it power to impose and collect customs revenue. Usually the expenditure involved in the performance of this function will not be very great, while the revenue attached to it, if any protective tariff measures are adopted, will be substantial. Here then is a potential source of revenue to the Federal Government which will probably be more than sufficient to meet all expenditure requirements. In addition, it is probable that the Federal Government will be given control of post and telegraph services which may be potentially profitable and yield revenue in excess of expenditure. Other services, also potentially profitable, may fall within its sphere of influence. Transport services which cover more than one State might be one example.

One highly lucrative source of revenue which may conceivably be given to the Federal Government is the power to impose and collect taxes on incomes. The only adequate reason for this is that it was thought necessary at the time of the formation of the Federation that income taxes should be levied uniformly throughout the Federation. This could only be satisfactorily achieved if there is but one taxing authority in the field, and the Federal Government is the only choice. If power to levy income tax is given to this authority, then its financial superiority over the State Governments will be assured and the financial problem will be related to the passing over of revenue from the Federal to

to the State Governments.⁶

It can be assumed, then, that this is the problem which will arise. As pointed out previously, although it is not inevitable that this will happen, it presents the greatest possibility. For this reason, and for other that will become more apparent at a later stage, the position where the Federal Government is the administrative authority which has potential financial resources in excess of its requirements will be considered exclusively in this essay.

Briefly summarising the position which it has been assumed will arise, both the Federal Government and the Governments of the member States will have been allotted certain functional and certain revenue raising powers and the distribution of these powers will be such that the revenue raising potential of the Federal Government will be greater than that which is required to meet all its necessary expenditure. The State Governments on the other hand, if they tax to the full extent in the fields remaining to them, will be unable to finance adequately the functions which have been allotted to them by the Constitution. It is then incumbent upon the Federal Government to raise revenue in excess of its immediate requirements and transfer the surplus revenue to the State Governments. Of course it will be impossible to determine exactly the revenue requirements of the member States over and above the revenue they themselves can raise from the sources available to them. In any case it will be a matter of judgment as to the required level of necessary expenditure by each authority. Nevertheless, it should be possible to determine, with a small margin of error, how much will be required. In practice it will probably be found that both authorities will tax to the capacity that is politically desirable in the potential fields of each, and avenues of expenditure will always exist to absorb all revenue that is raised.

6. This proposition relates only to the present era. When the Australian Constitution was designed, the importance of income taxing powers was far less than it is now. However, in the establishment of a new Federation, or the revision of the Constitution of an existing Federation, the allocation of income taxing powers will be highly important.

Given this situation, there will always be an annual surplus in the hands of the Federal Government which is to be paid out to the several State Governments. The major financial problem of a Federation now becomes apparent. This is to determine how the surplus revenue of the Federal Government is to be divided between the several States. The distribution can be determined according to one of several possible alternatives. These will be explained in detail in subsequent Chapters. Before proceeding with this analysis, however, it might be of advantage to consider the probable organisation of the Federation in order that the processes necessary to carry out the distribution according to whichever principle it has been thought advisable to adopt may be appreciated.

As seen earlier,⁷ the member States of a Federation will be fully independent in their respective fields. They will presumably have their own legislatures, executives and judiciaries which are fully answerable to the people. It is almost inconceivable that a Federation, as the concept is understood, could exist under any political philosophy other than democracy. On the other hand, the Federal Government will also be a complete entity with independence in its allotted field. Presumably the legislature of this federal authority will be an elected body and in this respect it will be representative of all the electors in the Federation irrespective of the States in which they reside. Thus, in each State there will be at least two authorities functioning. The first, the Federal Government, will deal with all matters common to all people in the Federation. The other, the State Governments, will deal with all matters of purely local concern. It is essential that there should be no conflict or disharmony between the two authorities, for they should both be working to achieve the same ends, namely, the provision of good government and essential services.

The executive, as the agent of the legislature, will in each case be the body responsible for the raising of revenue and its proper expenditure, although the policy relating to these matters will be determined by the legislatures. It will be

7. See Page 1 above.

convenient for the determination of the financial problem if each body adopts the same budgeting and accounting period. The procedure which should be adopted annually to achieve the desired results should be that the executive in each State should prepare an estimate of the necessary expenditure and the expected revenue which will be raised from the sources available to it. Thus the Federal authority will be aware of the amount in excess of its own requirements that it must raise for transfer to the several State Governments. This may be more or less than the revenue potential of the Federal Government. If it is less then taxation measures can be imposed which fall short of drawing off all available revenue from the taxpayer. If it is more than the revenue potential available, then the executives of the States will have to inform their legislatures that expected revenue will be lower than anticipated and that expenditure will have to be reduced. In this way, the overall balance may be preserved.

This is the ideal situation with perfect co-ordination between each State Government and the Federal Government. In actual fact it might not work out in this way. The difficulty of co-ordinating the bringing-down of budgets alone may prevent its attainment. It is probable that the Federal Government will be called upon to estimate the requirements of the several States and to budget accordingly. In this way a specific amount will be allocated to each State from the anticipated revenue of the Federal Government during each particular financial year. If this procedure is carried out sufficiently early in the financial year, the authorities in each State will be aware of the revenue which will be available from the Federal Government and will be able to adjust expenditure accordingly. The great deficiency of this method is that no allowance can be made for errors in estimation. The Federal Government may, at the beginning of the financial year, levy certain rates of taxation which it estimates will produce sufficient revenue to meet its own requirements and the requirements of the States above those which can be financed from the sources of revenue available to them.

This supposition may not be realised for one or more of a number of reasons. For example, general economic conditions affecting overseas trade and incomes of residents may fluctuate unexpectedly thus altering the effect of a given schedule of taxation rates during the course of the financial year. Under such circumstances it will be necessary for expenditure plans to be altered or alternatively, for governments to be prepared to accept a deficit or surplus on revenue account.

It will be noticed that no mention has here been made concerning the investment activities of the several authorities. This omission has been deliberate. The main concern will be with the revenue transactions of the various governments, and the part played by expenditure on capital development will be introduced at a later stage.

The main financial problem which will be encountered in a Federation has now been stated, and it remains to consider possible alternative principles which can be adopted as a basis for the distribution of the surplus revenue of the Federal Government to the member States of the Federation.

Before doing so, it has been thought desirable to examine briefly the objectives of government financial policy. Although the specific powers and functions of the governments in a Federation are laid down in a Constitution, those functions are merely the details of a much wider purpose. The revenue requirements of the Federal and State Governments should be sufficient to permit them to perform adequately their respective functions. The extent to which they should go when interpreting the range of a particular function is not, however, determined in a Constitution but is a matter of public policy which is itself formed in accordance with current views as to the scope of government and which can be expected to vary from time to time.

Objectives of Financial Policy in a Federation

While it is difficult to classify objectives of governmental financial activity into watertight compartments, it does appear possible to distinguish four main objectives in the modern developed economy. These may be termed the institutional, the redistributive, the developmental and the anti-cyclical objectives. The first, the institutional objective, contains the basic functions of government designed to maintain the framework and institutions of society. The redistributive objective gives a government the responsibility of ensuring an adequate distribution of goods and services between the members of the community. The third, the developmental objective is concerned with the part played by governments in procuring the most advantageous allocation of available resources, and finally, the anti-cyclical objective is aimed at influencing the achievement and maintenance of full employment.

The process of carrying out these objectives involves a government in revenue and spending problems and these problems are somewhat different in a Federation as compared with a unitary State. This is particularly so in connection with the redistributive objective but it still applies, although with lesser significance, with the developmental and the anti-cyclical objectives.

A. The Institutional Objective

So far as this objective is concerned, no very serious problem will be encountered. Certain activities, such as the preservation of law and order, the supervision of public safety, the organisation of defence requirements and the regulation of industry must be performed and their adequate performance requires expenditure of a certain magnitude. This amount must be raised by taxation or by other means at the disposal of governments. The procedure will be almost identical in both a Federation and a state.

with a unitary form of government, and can therefore be passed over in this analysis.¹

2. The Redistributive Objective.

One of the features of the modern developed economy is the uneven distribution of incomes received by members of the society. Inequality of incomes is characteristically marked by a concentration of income earners in the middle and low income groups, with a small number in the upper income brackets receiving a substantial proportion of all incomes. For example, in Australia in 1951-52, 3.25% of all taxpayers received 16.83% of all incomes. These people received actual incomes before taxation of over £2,000 in that year. The remaining 96.75% had incomes of less than £2,000 and together received 83.17% of all incomes.²

This purely statistical comparison should be qualified in that the low income earners in a country which has developed industrially are usually minors. Nevertheless it would be true to say that the distribution of money incomes of adults of labour-force age is concentrated at the lower end of the scale. Furthermore, it is usually found that it is the low-income earner who has the greatest family responsibilities in the form of dependents and sickness.

In this respect, a clear distinction should be made between inequality of incomes and poverty. Undoubtedly the two are closely connected but the motive behind the remedying of dire poverty is quite different from that behind the reduction of inequality. There can be no question that in modern developed society the prevention of extreme poverty is accepted as a basic duty of governments. It is carried out for humane reasons. On the other hand, the reduction of equality, as part of the

1. For a detailed examination of the historical development of views on the basic functions of governments, see H. J. Baumol, "Welfare Economics and the Theory of the State", Chapter 12, pp. 140 - 156.

2. Commonwealth Budget Papers, 1954-55; Parliamentary Paper F3321 p. 152.

redistributive objective is undertaken, as will be seen subsequently, with the purpose of increasing the welfare of the society.

The degree of inequality which was mentioned above in connection with Australian circumstances is common to all civilised communities, and governments have undertaken to effect some redistribution by, in effect, taking from the rich and giving to the poor. This function of government is of fairly recent origin and it will be of advantage in understanding the implications of financial policy to understand why governments feel that one of their functions is to attempt to reduce the inequalities which exist.

Undoubtedly one of the reasons can be traced to the system of democratic government which exists in most of these communities. It follows that because the great majority of income earners are in the lower income groups, the great majority of electors are also in the low income groups. If it is the will of the majority of electors that the elected government should adopt as part of its financial policy the function of redistributing incomes, then it will elect a government which undertakes to follow such a procedure. This is what the majority of electors will desire of its elected representatives if that majority comprises the lower income groups.

However, this process will develop slowly. A newly enfranchised lower income group will not usually demand sweeping reforms in the direction of establishing greater equality of incomes. As small concessions are gained, the electors will become increasingly aware of the differences in income which exist and of the power which they, as electors, hold to reduce the inequality.

The process of the trend towards greater equality through deliberate financial policy of governments has been hastened by the occurrence of what may be called national disasters. In times of emergency, governments have found it necessary to increase

their revenue substantially, and this has been done by the imposition of heavy taxation on the high income receiver. This was particularly noticeable during the wars of 1914-18 and 1939-45. After the need for additional revenue has passed, the high rates of taxation have been continued or reduced by less than the former increase, and the revenue thus obtained used mainly for purposes to the benefit of persons in the lower income groups.

Despite the political aspects of the trend towards greater equality as part of the financial policy of governments, it would be true to say that the trend would not have taken place purely because the franchise was widened and the newly-enfranchised electors, as potential receivers of assistance, desired greater equality. There must be some ethical foundation which justifies the movement towards greater equality, in part at least, in the eyes of income receivers who will suffer a reduction in income as a result of the adoption of the policy.

An ethical justification of the policy is not hard to find. It stems from the fact that the wide differences in income which are evident between members of a society are not caused solely by the ability of the persons concerned. If the only source of income available to each person in the community was the amount which he could earn by his own labour and initiative, it would be true to say that the range of incomes would be much narrower than it is at present. That is, a large part of the difference is caused by ownership of property and inequality of opportunity.

From this hypothesis it follows that if the only source of individual income was that which could be earned by personal effort, the range of incomes in the community would be distributed according to ability. On the other hand, the absolute potentiality for satisfaction would be randomly distributed. It would be illogical to argue that because the ability of a person is less than that of his neighbour, his potentiality for satisfaction is correspondingly lower. There can be little doubt that this

potentiality for satisfaction will be different for different persons, but there seems no reason why the distribution should be the same as the distribution of abilities or of material wealth.

This raises the ethical question of whether a man should be restricted in the satisfaction of his wants because his relative ability is low. The answer to this question is one which has been debated for many years and the differences of opinion have given rise to the establishment of political philosophies, political parties and the overthrow of governments. From the changes which have taken place in the attitudes of governments, and particularly the emergence of the welfare state, it would appear to be now generally accepted that while the incentive of those of greater ability should be preserved, the person with relatively lower ability, and hence receiving a relatively lower income, should not be restricted in the satisfaction of his wants to the extent of his income. In other words, it is generally accepted that his income should be supplemented at the expense of the higher income receiver and so increase his satisfaction to a level nearer that of a man with greater ability. At the same time, the extent of the equalisation process should be limited to the extent where there is still incentive for all men to use their ability to the greatest extent.

As mentioned above, this attitude to the range of inequality of incomes in a community has led to the emergence of the welfare State and for simplicity of exposition will be referred to as the "welfare" or "redistributive" function of governments. It has been generally accepted that the process of redistributing incomes in a community will increase the welfare of the community as a whole. More correctly, it is a process designed to allow greater equality of the means to satisfy potential wants.

Given that this is one of the major objectives of government financial policy in the modern state, the question of how financial policy can be adapted to bring about greater equality of incomes, and hence greater equality of the means to satisfy potential

wants must be considered. It is not here necessary to explain in detail the organisation of the finances of governments. It is sufficient to say that on the one side, governments receive revenue from the imposition of taxation and various charges for services rendered, and also by means of public borrowing. On the other hand, the money received is spent on the provision of services. These services, interpreted in the widest sense, include the maintenance of the institutions of the society, the provision of social³ and general services, the provision of public utilities, the payment of debt management charges and investment in public capital works.⁴ Within this framework a government, if it is to perform the redistributive function referred to earlier, must bring about greater equality of incomes of residents.

The major source of a government's current revenue is taxation in its various forms. In Australia in 1952-53, taxation was responsible for 86% of all revenue of the Government of the Commonwealth of Australia.⁵ The taxation takes several forms, the most important of which are income and company taxes, sales or purchase tax, stamp and death duties and customs and excise duties. Income tax can be levied on all income receivers whether they are wage and salary earners, rentiers, professional men or companies. Sales tax can be imposed on all who purchase consumer or capital goods. Customs and excise duties will ultimately be paid in the retail price of the goods on which they are imposed, and will therefore be paid by all sections of the community.

It can be appreciated that if a government adopts a selective taxation policy it will be a highly effective implement for bringing about greater equality of incomes. Income tax is the greatest potential source of revenue and is at the same time the most important means at the disposal of governments for reducing inequality of incomes. While considerable inequality is to be found in the distribution of actual incomes before taxation, when a progressive rate of income tax is imposed, the degree of inequality of incomes after taxation will be less noticeable. The extent of the inequality after taxation will depend on the extent of the inequality before taxation and the degree of progression in the rates of taxation.

The same principle can be applied to other forms

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3. Social services provided by governments are of two kinds. The first is the provision of some actual physical services such as education. The second is a cash payment in the form of a pension or other cash benefit.
 4. The investment activities of governments will be dealt with as part of the developmental objective. See p 30 *et. seq.* below.
 5. Financial Statement of the Treasurer of the Commonwealth of Australia, 1952-53.

of taxation but the effects are less spectacular than those achieved by the use of progressive rates of taxation on incomes. Taxation of estates of deceased persons can be steeply progressive, and in the past, death duties have played an important part in bringing about a greater equality of incomes by removing part of the source of inequality. There is less scope for selectivity with the other main forms of taxation, namely sales tax and customs and excise duties, for the great majority of goods subject to these taxes are consumed by those in the lower income groups. Nevertheless, even in these cases there is some scope for selectivity by, for example, imposing high rates of duty or tax on goods which are normally consumed by people in the higher income brackets. Furthermore, the imposition of duties on goods which are consumed by people in the lower income groups can play an important part in a government's anti-cyclical policy. This aspect will be treated in some detail later in this Chapter.

Thus, through its taxation powers, a government has an important means for implementing a policy designed to bring about greater equality of incomes. This, however, is only part of the process. The aim cannot be achieved by taxation policy alone. In its expenditure policy the government must also discriminate between the relative needs of the different income groups in the community.

As mentioned earlier, a government will spend its revenue on maintaining the institutions of the society, providing social and general services, meeting its interest and sinking fund commitments and investing in new capital works. From the point of view of decreasing the degree of inequality in the community, the most important of these expenditure functions is the provision of social services. Through its expenditure on social services the government will be able to discriminate between those in the high income groups and those in the low income groups. Both the provision of physical social services and the direct payment of financial assistance by way of pensions will be designed to benefit those who contributed least to the revenue of the government by way of taxation and other charges.

In the Australian economy, the manner in which the distribution is made through the agency of social services and direct financial payments can be readily appreciated. All pensions paid are subject to a means test. That is, they are only paid if the recipient's income from other sources is very low. Child endowment is paid to all parents of children under sixteen years of age irrespective of income, but the relative benefit is much greater to those in the lower income groups. In the field of the provision of physical services as opposed to the payment of direct financial assistance, the main avenues of expenditure are in the provision

of medical and education services. These are available to all members of the community irrespective of the level of their incomes. However, it has been found in some countries that people in the higher income groups avail themselves of private medical and educational facilities leaving those provided by the state for people in the middle and lower income groups. This practice is not, however, universal and there appears to be a growing tendency on the part of better-off people to use the available public services. Nevertheless, as in the case of direct financial payments without a means test, the relative benefit derived from the service by the middle and lower income groups is far greater than that derived by those in the higher income groups who contribute through taxation a very much greater than proportionate share of the cost of the services.

These, briefly, are the processes which will be involved if a government wishes to pursue a policy designed to bring about greater equality of real income in the community. The extent to which it will carry out the objective, or the degree to which it will endeavour to increase equality, will be influenced largely by political considerations. A left-wing government will probably be more enthusiastic and carry the policy farther than a conservative government.. However, it appears that the welfare state has been firmly established and irrespective of the party in power, financial policy is being directed to a greater rather than a lesser degree towards reducing inequality of incomes. It can be safely said that this is now an accepted function of government in highly developed ^{economies} with non-socialist organisation of production.

The analysis which has been made of the processes involved in adopting a redistributive policy have been expressed in very general terms. There has been no distinction made between the procedure in say, a country with a unitary form of government and one with the federal form. However, it would be true to say that the description applies fairly generally to a country with the unitary form of government. While the description is itself a simplification of the vast amount of co-ordination that is necessary, there are no apparent modifications necessary when the policy is applied exclusively to a unitary government. Taxation is raised by a single central authority, cash social service benefits are paid uniformly throughout the country, and general social services can be supplied uniformly to all sections of the community.

In a federation difficulties in the implementation of this simple plan arise because of the division of fields of activity in both the revenue raising and spending spheres between the Federal Government on the one hand and the several State Governments on the other. It is the purpose of the remainder of this Section to show how the redistributive function of government

can be successfully applied in a Federation.

As pointed out in the previous Chapter,⁶ the distribution of powers between the Federal and the several State Governments will differ between Federations. For the purposes of illustration, and because this analysis will subsequently be confined to the Australian Federation, conditions which exist in Australia will be assumed to be typical of federations generally.

In Australia, the Federal Government has been given absolute power to impose customs and excise duties,⁷ and concurrent powers with the States to impose other forms of taxation. However, the Constitution provides that taxation shall be non-discriminatory between persons and States.⁸ In the field of expenditure on social services, it may pay invalid and old-age pensions⁹ and provide maternity allowances, widows' pensions, child endowment, unemployment, pharmaceutical, sickness and medical benefits, medical and dental services, benefits to students and family allowances.¹⁰ The State Governments have, by implication, the power to provide the major types of physical types of social services such as education and health services.

Whatever may have been the intention of those who were responsible for the framing of the Constitution, the provisions relating to concurrent powers in the field of taxation have been interpreted by the courts to mean that the Federal Government has a prior right to tax, and this decision, in conjunction with the power to make conditional grants to the States, has in fact excluded the States from the field of income taxation. The position in Australia is thus that the Federal Government has almost absolute control over the collection of income and sales tax and customs and excise duties.¹¹ At the same time, the States are responsible for a large part of social services expenditure.¹² This is the framework upon which the welfare State is built in Australia.

With a unitary form of government such as that which exists in the United Kingdom, it is a relatively simple matter to enforce a policy aimed at the redistribution of incomes. Taxes are levied uniformly throughout the country. Similarly social services are supplied on a uniform basis whether they are in the form of money transfers such as invalid or old-age pensions or in an indirect form such as education services or subsidised hospital treatment.

6. See page 10 above.

7. Constitution Act of the Commonwealth of Australia, Section 86

8. Constitution Act Section 51(11).

9. Constitution Act Section 51(xiii).

10. Constitution Act Section 51(xiiiA).

11. In 1952-53, taxation collections by all State Governments were £71m. and by the Commonwealth Government, £895m.

12. In 1952-53, expenditure by the States on the provision of social services was £141m. and by the Commonwealth Government, £166m.

In a Federation such as that which exists in Australia, such a redistributive policy cannot be implemented in the simple manner outlined for a unitary state. The Federal Government, which has the greater authority for the imposition and collection of taxes, can calculate and impose its rates of taxation in the accepted progressive form. So far as its expenditure on social and other services is concerned, here again the redistributive process can be effected by the adoption of a policy for the provision of services which are uniform in all sections of the community. The great majority of Federal social services expenditure in Australia is on the payment of cash pensions and allowances which are paid uniformly throughout the Commonwealth irrespective of the State of residence of the recipient.

But a small part of the total taxation collections and a large part of the total social services expenditure is the responsibility of the State Governments. As shown earlier, while the present constitutional arrangements exist in Australia, there must inevitably be some transfer of revenue from the Federal Government to the State Governments if the States are to be permitted to perform adequately their allotted functions. It must be admitted that there may be no compulsion on the part of the Commonwealth in making these grants to the States.¹³ The problem thus becomes one of determining how a policy of equalisation of incomes can be effectively implemented under such conditions.

The extent to which equalisation can be achieved throughout the whole federation, to the degree required by the political decisions of the governments concerned, will depend in the main upon the principles which are used to determine the amounts of the grants to each State. These principles will be examined in detail in a later Chapter.¹⁴ At this stage the object is merely to determine the way in which the redistributive policy of governments can be implemented in a Federation. The means indicated may point to the principle to be adopted.

It is generally accepted that the welfare of a community will be increased if inequalities of incomes are reduced and, as mentioned earlier, this is the fundamental reason for adopting a policy which involves redistribution of incomes. This concept can be applied to any community no matter how large or small. It could be applied, if necessary, to a small community within a unitary state. However, in a country with the unitary form of government such as the United Kingdom, it would be futile to attempt

13. The Constitution provides in Section 96 that the Commonwealth may make conditional grants to the States, but under the States Grants (Tax Reimbursement) Act, 1946, there are no conditions other than that which requires the States to refrain from imposing income tax.

14. See Chapter III

to bring about greater equality within say, each County separately. For if this were attempted there would undoubtedly be inequalities between people on the same level of actual income in different counties depending upon the absolute average level of income and the degree of inequality of incomes before taxation in each community. Such an attempt would be difficult to justify on either ethical or political grounds and there would be little doubt that the welfare of the nation as a whole would be increased if County boundaries were ignored and the same rates of taxation levied and standards of services supplied in all counties.

The position is similar in a Federation. It would be possible for Federal policy to aim at equalising incomes in each State individually. The Federal Government, as the chief revenue raising authority, could record funds raised from the residents in each State by way of taxation and also the amounts paid to or on behalf of the residents of each State. The remainder, if any, could then be paid to the respective governments of the several States and they would be responsible for its expenditure in such a way as to reduce the degree of inequality in each State individually.

Alternatively, the Commonwealth Government could adopt a different redistributive policy for each State based on the taxable capacity of each State. A State with a wider range of incomes would enjoy greater redistribution and higher absolute levels of services compared with a State with a narrow range of incomes. Such a scheme has little to recommend it from the practical viewpoint.

Either of these approaches, however, regards each State of the Federation as an integral unit. The alternative is to regard individuals, not as members of a particular State, but as members of the Federation as a whole. Under such circumstances, the objective of Federal governmental financial policy should be to reduce the degree of inequality of incomes throughout the Federation ignoring State boundaries. If this were the objective, Federal grants to the States would be designed to permit State Governments to adopt an expenditure policy which would decrease the degree of inequality to the extent where the same degree of inequality exists in all States of the Federation.

Under Australian conditions, this would involve an assessment of the relative severity of State taxation and the standards and impact of services supplied by the respective State Governments from their own sources of revenue. It could well be that one State in a Federation is particularly poorly endowed with natural resources and therefore it can be expected that incomes are, on average, lower than those enjoyed in other States. If Federal taxation is levied according to a progressive scale, collections

from that State will be relatively smaller than from other States. If, under these circumstances, the aim of financial policy is to reduce the degree of inequality of incomes in each State separately, the degree of redistribution of incomes by means of progressive taxation and discriminatory social services will be limited by the range of incomes.

In the case of a comparatively poor State where the range of incomes is narrow, the redistribution which can be effected will be small. In a State which is more prosperous and has a wide range of incomes and higher absolute levels, the scope for redistribution of incomes is correspondingly higher. Although there is no way of measuring the relative levels of satisfaction enjoyed by the residents of each State, it could be said that on average, the residents of the latter State would be better-off than the average resident of the former State. Although it is not possible to measure the extent to which they are better-off, it is possible to say that they are in a position to satisfy wants to a greater extent. However, in such a process of redistribution between States as well as within States, there will always be a range of uncertainty in which it will be impossible to determine whether greater redistribution will increase or decrease the average level of satisfaction.

The conclusion which can be reached from the foregoing analysis is that if a government decides to adopt a policy designed to redistribute the incomes of the members of its community, then the policy should be applied uniformly in all sections of the country. A unitary government would have no hesitation in redistributing incomes across local government boundaries because it would recognise that the boundaries themselves are purely artificial. In a Federation, the Federal Government should endeavour to reduce inequality uniformly throughout the Federation because State boundaries are similarly artificial and were probably designed purely for administrative purposes. To the extent that this uniformity cannot be achieved by the direct means at the disposal of the Federal Government, federal grants to the State Governments should be so designed that when spent by the respective State Governments, they will produce a uniform degree of inequality between States.

C. The Developmental Objective.

As in the case of the redistributive objective, the developmental objective of governments is of comparatively recent origin. It is only in recent decades that governments have undertaken the responsibility for supervising and encouraging first, a balanced use of available resources, and secondly a co-ordinated plan of capital investment. Together, these make up the developmental objective.

It is the accepted duty of a government in a modern developed economy to use its influence to ensure that the allocation of available resources is such that present and future flows of goods and services are maximised. This calls for the planned use of resources in the production of goods for current consumption on the one hand, and in the production of capital goods for future production of consumer goods on the other.

Corresponding to each combination of available resources there is a certain output of goods and services. One particular combination gives the maximum possible output, and this may be called the optimum allocation of resources giving maximum production. It is a function of governments to influence the allocation of resources to produce this optimum.

It has been suggested in economic writings¹⁵ that a completely free market will produce an allocation of resources which is below the optimum. The apparent reason for this is that the free market is individualistic with each individual, either producer or consumer, activated solely by the profit motive. The aim of each individual is to maximise profits, and individual profits may be maximised when total production is less than a maximum with perhaps some unused resources available.

The effects of private enterprise left to itself can be seen, in a simple illustration, by the need for development in many countries of town planning authorities. With lack of positive direction, the development of suburban areas of cities has proceeded almost irresponsibly. Town planning authorities have been developed to ensure that proper facilities for shopping centres, playing areas and even street formation are provided for.

The same type of effect can be expected on a larger scale with decisions concerning production. Private industry may be unwilling to accept the responsibility for long-range planning or bear the cost of building up capital resources for future production when the profit margin is less certain. Even in the case of the use of available resources for immediate production, private industry will not usually have the necessary knowledge or even capital to make the best possible use of those resources.

Under these circumstances, if governments can intervene to influence reallocation in the direction of the optimum, then the total output of goods and services, and hence the national income and the average level of income in the community will be increased. That is, the financial policy of governments should be directed

15. See, for example, W.J. Baumol, "Welfare Economics and the Theory of the State", Chapters 1 and 2.

towards bringing about the optimum allocation of resources in order that the power of the community to satisfy its wants will be maximised

In attempting to determine the optimum allocation of available resources, a government should give consideration to the long-term as well as the immediate maximisation of output of goods and services. It could happen that at a given moment the allocation of available resources is such that the production of consumer goods and services is maximised. However, if certain resources were to be transferred to the production of capital goods, the output of consumer goods at present would be reduced but would permit the future stream of consumer goods to be increased. Therefore, decisions will need to be made as to the allocation of resources which will give the required balance between the production of consumer and capital goods.

Reallocation of resources can be both influenced by and effected by governmental financial policy and other more direct controls. In the extreme case such as that which exists in time of war, the government should undertake the responsibility for allocating all factors of production by means of direct controls. An example of this was seen in Australia and other countries during the 1939-45 war, with official conscription of labour both for the defence forces and civilian production. When this emergency is absent, the complete regimentation associated with a comprehensive range of direct controls is impossible.

Under such circumstances, in a modern democracy a government must use more indirect methods. By use of its financial power it can influence the allocation of available resources, but again it will be easier to achieve this aim in a unitary state rather than in a federation. The ways in which a government can influence this allocation through financial policy are varied, but the more important will be briefly mentioned.

As in the case of financial policy aimed at producing greater equality of incomes in the community, discriminatory taxation and judicious expenditure policies are the main weapons at its disposal. The state, as the largest single enterprise in the community, can do a great deal in its own expenditure policy to counteract any maladjustments which can be seen in the private sector of the economy. In this respect, the payment of bounties and subsidies can play an important part. But in the reallocation of resources, financial policy must inevitably be accompanied by other methods such as the imposition of direct controls and discrimination in the application of rates of taxation and other charges. Its

influence on Central Bank credit policy will also play an important part.^{16.}

The major part of the task facing governments in the implementation of this policy will be to determine the extent to which production is below the optimum and then the nature of the reallocation of resources necessary to improve the position. In some cases the need for reallocation will be immediately apparent. For example, good agricultural land may be going out of production because farm labour is not available in the immediate vicinity. A decision could then be made as to whether production as a whole would be increased if labour were transferred from urban areas to the particular rural areas to the advantage of total production and hence national income and the average level of incomes.

If this decision were made it would be possible, for example, for the government to allow taxation concessions to workers in the area, to improve amenities to encourage labour to move to the farms or, negatively, to discourage the expansion of industries responsible for the transfer of labour by credit and capital control. Alternatively, it might encourage the greater use of labour-saving machinery by the farmers to offset the loss of labour by concessions in the form of cheaper electric power or lower excise and customs duty or sales tax on the machinery involved. Again, it may help to reduce the costs of production to the farmer by concessional transport charges. Similar examples could be suggested to illustrate the way in which governments can influence the allocation of resources in other fields of economic activity.

In a federation the problem of State boundaries and the distribution of powers between the Federal and State Governments again proves to be a barrier to the simple implementation of such a policy. If, for example, the Federal Government has decided to adopt this approach to output maximisation, the full range of policy decisions necessary for making it work effectively are not available to the Federal Government. While it controls Central Banking policy and a large part of taxation raising policy, part of the power to impose taxation and a large part of expenditure power, particularly in the field of expenditure on capital works, is in the hands of the several State Governments. They also control such purely domestic matters as the levels of charges for State services including railway and electricity services. Consequently neither authority is in a

16. This is in general agreement with the statement by W.J. Baumol in "Welfare Economics and the Theory of the State" p.63, that "the general problem of maldistribution of resources seems to be one that is amenable to amelioration by a system of bounties and taxes so long as we have some idea of its direction and magnitude."

position to implement effectively a policy of redistribution of resources independently of the other.

Since it is impossible for either the Federal or State Governments to achieve the desired end independently, the solution must lie in some form of agreement or cooperation between them. If a uniform approach is desired, the Federal Government must be the coordinating authority. Constitutionally the State Governments remain free to act as they think fit and difficulty might be experienced in persuading governments with opposing views to adopt a uniform policy in this respect. Danger thus exists that different policies may be adopted in different States and this might prejudice the success of the policy of the Federal Government.

One safeguard exists in that the Federal Government is bound by the Constitution to adopt a uniform taxation policy throughout the Federation. Even if it so desires it would find it difficult to discriminate between States except so far as the payment of grants is concerned. If two State Governments proposed different approaches to a particular problem, a certain amount of uniformity would be maintained by the actions of the Federal Government. The Federal Government is prevented from imposing different rates of taxation in different States and therefore policies involving the imposition of discriminatory taxation must be applied uniformly throughout the Federation. In its control over Central Bank policy and in its expenditure policy there is no such limitation however, and in these fields it would be possible for the Federal Government to discriminate between States.

If it is agreed that the Federal Government should adopt a policy aimed at maximising production in the Federation, this policy should be applied to its revenue, expenditure and banking policies. A considerable portion of its expenditure, however, is used for the purpose of making grants to the States. If the States are to be placed in a position where they can cooperate in the implementation of the policy, the grants should be determined accordingly. That is, the amounts which each State shall receive from the Federal Government should be determined after taking into consideration the ability of the State to assist in the implementation of the required policy from its own resources.

In this respect, Federal financial assistance will probably play a smaller part than will be needed for the implementation of a policy designed to reduce inequality through redistribution of incomes. In a policy of redistribution of resources according to some preconceived plan, expenditure from current revenue will probably play a relatively small part. Considerably more influence can be

wielded through expenditure on capital works. Nevertheless, this aspect will have to be considered in the determination of Federal grants even if only to allow for differences between States in the severity of debt management expenses, particularly interest and sinking fund contributions resultant upon expenditure from loan funds.

The principle involved in determining the respective parts which the Federal and State Governments should play in a policy designed to maximise production through improved allocation of resources can now be stated in general terms. It would seem that the implementation of a policy aimed at encouraging the attainment of the optimum allocation of resources, when introduced by the Federal Government, can only be properly aimed at producing the optimum in the Federation as a whole. Further, since the sphere of action of the Federal Government is limited by the provisions of the Constitution, the Federal policy must be implemented in part by State action. It is reasonable to suppose that the national income of the federation as a whole will be greater if the policy is aimed at obtaining the optimum allocation of resources in the Federation as a whole rather than in each State individually. Therefore the plan should be one designed by the Federal Government and supplemented by such action as is necessary on the part of the States in the fields where they have complete constitutional power to act.

However, if the Federal aim is to be fully effective, the States must be placed in a position where financially they may play their part. For this reason, Federal financial assistance to a State must recognise the State's ability to supplement the Federal policy. In other words, the grants to the States must include amounts sufficient to permit their Governments to play their part in carrying out the policy. In order to ensure that the States will cooperate in the implementation of the overall plan, it may be necessary for the Federal Government to impose some conditions upon the payment of such grants. However, it would probably be found that the mere fact that the Federal Government has power to compel cooperation will prevent the need for such action.

The payment of Federal grants may involve a transfer of financial resources from one State to another which act, by itself, could be an effective factor in the redistribution of resources. An underdeveloped State will be placed in a position where, because of increased financial resources, it will be able to import from the wealthier States relatively more material resources than it could have afforded from its own income. Whether or not this is desirable will be determined as part of the overall plan.

Should the Federal Government not make provision for the adoption by a State of the policy of reallocation of resources in the

determination of the grant to be made, the anomalous position will arise where the Federal Government is attempting to maximise production throughout the Federation while the State Governments will be capable only of maximising production in each State individually. Since the States hold a large part of the power to implement the policy, lack of coordination could render the power of both ineffective. The existence of the Federal Government operating in this field will cause more to be achieved than if the States were functioning alone, but the optimum will probably never be reached unless the Federal Government recognises its responsibility. The onus rests with the Federal Government to determine grants in such a way to permit the State Governments to perform their parts.

Before dealing with the fourth major objective of governmental financial policy, mention should perhaps be made of the investment activities of governments. In determining the optimum allocation of resources, a Government will have to pay particular attention to maintaining a balance between the production of present and future flows of consumer goods. This involves decisions concerning the allocation of resources between investment projects with varying time-lags between commencement and the stage when the resultant flow of consumer goods begins. That is, it must develop a long-range investment plan for the economy as a whole and attempt to bring about an allocation of resources in accordance with this plan.

As with other cases where the Government attempts to direct the operation of the market, it may approach the problem in two ways, one direct and the other indirect. The direct approach involves capital expenditure by the Government itself, while the indirect approach involves creating conditions which influence the private sector of the economy in adopting an investment policy of the Government's making.

Government capital expenditure will be financed from current revenue or from borrowed funds. To the extent that current revenue used for this purpose is raised by taxation or similar imposts the Government will have drawn off purchasing power from the public which may eventually have been used for current expenditure or which, if saved, could have found its way into private investment.

In this way the Government can influence the community's saving and the direction of the corresponding investment. The Government will decide, according to its overall plan, the manner in which the funds shall be expended and the time-lag between the time of investment and the time when a flow of consumer goods is to begin.

Apart from such direct action on the distribution of available resources between the production of short and long term

investment goods, a Government may indirectly affect the distribution. A selective taxation policy combined with direction of Central Bank credit, can be instrumental in encouraging private investment to follow the lead of the Government.

A Government can also play a decisive part through the conduct of its every-day administration. For example, in the modern economy, restrictions have been placed on overseas immigration. By adopting a policy which limits entry to those of certain skills and professions, the distribution of the labour force can be substantially influenced.¹⁷ Similarly, a large part of overseas borrowing is now conducted by governments and the remainder is subject to direct supervision. Present-day currency restrictions make it comparatively easy to ensure governmental direction of overseas capital.

It can be appreciated that the development and supervision of a balanced investment programme is a task for a centralised government. In a Federation with revenue raising and spending authority divided between several Governments, the successful operation of such a plan is far more difficult than in a unitary state where a single authority holds all necessary power.

The problem is not one which impinges to any great extent on the financial relationships of Federal and State Governments at least so far as Federal grants to the States are concerned. It is, however, a matter which calls for close cooperation between the two types of government and this co-operation will not be forthcoming unless both are satisfied with financial relationships in connection with the determination of grants from current revenue.

D. The Anti-cyclical Objective.

In this Section it is proposed that the anti-cyclical objective of government financial policy be examined in a manner similar to that used for the redistributive and developmental objectives. The main problem will be to show how accepted practice in a unitary state must be modified to comply with the peculiar position which arises in a Federation.

It would be true to say that until twenty years ago, there were no commonly held views on the part which government financial policy should play in counteracting the effects of the Trade Cycle. The laissez faire view that an alternation of periods of prosperity and depression was an inevitable concomitant of industrial society had not been completely abandoned. The welfare state had grown

17. Post-war immigration policy in Australia has included direct allocation of alien immigrants to specific industries and firms for a period of two years after arrival.

rapidly in the years after the first world war and the great depression of the 1930's was the first major opportunity for definite government policy to be adopted for this purpose. In the depression of the 1890's, for example, the role of government was still restricted. Until its size and scope was enlarged, the ability of government to play a positive part in anti-cyclical measures through financial policy was limited.

The occurrence of mass unemployment after 1929 found governments unprepared to adopt a definite financial policy to meet the crisis and its aftermath. The professional economist, and this profession was still in the embryonic stage, was similarly caught unawares. Most governments accepted some responsibility but the approaches adopted were palliatives only. For example, in Australia, the Premiers' Plan of 1930,^{18(a)} which called for a general reduction in wages, salaries and interest rates, was a step taken to effect a recovery from the depths of a depression. It was not designed as a corrective which could be applied to prevent a depression occurring. There were, in fact, no clear statements of financial policy designed to prevent a recurrence of the circumstances which had developed.

In 1936, when most countries had recovered from the worst effects of the depression, J. M. Keynes produced his "General Theory of Employment, Interest and Money". In this work, Keynes endeavoured to explain the interaction of factors which determine the level of employment at a point of time. Although not expressly stated in that work, later developments of the theory have produced from it principles of public financial policy which should be adopted by governments which are conscious of the trade cycle and which wish to counteract the effects of general economic fluctuations.

It is not an easy matter to state the Keynesian Theory in a few words. Almost every writer on Keynes has a different view.¹⁸ Nevertheless, it is possible to say that one of the main elements of the theory is that it can be shown that it is possible for an economy to be in equilibrium with a situation of less than full employment. A given level of national income and employment is compatible with a certain level of spending on consumption and investment. In the simplified case of a closed economy, the amount of spending on consumption and investment will be divided between the public and private sectors of the economy.

If unemployment threatens, it will be because the level of spending has declined below the full employment level, producing what has become known as a "deflationary gap". If, with full

18. For a summary of the General Theory, see Dudley Dillard - "The Economics of J. M. Keynes", p.48 ff.

18a. See Shann and Copland, "The Crisis in Australian Finance, 1929-31", pp.183-5.

employment, inflation threatens, the level of spending is above that necessary to give full employment and the difference is the "inflationary gap".

From the line of economic thought developed by Keynes and subsequent writers, a theory of the approach which should be adopted by governments to produce or maintain full employment of resources has been evolved.¹⁹ This theory suggests that since the level of employment is determined by the level of spending, full employment is compatible with one particular level of spending once the other relationships in the economy have been determined. The total volume of spending in a (closed) economy is divided between the public and private sectors. Thus, if a situation of less than full employment develops, it will be because the rate of expenditure by either or both of these sectors has fallen below the full employment level. This can be remedied by the public sector, under the control of the government, increasing its rate of spending to restore the former total level.

Conversely, if inflation threatens, it will be because the rate of total spending is greater than the rate corresponding to a situation of full employment. This can be corrected by a reduction in the rate of spending by the public sector.

The action required of a government if a position of stable full employment is to be maintained is thus to regulate its spending to counteract fluctuations in spending in the private sector of the economy. At the same time it can influence the level of private spending. The problem to be considered is how this stability can be best achieved with particular reference to conditions which are found in a federation.

There are three major approaches which a government can use through its financial policy to counteract the effects of the Trade Cycle. The first relates to the revenue side of the Consolidated Revenue Account, the second to the expenditure side of that Account and the third to variations in the rate of expenditure on public capital development. In adopting this tripartite division, it has been assumed that the government concerned draws a clear line of demarcation between expenditure from current revenue - that is, revenue which is generally recurrent each year - and expenditure from loan funds. In most countries, the distinction is not always made as clearly as this, but as a general rule in Australia the two sources of revenue are kept apart.²⁰ Current revenue is used to

19. See, for example, L.R.Klein, "The Keynesian Revolution" p.168 and Dudley Dillard "The Economics of J.M.Keynes" p.156 ff.

20. Even in Australia there are some exceptions. The Commonwealth Government and to a lesser extent, the financially larger State Governments finance some capital works from current revenue.

meet the cost of everyday administration and the provision of services, and loan funds for public investment purposes.²¹ The distinction between capital and revenue is useful for public accounting procedures, but has little significance for aggregative analysis. In this instance it is necessary to retain the distinction in order to understand the Australian position.

The first possible approach is from the revenue side. That is, the government can manipulate the amount of revenue it will receive by alteration to the rates of taxation it imposes. The major sources of revenue will vary between countries, but in most they will be found to be taxation in its various forms. Most important are usually income tax and customs and excise duties supplemented by sales or purchases tax, stamp and death duties and a multiplicity of minor taxes, duties and licences.

Earlier in this Chapter, a brief examination was made of the way in which taxation rates are generally imposed progressively and thus collected mainly from those in the higher income brackets.²² This is a simplification of the processes involved, but is sufficient for the purposes of illustration. An increase in rates of taxation with no alteration in price levels will result in a decrease in money wages and company incomes. This in turn will cause a decrease in purchases of consumer goods or a decrease in savings or a combination of both. In the higher income brackets, greater taxation rates will probably be at the expense of saving, whilst in the lower income brackets where a comparatively small proportion of net income is saved, it will be mainly at the expense of the purchase of consumer goods.

Conversely, a reduction in taxation will probably result in an increase in expenditure on consumer goods by the lower income groups and an increase in saving in the higher income groups. The reaction of the individual will, of course, vary from this general pattern, but for the community as a whole, this type of reaction may be expected with confidence.

In this respect, Keynes has stated²³ that "the fundamental psychological law upon which we are entitled to depend with great confidence, both a priori and from our knowledge of human nature and from the detailed facts of experience, is that men are disposed as a rule and on the average, to increase their consumption as their income increases, but not by as much as their increase in

21. In other countries, the practice varies widely. In the United Kingdom, for example, there is no distinction between expenditure on current goods and services and capital investment. The budget result is the difference between current revenue and expenditure of all types. However, capital expenditure by semi-governmental bodies is financed by public borrowing and is excluded from the budget.

22. See above, p.24.

23. General Theory, p.96.

incomes". This means, in effect, that since a reduction in taxation increases the money income of the people, part of the increase will be spent on the purchase of consumer goods and the remainder saved. By a judicious adjustment of the impact of the tax reduction or increase on the various income groups, a government should be able to determine approximately the shape of the consumption function.

The object of increased rates of taxation is to reduce the purchasing power in the hands of individuals in the community and hence reduce demand and production in order to reduce inflationary pressures which are present at times of over full employment. Conversely, the object of reducing rates of taxation is to increase purchasing power, demand and production and thereby increase employment. The effectiveness of either policy will be negated unless there is corresponding action on the part of governments to control or expand their own expenditure.

An increase in rates of taxation reduces purchasing power of individuals in the community and increases the purchasing power of the government by a corresponding amount. If no saving is involved and the government increases its expenditure by the full amount of the additional income, the effect of the increased taxation in curbing inflation will be made ineffective. Similarly, in times of less than full employment, if taxation is reduced and government expenditure reduced accordingly, there will be no stimulus for employment to increase. The fact that portion of individual incomes is saved means that if a government carries out this procedure, the reverse of the anticipated effects can be expected.

Consequently it is desirable that the increased taxation revenue should not be spent or that expenditure should be maintained at its previous level when a reduction in taxation rates is applied to bring about an increase in business activity. That is, if over full employment is threatening, governments should budget for a surplus in the Consolidated Revenue Account. In times when unemployment is threatening, they should budget for a substantial deficit.

The approach to sustaining or reducing total demand by altering the rates and impact of taxation and rates of government expenditure on current goods and services can be regarded as short-term public financial policy for anti-cyclical purposes. It is possible for a government to modify its income raising and spending programmes at comparatively short notice. In the case of threatening unemployment, for example, the decision to reduce taxation can be put into operation as quickly as the Parliament can pass the necessary legislation. Under present methods of income-tax collection, commonly referred to as "pay-as-you-earn", the effect of reduced

rates of taxation are immediately felt in the pockets of taxpayers. Money incomes will be increased and consequently the rate of expenditure is increased. Some of the immediate effects may be lost as part of the increase in money incomes is absorbed in savings. Nevertheless, demand will be stimulated to some extent, depending on the propensity of the community to consume its current income. As demand is stimulated, employment will be increased. The effects of alteration in the rates of taxation other than income taxation may be slower, although the effects of alterations in rates of sales or purchase taxes will be felt immediately.

If, at the same time, the rate of government expenditure is increased, there will be a further impetus to demand which again will take place almost immediately. For example, the increase in expenditure may take the form of increased pensions and other forms of transfer payments. The marginal propensity to consume amongst those in receipt of pensions would be comparatively high and therefore almost all the increase in incomes would be spent. Demand will thus be further stimulated.

The increased amount available for the purchase of goods, mainly consumer goods, will probably check any tendency for unemployment to develop or increase. This, however, is only a temporary measure which is recommended because its results are felt almost immediately. It would be true to say that more severe corrective measures are necessary to deal with a situation where unemployment has developed than are necessary to deal with threatening unemployment. Consequently it is essential that immediate remedial action be taken to prevent a major depression occurring. The use of budget deficits should be regarded as the method which can be used to hold up the process until more persuasive instruments of financial correction can be brought into play.

It should be mentioned that part of this corrective process of overcoming an inflationary or deflationary gap may be carried out automatically. This is sometimes referred to as "built-in flexibility" and suggests that the effect of progressive taxation rates, combined with relatively stable transfer payments tend to produce surpluses in times of prosperity and deficits in times of depression.

In all probability, the main cause of increasing unemployment would be a decrease in private investment activity below the point where, in conjunction with private and public consumption and public investment activity, it can maintain a full employment level of income. This is not to say that slumps are inevitably caused by decisions of the business world to reduce investment expenditure, but historically it appears that whatever the original

cause, business investment always plays an important part. The reduction, when seen, can be corrected by a corresponding increase in public investment. At the same time, private investment can be encouraged through such media as Central Bank credit policy. It is not here necessary to discuss the methods and processes of financing government budget deficits and increases in the rate of public capital expenditure. These matters are adequately dealt with in any work on public finance.²⁴

The action of increasing the rate of public investment will take some time. Even if emergency public works programmes have been prepared in advance, there will be some delay involved, and to some extent the degree of immediate budgetary action will be dictated by the speed with which it is possible to alter the rate of public investment. Once commenced there is still delay before the full effects are felt. There will be some direct increase in employment as men are hired to undertake the labour side of public works projects. The indirect increase with a time lag will occur through a stimulus to production resulting from the purchase of materials and equipment necessary to the emergency programme. The newly-employed will increase the demand for consumer goods. From there the process follows the now-familiar pattern of the Keynesian Multiplier.²⁵

Another significant difference between the two approaches, one using budgetary surpluses and deficits and the other the rate of public investment, is that the effects of the former are felt in all sections of the community while the effects of the investment programme may be more selective. If unemployment is threatening in a particular industry or group of industries, works programmes which will stimulate demand in those particular industries can be introduced. It would be very difficult to produce the same effects through adjustment to taxation rates.

In dealing with imminent over-full employment, the process is very similar but operates in reverse. The first action by a government will be to budget for a surplus by increasing rates of taxation and reducing its rate of spending on current goods and services. The existence of an inflationary gap means that the total expenditure which people desire to undertake exceeds the total value of maximum output. Hence money prices rise or shortages occur, or both. Government action is designed to reduce the desire for expenditure in both the public and private sectors, to the full employment level. Again, this is capable of achievement by increasing taxation in order to reduce individual expenditure on the purchase of goods and services, thus producing a surplus in the Consolidated Revenue Fund, and by reducing the rate of public investment. The Multiplier again comes into action, but this time the process is reversed.

²⁴. See, for example, "Public Finance", by Ursula K. Hicks.

²⁵ See "The General Theory of Employment Interest and Money" p113

It should be emphasised that this explanation of the processes involved is greatly simplified. However, it does show in broad outline the part which a government should play in its financial policy to prevent the occurrence or to mitigate the effects of the Trade Cycle. In fact, the situation calls for constant vigilance and preparedness on the part of governments in order that they may be in a position to take immediate action should the economy show signs of deviating from a position of full employment. In the immediate post-war years some governments recognised that this was one of their functions and in three, the United Kingdom, Canada and Australia, the respective governments formally adopted a policy designed to maintain full employment using as their basis the Keynesian approach.²⁶

In order to undertake a deliberate financial anti-cyclical policy, a government must therefore be in a position to alter rates of taxation, revise expenditure programmes and alter public investment programmes at short notice. In addition, it would be advantageous for it to have control of central banking facilities. It must be assumed that only a minimum of direct control can be exercised as would be the case in a modern democracy in times of peace.

Alteration of financial policy such as that envisaged as necessary for the implementation of an anti-cyclical policy would normally require action by the legislature. Only rarely could a complete scheme be introduced by the executive arm of government. Therefore it would be necessary either for the whole plan to be approved by Parliament or the executive given power to act as found to be necessary. Such constitutional arrangements may cause temporary delays but not, it is thought, delays of sufficient magnitude to prejudice the success of a full employment policy.

Once the approval of Parliament is obtained, there is no impediment in the way of the government taking the necessary action in a unitary state. The problem can be treated as a whole. Taxation rates apply to all residents, expenditure is distributed over all parts of the country, and public works activity can be introduced in any region.

In a Federation, the approach will be far more complicated. Constitutionally there is a Federal Government and several State Governments each responsible for financial administration over a particular sphere. As mentioned in a previous section of this Chapter,²⁷ in Australia the Federal Government has control of certain financial matters in Australia as a whole. The remainder rests with

26. United Kingdom, "Employment Policy" Cmd. 7399, 1944.

Canada: "Employment and Income", 1944. The policy set out in this document was further stated in a document entitled "Proposals of the Government of Canada" (q.v. p.7) prepared for the Dominion-Provincial Conference on Reconstruction, 1945.
Australia, "Full Employment in Australia", Parlt. Paper 2730, 1945.

27. Page 27 ff.

the State Governments. The Federal Government controls a large part of taxation revenue while the States have wide powers of expenditure from both revenue and loan funds.

It can be appreciated that neither the Federal Government nor the State Governments could effectively introduce a complete anti-cyclical policy based on financial measures. If action is needed to close a deflationary gap, the Federal Government can adopt an appropriate taxation policy in order to increase the purchasing power of individuals and companies. To a certain degree it could increase its expenditure but here its range is limited because constitutionally the field in which it may function is restricted. It may, of course, pay increased amounts by way of grants to the State Governments, but there can be no compulsion on the State Governments to spend any increased revenue they may receive.

Nevertheless, so far as short-term remedial action is concerned, it is mainly the Federal Government which must take the appropriate steps. A State Government is virtually powerless to initiate an anti-cyclical programme. Its taxation powers are comparatively small and the part it can play in increasing expenditure is limited by the extent of any grant received from the Federal Government. It is true that a State may undertake deficit financing in order to assist in an inflationary policy. In fact it seems only reasonable that if the Federal Government is adopting this procedure so too should the State Governments. However, in Australia at least, the State Governments are dependent upon the Federal Government for short-term loan funds to finance a temporary deficit.

Difficulty will no doubt be experienced in obtaining agreement between the several State Governments and the Federal Government as to the measures or the extent of the measures necessary to effect the improvement in the economic situation. However, uniformity is by no means essential so long as action is taken in the right direction and the total effect is sufficient. In this respect it would undoubtedly be appropriate for the State Governments to be guided by the Federal Government.

As mentioned earlier, budget financing is only a short-term approach to the problem. The permanent effects will be made through public investment policy. In this respect, most of the initiative must be taken by the State Governments. As will be seen in a subsequent Chapter,²⁸ in Australia, State Governments have retained almost all responsibility for the expenditure of loan money. If quick expansion of public works programmes is needed, the Federal Government, except in a restricted field, can only advise the State Governments.

28. Chapter 7. The Financial Agreement.

Even though shown to be desirable, a State Government may be unwilling to incur the debt charges which accompany heavy borrowing. Further, if selective investment expenditure is required, the State Governments may not have the necessary knowledge to apply the corrective treatment. Finally, the procedure of authorising the raising of loan monies in Australia is rather a lengthy process, involving a meeting of the Treasurers of all States and the Commonwealth. The process could probably be quickened, however, in an emergency such as a sharp recession.

In a case where it becomes necessary to close an inflationary gap, it would seem that the Federal Government has more opportunity to adopt an anti-cyclical policy embracing the whole Federation. Again, it has almost complete control of rates of taxation. In the field of controlling expenditure it is also in a powerful position in that the States are dependent on the Federal Government for a substantial portion of their revenue. If Federal grants to the States are suddenly reduced, a State Government has almost no alternative but to reduce expenditure. It may incur a deficit, but a deficit of substantial size in times of inflation would be dangerous politically. The Federal Government also has control of Central Bank credit which may prevent a State financing a deficit for any period of time.

According to a strict interpretation of the Constitution, the Federal Government in Australia has no power to limit the size of a State's capital expenditure in any year. In Australia this is a function of the Loan Council. However, as will be seen later in Chapter 7, Federal control of the Central Bank gives the Federal Government effective control of the annual amount which can be raised on behalf of all States and the Commonwealth. In short, the Federal Government cannot force a State Government to spend in order to close a deflationary gap, but it can restrict their expenditure when it becomes necessary to close an inflationary gap.

It is evident that in a Federation, responsibility for inaugurating an anti-cyclical policy must lie with the Federal Government. For it to be fully effective, however, the cooperation of the several State Governments is required. It is suggested that complete cooperation will only be forthcoming in times of crisis. Normally the State Governments would be suspicious of any attempt by the Federal Government to influence them in their domestic affairs. Therefore it becomes necessary for the Federal Government to persuade the State Governments to fall in line with the policy it has designed.

Normally the States will require little inducement to persuade them to spend money. In determining the amounts of Federal aid to the States, the Federal Government should therefore allow for

the effects of that expenditure on the level of business activity. To a certain extent it may be selective. If a State is relatively depressed, or even an industry in one State, the grant may be increased to permit the assistance by the State Government in effecting an improvement in conditions. The grant may even be conditional upon its being used in the manner prescribed by the Federal Government to implement its overall policy. Again, if expansion of capital works is required by one State rather than another for the same reasons, the Federal Government can encourage the State concerned to undertake the work and assist by meeting portion of the annual interest and sinking fund bill. Under these conditions a State would not be reluctant to increase its public debt.

The determination of grants on this basis will involve considerable organisation on the part of the Federal Government. It must be constantly aware of the state of business activity not only in the Federation as a whole but also in each individual industry and State. It must be prepared to apply remedial action both directly through its own constitutional powers and indirectly by persuading the several State Governments to adopt the correct revenue policy. There will inevitably be a tendency for the Federal Government to think that it could achieve its purpose far more effectively if its power were absolute in the necessary fields of activity. This, however, is not by itself an argument for unification. In the short period the constitutional arrangements can not be altered quickly and therefore the appropriate policy must be worked out within the existing framework.

The task of the Federal Government in determining the amounts of the grants to the States to permit an effective anti-cyclical policy will be extremely difficult. It will be much more so when it is remembered that at the same time grants must also be designed in the light of its redistributive and developmental policies. It is not a matter that can be decided by guesswork but must involve careful examination of all relevant considerations.

CHAPTER 3PRINCIPLES OF FEDERAL GRANTS

In order to test the adequacy of the financial provisions of the Australian Constitution, it will be necessary to develop alternative principles upon which Federal grants to State Governments can be made. These alternatives must then be examined to determine the most satisfactory for the required purpose. If the Australian practice is in accordance with the chosen principle, then it must be argued that the financial provisions of the Australian Constitution give the most satisfactory answer possible to the financial problem which arises in this type of Federation and which has been outlined above. On the other hand, if the practice does not agree with the principle which emerges as the most effective, suggestions should be made as to how conditions can be improved.

The assumption upon which this analysis will be made is that in a Federation the Federal Government has potential sources of revenue in excess of expenditure requirements, and that it is possible for the Federal Government to produce surplus revenue which would be available for distribution between the several States of the Federation. It is apparent that this situation must not necessarily arise in a Federation. The organisation could be such, for example, that the State Governments are the only revenue raising authorities and they in turn allocate portion of their funds to the Federal Government to permit it to fulfil its allotted functions. Again, the situation may be such that all authorities in the Federation have independent sources of revenue just sufficient for their needs and therefore no adjustment between the Federal and State Governments would be necessary.

It is thought, however, that the situation which at present exists in Australia is the one most likely to arise. Fundamentally it is also the situation which has arisen in the other main Federations such as the United States of America and the Dominion of Canada. Since it is the intention to develop principles against which the financial provisions of the Australian Constitution can be tested, it will be necessary to consider only the type of Federation which exists in Australia.

It appears that there are two possible alternative principles which could be adopted. The first which can be called the "compensation" principle, can be stated as the distribution of the surplus revenue of the Federal Government between the States upon the basis of compensating each State as far as possible for the loss of revenue resulting from the transfer of revenue raising powers to the Federal Government. The second, which can be called the "principle

of payment according to relative financial need" calls for the disbursement of the surplus revenue of the Federal Government to the State Governments according to the relative financial needs of each. These two basic principles are each capable of subdivision, but generally it can be stated that they are the two principles which can be considered in the case of a Federation similar to that which was adopted in Australia. The implications of the adoption of each can now be considered,

(a) The Compensation Principle

The compensation principle of disbursement of surplus revenue of the Federal Government is a simple concept. The people of each State contribute in various ways to the revenue of the Federal Government. When, for example, the Federal Government levies a customs duty, the duty is paid by the importers of the goods. They in turn recover the duty through increased prices and eventually the duty is paid by the consumer. There may be several intermediate steps, but inevitably the consumer contributes to the income of the collecting agent, in this case the Federal Government. The duty is imposed on all goods coming into the Federation and the people who pay the duty are distributed between the States of the Federation. Therefore each State, through the consumers of the population, contributes to the revenue of the Federal Government. Put in another way, the contribution of the State is the amount which would have been collected and paid into its own Treasury if it had sole power to raise such revenue and did so at the rate now adopted by the Federal Government.

If the amount of the contribution by each State is recorded, it is possible to divide the total revenue of the Federal Government according to the State in which it originated. Obviously not all this amount so collected can be returned to the States. Each must be responsible for portion of the cost of the Federal Government and this should be regarded in some measure as the price which must be paid for Federation. In effect, at the outset a new governmental authority is being established with some new powers or functions to perform which were not formerly carried out by any government. It is therefore inevitable that the total cost of government of the Federation as a whole will be increased and this must be borne by the people of the Federation. Whether it is borne from the revenue formerly accruing to the governments of the States or by greater taxation is a matter of policy, but in any case, the member States regarded collectively as groups of people must bear the extra burden.

In addition to the cost of the new functions given to it, the Federal Government will be involved in expenditure resulting from

the taking over of powers formerly held by the State Governments. Thus, its expenditure will be made up of two parts, the cost of newly created powers and the cost of powers taken over from the States. The total amount available for distribution in any period is the amount collected from all sources less the two types of cost mentioned above. The amount payable to each State Government under this principle of Federal disbursements is the amount of revenue collected in each less a share of the cost of Federal Government. Where the deduction is made for the cost of functions transferred to the Federal Government at the inauguration of the Federation, there will be no apparent loss to the State Governments. Any loss that arises will result from the cost of the newly created powers of the Federal Government.

The basis upon which the proportion of these costs which each State Government will be called upon to bear is calculated will probably present the most difficult problem to overcome. It would usually be impossible to calculate exactly the amount of expenditure incurred by the Federal Government on behalf of the people of each State, and therefore some arbitrary method must be devised. The simplest basis which can be adopted is to assume that expenditure is incurred on behalf of each State in the same proportion as that which each State's contribution bears to the total revenue of the Federal Government. This may not be a very realistic assumption, but it would give a distribution which should not differ very greatly from the actual distribution. An alternative assumption is that expenditure has been divided equally between all persons in the Federation. If this assumption is accepted, then costs of the Federal Government should be charged to each State on a per capita basis.

In considering this principle of disbursement, a distinction should be made between the "community" loss and the "Treasury" loss of the State. The two terms are not synonymous and it is necessary to distinguish between them in order to determine the loss that must be made good by the Federal Government as part of this principle of disbursement.

It is possible that a loss of revenue by a Treasury of a State is compensated for in part by a gain by the community as a whole. That is, a gain by the people who comprise the population of the State. For example, it may be that when the Federation is first inaugurated the level of taxation which is imposed is lower than that which existed in some States before Federation and greater than in others. Where it is lower than the former level, the community loss will be less than the Treasury loss. This situation will arise because the reduction in revenue received by the Treasury of the State concerned will be equal to the amount which would have been collected if the rates of taxation which applied before Federation were still being collected.

On the other hand, the community as a whole will be paying less in taxation than it would be required to pay had the former rates been levied. The community loss will be equal to the amount of taxation now paid to the Federal Government under the new rates of taxation. Since the new rates are lower than the rates formerly imposed by the State Government, the community loss will be less than the Treasury loss. Conversely, where the amount collected by the Federal Government is greater than the amount which would have been collected by the State Government if the former rates of taxation had continued to be imposed, the Treasury loss will be less than the community loss.

Under the principle of payment as compensation for loss, it is the community loss which must be considered in all cases. For if the community loss is less than the Treasury loss, and the Treasury of the State is compensated for the community loss, then the difference can be made up by the Treasury taking from the community an amount equal to the amount by which the taxation payments which it is required to make are reduced. Conversely, when the rates of taxation are higher under Federation compared with the rates which operated before Federation, the Treasury will receive the amount which the community pays to the Federal Government under the new rates of taxation. This will be greater than the amounts it would have received had the previous situation still obtained. The difference can then be remitted to taxpayers by lowering other forms of taxation if they exist, or by direct payments to the members of the community.

In this analysis it has been assumed that there are no complications to the collection of revenue by the Federal Government and payment of this amount to the several State Governments. As mentioned previously, the amount to be paid by the Federal Government will be the amount collected from all sources less cost of government, made up of the cost of administering functions transferred from the States and the cost of newly created functions. In determining the loss of each State, its contribution to these expenditures of the Federal Government must be deducted from the community loss. The amount so determined is the payment to be made to the State Government as compensation for financial loss incurred through Federation.

As a first approximation it can be assumed that the cost of the functions transferred to the Federal Government will be similar in amount to the cost to the State Governments in the years immediately preceding Federation. In fact, such cost may be lowered or increased by those now responsible for their administration. If this type of expenditure is reduced, the States as a group can restore the former position by additional expenditure on their own initiative. If it is increased, however, the State Governments will be forced to consider whether they will reduce expenditure on the performance of

other functions and services, or increase taxation in order to continue operation of the retained functions at the existing level.

It may be that one of the transferred functions is the control of defence expenditure, and that before Federation, one State Government found that if it was to give a reasonable level of other services, expenditure on defence must be kept at a very low level. After Federation and the transfer of powers of defence, it may happen that the Federal Government has deemed it advisable to expend a greater proportional amount on this service. If the allocation of this cost between the States is to be on a per capita or similar basis, then the cost of defence to the State which formerly felt that the new level could not be afforded will find that the cost of defence has increased considerably. This additional cost will be reflected in lower grants from the Federal Government than would otherwise have been the case. The decision must then be made by the Government of the State concerned as to whether it will now reduce expenditure on the provision of services which it considered more essential, or whether it will raise additional revenue through increased taxation in the fields remaining open to it in order merely to maintain the existing level of services which it provides to the population.

It can be seen that under this principle of disbursements by the Federal Government, that of payment as compensation for financial loss accruing to the State Governments as a direct result of Federation, the calculation of the amounts to be paid may become complicated. Further, the amounts which will be available for distribution may not in fact be sufficient to enable the States to operate at the level which formerly operated without recourse to higher taxation. If, during the process of drawing up a Constitution, it is decided that this principle should be adopted, then adequate provision should be made in the first instance to ensure that the States retain a considerable portion of the fields of taxation in order that they may remedy any financial difficulties that may arise because of the adoption of this principle, and secondly to ensure that expenditure by the Federal Government will not reach the level where individual States are forced to reduce expenditure in other fields. If the power to raise revenue by taxation is limited to the Federal Government, then the States will be dependent on payments from the Federal Government for almost all their income and the position could easily arise where such payments, if based on the principle of payment as compensation for loss, would be totally inadequate for the proper performance of the States' allotted functions. Some taxation fields must be retained by the States to prevent this situation arising.

Up to this stage, the only loss which has been considered has been the direct financial loss suffered by the States. Attention

must also be given to indirect financial loss which a State might suffer. Such indirect loss might arise in any one of a number of ways. The most likely to arise, however, is the case where the Federal Government adopts certain policies or courses of action which result in a loss of revenue to one or more of the States. The loss may be incurred by the Treasury of the State, as when the Federal law bans a certain activity which is subject to State tax, but it is more likely to affect an industry or group within a State. One possible example arises where the Federal Government has absolute control of migration policy and decided that it is in the best interests of the nation as a whole to prohibit migration from a certain country or countries. If an industry in one State is dependent on that labour in order that it may function efficiently, then direct prohibition will directly affect only that State. That is, a particular industry in one State will suffer a loss as an indirect consequence of Federation.¹ In such cases as these, where the impact of Federation is distributed unevenly between States, it may be conceded that it is only reasonable for the loss to be shared by all States since it was in the interests of all that the step was taken.

Where this type of indirect loss occurs, compensation may be made from the funds held by the Federal Government. It may be by grants-in-aid made directly to the industry concerned, or to the Treasury of the State or States involved, which in turn will be responsible for the distribution of the funds. It may take the form of a subsidy or bounty or special taxation or duty remissions directly in favour of the industry concerned.² In any of these cases it will represent a payment made as compensation for an indirect loss to which all States contribute. It is possible that the Federal Government will be called upon to make payments of this type. The main difficulty associated with them will undoubtedly be the determination of the amount of the loss in each case. Where the loss is direct, that is, through the transfer of taxation rights, it is a relatively simple matter to determine, within fairly close limits, the amounts involved. Where the loss is indirect, however, there is no simple measuring rod. The amount of the grant, subsidy or bounty will need to be determined by arbitrary methods.

A variation of this principle of payment according to loss arising from Federation is that the surplus revenue of the Federal Government can be distributed among the member States on a per capita basis. For this variation to be a true basis for compensation it

1. The example given is from actual Australian experience. Before Federation, the Queensland sugar producing industry recruited Pacific Islands labour on a contract basis. Commonwealth legislation in 1902 prohibited this recruitment forcing Queensland cane growers to use dearer white labour.
2. In the Australian case mentioned above (Note 1), the Commonwealth Government paid a bounty on sugar produced by white labour. See Year Book of the Commonwealth of Australia. No. 1. 1908. p 325/6.

would be necessary that all States have contributed to the Commonwealth revenue on a per capita basis. Otherwise, there will be some redistribution in favour of those States which have contributed relatively least. In short, it assumes that contributions are on a per capita basis. While such an assumption is unrealistic, it does have the advantage of being simple to administer.

(b) The Principle of Payment According to Financial Needs

This principle can be stated in the following way. Where the distribution of functional and financial powers between the Federal and State Governments is such that the revenue of the Federal Government is more than sufficient for its immediate requirements, the surplus may be distributed between the States according to their financial needs irrespective of the amount which each has contributed to the revenue of the Federal Government. The hypothesis upon which this principle is based is that before Federation all States were of different sizes with different standards of natural resources and generally different levels of prosperity and economic development. It follows that levels of taxation and standards of services supplied were also different. Unless these differences exist between the States, the adoption of the principle of payment according to financial needs will produce similar results to those obtained when the principle of payment as compensation for loss is adopted. For if all the States are of the same size with similar natural resources, and are at the same stage of development, both contributions and financial needs should be proportional to size. It is only when these differences are present that the two principles referred to produce different results and make necessary a choice between one or the other of the two alternatives.

In discussing this principle, it will first be necessary to distinguish between absolute financial needs and relative financial needs³ and determine which of the two must be considered. "Need" is a vague term and probably no two persons would agree as to the needs of an individual. When the needs of a community are being considered it is much more difficult to determine its precise meaning. Absolutely needs must be related to a welfare basis. In order to determine the absolute needs of a nation or any other community of individuals, it would be necessary to make certain value judgments as to the ultimate aim of economic policy. It could be assumed, for example, that the sole reason for the existence of a government is to ensure that the real income of the community is raised to a level where every member of the community is in receipt of a minimum real income. If this

3. The concept of financial needs as a principle for determining Federal Grants was developed in Australia by the Commonwealth Grants Commission. See First Report (1934) pp.83/84 and Third Report (1936) pp. 75-80.

were so, then the absolute financial needs of that community would be sufficient to permit everyone to receive this minimum. The national minimum real income would be determined on a purely scientific basis related to the requirements for nutrition, clothing, shelter, etc. If this problem were successfully solved, a further difficulty would arise relating to the existence of any inequality of income within the community. If the real national income of a community is just sufficient to permit each member to receive a personal minimum real income when the total is divided equally between all, then the existence of any inequality between members of the community will ensure that some receive more and some less than the determined minimum. One definition could thus be that the absolute financial needs of a community are equal to an amount sufficient to ensure that, when divided equally between all, each person receives at least a minimum living wage. However, because inequalities do exist, it would not be divided equally between all.

Apart from the difficulties of a technical nature which would arise if this basis of absolute need were adopted, there is an immediate financial problem which would prevent its adoption. It is the object of these chapters to develop a principle upon which the surplus revenue of the Federal Government in a Federation can be distributed between the States. It is immediately apparent that the financial resources of the Federal Government available for distribution would almost certainly be insufficient for the purpose of equalising the absolute financial needs of each member State. Rather it could be considered that the whole purpose of Federation would be to aim at producing the state of affairs where, in the long run, each individual within the Federation was receiving at least a minimum real income. In the initial stages of Federation it could reasonably be expected that only a principle of distribution would be adopted which could be followed in its entirety. All that could be expected would be that a principle of distribution of the surplus revenue between the States be adopted which would go as far as possible towards producing this ultimate result. This would possibly be achieved by adopting the principle of payment according to relative financial needs.

The principle of payment to the States according to relative financial needs can be stated as a principle of equalisation. That is, the distribution of the surplus revenue is made according to some predetermined principle whereby it is aimed to equalise some form or forms of economic activity by equalising payments from the Federal to the State Governments. The principle of payment according to absolute financial needs discussed in the preceding paragraphs could be regarded as a principle of complete equalisation. The adoption of the principle of relative financial needs is to adopt a principle of partial equalisation. It has been shown that complete

equalisation will be impossible without substantial transfers of revenue between States. However, it would be possible to go as far as the financial resources of the nation will permit towards the ultimate goal by applying the available surplus revenue in a manner designed to equalise certain burdens or standards of services between States. There are many possible fields in which equality can be engineered through the agency of the grants which the Federal Government makes to the State Governments. A few of the more important will be considered.

(i) Equalisation of taxation burdens.

If the initiation of the Federation carries with it the transfer of certain taxing powers from the State Governments to the Federal Government, there will be an automatic tendency towards greater equality between States so far as the impact of taxation is concerned. In all probability the tax levied by the Federal Government will be uniform throughout the Federation. In Australia, for example, a tax imposed by the Federal Government must be uniform in all States⁴.

Before Federation when the State Governments possessed their own taxation rights in these particular fields, different rates of taxation would inevitably have been levied in each State. The act of Federation and the entry of the Federal Government into the field of taxation would therefore reduce the degree of disparity of taxation rates between members of the separate States. It can be expected, however, that not all powers of taxation will be transferred to the Federal Government, and in the fields which remain within their individual jurisdiction, rates of taxation will still differ between States. The reasons for these differences are not of immediate relevance but if they do exist their effects can be corrected by the judicious apportionment of the funds made available by the Federal Government for distribution to the State Governments.

Equalisation of taxation burdens on the residents of the States cannot, however, be regarded in isolation. It must be looked at in conjunction with the possibility of equalising standards of services.

(ii) Equalisation of standards of services.

The raising of revenue by taxation and the provision of public services are complementary functions of government. Although a government will have other sources of revenue, it would be true to say that the extent to which a government can provide social and other services depends on the extent to which it can raise revenue by imposing taxation. In the main it is a political decision which is

4. Section 51(ii) of the Constitution gives the Federal Government powers to impose taxation "but so as not to discriminate between States or parts of States".

influenced by the attitude of the people themselves towards bearing high rates of taxation in order that high standards of services may be supplied. A chosen level of services implies a specific level of rates of taxation depending on such factors as the economic prosperity of the community and the distribution of incomes within the community.

At this stage it may be of advantage to explain briefly what is meant by the provision of services. The phrase is used here in its broadest sense. State services can be said to include any activity of a government whatever. The provision of a police force, of a judiciary and so on represents the provision of a type of service. Services generally should not be confused with social services which is only one branch of a field which has a much wider coverage. It can be said that for the purpose of exposition every item of expenditure of governments represents the provision of some service or other.

However, there are certain services which are generally accepted as the function of government. These are the basic functions of government which have been described earlier.⁵ The performance of these duties or the provision of these services implies a certain cost and normally this cost will be borne by the revenue of the government raised by taxation. In most cases, except where the government has a source of income other than revenue raised by taxation, the burden of taxation on the people will be determined by the standards of services which the government intends to provide. It may be decided, for example, to provide free education for all children in the community. The service will be free in the sense that there will be no direct cost to the people who receive the service. It will inevitably be paid for by higher rates of taxation.

It can be seen that there is a close inter-relationship between the burden of taxation and the standards of services supplied in a community. Within the community it will be of real importance as to the extent of the services given because, if taxation is at all progressive and incomes are unequally distributed, the benefits will be received mainly by those who contributed least by way of taxation. In other words, within the community there will be some redistribution of incomes. When each State is regarded as an entity and compared with other States in the Federation, considerable differences will be apparent. It is probable that if the same rates of taxation are levied by each State Government, the standards of services supplied will be different. Conversely, if the standards of services supplied in each State is the same, the level of taxation will probably be different. This will probably arise because of differences in natural resources, stages of development reached, distribution of incomes etc. between the communities.

5. See page 19 above.

One of the principle upon which the total amount of revenue which the Federal Government is prepared to make available can be distributed is the principle of equalisation of standards of services, but it automatically follows that equalisation of tax burdens must also be considered. For at the beginning of Federation all State Governments may be providing services of similar standards, but only at the expense of different severities of taxation. If the principle to be adopted were aimed at equalising standards of services then the amount available would be distributed on a per capita basis. It is only reasonable that if standards of services are already equalised, then attention should be given to the relative severity of taxation in each of the several communities,

(iii) Equalisation of Development

Inevitably the natural resources of each State in the Federation will have ensured that each has reached a different stage of development. In one community the natural resources available may have been capable of exploitation at comparatively little cost and being a profitable field for investment, were developed by private enterprise. In another, the resources may have been difficult to exploit without heavy capital expenditure. This has been the general experience in all the main Federations of the world today. In the latter community, if the same stage of development is to be reached as in the former, the rate of public investment will need to be relatively greater. If it is agreed that one of the financial objectives of a Federation is to permit all States to attain the same stage of development in the interests of maximising output in the Federation as a whole, then it will have to be agreed that public capital expenditure, and therefore public borrowing, must be relatively greater in those States which have not been able to develop their resources to the same extent as the more prosperous States.

It must be recognised that a policy directed towards these ends is not directly concerned with the financial problem of the distribution of the total amount made available by the Federal Government each year for payment to the State Governments. However, every act of public capital investment involves the borrowing authority in annual commitments in the form of interest and sinking fund payments. This will influence the severity of taxation in a community where the borrowing authority is the State Government. Before Federation, the amount which could be borrowed was probably limited because of the burden which would be placed on the taxpayers or the other types of services which would have to be foregone. If, however, one of the aims of Federation is to permit equalisation of development, the total amount available can be distributed between the State Governments in such a way as to permit the interest bill of one

State to increase disproportionately without throwing any relatively greater burden on the taxpayers of that State or without reducing the standards of other types of services below the general level operating in other States.

In other words, the people of the States which are more developed will be required to contribute some of the cost of the interest on, and the amortisation of the loans raised to finance development in the relatively under-developed States. Such a policy is justifiable in the interests of the maximisation of welfare in the Federation as a whole. In effect, this type of equalisation could reasonably be included under the heading of equalisation of standards of services. However, because of the different nature of this type of "service", it has been considered advisable to treat it independently of the other types of services. It involves a completely different decision - that of deciding the level of public borrowing in each State.

(iv) Equalisation of incomes.

In an earlier Chapter,⁶ attention was given to the part which inequality of incomes will play in retarding the attainment of the maximum average level of welfare in a community. It was shown that if inequality exists to any extent, the production of greater equality will be achieved by the imposition of progressive rates of taxation and with the revenue thus obtained, by providing public services to those whose need is greatest. The reduction of inequality is synonymous with increasing the average level of welfare.

This reasoning, which was related to the members of a single community, can be extended to apply to communities as well as individuals. If the average level of income differs between the States in a Federation, it may be said that the average level of welfare enjoyed by the people of the Federation as a whole can be increased by increasing incomes of those in the lower income brackets at the expense of those in the higher brackets.

There is ample scope for such redistribution in a Federation if the Federal Government imposes income taxation. If the rates of income taxation are progressive, the Federal Government will collect relatively more from the States where average incomes are high. It can then, by means of grants to the State Governments, bring about greater equality of incomes in the Federation as a whole by making the distribution in favour of the States with lower average incomes.

The four main possibilities for equalisation in adopting the principle of relative financial needs are thus, equalisation of the severity of taxation, standards of services, development and incomes. They are not mutually exclusive. In fact, if this principle is to be

placed on a basis which is at all satisfactory, it is desirable that the aims of producing equality, or reducing inequality in all these fields should be adopted simultaneously.

The extent to which the Federation can be successful in bringing about equality between States will depend primarily upon the amount of revenue which becomes available for distribution. This in turn will be dependent upon the constitutional provisions of the Federation which allocate functional and financial powers between the Federal and State Governments. At the one extreme the Federal Government will be given absolute control of taxation in which case the total amount available for distribution should be considerable and adequate for the purpose of bringing about equality between the States in the selected fields. On the other hand the taxation powers allotted to the Federal Government may be such that they provide revenue only slightly in excess of the amount necessary for the proper conduct of its own administration. In this latter case, the possibility of successfully applying a principle of payment of grants according to financial needs will be remote. The situation can be envisaged where the whole of the amount available is distributed to one or a few of the State Governments, and these amounts are still insufficient to bring about the required degree of equality in the chosen fields. The States to which no payment is made may still be in a position of superiority compared with those which actually received grants from the Federal Government.

A further possibility which must be considered is that the source of finance available to the Federal Government may be subject to some fluctuation, so that in years of prosperity the amount of revenue available for distribution to the State Governments is sufficient for the purpose of meeting the relative financial needs of all the State Governments, while in periods of reduced economic activity, the amount available falls short of requirements. Of course the possibility always exists for the Federal Government to produce a deficit budget result under such circumstances. This will mean in effect, that the Federal Government will be financing the attainment of equality between States in certain fields by deficit financing. There seems to be no justification for the Federal Government to be called upon to undertake deficit financing for this purpose. It may be justified, however, as part of a general policy designed to maintain full employment. Therefore constitutional provision should be made to ensure that sources of revenue available to the Federal Government are sufficient to ensure that total income, and hence the amount available for distribution to the States, is sufficient to satisfy the principle of payment according to relative financial needs.

It might be argued that the simplest way for this to be carried out would be for the Federal Government to assume responsibility for administration in the fields in which it is desirable that equality be brought about. The possibility does not arise, however, because it has been presupposed that certain communities have agreed to combine to form a Federation and that each wishes to retain its independence to as great a degree as possible. To hand the necessary functions to the Federal Government would be tantamount to the establishment of a unitary form of government in place of the federal form which exists. If, for example, it was decided that the aim of Federation was to produce equality of standards of services and of the burden of taxation, such a procedure would imply handing over to the Federal Government power to collect all taxes and also the power to administer the function of providing the necessary services. Earlier in this essay,⁷ the provision of services has been defined to include all fields in which governments incur expenditure. Thus the handing over of these powers to the Federal Government would imply the complete surrender of independence on the part of State Governments.

In support of the contention that the Federal Government should attempt to bring about equality in specified fields by assuming control of administration in those fields is the sometimes stated principle of public finance that those people who are responsible for the spending of public money should also be responsible for the raising of the necessary revenue. Such a contention can not logically be applied in a Federation. Carried to its ultimate conclusion, it would imply the continuous perfect distribution of functions and finances between the Federal and State Governments. There could be no payments from one to the other and the anomalous position would arise where, by accident or design, one authority had more than sufficient revenue for its requirements and the other had less than sufficient. Rigid adherence to this tenet would mean that unless this perfect co-ordination between functions and financial resources of the various governments was maintained, the governments of some States would experience easy financial positions while the others would be continually below standard. It is apparent therefore, that this cannot be followed with any rigidity in a Federation. While it is undoubtedly desirable that revenue raising and spending should be controlled by one authority, this is not practicable in a Federation.

A further aspect which should be taken into consideration in deciding whether or not it is practicable for the functions to be carried out by the State Governments while at the same time receiving financial assistance where necessary from the Federal Government, is that while it is possible to obtain equality in certain fields by this method, it does not assume that there must be equality between regions

⁷ See page 57 above

within a State. While this is undoubtedly desirable as a long-term policy, it is not reasonable to expect that it can be achieved over a short period by transfers of powers of administration to the Federal Government. It would seem to be preferable for these functions to be carried out by the State Governments. Those authorities will be in close touch with local thought and feeling, and more readily able to assess relative needs as between regions within the community.

If the Federal Government were to assume responsibility for the provision of, say, health and education services on the understanding that the services would be given without differentiation between members of the Federation, it would be incumbent upon it to provide the same standards of services in all districts of the States of the Federation. Such a policy would be difficult for a single central government to administer and a certain amount of devolution would be necessary. In a Federation, however, the machinery exists for effective administration of such services by State Governments. This would be wasted if control of the functions were handed to the Federal Government.

However, while arguments can be developed for and against the desirability of the unitary or federal form of government, in the present instance it is not strictly relevant. The question is merely to determine the best way to obtain financial stability in a Federation. It is not concerned with whether federation is more desirable than the unitary form of government.

This discussion of the efficacy of the whole system of grants from one authority to another in a Federation has been a slight digression from the main topic of the principles upon which grants are paid. Nevertheless it is not entirely irrelevant in that the question will always arise as to whether there is some alternative method of solving the major financial problem in a Federation. While this may be so, so long as the financial problem does exist, it is proper to put forward a financial solution while recognising that other solutions of a non-fiscal nature may also exist.

The principle of payment according to financial needs can thus be used as a means of correcting differences in standards which existed between the States before they federated. The principle of payment as compensation for financial loss is a means of maintaining the financial organisation and relationships which existed before Federation as far as possible. It is proposed to examine the relative merits of each in order to determine which of the alternatives is the more appropriate for the type of Federation which was established in Australia.

CHAPTER 4MERITS OF ALTERNATIVE PRINCIPLES

The two major alternative principles which may be adopted as a basis for the disbursement of the surplus revenue of the Federal Government have now been propounded. Briefly, it was found that the main possible alternatives were the principles of payment as compensation for financial loss incurred by a State as the result of entering the Federation, and payment according to relative financial needs. It remains now to determine which of the alternatives if adopted, would give the more beneficial results. To some extent, such a determination involves value judgments, but unfortunately the nature of the problem is such that this is unavoidable. However, it is anticipated that the conclusions reached with regard to each will be sufficiently distinct to make the choice relatively simple.

The background against which the merits of the alternative principles will be examined will be the possibility of attainment of the several financial objectives of government outlined in Chapter 2.¹ In that Chapter it was suggested that the main objectives of financial policy of governments are to redistribute incomes towards greater equality, to encourage development and to maintain full employment. It was further shown that in a Federation, either the Federal Government or the State Governments alone could not effectively pursue such objectives. Some cooperation is needed between States. This cooperation can be achieved through the system of grants made by the Federal to the State Governments. The test of the adequacy or otherwise of a principle for determining the amount of these grants will therefore be whether or not it permits the attainment of the objectives.

When several communities join together to form a Federation, it is more than probable that economic conditions will be different in each. There is a multitude of factors which will have given rise to this situation. Such things as accidents of history, geographical location and nearness to established trade channels, size, geological formation, policies of past governments, richness or poverty of natural resources, capital development, and many other factors will have influenced the determination of existing relationships. It follows that it is equally probable that the financial positions of the States will be different. If a community is richly endowed with natural resources such as minerals, forests, capacity to develop cheap power and so on, it is probable that the community is highly developed. Private capital will be encouraged to move to the centres of greatest potential productivity, and opportunity will exist

1. See above p. 19.

for the national income of the people to increase as industrial development takes place.

The government of such a community will be in a fortunate position. The fact that average incomes are relatively high will mean that the obligation to provide community services and amenities will be relatively small. The basic function of government, the organisation of defence, police and judicial services will be proportionate to the size of the population, but services for which the demand varies with the levels of incomes, such as medical services, free education, library services, etc. will be comparatively low. On the other hand, the taxable capacity of the people resident in the community will be high. The industrial prosperity of the country presupposes considerable overseas trade. If a protective tariff has been adopted, the revenue of the government from customs duties will be high. Similarly, since incomes are high, a fairly low rate of taxation should yield sufficient revenue to provide the necessary services.

Furthermore, since the abundance of natural resources make for profitable investment, it is possible that capital investment will be undertaken mainly by private enterprise and therefore the public debt of the community may not be very great. This means that the burden of debt charges on the finances of the government will not be very great.

It is possible, then that at one end of the scale of the group of communities which propose to combine in Federation is this type of community which has a government with relatively few commitments and high potential sources of revenue. At the other end of the scale is the community which is not well endowed with rich natural resources, and those which are available are not potentially profitable. In all probability, the population of such a community will be mainly engaged in rural activity, and any major developmental work which has taken place has been by public investment. The average level of incomes will not be high, and therefore the need for services financed by the State will be relatively great and at the same time, the taxable capacity of the people will be low. Overseas trade will be correspondingly small and income from customs duties will also be low.

The government of such a community will not be in an enviable position. It will be forced to impose high rates of taxation in order to receive sufficient revenue to provide even the bare minimum of services to meet the needs of the community. Its public debt may be high, but this depends on whether in the past governments have been sufficiently courageous to incur the annual burden of debt charges in view of the low taxable capacity and other needs of the community. Undoubtedly as a long-term plan, such a procedure would

be commendable, but politically it may have been difficult for a government to incur debt deliberately in the knowledge that other services would have to be curtailed until such time as the beneficial results of the investment became apparent.

The two cases which have been considered have been the two extreme possibilities. In actual practice it would probably be found that the communities entering the proposed Federation will all be somewhere between the two extremes. Nevertheless it would be safe to assume that conditions in each community will be different. It would be expected that the severity of taxation, the standards of services supplied, the degree of development of primary and secondary industry and the ratio between public and private capital development in all communities will be different. To a large extent, some of these are complementary. For example, equal standards of services may have been achieved by disparate severities of taxation. Conversely, equal standards of taxation could be achieved by adopting different standards of services.

To sum up, it may be said that before Federation, differences in natural conditions between States will have resulted in differences in the average incomes of the residents of the several States. Differences in average levels of incomes will have made it difficult for the governments of the States to pursue a policy designed to maximise welfare and which will give the same average level of welfare in each State. The scope for the effective pursuit of a policy designed to maximise welfare differed between States.

In an earlier Chapter², it was shown that where inequalities of income exist in a community, the welfare of the community as a whole will be increased if the degree of inequality is reduced. Similarly, if there are inequalities in the average level of incomes between States in a Federation, the welfare of the people of the Federation as a whole will be increased if the degree of inequality between States is reduced.

The establishment of a Federation with a Federal Government to coordinate, where necessary, the activities of the several States means that a new authority is set up whose objective is, as with all governments, to maximise the welfare of the people it represents. State Governments existed before Federation and their objective, both before and after the establishment of the Federation, is to maximise welfare within their State boundaries with the resources at their disposal. A new Government, with jurisdiction over the whole field of Federation would be superfluous if it were designed merely to carry out a few functions in which there should be some cooperation between States. Such responsibility could be carried

2. Chapter 2, p.20 ff.

out by a council of representatives of the various State Governments without any direct legislative power.

A Federal Government means something more than this. Its function should be to maximise the welfare of the people in the Federation as opposed to maximisation of welfare in each State separately. As shown in Chapter 2,³ this can be achieved by the adoption of appropriate financial policies. They are first, by decreasing the degree of income inequality in the community, secondly by influencing the distribution of resources and encouraging development in order to maximise production and hence incomes, and thirdly by ensuring that at all times the nation enjoys a situation of full employment. The alternative principles of payment of grants to the State Governments by the Federal Government should be examined in the light of the ways in which their adoption would help or hinder the Federal Government in attaining these objectives.

(1) Effect of Adoption of the Compensation Principle.

The adoption of the compensation principle implies that in distributing its surplus revenue, the Federal Government follows a principle designed to give each State Government, as far as possible, that portion of the surplus revenue which was actually collected from people resident in that State. At first sight, the accounting difficulties associated with such a method are prohibitive. It may be possible to determine with some degree of accuracy, the amounts actually collected from the people of each State. The extent of the difficulty which might arise in this connection will be in accordance with the nature of the source of revenue of the Federal Government,

Where the Federal Government has been given sole responsibility for the collection of customs duties, and customs duties are levied only on goods imported from foreign countries, the difficulty of apportioning these revenue collections between States will arise where goods are imported into one State and the duty paid at the port of entry and then the goods are subsequently distributed to the other States for retail sale. The difficulty is increased where raw materials are imported into one State, there converted into finished products, and then sold to residents of other States.

It is evident that complete accuracy in this regard could only be obtained by an intricate method of registration of imports, quantities of imported materials contained in locally manufactured goods, distribution of sales of goods and transfers across State borders by road, rail, sea and air of all goods involving an element of foreign material which has been subject to customs duty at the port of entry.

The reason why it is necessary for these details to be

known is to permit the Federal Government to determine how much of its customs revenue was actually derived from the residents of each State. It may be, for example, that one seaport serves the whole of the Federation, in which case all customs revenue collections will be shown as received from the State in which the seaport is situated. If most of the goods are subsequently transferred to wholesale agents in other States for disposal, the price paid by the ultimate consumer will include customs duty recorded to the credit of the importing State. In the interests of equity, it is essential that the persons who actually pay the duty are credited with the payments.

Almost precisely similar difficulties will be encountered if the Federal Government assumes control of the imposition and collection of excise duties. If the duty is paid and recorded in the State where the goods concerned were manufactured, the consumption of, and eventual payment of excise on those goods consumed in another State will be ignored. The records of collection of duty will not reveal the distribution of the origin of the duty. In this case, however, the determination of the correct distribution should not be difficult. If the rates of duty are the same throughout the Federation, all that must be known is the quantity of each type of article upon which excise duty is payable, transferred across State borders. The rest follows from simple arithmetical calculation.

Another important source of revenue which could conceivably be handed to the Federal Government at the inauguration of the Federation is the power to collect income taxes on individuals and companies. Difficulties of apportionment of income tax collections between States will arise where individuals and companies derive revenue from more than one State. In the case of a large industrial concern, for example, which has branches throughout the Federation, a tax on income, or profits in this case, could be imposed by the Federal Government on the total profits of the concern. If, however, it is necessary for the total tax payable to be divided according to the amounts payable arising from the activities of the concern in each State of the Federation, then a great deal more information will be required by the tax collecting authority, and a great deal more clerical and administrative work will be involved.

Similarly, if the incomes of individuals are taxed by the Federal Government, where incomes are earned in more than one State additional information will be required to permit the Federal Government to correctly determine the origin of individual incomes. If this information is not available, it must be assumed that all incomes of individuals are earned in the State of residence. While it may be expected that the error which is likely to arise from making this assumption will be reduced by compensating errors in the case of each State, there must be some error, however small.

The determination of the amount of revenue collected according to source would be simpler in the case of other types of taxation. For example, the distribution of collections of Land Tax, Sales or Purchase Tax and Entertainments or Amusement tax would be straightforward. Almost invariably the collections would be made in the State in which the person paying the tax resided. There would possibly be some interstate ownership of land, but it should not be very difficult to apportion revenue from these sources correctly. Duty on Gifts and Death Duties might similarly present some difficulties, but again, it should not be impossible for these to be overcome. These, however, are comparatively minor sources of revenue. The more important sources of taxation revenue are Income Taxation and Customs and Excise Duties and as explained above, they would be difficult to apportion accurately.

The allocation of revenue derived from services supplied by the Federal Government must also be considered. The most important services from the revenue viewpoint, and the ones most likely to be taken over by the newly formed Federal Government are post and telegraph services and transport services by road, rail, sea and air.⁴ In the first case no serious difficulty should be encountered in determining how much of the total revenue received in the Federation from the provision of services was derived from the residents of each State. Post and telegraph services are usually received and paid for in one place. Where the service extends beyond the boundaries of one State, such as in the case of carriage by mail, there is usually a compensating movement in the opposite direction. This is also true, to a lesser extent, in the case of transport services. Where goods are shipped from one place to another, it is usual for the shipper to pay the freight in the first place and recover the transport costs by charging correspondingly higher prices to the consignee. Ultimately the cost of the transport is paid by the consumer. Unless there is a correspondence between the imports into and exports from any particular State of the Federation, the collections in transport charges by the Federal Government or its agency will be shown to be greater per head in the areas which import least. In fact the greatest cost per head will be in the State which imports most, but the cost will be borne in portion of the prices paid for the goods imported. This factor must also be taken into consideration when assessing the relative amounts paid by the members of each State for services supplied when those services are supplied by the Federal Government.

It can readily be appreciated that there will be a serious difficulty encountered in ascertaining how much of the revenue of the Federal Government was contributed by members of the several States of the Federation. Probably even greater difficulty will be

4. It may be that the provision of these services is undertaken by private enterprise. If so, the problem will not arise.

encountered in determining the portion of total Federal Government expenditure incurred on behalf of each State. Excepting specific grants to State Governments, almost every item of expenditure will need to be scrutinised carefully and if possible, properly apportioned. In many cases this will be practically impossible.

In the case of expenditure on defence, which may under certain circumstances represent a substantial portion of total expenditure, there can be no completely satisfactory basis of distribution between States. The fact that certain items of expenditure are incurred in a specific State of the Federation does not necessarily mean that such expenditure is made on behalf of that area alone. It may be in the interests of the Federation as a whole that defence expenditure be concentrated in certain strategic areas. If those areas chance to be in one or a few of the territories of the States, it is not reasonable that the expenditure be regarded as being incurred on behalf of those States alone. All members of the Federation should be regarded as having contributed to the total cost. Therefore, some means must be devised to apportion the cost between the States which comprise the Federation. This will necessarily be an arbitrary device. It may be decided that relative population sizes should be the basis, but this suffers from the drawback that defence requirement may bear only remote relation to the population. Whatever method is chosen, there will inevitably be some deficiencies.

Another type of expenditure which will be difficult to apportion between States will be the annual commitments for interest and sinking fund charges incurred by the Federal Government. These commitments will arise from the expenditure made from loan funds on capital goods and construction works from which the members of the Federation will benefit. The correct apportionment of subsequent loan charges will entail the recording of all capital expenditure and amortisation according to States the members of which benefitted from the expenditure. This will not always be easy to calculate, but such expenditure should be subject to reasonably accurate distribution. Most items of expenditure will permit simple apportionment. Others, but probably few, will call for an arbitrary decision.

These two examples illustrate the difficulties which will be encountered by the Federal Government should it require to distribute the total expenditure on central government activities between the States. It can readily be appreciated that if even a reasonably accurate assessment is to be made, a considerable amount of work will be involved. This, in itself, will cause greater expenditure by the Federal Government.

In many cases, in order to arrive at a reasonable approximation to a correct distribution between States of expenditure

made on their behalf, and revenue received by the Federal Government, some arbitrary basis will have to be adopted. Under ordinary circumstances, it will probably be found that the only satisfactory basis will be a per capita distribution. While in some cases this may be sufficiently accurate in others it may be completely inadequate. It could never be used, for example, as a means for distributing revenue received from the imposition of customs and excise duties and from income taxation. It is apparent that in these cases a more exact method is required. Generally it can be assumed that a considerable amount of time and money will be expended in the process of reaching the desired degree of accuracy. It may, however, be possible to reduce the work involved by use of accepted statistical techniques.

Undoubtedly it will be possible to arrive at some reasonable figure showing the revenue and expenditure of the Federal Government according to the State of origin or destination. Under the assumption made previously - that the revenue of the Federal Government will exceed its expenditure - the net result will be a surplus divided according to the State of origin. Under the principle of payment as compensation for financial loss incurred by the several States, these are the amounts to be paid by the Federal Government to the respective State Governments.

The effect of the adoption of this principle of determining the amounts to be paid to the State Governments from the surplus revenue of the Federal Government can now be considered. The very method of determining the size of the grant in each case ensures that the State will receive the net amount of the contribution of its members to the surplus revenue of the Federal Government. Under this principle, no attempt is made to use the surplus revenue as a means of redistributing the total financial resources of the Federation. Each State will receive the amount its residents contributed in various ways to the revenue of the Federal Government less a proportion of the cost of the Federal Government.

It can be safely assumed that all States will be of different economic strength⁵, and as a result, some actual inequity might be caused by the methods used in the adoption of this principle of distribution. When the States form themselves into a Federation they surrender certain functional powers to the newly formed Federal Government. Henceforward they will have no authority as to the amount of revenue income which will be expended in these fields, and yet they will be required, by the nature of the distribution of the financial powers of the Federation between the Federal and State Governments to contribute to the financial support of the exercising

5. See pp. 63-64.

of those powers to the extent that the Federal Government considers necessary. The case of the handing over of the defence powers of the Federation affords an excellent example of the manner in which this can operate.⁶ The same effect might be felt in any field which passes to the control of the Federal Government. The scope of activity covered by any of the transferred functions might be interpreted quite differently by the authority now responsible for its administration. They may be interpreted in a wider sense and this could conceivably result in greater overall expenditure than before Federation. On the other hand, the taking over of a function formerly administered by several authorities by a single administrative agent should result in some reduction of total expenditure. Nevertheless, if total expenditure does increase, the members of the several States will be receiving some service which was previously provided by their own State Governments. But as a result of Federation, there may be changed emphasis on the relative importance of the different types of services supplied.

In addition, there will be some expenditure incurred by the Federal Government which was not necessary before Federation. The establishment of a new legislature and associated administrative machinery implies expenditure not previously necessary. If this type of cost of government is distributed between the States on a population basis, it is possible that the extra burden, although negligible in the case of the more prosperous States, would be of considerable significance in the cases of the poorer communities.

The first of the objectives of governmental financial policy is the redistributive objective. As explained earlier,⁷ the purpose of this objective is to reduce inequalities of incomes in the community. From the point of view of the Federal Government, the community it represents is the Federation as a whole, and therefore it should aim at achieving this objective throughout the Federation. However, it can be shown that if the surplus revenue of the Federal Government is substantial and the principle of redistribution of this surplus revenue is to be the compensation principle, it will be impossible for the Federal Government to achieve this objective.

Under the compensation principle, the people of a particular State cannot receive proportionately more of the surplus revenue distribution than their contribution to the revenue of the Federal Government. If average incomes are relatively low in one State, the total welfare of the Federation will be increased if this inequality between States is reduced by giving to that State a relatively greater portion of the surplus revenue of the Federal Government than the contribution to revenue. Under the compensation principle this cannot be done.

6. See above p. 52

7. Chapter 2 p.20 ff.

Generally it may be said that the adoption of the compensation principle will maintain, within certain limits, the situation which existed before the inauguration of the Federation. The political situation will have changed considerably, but from the point of view of the material position of the members of the several States of the Federation, their relative positions would remain virtually unchanged. There will probably be some change in the structure of the services received, but overall the relative positions should remain unaltered. If taxation was relatively high in one State before Federation, it will probably remain so after Federation. If standards of services received were below average, they will still be at the same relative level after Federation. There may be some slight reduction in standards of services, or increases in taxation as a result of the additional cost of the new government, and this will be felt most in the States where taxation was already high or where standards of services were low.

Since the relative position of the States remain the same after Federation, it follows that differences in welfare levels between the States will remain unaltered. The adoption of the compensation principle makes it practically impossible for the Federal Government to undertake effectively a policy designed to reduce inequalities of incomes in the Federation as a whole. If it has power to impose taxes on incomes and there are inequalities of income between people in the Federation, it may impose progressive rates of taxation for the purpose of bringing about greater equality. However, since it is bound to return revenue according to the State of origin, there can be no redistribution of incomes between States.

The second objective is that of maximising production through redistributing resources and influencing progress and capital development. Here, the Federal Government will similarly be limited in its scope. It has been suggested⁸ that a government can use direct and indirect means to achieve these objectives. The direct means include discriminatory taxation, the payment of bounties and subsidies, and manipulation of its own expenditure policies.

In a Federation, if the Federal Government must adopt the principle of payment for compensation as the basis for grants-in-aid, it will not be able to use these direct means of reallocating resources and influencing development. If, for example, the Federal Government proposes encouraging the development of a particular industry in an undeveloped State by payment of bounties and subsidies, such payments would be classified as payments for that State. The grant to the State Government would be reduced accordingly.

8. See above, pp. 32-33.

Similarly, if it wished to encourage a State Government to embark on new capital works, it could make available the necessary finance by, for example, central bank credit. However, the State Government would be required to meet debt charges as they would be regarded as payments for the State and accordingly charged against the State. In these circumstances, it is doubtful if the State Government concerned would respond to the encouragement of the Federal Government.

So far as indirect methods are concerned, the obstacles imposed by the adoption of the compensation principle will not be so great. Such approaches as the discriminatory use of central bank credit and direct controls will not be affected by the principle adopted to determine grants-in-aid.

The third major financial objective of government policy is the attainment and maintenance of full employment. As in the previous case, the successful application of this policy involves discriminatory taxation, encouragement of private and public capital investment in certain sections of the Federation, and manipulation of Federal Government direct expenditure to produce the best results. Again, the complete application of the policy will be prevented if the Federal Government is restricted to the use of the compensation principle in determining the payment of grants to the State Governments.

This is particularly so to the extent that it may prevent rapid expansion and contraction of public investment programmes. In the Australian Federation, the State Governments are mainly responsible for such expenditure. Consequently, if this is to expand, it is the State Governments which must accept the responsibility. The Federal Government can encourage expansion in a Particular State by contributing from its revenue to the resultant annual debt charges. If the compensation principle is to be used, the Federal Government is prevented from giving this type of assistance.

It may be said, therefore, that the use of the compensation principle will prevent a Federal Government from effectively attaining all three objectives of governmental financial policy if the field of its operation is regarded as the Federation as a whole and not the several States individually. When this principle of determining grants is adopted, the Federal Government will be forced to treat each State as a separate unit and reduce inequality, maximise production, and maintain full employment within the limits set by the natural resources and economic development of each separate State. Each objective could be more adequately pursued if the Federal Government were permitted to ignore State boundaries and influence the transfer of resources, physical and financial, to those parts of the Federation where they will produce the most beneficial results for the Federation as a whole.

(11) Effect of Adoption of Principle of Financial Needs.

The principle of disbursement of the surplus revenue of the Federal Government to the State Governments of the Federation according to the relative financial needs of each has been stated as a principle aimed at producing equality between States in certain fields of economic activity.⁹ The implications of the adoption of this principle are that before Federation there was a fairly wide range of differences in the economic conditions which existed in the several States. In particular, rates of taxation, standards of services and levels of public indebtedness would be different. The possibility of implementing the principle arises when the Federal Government receives substantially more revenue than it requires to finance its own operations. The annual surplus would then be divided between the States with the object of equalising conditions, and in particular the three aspects of governmental activity mentioned.

In essence, the process of equalisation in these fields on a Federal basis is similar to the process which would be adopted if a government were attempting to equalise the incomes of its individual members. In that case, the authority concerned would levy taxes on a progressive scale, thus drawing the major portion of its revenue from the wealthier of its community, and with the proceeds provide services, pensions, etc. to people in the lower income groups.

When it is thought desirable to produce equality in certain spheres of economic activity in States, the Federal Government will impose rates of taxation which will be progressive as far as possible. An income tax will almost invariably be of a progressive nature, but a customs duty will usually be regressive. Nevertheless, the rates of duty or taxation imposed will probably be progressive throughout the Federation. Under certain circumstances it would render the process of bringing about equalisation impossible if this were not so. If, for example, both the Federal and State Governments were permitted to levy income tax concurrently, and the revenue derived from income tax formed a reasonably high portion of the total revenue of the several authorities, it would be possible for the Federal Government to levy differential rates of taxation between States and so obviate the necessity to make payments to the States. That is, the Federal Government could dispense with a revenue surplus and hence dispense with the necessity to make a distribution. If the revenue of the Federal Government from other sources was still sufficiently great to produce a surplus, thus retaining the necessity to make a distribution, the rates of certain types of taxation could be so adjusted between States to permit the distribution of the surplus by the simplest possible method. For example, it may be

9/ See pp. 54 ff.

possible, by manipulation of certain rates of taxes between States, to permit the disbursement of the surplus revenue on a per capita basis and still achieve the desired purpose.

Despite the attractiveness of such a scheme, main consideration must be given to the case where it is incumbent upon the Federal Government to impose uniform rates of taxation and duties in each State of the Federation. This is the situation which exists in Australia. In effect, under such a system of payments to the member States as here envisaged, this uniformity of taxation rates will be technically invalidated. For while rates of taxation will be uniform, payments to the several States will bear no relationship to the amounts contributed by each and hence the ultimate effect will be that the net burden on the taxpayer of some States will be less than the burden on taxpayers in other States. Nevertheless, superficial uniformity will exist and presumably all that is required is that rates of taxation alone shall be uniform throughout the Federation.

Since the general level of prosperity will be higher in some States than in others, it can be assumed that the average level of incomes will be correspondingly greater. It follows that Federal Government collections of income tax per head will also be greater. Progressive income tax rates will ensure that residents of the more prosperous States will contribute relatively more than the average to Federal revenue. Even in the case of customs duties collections, the same effect will be gained, although by a different process. It can be safely assumed that in a Federation, the more prosperous a community, the greater the volume of imports per head from outside the Federation. At first sight this may appear to be a contradiction. It would appear that a prosperous community would be producing relatively more than its poorer neighbours, but generally this prosperity will be in a few fields of production. Few communities are capable of producing all their requirements in both primary and secondary industrial fields, and most find it economically advantageous to specialise in producing commodities for which cost conditions are most favourable. In such cases, the more of the commodities in which they specialise are produced, the greater their capacity to exchange the surplus over current requirements with countries which have specialised in the production of other types of goods. Hence, as prosperity grows, so will exports and imports and thus the revenue from import duties.

Thus, if the rates of Federal Government taxation are uniform between the States of the Federation, and rates of some types of taxation are progressive, collections per head will be relatively higher in the more prosperous States. Expenditure from the revenue of the Federal Government thus derived will be first upon the proper performance of its allotted functions. The type of expenditure which

it will be necessary to incur will be determined by the provisions of the Constitution of the Federation which distribute functional powers between the Federal and State Governments. The expenditure will be in the interests of all members of the Federation but it is inevitable that there will be some differences in the relative amounts spent for or on behalf of each State. To take a simple case which could conceivably arise, if the Federal Government is given power to pay pensions to aged persons in the Federation, and one State has a disproportionately high percentage of its population in the higher age-groups, then the people in that State collectively will receive relatively more in pension payments than the other States. Such differences will operate throughout all fields of expenditure in which the Federal Government operates.

Consequently there will be many factors which contribute to the determination of the relative distribution between States of the expenditure of the Federal Government. In all probability there will be some cancellation of positive and negative differences, and the final balance in favour of or against each State may be only small. There will be no force operating to ensure that this distribution will be in favour of the States in which the financial need is relatively greatest. In the case quoted above as a simple example, the State with lowest taxation rates and highest average incomes might also have the highest percentage of older people in its population. As a result of a demographic accident, this State will receive more per head on this account than any other State.

The balance of revenue remaining to the Federal Government after making the necessary payments, is the amount available for distribution to the member States. Under the principle that these payments should be made according to the relative financial needs of each, the amount will be distributed in such a way as to ensure that the economic conditions in the various States are equalised in certain fields. The manner in which the amounts can be determined will be considered in the next Chapter. For the present it will be assumed that the distribution has been made successfully.

When this principle is adopted, the poorer States will be raised to somewhere nearer the level of the more prosperous States. Rates of taxation should be reduced, standards of services raised and standards of development brought more into line with development in other States. In the more prosperous States where standards are generally relatively high, standards of services should be lowered and rates of taxation increased slightly.

It may be assumed for the moment that the principle of payment according to financial needs has been adopted in a newly-formed Federation, and it has been decided that the principle will be put into operation by endeavouring to equalise the standards of services

supplied and the level of taxation in the fields remaining to the State Governments. This presupposes inequality before Federation but, as pointed out above, this is a reasonable supposition. The State Governments will be required to surrender certain taxation rights and certain functions which formerly entailed some expenditure.

However, it may be assumed that the revenue foregone will, in all cases, exceed the expenditure taken over by the Federal Government. If no recompense is forthcoming in the form of a grant from the Federal Government, each State Government will be faced with three alternatives in the determination of future policy. It may reduce its expenditure on its allotted functions to the extent of the net reduction in its revenue; it may increase rates of taxation in the fields remaining to it in order to offset the loss of revenue as a result of Federation; or it may combine both, reducing expenditure and increasing rates of taxation but in both cases by less than if the operation were made through only one avenue.

If the Federal Government makes a grant to a State Government, and the amount of the grant is less than the amount of revenue foregone as a result of Federation, then that State will still be required to reduce its expenditure below the former level, increase rates of taxation to maintain expenditure, or combine both to a modified degree. If the grant to the State Government is greater than the net amount foregone, that State will be in a position to increase expenditure on the provision of services, reduce taxation in the fields remaining to it, or combine both approaches.

It is apparent, therefore, that by manipulation of the amount which the Federal Government pays to each State from its surplus revenue, it is possible to bring about equalisation in these fields. This does not mean to imply that conditions will then be identical between States. The Government of each State will retain independence in the expenditure of all money received, and it will entail a policy decision on the part of each Government as to the field in which the adjustment is to be made. The Federal Government should only be concerned with the net burden on the individual within the Federation. The way in which the burden is distributed must remain a function of the State Governments.

The way in which equalisation can be brought about in these two fields, which can in fact be regarded as complementary, can also be extended to operate in other fields. In the field of development generally, the process will be a little more complicated. In this case, decisions are required with regard to expenditure from loan funds as well as from general revenue. Economic development of a community will be by a combination of public and private investment. Manipulation of investment programmes must be through public investment. It may be clearly stated at the outset of Federation, and even incorporated in the Constitution in order that

the State Governments may be fully aware of it, that a policy is to be followed to permit relatively under-developed States to borrow greater than proportional amounts for public investment. The States concerned would then realise that they may increase their public debt and the amount of the grant by the Federal Government will be correspondingly greater to offset the higher interest and sinking fund payments which it will be required to make.

It is not suggested that grants should be made from the surplus revenue of the Federal Government for the purpose of subsidising capital investment in the weaker States. All developmental programmes should be financed from loan raisings,¹⁰ and if necessary the higher debt charges of the weaker States met from surplus revenue. Again, it could be suggested that the Federal Government might assume responsibility for the public debt incurred before Federation by each State and be responsible for all future borrowing programmes and the annual charges payable. Such a scheme would be feasible only if it could be ensured that the income of the Federal Government would always be sufficient to meet the combined annual charges on the public debt of all States.

This may be possible if the distribution of the taxation fields between the Federal and State Governments is sufficiently flexible to permit a reduction in taxation rates by the State Governments and a corresponding increase in rates by the Federal Government if the possibility arises where the funds available to the Federal Government appear to be insufficient for the purpose. If this method of applying the principle of relative financial needs is adopted, there will be implied a complete loss of independence on the part of State Governments in determining the extent of public investment which will take place. Since there is a close relationship between expenditure from loans and from revenue, it is desirable that State Governments retain control of the direction at least, of expenditure from loan funds. Furthermore, the adoption of this method could lead to complications if there was a change in the relative status of the several States.

As the State developed, it might become less independent on financial assistance from the Federal Government. If the Federal Government were committed to meet all debt charges of that State, the position might arise where the needs of the State were less than the commitments on its behalf by the Federal Government. However, apart from this consideration, it is thought that the possibility can be rejected solely on the ground of the loss of independence by the State Governments.

It can now be seen that if the principle of payment

10. This condition relates to Australian circumstances. See p.39 above and note 20 on that page.

according to relative financial needs is adopted, the Federal Government will be in a position where it can effectively adopt a policy designed to maximise the welfare of the people of the Federation as a whole. It has been stated that the principle of payment according to relative financial needs is a principle of equalisation. If correctly applied, it tends to equalise the burden of taxation throughout the Federation and at the same time equalise the standards of services supplied in each State. In effect it takes revenue from the relatively wealthy States and gives to the relatively poorer. In other words it tends to equalise the levels of real income between States.

At the same time, the Federal Government can use its power to differentiate between States in distributing surplus revenue in order to influence the allocation of resources. In this respect, an increase in the grants to a State will increase the relative purchasing power of that State compared with the other States. With the increased revenue, factors of production formerly held in other States may be transferred to the State receiving the additional grant.

So far as the implementation of a full employment policy is concerned, the influence which the Federal Government can exert on a State Government to increase expenditure when unemployment threatens, and reduce expenditure when inflation threatens, can be brought to bear through grants designed to meet relative financial needs. So far as public investment programmes are concerned, the Federal Government can again influence the level of spending by the State Governments through financial aid to assist the States in meeting the necessary debt management charges.

On the other hand, the adoption of the principle of payment as compensation for financial loss would prevent the Federal Government from pursuing any of these policies. It would ensure that the position which existed before Federation would be maintained as far as possible. Inequalities between States would be perpetuated and therefore the Federal Government would be barred from pursuing a policy designed to maximise the welfare of the people within the Federation.

There can be little doubt that if the Federation is to be an effective union, the Federal Government should adopt the principle of relative financial needs as the only basis for distributing its surplus revenue between the State Governments. By using this principle it is in a position to adopt the only policy which is acceptable for Governments in modern communities - that is, maximisation of welfare and with it the maintenance of full employment.

The formal adoption of the principle of payment according to relative financial needs will place the Federal Government in a position where, other conditions being favourable, it

may effectively adopt a policy designed to maximise welfare. For this to exist, it will be necessary for several other conditions to be satisfied. For example, the surplus revenue of the Federal Government will need to be large enough to permit it to make substantial grants to the States. These grants will have to represent a large proportion of the total revenue of the States. Precisely how large this proportion should be will depend on the degree of inequality between the States and the state of business activity at the particular time.

Furthermore, the correct application of the policy will depend on the ability of the Federal Government or its agents to interpret the relative financial positions of the States. Nevertheless, if these conditions were satisfied, and the principle of payment as compensation for loss were adopted, the Federal Government would still be prevented from effectively putting its policy into operation. The adoption of the principle of distribution according to relative financial needs is the major prerequisite.

Attention should also be given in passing to the possibility or adequacy of the per capita basis for distribution. At an earlier stage it was mentioned¹¹ that this was merely a variation of the principle of compensation for loss. In fact it does not involve any principle at all, but may be regarded as a method which has no logical justification other than simplicity. The results which would be obtained from the adoption of this method would probably be better than the results which would be obtained if the principle of compensation for loss were adopted. A per capita distribution would favour slightly those States which contributed least per head of population to Federal revenue from which the distribution is made. In this respect, advantages would accrue to the weaker States at the expense of the more prosperous States. To this extent the adoption of a per capita distribution would have more to commend it, so far as equalisation is concerned, than distribution as compensation for loss.

Nevertheless it has the disadvantage of bringing about some measure of equalisation according to no logical principle. Furthermore, there can be no guarantee that per capita payments will achieve the desired result. Therefore it is considered that while this method has some advantages over the compensation principle, it cannot compare with the principle of payment according to financial needs which, it is contended, is the correct principle to adopt.

The principle of payment according to financial needs must be regarded as a principle which is aimed at altering the existing set of financial relations. The principle of payment as compensation for loss on the other hand, is a principle designed to perpetuate existing relationships. There can be no long-range

11. See above pp. 53-54.

objective with the latter principle. From the outset it is aimed at continuing the existing distribution of the total resources of the Federation. On the other hand, it must be assumed that there is some ultimate objective, some long-range purpose in the adoption of the principle of payment according to financial needs, and eventually that objective will be reached. In this case the ultimate objective is equality of general economic prosperity between States. As the States which are relatively weak at the outset become stronger and approach equality with the former economically stronger States, it will be found that the payments necessary to produce equality will approach more closely to some other standard, such as amounts per head of population or amounts roughly in proportion to the amounts contributed to the revenue of the Federal Government. When this stage is reached it can be claimed that the purpose of the adoption of the principle of payment according to financial needs has been achieved. The length of time which will elapse before this state of affairs comes about will depend partly on the way in which the principle is applied, but mainly on the degree of difference in economic conditions which exist between States at the inauguration of the Federation. It may be that in a reasonably short period of time, all but a few of the States will reach equality in the desired fields. At that stage, partial conversion to a new principle may be desirable in the interests of simplicity. Nevertheless, there will always be need for differentiation between States for purposes of maximising welfare by means other than equalising incomes.

The great danger of the adoption of this principle is that there is every opportunity for it to lead to a transfer of functional powers from the State to the Federal Government. The Federal Government may feel that its policy could be more effective if its spending powers were increased at the expense of the States. If involuntary unification is to be prevented, the individual States should retain independence of action in as wide a field of activity as possible. The surest way to ensure this is for the respective fields of operation of the State and Federal Governments to be clearly defined in the Constitution. Then the transfer of powers can only be in accordance with the constitutional provisions for amendment of the Constitution.^{12.}

12. In Australia, Section 128 of the Constitution requires approval by both a majority of States and electors for alteration of the Constitution.

CHAPTER 5DETERMINATION OF AMOUNTS OF GRANTS

It has been shown that the distribution of powers and resources between the several States which comprise the Federation will usually be such that a redistribution of revenue between the Federal and State Governments, from the former to the latter, will be necessary. Where this situation does arise, a decision must be made as to the principle which should be adopted as a basis for the redistribution. Where any inequality of resources exists between States, it is suggested that the principle of payment according to relative financial needs be adopted in order that these inequalities should not be perpetuated and so that the Federal Government is placed in a position where it can effectively implement a policy designed to maximise welfare in the Federation as a whole. In short, the Federal Government will, in each accounting period, allot a certain amount of its revenue to be distributed between the State Governments. For the reasons which have been examined previously, it is suggested that this distribution should be made according to the financial needs of each. When this situation arises, a problem develops as to the manner in which the amount payable to each State should be determined.

Consideration must first be given to the body or institution which is to accept responsibility for the determination of the relative financial needs of each State Government. There appear to be several possibilities, but these can be reduced to two major alternatives. The first of these is that the Federal Government itself should accept responsibility while the second is that an independent committee, board or tribunal be appointed for the purpose. In the final analysis, the responsibility for appropriation of Federal Revenue for the payment of grants to the State Governments will rest with the Federal Parliament. If a completely independent body is appointed for the purpose, its function can therefore be advisory only. This may be subject to some qualifications, as will be seen later.

The choice between the two alternatives is not an easy one to make. Each has important advantages and disadvantages. The eventual choice may depend on the particular circumstances of the Federation in question. Nevertheless an attempt should be made to reach a definite conclusion, at least so far as the authority most appropriate for the Australian Federation is concerned.

If the Federal Government regards its ability to make grants to the State Governments as an instrument for the implementation of a policy designed to maximise welfare, it will be vitally concerned with the determination of the amounts which each State will

receive periodically. In fact it will be part of Federal Government policy. For example, in the process of enforcing a full employment policy, the Federal Government will have to decide the total amount which is to be available for expenditure by all governments in the Federation. This in turn will necessitate a policy decision concerning the rates of taxation and other charges to be made. Obviously such decisions must be made by the Federal Government itself. They cannot be delegated to an independent authority which is not politically answerable to the people.

The first conclusion to be reached is therefore that the total amount available for distribution to the States in any period must be determined by the Federal Government as part of its anti-cyclical policy. In fact, such decisions will probably be made by the economic experts advising the Federal Government, although these recommendations may be modified for political reasons. It is not necessary to debate here the advisability or otherwise of expert recommendations on economic matters being modified at the ministerial level for political reasons. It must be assumed that the Federal Government proposes to adopt a policy designed to maximise welfare, including the maintenance of full employment.

Once the total amount available has been determined, the problem remains to distribute this amount between the States in such a way that the policy of welfare maximisation is still followed. In the main, this will require a distribution which will reduce inequalities between States and, to a lesser degree, influence the allocation of resources between States to maximise production as far as possible. It is quite apparent that the Federal Government as such, would be technically incapable of making such a determination. If the task remained with the Federal Government, it would devolve upon public servants who would be responsible for the necessary calculations. The results would be conveyed to the Federal Government which would inevitably accept them almost without question because the processes by which the results were obtained would be largely unintelligible to the individuals concerned. Any modification made would probably be made for political rather than economic reasons. It must be recognised that usually politicians have not been trained to comprehend the intricacies involved.

The choice of the body to whom shall be given the responsibility for distributing the total amount available thus becomes a choice between members of the public service employed by the Federal Government and a body of disinterested experts. So far as ability to perform the task is concerned, there is no choice to be made. It is a choice between experts within or outside the Public Service.

The difference between them is that where the experts in the employment of the Federal Government are used, there is danger that they may be considered to be interested parties. Such an accusation would, of course, be quite unfair. To the outside observer, however, the distribution would be made by the Federal Government itself, and this is composed of representatives of the States. Although unlikely, there is danger that it would be accused of partiality.

The alternative, an independent commission whose sole function would be to distribute between the State Governments a total amount indicated by the Federal Government, would avoid any such accusations. The members of the commission could be appointed by the Federal and State Governments after consultation, and the distribution would thus be withdrawn from the political field.

In the Australian Federation, this idea has much to commend it. Whereas the State Governments would be suspicious of a distribution made within the walls of the Federal Treasury, a body which has no political affiliation, and made up of recognised experts in the field of public finance, would probably avoid such feeling. The reasoning of such a body would be independent of the accidents of Federal politics.

If it were decided to establish such a body, it could have advisory powers only, or it could be responsible for the actual distribution of the grants. That is, it could be advised by the Federal Government of the total amount which it, the Federal Government decided to make available to the State Governments, and in turn it would advise the Federal Government of the best way to distribute this amount in order to achieve the desired objectives. Alternatively, this committee could receive the total amount from the Federal Government and distribute this between the States as it thinks best.

The latter alternative has the advantage of removing any possibility of the Federal Government altering any recommendations of the committee. A block amount could be voted by the Federal Parliament for payment to the committee for distribution to the several State Governments according to the principle of relative financial needs. Such a procedure would, however, prevent the Federal Government from attaching any conditions to the grants. An independent committee such as that envisaged would not have the necessary powers to impose conditions on grants made to the States.

A compromise solution might be the establishment of a separate department under the Federal Government with the necessary power. It could, in fact, be the commission envisaged above but operating within the framework of the Federal Public Service. Even in this form it could be independent of the Federal Government in that each year an amount could be appropriated to that department for

distribution to the States, Criticism could still be made of the fact that it would be an agent of the Federal Government, but it would avoid the necessity of voting a certain amount for each State in the Federal Parliament.

One of the main factors which must be counted against any proposal for the distribution of the total amount available being removed from the hands of the Federal Government or those responsible to it, is the size of the amount involved. For example, in Australia in 1952-53, direct payments from the Federal to the State Governments amounted to £183m., or 19% of the total expenditure of the Federal Government. The establishment of an independent body with responsibility for spending this proportion of the revenue of the Federal Government without responsibility to the people would surely be without precedent in the practice of British government.

Nevertheless, the proposal is practically sound. While the Federal Parliament would retain the right to determine the total amount to be paid to the States as a whole, the distribution between the States would be taken out of Parliament's hands. While there may be strong objections to such a proposal on political grounds, it would prevent the distribution of the total amount being subjected to the vagaries of party politics and the influence of individual States on the decisions of the Federal legislature.

Any opposition to such a proposal on the grounds of the large amounts involved could be overcome by the direct payment by the Federal to the State Governments of a fixed amount each year, or a certain amount per head of population. For example, the Federal Government could pay to each State Government an amount of £10 for each resident in that State. In Australia in 1952-53, this would have absorbed approximately £90m., leaving a further £93m. to be distributed according to the principle of relative financial needs. In this way the actual amount which the distributing body would be required to handle would be considerably reduced. The claim for responsibility of Parliament would be partially satisfied and yet the principle of equalisation could still be satisfied by the equitable distribution of the remaining amount.

If the objection relating to the responsibility of Parliament to its electors is satisfactorily overcome in this way, there would be no impassable barrier to the setting up of an independent committee of experts. If public and political feeling were still strongly opposed to it, the compromise solution of placing this body within the walls of the Federal Treasury might be adopted. The solution will depend on the outlook and attitudes of the times. Whereas a completely independent body might be unacceptable now, it might be regarded with favour in another decade.

The other decision to be made is whether the body should be advisory only or should accept full responsibility for the distribution of the total amount made available in each year by the Federal Government. In the light of present feeling on related matters, it would appear inadvisable to give a body of persons not responsible to Parliament and hence to the electors, supreme power to control the finances of the States. Such a procedure could be adopted however, if this body were actually part of the machinery of the Federal Government.

The alternatives thus appear to be, if the Federal Government and Parliament is excluded, to establish a body within the framework of government but with the maximum of independence compatible with this position, to be solely responsible for the distribution of a sum determined by the Federal Parliament, or an independent body acting in an advisory capacity only. In view of the importance of the need that the distribution should be in accordance with the principle of relative financial needs, it is desirable that the actual distribution should be removed from the possibility of alteration by Parliament. Therefore, at the present time, so far as the Australian Federation is concerned, the choice appears to be the former alternative, a body within the framework of the Federal Government structure.

There is in Australia, no institution such as that which has been envisaged above.¹ However, its introduction should not be impossible. While it would seem that the adoption of this course is advisable in the interests of the implementation of the principle of equality in the determination of Federal grants, it is not completely essential. It is quite possible that the same ends can be achieved if the Federal Government itself, through its expert advisers, makes the decisions. However, the final responsibility for the payment of grants rests with the Federal Parliament, and therefore there is always the possibility that recommendations by experts may be disregarded. While this possibility exists, there is continual danger that the accepted principle will be modified to satisfy political expediency.

The actual methods used by such a body to determine the relative financial needs, and hence the amount of the grant which should be paid to each State Government will be a matter to be decided by the committee itself, after having taken account of the conditions which exist in the particular Federation. Such conditions will vary from time to time and from place to place, and hence it will be impossible to examine in detail all the factors which must be

1. The nearest approach would be the Commonwealth Grants Commission (see Chapter 8 below) and the Commonwealth Court of Conciliation and Arbitration. For a description of the organisation and functions of this Court, see Labour Report No. 41 pp.51 ff.

considered. However, it is possible to reach certain tentative conclusions concerning some of the wider issues involved which can be assumed to apply uniformly over time and distance. The more complete detail is a matter for individual assessment. The first of these broader aspects of the determination of the size of the grants is possibly part of the principle upon which the grants are determined.

It has been stated earlier that the principle of relative financial needs is a principle of equalisation. There may be no statement of principle in the constitutional provisions of the Federation, and the distributing committee may receive no instruction on this important matter. Consequently, it may fall upon the committee itself to first determine the principle it will use. Even if guidance is given to this body, it will probably be in broad outline only, and although the committee may be instructed to adopt the principle of relative financial needs, it must still determine the fields in which it will aim to bring about equality between States.

The choice of these fields in the particular circumstances which exist may be quite obvious. For example there may be wide differences in the relative severity of taxation between States which are retarding the development of the weaker States and perpetuating or even increasing the inequalities which exist. Under such circumstances, one of the primary aims of the committee could be to establish methods of determining grants which, when paid, give rise to equality of severity of taxation throughout the Federation. Similarly with the standards of services supplied and the degree of development in each State.

It is suggested that the committee should first aim at bringing about equality of standards in these fields. This can be achieved with reasonable accuracy by a statistical comparison of existing conditions, and by assessing the amount of money required by the government of each State to permit the same standards to operate in each State, assuming equal efficiency of operation. There are certain difficulties associated with such an assessment, but these would not be insurmountable, particularly if the committee were provided with adequate investigatory staff and has full access to the records of each State. It is conceivable that the development of satisfactory techniques of measurement could not be made over a short period. At the outset it would be faced with the problem of obtaining a quick solution, and it would be found necessary to use temporary measures to give an approximation to the desired result. With more experience, greater accuracy could be expected.

It could be expected that over a period of time some change would take place in the relative financial positions of the member States of the Federation. Regular payments of redistribution grants aimed at giving greater equality should tend to bring about

greater natural equality. Consequently, it would be inappropriate,, for example, for a formula to be developed which would automatically determine the proportion of the total amount to be made available to each State. While such a formula could possibly be devised, it is improbable that it would meet all aspects of inequality adequately, and even if it did produce satisfactory results in one or several years, there could be no assurance that it would be sufficient for the purpose of operating over a longer period of time. It would be necessary for the distributing committee in question to be constantly reviewing its methods and measures if satisfactory results are to be obtained.

This matter leads to another question which is probably incapable of adequate solution without reference to the particular conditions of a specific Federation. That is, to decide whether the committee in question should confine itself merely to a statistical comparison of conditions existing in each State, or whether it should be competent to use its intuitive judgment after observation of the relevant data. Arguments can be put forward to justify the use of either alternative in general, but the deciding factors will probably only be revealed in the particular circumstances. The use of statistical comparisons alone will present a clear-cut picture of such aspects of the economy as the relative severity of taxation, and will permit the authorities in the several States to realise the position in which each stands in relation to the other States. In other words, it will permit the body making the assessment to justify its determination of the relative financial needs of each State should the occasion arise where this becomes necessary. This method, however, is partly unsatisfactory in that there are many aspects of the economy which cannot be subjected to precise statistical comparison.

The concept of standards of services is one example of a rather nebulous term which cannot really be defined adequately. It can be appreciated that it would be difficult to measure this concept with statistical apparatus and remain confident of being in a position to justify the conclusions drawn from such measurement. On the other hand, it may be possible for a body of competent individuals to be able to assess with reasonable accuracy the relative financial needs of the several States from observation based on such statistical data which may be available.

It would not be possible, under these circumstances, for the committee concerned to be called upon to justify and explain its reasoning, for it is conceivable that several different interpretations could be placed on the available information. Since the individuals concerned have been chosen for their ability, it must be assumed that their interpretation will be the best possible. Consequently, if this method of assessment were used, then the

committee would need to be placed beyond the position where it can be called upon to justify its actions either to the Federal Parliament or to the appropriate authorities in the States. It would, in effect, require to be given almost dictatorial powers. It would be given financial powers of a judicial nature. Such a procedure is contrary to the accepted principle of public finance that Parliament should be the only body to spend public money, and could only be justified if the legislatures concerned were convinced of the ability and integrity of the individuals concerned.

It would, of course, be possible for this committee to evolve methods which would make the best possible use of both alternatives. In other words, in the fields where complete statistical comparison is possible, it could be guided by the statistical information alone. In other fields where statistical comparison is impossible, then intuitive judgment could be brought into play in the interests of producing the best results.

Another of the broader types of problem associated with the assessment of relative financial needs which can be mentioned conveniently at this stage is the problem associated with the difficulty of assessing needs in advance. In point of fact, for the purpose of convenience, it will be necessary for the committee to carry out its investigations on an annual basis. It is almost universally accepted that the financial accounting period shall be the complete year. The choice of this period is purely arbitrary and by some tests, public accounting and financial practice could be improved if the accounting period were lengthened. However, in all probability the period of the particular Federation will be fixed already, and the system of the disbursement of the surplus revenue of the Federal Government will need to be woven into the existing pattern. If the accounting period is say, from 1st July to 30th June, as in Australia, then available revenue must necessarily relate to that period, and the distribution must also be made in that period.

It must be assumed that, in bringing down its budget for a particular financial year, the Federal Government will estimate the amount of revenue which should be available for distribution to the several State Governments. This is the amount which the authorised body, whether it is composed of politicians, public servants, or disinterested individuals, must distribute between the member States according to the predetermined principle. In actual practice, this body will be required to assess the financial needs of the States at least one year in advance, for it will be essential for the proper conduct of the financial affairs of the State Governments that they know as early as possible in the financial year the amount of revenue they will receive from the disbursement of the total amount made available by the Federal Government. This will be necessary in order

that they may adjust their revenue and expenditure policies accordingly. Thus the committee responsible for the determination, will be estimating constantly not present needs, but future needs.

This will, of course, make the task of distributing the available supply of revenue on an equitable basis much more difficult. In fact it will probably be found that the most satisfactory way of circumventing this difficulty will be for the body concerned to make use of the information relating to a particular financial year in calculating a measure of the relative financial needs in that year. Statistically this will be difficult, as a statistical analysis is essentially an historical analysis. However, it is not inconceivable that an expert body could develop statistical techniques which would enable it to have assessed at the end of the financial year, the measure of the financial needs for that year. The estimate could then be used as a basis for the distribution in the coming financial year, and in that way, the distribution could be made as soon as the amount available for distribution became known.

The deficiencies of a scheme such as this, involving a time lag of one year, are immediately apparent. The main drawback will be that the amount of money distributed in any financial year will materially affect the relative financial needs of the several States in that year. As soon as the grant becomes known, each State Government will determine its revenue and expenditure policy, and if the estimate of financial needs is in any way related to revenue and expenditure policies of governments, then the estimate will be found to differ considerably from the actual needs. For example, it may be found that a particular State will find that the amount of the grant it will receive will be less than sufficient to permit it to maintain existing services and levels of taxation, and so either standards of services must be reduced or the severity of taxation increased. If the same proportionate change has taken place in all States, then relative financial needs will remain unaltered, but if the change is not proportionate, then relative needs will have changed between the period to which the assessment relates, and the year in which the grant is actually made.

One of the major problems to be resolved will be to decide the nature or form of the grants which will be made to the State Governments. This will be almost a matter of principle as in some ways the decision in this field may influence the way in which the amounts of the grants will be determined. The main alternatives open are first, the payment of a series of specific purpose grants, second, the use of specific purpose grants on a basis proportionate to the amounts expended within the States from their own financial resources, and thirdly, the payment of a single unconditional grant. It is possible that combinations of these alternatives may be used.

The association of special purpose or "ad hoc" grants with the principle of relative financial needs implies that it would be possible for the body responsible for the distribution of the total amount available to isolate relative needs in all the spheres of governmental activity. If this method of payment is adopted, it automatically assumes that relative financial needs will be assessed by reference to actual government expenditure on the various services rather than by reference to the inherent natural differences which exist between States. The major difference between the two approaches of the assessment of relative financial needs is that the former will be influenced by government policy while the latter is independent of government policy. When the system of special purpose grants is adopted, the distributing committee will be required to determine relative needs in each of the fields in which it is proposed to bring about equality and then to recommend specific payments which, when expended on the provision of the specified services, will bring about equality in those fields.

For example, it may be found that in the field of the provision of education services there would be a very wide difference if the States were compelled to rely on their own sources of revenue to finance the provision of the service. An amount of expenditure per head would then be calculated which would be sufficient, after allowing for inherent differences between States, to bring all States to at least the level of the one enjoying the highest standard of all States in the Federation, and this would be compared with the actual expenditure per head of population. The difference represents the basic grant per head in all but one of the States, if the grant is designed to bring all up to the standard of the highest. The State with the highest standard would, in the first instance, receive no specific grant for the purpose of expenditure on education. Subsequently it might be decided that the standard should be raised still higher, and if this should happen all States will receive an education grant.

This example has related to a specific purpose grant for one particular service which might be provided by the several State Governments. The same procedure would be carried through for each type of service in which it is proposed to bring about equality and will be continued until the available financial resources are exhausted. This is only one way in which the required calculation can be made, and can relate primarily to the determination of the amounts of the specific purpose grants during the first year of the operation of the principle of relative financial needs. In subsequent years, alterations to the amounts determined in the first year will be necessary depending on the amount of revenue made available by the Federal Government and the changing pattern of needs between States.

The method could only operate effectively if the total amount available is sufficient to bring all States up to the standard of the State enjoying the highest standard through the use of its own financial resources. If this were not so it would be impossible to obtain equality as it would undoubtedly be found that, as a result of government policy, some States would be enjoying standards superior to those which could be achieved through the distribution of the total amount available. Once the government of a particular State determined to concentrate its expenditure upon one particular type of service it would be difficult for adjustment grants to be calculated to bring all States up to this standard. It would be impossible if each State concentrated on a different field of expenditure. If, however, grants from the Federal Government constituted a major portion of the incomes of the governments of the States, the situation envisaged above would probably never arise.

The greatest difficulty attached to this method will, however, relate to the timing of the assessment and payment of grants. The method presupposes that it will produce equality of standards of services over a wide field, and the achievement of that equality will depend in part on action taken by the several State Governments. The grants will be made at the beginning of the financial year and they will be aimed at producing equality in the financial year. The procedure involved will be first that the assessing committee will require to know the amount available for distribution by the Federal Government very early in the financial year. It will also require to know proposed expenditure on the various services, in the fields in which it is hoped to produce equality, by the State Governments similarly early in the financial year. Amounts of grants will then have to be calculated to absorb all available revenue and produce the desired equality in order to make known to the States the amounts they will receive for expenditure on the various services. This leaves a very short period in which the calculations must be made, but this will not be impossible if preliminary investigation has been proceeding in the months before the beginning of the financial year.

Another difficulty would lie in the possibility of errors of estimation on the part of the State Governments in predicting their expenditure on the various services from their own resources.

Presumably estimates would be made before presentation to and consideration by the legislatures, for the budget would necessarily include the amounts of the grants from the Federal Government. The legislatures in question would then be quite within their rights to alter the estimated expenditure and throw out of balance the pattern arranged by the distributing committee. Furthermore, unforeseen circumstances may cause the budget estimate to be altered through no fault of the governments concerned.

There seems to be no adequate means of overcoming this difficulty whilst retaining the desired equality in each field of provision of services. In actual practice, the overall picture would not be greatly altered if the States' budget estimates of revenue and expenditure from their own resources were subject to some slight subsequent alteration. In any State, variations bring below standard expenditure on one type of service would probably be counterbalanced by variations bringing about above standard expenditure on another type of service. This may not be precisely so because a certain amount expended on one type of service will not necessarily produce the same results, so far as welfare is concerned, as the same amount spent on another type of service. For example, one State might find it particularly difficult to provide education services and comparatively easy to provide hospital services. A certain amount of money transferred from the provision of the former to the latter will result in an increase in comparative standards, while a reduction in the amount spent on hospital services at the expense of expenditure on education services will result in a decrease in comparative standards. If the extent of the deviation from the original estimate is not very significant, the effect would similarly be small. However, it would mean that the purpose of using the specific grants would be lost. That is, there would no longer be equality between States in the standards of each type of service supplied. If there was much likelihood of this deviation occurring, it would be advisable to adopt an alternative method which would permit some interchange of revenue between different types of services without producing these adverse effects.

The second possible type of grant which should be considered is a variation of the special purpose grant mentioned above, yet in some ways it will produce completely different results. This is the allocation of the total amount available according to the amount expended by the various State Governments on certain types of services. In American terminology it is the "matching" grant.² The basis upon which this type of grant is determined is that the Federal Government agrees to match expenditure by the several State Governments on certain types of services. Essentially under this method, the Federal Government set out to determine the standards which will be achieved in any particular field. It proceeds to ensure that this aim is achieved by giving to the State Governments sufficient revenue to ensure that they are able to supply services equal to a predetermined standard. This can only be achieved, however, if the States themselves are prepared to spend sufficient of their

2. See, for example, "Federal Grants-in-Aid", a Report of the Committee on Federal Grants-in-Aid of the Council of State Governments in the U. S. A., 1949, pp.76-80. These grants are sometimes referred to as open-end grants.

available financial resources in the prescribed fields. In other words, if the Federal Government decides to subsidise expenditure on the provision of certain services on a "£ for £" basis, then it is conceivable that the States concerned would transfer all available revenue to that field of expenditure in order to attract the maximum amount of subsidisation. If this method is the only one used to distribute the total amount of revenue available, it is difficult to see how it can successfully satisfy the principle of payment according to relative financial needs. In the first place it is a very indeterminate way of achieving the desired end. The Federal Government will be called upon to decide which services shall be subsidised on this basis at the commencement of the financial year, before it is aware of the amount which each State proposes to spend in these fields. Hence, the amount which it will be called upon to provide may vary considerably from the actual amount available. This effect will be negligible only if the amount which the Federal Government pays out in grants to the State Governments represents a small proportion of its total expenditure. Furthermore, the amount which the Federal Government is called upon to provide may differ materially from the total amount necessary to maintain a stable level of employment.

A more fundamental criticism of this method of distribution, from the point of view of inducing equalisation between States, is that it takes no account of their relative abilities to provide services from their own resources. If, for example, a Federal Government decides to subsidise expenditure by each State Government on a £ for £ basis according to the amount spent by each State, it assumes that the needs of each are proportionate to their expenditure from their own resources. A State which spends a small amount per head of population for the only reason that its income from independent sources is small, will receive a correspondingly small grant as assistance from the Federal Government. A State which is prosperous and has a relatively high rate of expenditure per head of population will need assistance least, but will receive most. Thus it can be seen that the use of this method of distribution of the total amount available, and the principle of payment according to relative financial needs are somewhat conflicting.

The method of using matching payments can only be used successfully in conjunction with the principle of payment according to relative financial needs if there is some discrimination between States according to their needs. For example, in one particular State where the need is relatively high, the subsidy for expenditure on a certain service might be £2 for every £1 expended by the State Government from its own resources. In another State, where need is relatively low, the subsidy might be only 10/- for each £1 spent. In this case it will be necessary for the Federal Government or the distributing agent, to determine the relative financial needs of

each in order to assess the extent to which expenditure on each service in each State will be matched. As soon as this situation arises, the method becomes almost identical with the one considered earlier, that of making specific purpose grants. In order to assess relative needs it will be necessary to ascertain expected expenditure in each State and the determination of the matching grant along these lines will be, in fact, the determination of a specific amount.

The third alternative available is that the Federal Government or the distributing committee can make a block unconditional grant to each State based on the relative financial needs of each. The grant can be unconditional in the sense that the respective State Governments are free to distribute the amount received between the provision of the various services as they choose. In the case of special purpose and matching grants, payment of each grant was conditional upon its being used for a specific purpose. An education grant could not, for example, be transferred to the provision of health services at the discretion of the recipient State Governments. In the case of a block grant, however, the State Governments can use their discretion as to the use which is to be made of the amount provided by the Federal Government.

In calculating the portion of the total amount available which shall be paid to each State Government, the distributing body should have regard to all aspects of governmental expenditure in which it is proposed to bring about equality. An amount should be calculated which, when expended wisely, will permit the standards of State services to be provided at approximately the same level in each State. Complete equality will not be possible by this method but there is a degree of approximation in any method which might be used. However, in this case it arises because of the discretionary powers remaining with the State Governments.

As explained earlier, community welfare, so far as Government activity is concerned is amongst other things made up of the interaction of the impact of taxation and other charges on the one hand, and the extent of services supplied on the other. The greater the equalising effect of taxation, the higher the average level of welfare enjoyed by residents in the community. Thus a block grant may be determined by the distributing committee and be designed to raise the residents of all States to a common average level of welfare, given the existing structure of taxation. The committee might assume that existing State taxation rates would be continued and the amount of the grant used solely for the provision of services.

A particular State Government might decide that portion of its unconditional grant should be used to reduce the severity of State taxation. That is, State taxation rates would be reduced and existing levels of services maintained. If all other States received

similar grants from the Federal Government and used them for the provision of services, it would probably happen that the people of the State which used the grant to reduce the severity of taxation would find that their average welfare standards were below those in other States despite the fact that the amounts of the grants were designed to equalise average levels of welfare.

Such a situation could only arise if the State Governments were responsible for the collection of a large portion of total taxation revenue. If the scope for imposing taxation residing with the State Governments was small, their ability to use Federal grants to reduce the severity of State taxation would be limited. In the Australian Federation, for example, the Federal Government is by far the most important taxing authority and therefore it is probable that the possibility of error arising from this cause would not be of very great importance.

Differences between the anticipated level of welfare in a State as a result of the payment of a certain grant and the actual level which results may arise from another cause. In calculating the amount of the grant each State is to receive, the distributing body must assume that it will be used for certain purposes. That is, a certain portion will be allocated for the provision of education services, another portion for health services, and so on. As explained earlier in another connection,³ deviation from this distribution of the grant within a State may cause the final result to be different from that which was originally anticipated.

Thus there are several ways in which small variations from complete equality may arise other than the natural error which will arise from the difficulties of calculation. However, the distributing agent would probably assume that money provided by the Federal Government by way of grants would be spent in such a way as to maximise welfare given the available resources. If this maximum is not obtained, the fault lies with the State Government concerned and cannot be corrected by action of the Federal Government or its agent.

As with other methods of distribution, a problem will arise concerning the timing of the necessary calculations and the payment of the grants. Again, the committee will be forced to assess future needs on the basis of past and present experience and on preliminary budget estimates by the several State Governments. While this necessity introduces an element of approximation, it appears to be inevitable in any system by which financial resources in a Federation are redistributed between the Federal and State Governments.

3. See above, p.93.

The three alternative methods by which the grants may be paid have now been examined. The first was the use of a series of special purpose grants to bring about equality in certain selected fields, and this can be criticised on several grounds. First, it has not been shown that the principle of payment according to relative financial needs is best served by endeavouring to obtain equality separately in certain fields of the provision of services. Rather it is suggested that the principle would operate more effectively if some flexibility were permitted and lower than average standards in one field counterbalanced by above average expenditure in another.

Secondly, there is no guarantee that the purpose of the special purpose grant could be successfully achieved, as subsequent alteration through a change of intention on the part of the State legislatures, or by errors of estimation or even changing economic circumstances, would probably mean that the pattern designed at the commencement of the financial year would be subjected to considerable change by the end of that year. Thus the designed equality in each individual field of expenditure would probably not be achieved.

Thirdly, the method is open to criticism on the ground that it imposes a limit on the independence of the State Governments which is incompatible with the concept of federalism. It is essential for the well-being of a Federation that the State Governments retain the greatest possible degree of independence. Under this method, the receipt of the grants would be conditional upon their being used for the specific purpose for which the grant was made. The Government concerned would have no power to transfer amounts received as specific purpose grants from one use to another. It is possible that the specificity of the grants could be circumvented by transfer, after receipt of the grants, of appropriation of revenue from the State's own independent sources of revenue. If such a procedure were adopted, the whole purpose of the special purpose grant would be lost and the distributing body would have no means of correcting the position.

The second method of payment which was considered was the "matching" grant. As already explained, unless the pure form of the application of this method is modified to permit different rates of subsidisation to different States according to need, the method is directly opposed to the principle of payment according to relative financial need. This method suffers from a further drawback in that it would be very difficult for the Federal Government to determine in advance the total amount it would make available to the several State Governments in any financial year. Thus it would be particularly difficult for the Federal Government to implement a policy of full employment, at least so far as Federal grants are concerned.

The third method, the payment of a block grant, seems to meet the needs of the principle more than the other two alternatives. Its main advantage is that it leaves the State Governments of the Federation with the maximum of independence in their operations. This is essential at all times or there will be a persistent danger of the federal form of government developing into the unitary form. In the Australian Federation, for example, the Constitution has specifically excluded the Federal Government from the field of the provision of education services. If a large portion of the revenue of the State Governments is derived from Federal grants, and they are made subject to conditions as to the proportion to be spent on education, the Federal Government is actually using its financial superiority to influence the level and direction of State spending in fields in which the States are constitutionally autonomous.

When payment is made in the form of a block grant, the State Governments will retain sufficient incentive to ensure efficient operation, and the danger of centralisation is avoided. It is suggested, therefore, that this will be the most effective method of producing the desired result - that is, the establishment of equality in the average level of welfare in each State whilst leaving the State Governments with the maximum of independence. The grants should be looked upon as payments received as a matter of right and not in the form of a gratuity from the Federal Government.

It has been mentioned earlier that the adoption of this principle of payment according to relative financial needs, the equalisation principle, is merely a step in a process towards a desired end. This is the attainment of the position where equalisation of resources has been brought about and the financial needs of the States become proportionate to say, the populations of the States. If this is to be so, then some recognition would need to be given to it in the calculation of the distribution of the total amount available. One method of achieving such an end would be to include in the amount of the grant to the States which are relatively underdeveloped an amount which, if prudently expended on development, would induce a greater rate of economic development than in the already prosperous States. This method is rather cumbersome, however, and would mean that part of the grant to this type of State would be conditional upon its being used for a specific purpose. A more satisfactory approach would be to include an allowance for greater than average expenditure on debt charges when calculating the need for services supplied by the governments concerned. In order to prevent this becoming a conditional grant, some organisation of public borrowing programmes would be required. In other words, it would be necessary to permit the poorer States to borrow proportionately more than the wealthier States in order that they may "catch-up" on development. This would probably require the organisation of

a body to determine within reasonable limits the extent to which each State could borrow money for public capital investment purposes.

This function could perhaps be entrusted to the body responsible for the determination of the needs of each State, particularly as it relates, so far as interest and sinking fund payments are concerned, to relative financial needs. Care would have to be taken, however, to ensure that the maximum degree of independence was retained by the State Governments. If the borrowing of the State Governments were unrestricted, it would need to be understood that proportionately greater borrowing by the poorer States would be permitted and the charges would represent legitimate financial needs.

The major problems which would have to be considered by any authority which undertakes to distribute the total amount of revenue made available each year by the Federal Government between the several State Governments have now been mentioned. It has not been the purpose of this analysis to attempt to supply an answer to every problem with which a Federation will be faced in its financial relationships. Many of the problems which have not been mentioned here will need to be solved with reference to the peculiar circumstances which exist in each Federation. However, it is thought that the broader matters which have been raised and possible suggestions for solutions made are the problems which are common to all Federations in which the Federal Government is financially superior to the governments of the several States which comprise the Federation.

The brief analysis of the financial problems which can be expected to arise in a Federation, together with the suggested principles and methods by which a solution can be reached has now been completed. It would be impossible to deal adequately with such a complex problem in a brief essay such as this. Some of the matters which have been summarily dealt with warrant at least a full chapter for adequate treatment. The study of principle and methods can well be regarded as complete in itself, and if the main purpose had been to confine the analysis to this aspect, a much fuller treatment of the subject could have been given in the preceding chapters.

The major object of this study is, however, to develop first an outline of the principle involved and secondly to examine the financial organisation of the Australian Federation in the light of these principles and methods which have emerged. It is proposed that the second part of this objective should be attempted in the following chapters. Again, in the space available it will be impossible to make a complete critical analysis of the Federal-State financial relations in the Australian Federation. Attention must be concentrated on the organisations established for this purpose. Any omissions will be deliberate and must be regarded as being of secondary importance.

PART 2

EXAMINATION OF THE PAYMENT OF GRANTS
FROM THE COMMONWEALTH TO THE STATE
GOVERNMENTS IN THE AUSTRALIAN FEDERATION
IN THE LIGHT OF THE PRINCIPLES
WHICH HAVE EMERGED.

CHAPTER 6

THE INITIAL PERIOD - 1901 to 1927

In order to provide a background for a critical analysis of financial relationships between the Commonwealth and State Governments in Australia, it will be necessary to examine briefly the financial provisions of the Australian Constitution.¹ All aspects of Federal-State financial relations are in some way connected with, or influenced by these constitutional provisions and therefore a comprehensive knowledge of them is necessary for an understanding of the implications of the form of Federal-State financial relations which has arisen out of the Constitution.

The formation of the Constitution, including the financial provisions, passed through three main stages - the first draft prepared by a National Convention in 1897, a second or amended draft resulting from the convention of 1899 and which was submitted to and rejected by the people in the first constitutional referendum, and the final draft which was the second draft altered in a few significant aspects by a meeting of Colonial Premiers in 1900 and accepted by the people in the second referendum held later in that year. Although there were some material differences between the financial provisions of the first and final drafts, it will not be necessary to study the earlier formulations. While they undoubtedly had some influence on the final decisions, they have had little or no direct effect on financial relationships since Federation, which is the subject matter of this essay. Furthermore, no attention will be given to the forces and conflicts which led up to the framing of the Constitution. These and related aspects have been adequately surveyed in other publications.² In short, this Part will consist of a critical survey of Federal-State financial relations which exist at present, not an historical examination. In some ways it will be inevitable that the manner in which the analysis is made will be to deal with the different forms of payment as they emerged chronologically. However, it is not intended to be an historical survey in the true meaning of the term. It would be illogical to examine some recent development before those which have been in operation since Federation.

In the distribution of the functional powers, which was one of the main matters to be decided in drawing up the Constitution, it was agreed from the outset that the Federal Government should be given control of international trade and hence the imposition of a tariff and collection of customs and excise duties. Other functional

1. The Constitution of the Commonwealth of Australia is printed in each edition of the Year Book of the Commonwealth of Australia. See, for example, No. 39 pp. 8 - 26.

2. See, for example, "The Future of Australian Federalism", by G. Greenwood.

powers were to be transferred to the Federal Government, but it was envisaged that the revenue of the Federal Government would usually be greater than necessary expenditure, and therefore provision would need to be made for the transfer of surplus Federal revenue to the States. The problem concerning the basis upon which this surplus revenue should be divided between the States had then to be considered.

The Constitution dealt with the transfer of surplus revenue from the Commonwealth to the States in two major period divisions. The first was to be limited to ten years after the establishment of the Federation which was to be regarded as the period of transition. During this time, specific limits were to be placed on the Federal Government as regards its revenue and expenditure policy and the amount which was to be available for transfer to the States. After the expiration of this period, the Federal Government was to be given absolute discretion in the field. The Sections of the constitution which dealt with Federal- State financial relations were 87, 88 89, 93, 94, 94, 95 and 96. Other Sections would have some influence on these relations, but the Sections mentioned are those which deal exclusively with the financial problem. Of these Sections, all but two, 94 and 96 relate exclusively to the first ten years of Federation.

Section 87 provided that for ten years after the establishment of the Federation, and thereafter until the Parliament otherwise provided, at least three-quarters of the customs and excise revenue of the Commonwealth was to be returned to the States. Section 88 said that uniform duties of customs and excise were to be imposed within two years of the establishment of the Commonwealth and, in conjunction with this, Section 89 stated that until such time as uniform duties were imposed, the Commonwealth should collect customs and excise duties on behalf of the States and that the amounts so collected should be paid to the States less the actual amounts expended on transferred functions in each State and a per capita portion of the cost of the original powers of the Commonwealth.

For the first five years after the imposition of uniform duties, the Commonwealth was required to record the amount of duty paid on goods imported from outside Australia and entering consumption in each State and pay this amount to the States after deducting, as in the period before uniform duties, the actual costs incurred on behalf of each State in performing the transferred functions and a per capita portion of the cost of original powers. This was laid down in Section 93. Section 95 made special provision for Western Australia as it was recognised that this State would suffer most from the abolition of interstate duties. This Section provided that during the first five years after the imposition of uniform duties, the Government of Western Australia could impose duties on the goods entering the State from other States. It was stipulated that in the first year of this period, the rates of such duty were not to exceed

those in force in the last year prior to uniform duties, and that they should diminish by one-fifth in each subsequent year so that they would completely disappear at the end of the five-year period.

These, then were the constitutional provisions relating to the transfer of surplus revenue from the Commonwealth to the States during the first ten years of Federation. It can be seen that within this period there were several sub-periods which are not completely defined. Section 87, stipulating that the States should receive at least three-quarters of Federal income from customs and excise duties was to operate throughout the whole period. The provisions relating to the repayment of net collections during the period before uniform duties were imposed was limited to two years at the most, while the next sub-period was to last for five years, during which the repayment of three-quarters of customs and excise revenue was to be determined by the "book-keeping" method. For the remainder of the ten-year period, which might be anywhere between three and five years according to the time which elapsed after the commencement of Federation and before uniform duties were imposed, Section 87 was still to operate but the distribution of the total amount was to be in accordance with Section 94, which stated that after five years from the imposition of uniform duties, the distribution of the surplus revenue was to be on such basis as the Federal Parliament thought fair.

Thus for at least five, and possibly seven years after the establishment of Federation, a minimum amount was fixed for distribution, and the principle and method by which the distribution was to be made was unequivocally fixed by the Constitution. It ensured that the Commonwealth would need to levy rates of duty which were sufficiently high to yield four times the amount required to meet its necessary expenditure, and in this way it was provided that the three-quarters of such revenue which was returnable to the States would be fairly substantial. It can be said that but for two Sections of the Constitution, this represented the application of the compensation principle of redistribution. The exceptions were first, the special provision made in the case of Western Australia and secondly, the insertion of Section 96. This stated that for ten years after the establishment of the Commonwealth, and thereafter until the Federal provided otherwise, the Parliament could grant financial assistance to any State on such terms and conditions as it thought fit. It meant in effect, that during this initial book-keeping period, the Federal Government could use any surplus revenue available after the three-quarters of customs and excise revenue had been appropriated for return to the States according to the book-keeping method, for making conditional grants to any State which it thought was in need of additional revenue. If adequate funds were found to be available, this Section could have been used to make it possible for the Federal Government to modify the principle of payment for loss incurred which was

implied in the other Sections relating to financial relationships in this period.

For the remaining three to five years of the first ten years of Federation, the "minimum amount" provision of Section 87 still applied, but it was possible for the Federal Government, if it so desired, to adopt any principle of payment it chose. After the expiration of the ten years during which Section 87 operated, payments from the Commonwealth to the States were to be governed entirely by Sections 94 and 96. In some ways it would appear that the provisions of these two clauses cover the same ground. They both gave the Commonwealth discretion to make grants to the States, but the impression is gained that it was intended under Section 96 to make conditional or specific purpose grants to any State, and the surplus revenue for distribution under Section 94 would be determined after the payment of those grants had been made. The grants resulting from the distribution of surplus revenue would be unconditional and all States would participate. Provision thus existed for the Federal Government to adopt any principle and method it chose for the payment of surplus revenue to the States after the expiration of, at the most, seven years of Federation.

While it is not the intention to examine here the motives which prompted the framers of the Constitution to adopt this line of approach to the problem which confronted them, mention can be made of the main conflicts which it can be assumed were operating. It would appear that the framers of the Constitution felt concern at the possibility of State revenues being drastically reduced following the commencement of the Federation. This would not be very serious if it was the result of the imposition by the Commonwealth of lower customs and excise duties, for in such a case, the Treasury loss would be greater than the community loss in the State concerned, and the difference could be recovered by increasing taxation in the fields of taxation remaining to the States. The danger they probably envisaged would arise if Federal expenditure on the administration of original powers became materially greater than anticipated, or if different interpretation of transferred powers resulted in increased expenditure on those functions. Whatever the motive, it was apparently thought advisable to place some restriction on Commonwealth revenue and expenditure during the transitional period. In the draft of 1899, the operation of Section 87 was not limited to a period of ten years. It was to continue for the duration of the Federation or until the Constitution was amended.

This restriction on the Commonwealth and the implied necessity for a restrictive tariff to finance Commonwealth activity from the remaining quarter of customs and excise revenue, was one of the arguments used by the opponents of the Constitution, particularly in New South Wales, the free-trade State, against its adoption in the

first constitutional referendum. The Premiers' Conference of 1900 altered this provision to limit its operation to a period of ten years after the commencement of the Federation, and they also inserted a new Section 96. The amended Sections were acceptable to both the electors and the Parliaments of the several States. It can be said that the nature of the financial provisions of the Constitution grew out of the conflict which existed between certain States - some opposed to any provision which would make it necessary for the Commonwealth to impose high rates of duties, and others opposed to any provision which would reduce their revenue. Consequently, the result was a compromise.

No serious consideration was given to the incorporation of the principle of payment according to relative financial needs in the Constitution, with the possible exception of the inclusion of Section 96, virtually as an afterthought. None of the wealthier States expressed willingness to surrender portion of their revenue to assist the weaker States. It would even appear that the poorer States would not have been willing to accept this kind of assistance. Probably it was in opposition to the political philosophy of the time. Where consideration was given to support of the financially weaker States, it was in terms of special purpose grants to meet special difficulties. The case of the special provision to Western Australia illustrates the point. It would have been possible for the same provisions relating to uniform duties and free interstate trade to be applied to Western Australia as in the case of the other States. The deficiencies which Western Australia would suffer could then be made good by the Federal Government under Section 96 of the Constitution. However, it was felt necessary to insert the special provision in the Constitution in order that Western Australia would be satisfied that its revenue was protected, at least for some time after Federation.

It is abundantly clear that the intention was that the distribution of surplus revenue was to be according to the compensation principle, or some variation of this principle, such as per capita grants, although some small recognition was given to the fact that some States might need additional assistance to compensate for the extra disabilities they might suffer as a result of Federation. It was probably envisaged that the administrative difficulties associated with the book-keeping system would grow with the Federation, and that after the transitional period had been successfully negotiated, the Federal Parliament would adopt a similar system which would be simpler to operate but would give a close approximation to the result obtained by the book-keeping method.

In this brief survey of the financial provisions of the Constitution and the principles of payment to the States involved, two provisions have been omitted, one of which has played an important

part in Federal-State financial relations in recent years. This was Section 51(ii), which gave the Commonwealth power concurrently with the States to make laws with respect to taxation but "so as not to discriminate between States or parts of States." The other, which is less important from the immediate viewpoint, is Section 105, which gave the Commonwealth power to take over all or part of State debts existing at the time of the establishment of the Federation, and to deduct the interest cost of such debts from the proportion of surplus revenue due to each State. These provisions are not directly related to the payment of grants by the Commonwealth to the States, but as will be seen later, the former has come to influence the amount of revenue available for distribution.

Summarising the implications of the financial provisions of the Constitution as regards the principle of payment of surplus revenue to the States, it can be said that while it was stipulated that the Federal Government was compelled to adopt the compensation principle in the early years of Federation, thereafter it was free to adopt whichever principle it chose. The remainder of this Part will be devoted to an analysis of the types of payments which have been used, and more particularly, those which are being used at present, to determine the extent to which the need for the adoption of the principle of payment according to relative financial need has been recognised.

It will not be necessary to dwell at any length on the period which finished with the expiration of the five-year "book-keeping" period. During this time the Commonwealth had no alternative but to adopt the principles and methods of disbursement which were laid down in the Constitution. It was compelled to return in total, three-quarters of customs revenue, and the distribution was to be according to collections in, or on behalf of each State, less expenses incurred in each State for transferred functions, less a per capita distribution of the cost of original functions. If the Federal Government had a surplus available for distribution which exceeded three-quarters of customs and excise revenue, there were two alternative methods of disposing of this additional surplus which could be adopted. The first was to treat the whole amount as available for distribution according to the book-keeping method. That is, a record would be kept of all revenue collections and expenditure in, or on behalf of, each State, and the balance remaining in each case would be distributed accordingly. In other words, the principle of payment as compensation for loss would be adhered to in its entirety. The second alternative would have been for the Federal Government to make special grants under Section 96 of the Constitution to the extent of the amount by which surplus revenue exceeded three-quarters of customs and excise revenue. These grants would be treated as expenditure on the performance of original functions and each State would contribute to the cost on a per capita basis. Thus it would have been possible for

the Federal Government to modify the adverse effects of strict adherence to the compensation principle as laid down in Sections 89 and 93 of the Constitution.

In fact, during the period under review, the Commonwealth adopted the former alternative. In 1905-06, for example, Commonwealth net customs and excise collections totalled £8,749,000, while the total amount returned to the States was £7,385,000, or 84½% of collections. This means that about £830,000 could have been disbursed according to Section 96 while still conforming to the provisions of the Constitution. The determination of the distribution of this additional amount could have been according to the principle of relative financial needs, but the Federal Government chose to adopt the principle of payment for loss of revenue incurred.

It is evident that before Federation, there was considerable inequality between States, and this was maintained, if not emphasised, during the period of the book-keeping method of distribution. The following table ³ shows the relative positions of the several States in 1899-1900 and 1905-06:

Effect of Federation on State Revenues 1899-1900 to 1905-06

STATE	1899 - 1900		1905 - 06	
	Net Customs & Excise Rev. X	State Taxn. per head;	Amt. Returned by C'wealth	State Taxn. per head;
	£'000	s. d.	£'000	s. d.
N. S. W.	1,480	13 0	2,742	17 7
Victoria	2,061	14 11	2,095	17 9
Queensland	1,394	15 4	1,858	18 9
Sth. Aust.	638	14 6	562	19 0
West Aust.	842	13 9	872	20 6
Tasmania	477	12 10	256	27 9
Total	6,892	--	7,384	--

X - Collections, less cost of functions subsequently transferred to the Commonwealth.

One of the reasons for the wide variation in the change in incomes of the several States from these sources was the wide variations in the severity of customs duties which existed before Federation. These variations are clearly evident from the next table. ⁴

3. Source - Statistics of Tasmania for 1899 - Appendix B, pages 19, 22 and 24; Statistics for 1905-06, Appendix B, pages 19 and 22.
 4. Source - Statistics of Tasmania for 1900 - Appendix B, page 19.

Severity of Customs Duties - Australian Colonies - 1900

Colony	Imports per head			Customs Revenue per head			Index of Severity; (All colonies= 100)
	£.	s.	d.	£.	s.	d.	
N. S. W.	17	15	7	1.	3.	4.	48.5
Victoria	15	17	3	1	12	7	78.4
Queensland	14	13	1	2	14	9	138.0
Sth. Aust.	22	15	11	1	13	7	54.4
West Aust.	33	18	11	5	6	7	116.0
Tasmania	12	0	1	2	14	0	164.7

The implications of these tables is that with the establishment of uniform customs duties, the amount collected in the States which formerly had a high severity, would fall, and conversely it would rise in the States with a low severity. The exact extent of the variation would depend on the level of duties imposed by the Commonwealth. The effect of the adoption of the book-keeping method is very apparent in the case of Tasmania. Before Federation, revenue for necessary expenditure was raised by means of high customs duties. After Federation, this source of revenue vanished, and was only partially replaced by grants from the Commonwealth. Thus resort had to be made to higher taxation in other fields. Probably the actual relative inequality did not alter much between States, but it became much more apparent when a uniform tariff was introduced, as it concentrated the inequality in a narrower field. Another feature of this period which is not brought out by the above tables is that Commonwealth expenditure on functions transferred from the States rose over the period. In 1899-1900, expenditure on these functions by the Colonies was £790,000: Commonwealth expenditure in 1905-06 on the same functions was £1,115,000, while at the same time the cost of original functions was about £500,000.⁵ This increase in expenditure represented an additional burden on the taxpayer, which in most cases would have to be levied by the State Governments.

The inequalities between States which existed at the commencement of the Federation could have been overcome, to some extent at least, by the use of surplus Commonwealth Revenue to make grants to the more necessitous States. The distribution of

5. Source - Statistics of the State of Tasmania for the year 1905-06; - pages 25 and 28.

the surplus according to the compensation principle ensured that inequalities which existed before Federation were continued in this period. While the Federal Government was in a position to correct this to some extent, it was hampered by the Constitutional provisions which allocated by far the larger portion of surplus Commonwealth revenue according to the principle of compensation for loss. Thus, the degree to which the Federal Government could modify the effects of the principle in these years was limited.

Uniform duties of customs and excise were imposed by the Federal Government as from 9th. October, 1901. Thus the five-year period during which the book-keeping method was to operate would continue until at least 8th. October, 1906. Thereafter, the Commonwealth was free to distribute its surplus revenue at its own discretion, but until the end of 1910, this surplus revenue had to equal at least three-quarters of net collections of customs and excise revenue. The Federal Government continued the book-keeping method for the year 1907-08, and in 1908 it passed the Surplus Revenue Act, which provided for the continuation of the book-keeping system, and also that any surplus revenue available after the three-quarters of customs and excise revenue had been paid, was to be distributed between the States in proportion to their populations. However, in the same year an Act was passed authorising the Federal Government to pay old-age pensions, and although this Act was not to operate until the beginning of the 1909-10 financial year, an amount of £656,000, equal to the amount of surplus revenue in excess of three-quarters of net customs and excise collections in 1907-08 was transferred to a Trust Fund to meet the future cost of these pensions. The Constitutional legality of this transfer was challenged, but the action of the Commonwealth was upheld. Consequently, in 1908-09, the amount of revenue transferred to the States was exactly equal to three-quarters of net customs and excise collections. The provisions of the 1908 Surplus Revenue Act concerning the distribution of this further surplus revenue did not come into operation.

The year 1909-10 was to be the last in which the Braddon Clause was to operate, and completed the ten year period during which the Commonwealth Government was obliged to transfer three-quarters of its customs revenue to the States. Since 1906, it had voluntarily continued the book-keeping method of determining the amounts to be paid to the States, and by so doing, had automatically continued to apply the principle of payment as compensation for loss of revenue resulting from Federation. No attempt was made to redistribute revenue received and available for distribution to the States, and therefore it must be assumed that

the inequalities which existed before Federation were still evident. In fact, it would appear that these inequalities had even been slightly accentuated. This can be seen from the following table which compares gross revenue per head of population in all States in 1899-1900 and in 1909-10, and also the revenue per head received by each State from taxation other than customs and excise:

Total Revenue and Revenue from Taxation per head - by States⁶
1899-1900 and 1909-10

State	Total Revenue		Revenue from Taxation (other than customs etc.)	
	1899-1900	1909-10	1899-1900	1909-10
New South Wales	£ 7 7 0	£ 8 19 4	£ 13 0	£ 15 1
Victoria	6 6 1	6 11 11	13 11	16 8
Queensland	9 10 3	8 18 9	15 6	20 5
Sth. Aust.	7 8 6	9 13 10	17 1	23 1
West Aust.	16 16 2	13 7 5	14 3	24 7
Tasmania	5 4 11	5 8 0	11 0	22 6

From this table it can be seen that the States which could be expected to be the most prosperous, New South Wales and Victoria, increased their revenue per head considerably and taxation per head only slightly. Queensland, Western Australia and Tasmania showed a falling off in total revenue per head and taxation increased considerably. While it must be admitted that this table does not show the full picture, it is ample verification of the assertion that the principle of payment as compensation for loss incurred will not reduce any inequality which exists before its introduction. It is suggested that any superficial examination of financial needs that could have been made in 1910 would have revealed that the need for financial assistance from the Commonwealth was relatively far greater in, for example, Tasmania than in New South Wales or Victoria. This alone would have been sufficient justification for the partial deviation at least, from the use of the compensation principle.

It must be remembered, however, that the Commonwealth Government was aware that the effects of Section 87 would soon be over and some revision of the whole system of Federal-State financial relations would be necessary. It may have been thought that until the time came for the introduction of a completely new method, it would be simpler to continue the existing method. A second influence would be that the Federal Senate, which was supposed to be the body responsible for the protection of State rights, had not proved to be as effective as anticipated, and in the Lower House, the two States which would stand to lose the most revenue from the adoption

6. Source: - Statistics of Tasmania, 1899, Appendix B p. 19 and Commonwealth Year Book No. 4, pp. 827 and 829.

of the principle of payment according to financial needs, New South Wales and Victoria controlled forty-nine of the seventy-five seats. It would therefore be fairly difficult for the Federal Government, even if it were so inclined, to introduce legislation to help the poorer States at the expense of the richer. Consequently, by 1910, the end of the first period, nothing had been attempted to bring about equality of taxation burdens or services supplied as between the States by manipulation of the distribution of surplus Commonwealth Revenue. It is true that equalisation had taken place in the fields in which the Federal Government operated, such as the levying of customs and excise duties and the payment of old-age pensions, but this equality was only achieved at the expense of greater inequality in fields of taxation and services supplied by the State Governments.

In the years which preceded the expiration of Section 87, several conferences of the State Premiers and the Federal Prime Minister were held to attempt to determine a method of securing Federal support for State finances. In 1909 an agreement was reached between the Prime Minister and the State Premiers by which it was agreed to amend the Constitution to introduce a new scheme to replace the provisions of Section 87. The reason why it was thought necessary to incorporate the agreement in the Constitution was because "it was imperative that the financial relations of the Federal and State Governments - which, under the Constitution were determined only in part and for a term of years - should be placed upon a sound and permanent basis." In essence, the agreement provided that the Commonwealth should pay to the States a sum of twenty-five shillings per head of population annually. Special provision was made in the case of Western Australia where, because of its large customs revenue, a special annual payment of £250,000 for 1910-11, diminishing by £10,000 in each successive year was to be made. Half of this amount was to be subscribed by the States, including Western Australia, from their subsidy of twenty-five shillings per head. The other half was to be subscribed by the Commonwealth.

Although the referendum which was to incorporate this agreement in the Constitution rejected the proposal, the Federal Government passed in 1910, the Surplus Revenue Act which brought the provisions of the agreement into force from 1st. July, 1910, for a period of ten years and thereafter until the Parliament otherwise provided. The Act also stipulated that if any surplus revenue remained to the Federal Government after the payment of the per capita grant it should be distributed to the States in proportion to the number of their people. The immediate effect of the change from the book-keeping method to the per capita method of distribution can be seen from the following table which shows the amounts paid to the States by the Commonwealth in 1909-10, the last year in which the book-keeping method operated, and in 1910-11 and 1911-12, the first two years of the operation of the per capita method:

Commonwealth Payments to the States - 1909-10 to 1911-12. (£'000)⁷

State	1909-10	1910-11	1911-12
New South Wales	3,480	1,955	2,047
Victoria	2,109	1,617	1,667
Queensland	1,099	692	761
South Australia	843	515	512
Western Australia	708	591	600
Tasmania	253	233	237

The immediate effect was to reduce the total amount payable to the States by £2,889,000, but more important was the effect on the States separately. New South Wales and Victoria suffered most. Together their reduction was £2,117,000. Tasmania was least affected by the change.

The implication of the reduction in the absolute amount payable to the States as a whole or individually is not the immediate concern of this analysis. It has been shown earlier⁸ that the relative financial positions of the Federal and State Governments will be determined by the distribution of functional and financial powers at the time of the formation of the Constitution. The share of revenue and expenditure accruing to the Federal Government will result from the allocation of powers which are considered to be nation-wide in their impact, and if the financial resources of the Federal Government are greater than its necessary expenditure, the balance should be disbursed to the States. The severity of taxation burdens and the extent of expenditure on services supplied by the Federal Government and State Governments must be regarded as complementary, so that given a certain amount of revenue, whether raised and expended by either authority, as a first approximation it can be said that the same overall standards of services are supplied. If the Commonwealth takes over a certain service, the States are relieved of the expenditure involved. On the other hand, if the Commonwealth introduced a new service, it in effect forces the States to pay for it from the revenue formerly accruing to them and their expenditure on other services must be reduced. In effect, a new service is given by the Federal Government in place of one formerly given by the States, or alternatively, the States must raise additional revenue from taxation in order to give the same service as before. It can be said that unless one authority operates more efficiently than the other, the community as a whole is no better or no worse off than before. Within the community a different group of people may be deriving more benefit, but taking the communities as a whole, there will be very little difference.

It has, however, been stated previously that it is the essence of a Federation that the States should retain a maximum of

7. Commonwealth Year Book No. 6, p.800.

8. See above, pp.8 ff.

independence, and therefore the assumption of functions by the Commonwealth which force the States to reduce their expenditure on the provision of services must be regarded as detrimental to the successful operation of the Federation as a whole. In the particular case of the Australian Federation in 1910, one of the important factors which influenced the Federal Government in reducing the amounts payable to all States was that the Federal Government had decided to institute the payment of old-age pensions. Provision had been made for it to act concurrently with the States in this matter in Section 51 of the Constitution. Queensland, New South Wales and Victoria were already paying such pensions, and therefore the action of the Commonwealth relieved them of certain expenditure in addition to the reduction of revenue. To the extent that other States lost revenue for this reason, they were obliged to reduce services or increase taxation.

The effect was that the Federal surplus revenue available for distribution to the States was to be smaller than previously, but more significant, there was to be a new basis for the distribution of the surplus to the States. The adoption of the per capita method of distribution was in fact the adoption of a variation of the compensation principle, but it operates under one major assumption which, if incorrect, can produce results very different from the adoption of the pure compensation principle. The assumption is that all States contribute to the revenue which is to be disbursed in proportion to their populations. In Australia, at the end of the book-keeping period this was not so. If the amount per head of population returned to the States in 1909-10, when the pure compensation principle was operating, is taken as an indication of the relative amounts contributed to Federal Revenue, it is seen that New South Wales contributed £2.15 per head; Victoria, £1.65; Queensland, £1.90; South Australia, £2.13; Western Australia, £2.66; and Tasmania, £1.31. Thus, the differences were considerable. It can be assumed with some confidence that the greater the contribution of a State, the less the need for assistance. This does not follow inevitably, as witness the case of Western Australia where its isolation and the nature of its resources made it necessary for it to import most of its needs and hence contributed more than the average to the Federal revenue through customs duties while its needs were fairly great. Nevertheless, the amount of the contribution may be taken as a reasonable indication of relative needs.

If, under conditions of varying relative contributions to the revenue of the Federal Government, a distribution of the surplus is made according to the size of the population in each State, there will inevitable be some redistribution of the financial resources of the Federation as a whole which favours the States whose needs are greatest. The adoption of the method of per capita payments in Australia in 1910-11 meant that the relative positions of the States which received least under the book-keeping method, was considerably

improved. This is illustrated by the following comparison of State taxation per head in 1909-10 and 1911-12:⁹

<u>State.</u>	<u>1909-10</u>	<u>1911-12</u>	<u>Increase</u>
New South Wales	£- 15 2	£1 2 6	£ - 7 4
Victoria	£ - 17 0	£1 2 1	£ - 5 1
Queensland	£ 1 0 3	£1 5 4	* - 5 1
South Australia	£ 1 4 3	£1 6 2	£ - 1 11
Western Australia	£ 1 5 4	£1 3 11	-£ - 1 5
Tasmania	£ 1 11 5	£1 15 2	£ - 3 9

It can be seen that the State which lost most from the adoption of the new method, New South Wales, increased taxation more than any other State. Thus, the use of per capita grants, taken in conjunction with greater expenditure by the Federal Government on a uniform basis throughout the Commonwealth, did go some way towards reducing the inequality which existed. However, it must be recognised that there can be no accuracy with the adoption of this method. Greater than average needs are recognised as being present in the States which contribute least per head of population to the common fund, but it makes no attempt to measure and correct exactly the degree of inequality. It may even accentuate it in some circumstances.

The adoption of a per capita method of disbursing the surplus revenue of the Commonwealth can be questioned on another ground. The proposal was for a fixed per capita amount to be disbursed for a period of at least ten years, and for the reason that it was fixed, it could not be a true disbursement of surplus revenue. It is inconceivable that for this period the amount of twenty-five shillings per head would represent the exact amount of the surplus in any year. Admittedly, provision was made in the Surplus Revenue Act of 1910 for the per capita distribution of any surplus which remained after the payment of the fixed amount of twenty-five shillings per head to the States. However, this surplus never appeared, and the payments did not exceed this amount except in the case of Western Australia which received a special subsidy which has already been mentioned. It is apparent, therefore, that either the revenue resources or spending capacity of the Federal Government was sufficiently flexible to permit adjustment to provide that exactly the amount of the required surplus was produced. From the point of view of the Federation as a whole, such a procedure would have little or no effect on the net burden on the community. From the point of view of the States, however, it was significant. If, for example, the Federal Government had increased taxation to produce a surplus equivalent to say, fifty shillings per head, and distributed this amount between the States according to population, the States with lowest taxable capacity would gain relatively most. Thus, there would be a distribution which would produce a greater degree of equality than if the surplus was twenty-five shillings per head, and probably the net burden of the balance between

9. Commonwealth Year Book, No.6 p.809.

taxation drawn off and services supplied would be more nearly equal between the States. There is, however, a limit to the extent of this process. There may be a limit to the percentage of income which can be taken in taxation without adverse repercussions and if this is so, the limit may be reached before the desired state of equality. Furthermore, it may be both politically and economically unsound to raise taxation to a position approaching this level.

The alternative is for the Federal Government to reduce expenditure on the provision of its services in order to pay a greater per capita amount to the States. It is conceivable that such a procedure would have adverse effects if the cost of giving any particular service is relatively greater in one State than in another. It can be seen, therefore, that it may not be practical for the Federal Government to produce sufficient revenue to bring about the required equality when the distribution is to be made on a per capita basis. In fact, it is quite probable that it can never be produced if there is any considerable inequality between States.

During the first ten years of the operation of the method of distribution according to population, a considerable change was seen in the scope and extent of Commonwealth revenue and expenditure. The war of 1914-18 expanded the functions of the Federal Government tremendously, and in 1914 it entered the field of Estate Duties tax and in 1915-16 it levied a tax on incomes for the first time. A Land Tax had already been imposed in 1910-11. The imposition of these taxes by the Commonwealth on a uniform basis made it difficult for the States to vary their rates of taxation, particularly in the States where the rates of tax were already comparatively high. In other words, it increased the disparity between the taxable capacities of the States so far as State taxation was concerned.

After 1919, the Federal Government continued its method of per capita grants of twenty-five shillings per head although various proposals had been made by both the Federal and State Governments for the alteration of the existing method or the adoption of some new alternative. As early as 1919, the Federal Government had suggested reducing the amount of the per capita grant because of its increased commitments, but the main proposal of the Federal Government at this stage was that it should withdraw from some fields of taxation, and discontinue all grants to the States. The effect of this change, had it been adopted, would have been to reintroduce in principle the situation which existed before Federation. The per capita method did give some benefit to the weaker States, although it was probably not very significant.

It may be convenient at this stage to consider the effect of the operation of Section 96 of the Constitution during this period. Western Australia had been receiving a special subvention, half of

which was contributed by all States from their per capita grants and half from the Consolidated Revenue of the Commonwealth. During this time, the payment was regarded in the same light as the per capita grants, but since that time it has been thought of as equivalent to a special grant under Section 96. At least the portion contributed from Federal Revenue can be so regarded. This amounted to £125,000 in 1910-11 and diminished progressively until it stood at £55,000 in 1924-25.

In 1910 the Government of Tasmania claimed special financial assistance under Section 96 as a result of the findings of a Royal Commission which was appointed by the Federal Government to enquire into the finances of Tasmania. The Commission reported¹⁰ that "... the losses (arising from Federation) suffered by Tasmania .. are such as to render assistance to that State imperative." It recommended the payment of £900,000 spread over the ten year period 1911-12 to 1920-21 commencing with £120,000 in the first year and diminishing by £5,000 in each of the first five years and by £10,000 in each of the last five years. The Tasmanian Government submitted a claim in accordance with these findings. In 1912, the Federal Government passed the Tasmania Grants Act which made provision for the payment of £500,000 over the ten year period, commencing with £95,000 in 1911-12 and reducing by £10,000 in each successive year. In 1913, another Tasmania Grants Act was passed to pay a further £400,000 over the remaining nine years of the ten-year period commencing with £5,000 and increasing by £10,000 in each successive year. The effect of the combination of the two Acts was to carry out the recommendations of the Royal Commission and give Tasmania a special grant averaging £90,000 per year for ten years.

The grants to Tasmania were in effect the first made directly under Section 96 of the Constitution, and the first serious attempt by the Federal Government to depart from the principle of payment for loss incurred. However, the reasons given by the Royal Commission for the necessity for making a series of grants to Tasmania was as compensation for loss incurred as a result of Federation. An examination of the documents¹¹ relating to these grants seems to reveal a lack of understanding of the reason for the relatively disadvantageous position in which Tasmania was found after ten years of Federation. For example, it was repeatedly quoted that the average level of State taxation in Tasmania had more than doubled, but it was not recognised that this high level of taxation might only have been imposed to recoup Treasury loss which occurred when the right to levy customs and excise duty was handed to the Commonwealth, and that the net burden on the community was relatively no greater than before

10. Report of the Royal Commission on Tasmanian Customs Leakage, 1911, p. xii.

11. Report of the Royal Commission on Tasmanian Customs Leakage, 1911. Debate in the Commonwealth Parliament on Tasmanian Grants Bills, 1912 and 1913; Federal Hansard pp.4627 ff. (1912) and 1866 ff. (1913).

Federation. Consequently, it is contended that the grant was designed to offset in part the inequalities which existed, not necessarily as a result of Federation, but because they had become more apparent with the concentration of the inequalities in a narrower field.

It will be remembered that Section 96 gave the Federal Government power to make conditional grants to the States. When the Federal Parliament was debating the Bill to make the grants to Tasmania, the question of conditions was raised, and the then Prime Minister stated: "There is no doubt as to the power of the Parliament to impose conditions, but so far from recommending a course of this kind, I strongly deprecate it. At the same time, however, I should not like to commit myself or any of my colleagues to a declaration that at no time should the Commonwealth impose conditions in regard to a grant. Circumstances may arise under which it would be the duty of the Commonwealth Government and Parliament to make a grant of this kind conditional, but in the present case I do not think there is any warrant to do so."¹² This contention was apparently held by other Federal Ministers for at no stage was a condition attached to this type of grant. Similarly, the grant to Western Australia was unconditional. Special grants have been paid in each subsequent year to Western Australia and Tasmania, and South Australia first received a grant in 1929-30. This type of grant, as it operated in subsequent years, will be dealt with more fully in a later Chapter.¹³

The method of distributing surplus Commonwealth revenue according to the method of per capita grants continued on an annual basis until 1926-27. In the last few years before this time the Commonwealth Government had made several attempts to reach agreement concerning the future of Federal-State financial relations, but nothing had been firmly agreed, usually because of opposition on the part of the States to the Commonwealth proposals. Finally the Federal Government announced in June, 1926, its intention to introduce legislation which would authorise the cessation of per capita payments. Shortly afterwards, the Commonwealth put forward certain alternative proposals which, in the light of the action of the Federal Government in making a definite move to abolish the per capita grants, the States felt bound to accept. These proposals resulted in the Financial Agreement, 1927, the subject of the next Chapter.

Viewed in retrospect, the period up to 1927 can be regarded as the trial phase in the development of a system of Federal-State financial relations. It is notable that almost without exception, the methods of determining the amounts which the Federal Government would pay to the States which were in operation during this period are no longer in use. The payment of special grants under Section 96 has continued, but the method of arriving at the amounts of these grants is now very different. Similarly with certain special purpose grants

12. Federal Hansard, 24th December, 1912, p.4627.

13. Chapter 8, "The Commonwealth Grants Commission."

for road construction and maintenance, which will be mentioned again at a later stage.¹⁴ Generally it can be said that, from this time onwards, the structure of financial relationships began to assume greater permanence. The Financial Agreement of 1927 is still in operation today, and the Commonwealth Grants Commission which was formed in 1933 to recommend payments of special grants under Section 96, still functions upon the basis which it adopted at its formation. Uniform Taxation and Tax Reimbursement Grants were later developments.

By 1927, some progress had been made towards devising a system which would go some way towards bringing all States to a common level. The idea of making payments to States from Federal Revenue as compensation for losses incurred as a result of Federation was still dominant, but the method of application of the principle had resulted in a measure of redistribution of the total resources of the Commonwealth in favour of the weaker States. The per capita distribution of portion of Commonwealth revenue was operating to a limited extent towards this end, and this was supplemented by the use of Section 96 for the payment of grants to the more necessitous States. It must not be imagined, however, that the Federal Government was deliberately adopting a policy designed to bring all States to a common level of development. In large measure, the favourable results which were achieved were accidental. It is thought that the adoption of the per capita method was designed to give simplicity of administration and while those who were responsible for its introduction were probably aware of the redistributive effects consequent upon its adoption, and were quite satisfied with these effects, these were undoubtedly only second to the main reason which was simplicity of administration. The difficulties which had been associated with the book-keeping system of assessing the amount contributed by and expended on behalf of the States had been tremendous, and there was no satisfaction that the methods used had achieved the correct result.¹⁵

So far as the payment of special grants were concerned, their use was definitely a move in the right direction. It was realised that although the per capita distribution favoured the States which contributed relatively least to Commonwealth revenue, their position was still unsatisfactory when compared with the larger, more industrialised States. Although not specifically stated in so many words, the special grants were designed to permit the weaker States to operate at a certain minimum standard which was considerably below the standard operating in the wealthier States. Furthermore, the method of assessment of the amounts of the special grants was rather indefinite. On occasions Royal Commissions were appointed to recommend the amounts which should be paid, but it is significant that the amounts recommended were usually in the nature of a fixed payment over a period as long as ten years. In addition, the fixed grants were to be for decreasing amounts, which assumed that the financial position

¹⁴ See p. 780-88.
¹⁵ See, for example, the Report of the Royal Commission on Tasmanian Customs Leakage. 1911. Parliamentary Paper F13759.

of the States concerned would improve, over a short period, to an extent sufficient to make them independent of special financial assistance. This was evidenced in statements by some Federal politicians that the first special grant to Tasmania was to be regarded as a loan to be repaid at some future date.¹⁶

The same assumption operated with respect to the per capita grants. The Federal Government was always looking to the time in the future when the States would be independent of financial assistance from the Commonwealth. Whether this state of affairs was to be achieved by the Commonwealth gradually assuming control of some of the functions then performed by the States or by increased prosperity of all States is not clear, but it would appear that the payment of annual subventions from Commonwealth revenue for the assistance of State revenues could act only as a palliative, and not as a cure for the disbalance of functional and financial powers. In other words, this procedure, on its own, could do nothing permanent to correct the disbalance. At no stage in this period was attention given to regulation of the public borrowing policies of the various States,¹⁷ and on this aspect depended, in large measure, the extent of the development of the States, and the future capacity to increase taxable capacity and reduce the dependence of the population on services supplied from public funds.

Generally, in this period, the adjustment of the lack of balance between functional and financial powers of the Commonwealth and States was confused by the vagueness of the Constitutional provisions which divided powers between the authorities. At the outset the functional powers of the Federal Government were few while revenue was substantial, but the extension of the field of operation of the Commonwealth gradually reduced the amount of revenue available to the States. As pointed out previously, there was probably no absolute loss to the community as a whole from the change in emphasis, but it meant that the Federal Government was refusing to recognise its function as acting as an agent to collect revenue on a uniform basis and distribute it in the best interests of the Federation as a whole. Rather, it had decided to use its surplus revenue to increase its range of activities. To this extent it was bringing about equality in certain fields of taxation and services, but the effect was to concentrate the inequality into a smaller field of State activity, which included on the expenditure side such important functions as the provision of health and education services.

It is not the purpose of this essay to criticise the actions of the Federal Government in the expansion of its functions, but where these actions result in a reduction of its surplus revenue to the point where it is not in a position to bring about equality between the States through the distribution of its revenue, then it

16. See Federal Hansard, 24th October, 1912, pp.4626 ff.

17. See note p.120.

intrudes on the subject matter of the points under consideration. This seems to have been what was happening in the years before 1927. The Commonwealth concentrated on bringing about that measure of equality which could be obtained through expenditure of its own revenue. It was, however, bound to carry out the provision of services impartially between States, and therefore there could only be partial redistribution. This involved the introduction of new services administered by the Federal Government on a uniform basis, whilst leaving existing services as provided by the States on an unequal basis. It might be said that in the interests of Federation, if it was found necessary to expand Commonwealth expenditure to that extent, the correct action would have been to expand revenue accordingly to ensure that a sufficient amount would be available for the payment of equalisation grants. Admittedly, this would have been a further incursion into the independence of the States, but if this was necessary to bring about the desired equality, then it would have been justified. The correct action, however, would be for the Commonwealth to limit its functional powers to those which are truly nation-wide in their impact until equality was reached in the fields of State revenue and expenditure.

CHAPTER 7THE FINANCIAL AGREEMENT - 1927

As an alternative to the method of per capita payments to the States, the Federal Government submitted a proposal which was finally accepted by each Parliament and which is usually referred to as the "Financial Agreement". The original agreement was framed in 1927 and the power of the Commonwealth to make such an agreement ratified by the people in a referendum which gave rise to Section 105a of the Constitution. The original provisions were subsequently altered by certain Debt Conversion Agreements of 1931, and a further Financial Agreement of 1944.¹ The main points of the Agreement, which governs public borrowing at the present time may be summarised as follows:

- (1) A Loan Council was established² with the Prime Minister or his representative as Chairman, and the several State Premiers or their representatives as members to determine the amount, distribution and conditions of public borrowing. Each State was to have one vote and the Commonwealth two votes and a casting vote. If a unanimous decision were not reached, one-fifth of the total loan raisings in any year were to be available for the use of the Commonwealth Government, and the remaining four-fifths divided between the States in proportion to their net loan expenditure in the preceding five years.
- (ii) All loan raisings were to be managed by the Commonwealth on behalf of the Commonwealth and States. This was subject to some exceptions, such as borrowing by a State outside the Commonwealth subject to the approval of the Loan Council, or borrowing by a State within its boundaries from bodies established under Federal or State law. A State could use public monies for temporary purposes.
- (iii) Each Government was to submit annually to the Loan Council a programme showing the amount it desired to raise in that year. This was to exclude loans for the conversion, renewal or redemption of existing loans and temporary borrowing. Loans for the purpose of funding deficits were to be included but loans for defence purposes were excluded.
- (iv) The Commonwealth agreed to take over the public debts of the States as they existed on 30th June, 1927. The exact amounts involved were specified in the Agreement. Arrangements were also made for the complete taking over by the Commonwealth of State

1. See "Financial Agreement between Commonwealth and States", 1944, Commonwealth Parliamentary Paper 3029.

2. A Loan Council had been in existence for several years previously. However it was a voluntary association between the Commonwealth and States and had no legal existence.

debts relating to property transferred to the Commonwealth under the Constitution. The States were to continue to be liable for the interest on the debt (other than that relating to the transferred properties) taken over by the Commonwealth, but the Federal Government was to contribute to each State an amount equal to the amount of the per capita grant received by each State in 1926-27, the last year of the operation of that method, for a period of 58 years. A sinking fund of $7/6$ per cent, of which the Commonwealth would contribute $2/6$ per cent and the States $5/-$ per cent was to be established to extinguish the debt existing on 30th June, 1927, over a period of 58 years. With respect to debt incurred after 1927, the State and the Commonwealth would each contribute $5/-$ per cent to a sinking fund to eliminate the debt over 53 years.

- (v) The supplementary agreement of 1944 provided that where loans were raised to meet a revenue deficit occurring after 1927, the Commonwealth would make no sinking fund contribution and the State concerned would contribute to a sinking fund at the rate of not less than 4% per annum. Special provision was made for the redemption of Treasury Bills raised to finance deficits which occurred before 1st July, 1935.
- (vi) Sinking funds were to be controlled by a National Debt Commission and contributions to these funds were not to be accumulated but were to be applied to the redemption and repurchase of loan securities.
- (vii) Certain rules were made by the Loan Council regarding borrowing by semi-governmental bodies, and these were incorporated in 1936 to form a "gentlemen's agreement" which provides for submission to and approval by the Loan Council of all loan programmes of semi-governmental bodies proposing to borrow £100,000 or more in any financial year.

These are the main points of the Agreement which is still in force and has governed public borrowing in Australia from 1927 down to the present time. In addition there were other points of relatively minor importance, such as those governing the procedure of the Loan Council, certain aspects relating to the payment of interest and the establishment of sinking funds, repayment from State revenues of sinking fund monies which are applied to the redemption of loans converted at a discount, and so on. These and other matters have not been covered in detail because they have only an indirect effect on the relative position of State finances, which is the main concern of this analysis.³

The situation immediately prior to the introduction of the Financial Agreement was that the Federal Government passed the States Grants Act which abolished the obligation of the Federal Government to continue the per capita grants to the States. Failing acceptance by the States of the Commonwealth proposals, there was every probability that the States would receive no financial assistance in 1927-28 or

3. For full details, see "Financial Agreement between Commonwealth

subsequent years. In effect, the States had no alternative but to accept the Commonwealth's proposition. At the time, the representatives of the States resented the attitude of the Commonwealth Government in its approach to this problem, but in fairness to the Commonwealth, it had been endeavouring to come to some arrangement with the States since 1919. It would appear that the States had not been entirely cooperative in helping to arrive at a satisfactory solution. Constitutionally the Commonwealth was in a position to distribute its surplus revenue upon any basis it deemed fair. An earlier High Court decision had given legal backing to the action of the Commonwealth in transferring revenue to trust funds and this meant that if it desired, the Commonwealth could achieve the position whereby there was no surplus revenue to be returned to the States. Nevertheless, the States considered that it was their right to receive some of the revenue collected by the Commonwealth. Constitutionally this was not so, but undoubtedly it was in the interests of the Federation that the Commonwealth should use some of the revenue for the purpose of grants to the States.

There appear to be two major aspects of the 'Financial Agreement' which warrant detailed examination in this analysis of Federal-State financial arrangements in Australia. The first is concerned with the implications of the transfer of power in the field of public borrowing from the States to the Loan Council, and the second with the implications of the incorporation of Commonwealth payments of surplus revenue to the States in the Agreement, and the extent to which this is compatible or otherwise with the payments of grants from the Commonwealth to the States under the principle of payment according to financial needs. Substantially, the main concern is with the latter of these two aspects, but in some ways its importance cannot be fully appreciated until the wider implications of the first aspect have been examined.

Under the provisions of the Agreement, the States are to submit annually their borrowing programmes to the Loan Council. This Council, consisting of the Prime Minister of the Commonwealth and the Premiers of the several States, the former with two votes and the latter each with a single vote, first considers the programmes for all authorities as a whole. They will determine whether it is both possible and desirable that the total amount required by the Commonwealth and the States should be raised. If this is agreed, then no difficulty arises. The period of the loan, the rate of interest and other details are decided, and all authorities will receive the amount requested unless the market is not as productive as anticipated. In such circumstances, there will probably be some agreed amendment to the conditions of borrowing in order to bring forth the required amount. When the Council decides that the full amount of the combined programmes

can not, or should not be raised, it is necessary to apportion the total amount available between the States. The Financial Agreement provides that under these circumstances the distribution shall be by unanimous decision of the Loan Council, but if unanimity is not reached, then a formula shall determine the distribution. The formula divides the total amount between the Commonwealth and States in the proportions one-fifth and four-fifths. The four-fifths allocated to the States will be distributed according to the amounts raised for each State during the five years preceding the year under consideration.

Under the Agreement, the States automatically surrender their rights to determine the amounts they would borrow for the purpose of capital development and the term of borrowing to a Loan Council in the decisions of which each has but a small voice. Attention has been drawn on several occasions to the peculiar nature of the constitution and powers of the Loan Council.⁴ The argument put forward is briefly that by acceptance of the Financial Agreement, the Parliament of the States and the Commonwealth have delegated their powers to make decisions on matters relating to public borrowing to an extra-Parliamentary body consisting of the Premiers of the States and the Prime Minister of the Commonwealth. Once the Loan Council has made a decision, it is automatically binding on all Parliaments. Even in the event of one or more Parliaments disagreeing with any decision, they have no power to alter it or refuse to accept it. The only remedy to discipline their respective Parliamentary leaders and so prevent recurrence. Despite this peculiar type of delegation of powers, there does not appear to be any danger of a breach of democratic principles. The final decisions are made by elected representatives of the people and the Parliamentary leaders in the several States. The act of delegation was made by the Parliaments in full knowledge of the implications of their actions.

However, a more serious breach has occurred if the States were under the impression that they were surrendering borrowing power to the Loan Council while in fact they were surrendered to the Commonwealth Government. It would appear from a superficial study of the provisions of the Financial Agreement that the position of each State in relation to the Commonwealth is one of near-equality. This was the view which must have been taken by the States in 1927. According to the constitution of the Loan Council, the States, when acting as a coordination, can easily outvote the Commonwealth although unanimity is necessary under certain circumstances. Other sections of the agreement, however, give sole power to the Commonwealth to borrow money on behalf of the States and the Commonwealth. This implied that whatever the decision of the Loan Council regarding the amount that is to be raised the Commonwealth has power to decide whether or not the determined amount can be raised in the market or by other means.

4. See, for example, an article by R. C. Mills in the "Economic Record", May, 1929; also, "The Future of Australian Federalism" by R. C. Mills.

It may appear from this statement that there will always be a limit to the amount of investible funds available for borrowing by Governments. While it is not necessary to undertake a digression to discuss these aspects of public finance, it should be mentioned that in a technical sense there can never be a shortage of funds available for use by governments. If the required amount cannot be raised in the open market, the amount that is actually raised in this way can usually be supplemented by the issue of Treasury Bills by the Government with the assistance of the Central Bank. In Australia, it is the Commonwealth rather than the State Governments which can adopt this procedure because of its relationship with the Commonwealth Bank. Thus, the Loan Council may decide that the full programme submitted by all authorities should be raised, but that the market could not provide the full amount, and that the balance should be made up by the creation of credit. This latter decision is not, however, one which the Loan Council is competent to make. It lies within the field of activity of the Commonwealth Government, and while the Loan Council can request that the Commonwealth assist the loan programme in this way, the final decision will rest with the Commonwealth Government. It is the Commonwealth Government, not the Loan Council, which will usually decide the total amount which the market will provide, for in large measure, the Commonwealth Government is the market.

The powers which reside with the Commonwealth can be appreciated from an examination of decisions made by the Loan Council and the Commonwealth in 1951-52. In that year, combined programmes of the States and the Commonwealth submitted to the Loan Council amounted to £351m. The Commonwealth representatives suggested that with Commonwealth support, the market would yield only £180m. and of this, the Commonwealth Government was prepared, either directly or indirectly, to contribute £125m. Nevertheless, the States combined and outvoted the Commonwealth, and by a majority decision the Loan Council approved a borrowing programme of £247.5m. It was apparent that without further Commonwealth support, the effective programme for the year would be £180m., the amount which the Commonwealth was prepared to underwrite. Obviously the Commonwealth could have underwritten the programme to a greater extent, but chose not to do so. In this case it was stated that the issue of further Treasury Bills would create inflationary pressure which was undesirable at the time. In short, the Commonwealth has taken upon itself power to decide whether a certain amount of borrowing would be detrimental to the economy as a whole, whereas it is suggested that this is a function of the Loan Council. It is not intended to debate whether the action of the Commonwealth was right or wrong, but merely to demonstrate that the States have surrendered power to borrow, not to the Loan Council, but to the Commonwealth Government.

The second aspect of the way in which the Commonwealth Government has assumed control of decisions of the Loan Council relates to the distribution of the total amount which the Council has decided to raise by public borrowing in any year. The problem will not arise if the full programme submitted by the State Governments is agreed to. In this case, since all States are allocated the amount asked for, there is no need for a distribution by the Loan Council.

If the total amount asked for is reduced, however, the actual amount decided upon must be divided between the Governments of the States and the Commonwealth. If unanimous agreement concerning this distribution is not forthcoming, the distribution is made in accordance with Section 10 of the Financial Agreement. This specifies that the Commonwealth Government shall receive one-fifth of the total and the remainder shall be distributed between the States in accordance with the proportions of the totals which they received in the preceding five years.

In recent years, all State Governments would have suffered a reduction in the amount of loan money they received had this formula been called into operation. Customarily the Federal Government has required less than one-fifth of the total amount to be raised. The rest of its requirements for finance for capital investment projects are supplied from its current revenue. Therefore, if complete agreement were not forthcoming and the distribution were to be determined by the Formula, the Commonwealth could demand one-fifth leaving a lower amount for distribution to the States compared with the amount which would have been distributed with a unanimous decision.

The way in which this can work may be illustrated by reference to the actual determination in a particular year. In 1951-52 the total amount agreed to be raised by the Loan Council for distribution to the Commonwealth and State Governments was £225m. of which the Commonwealth required only £23m.. Had the Loan Council not reached unanimous agreement on the distribution of the remaining £202m., the Commonwealth could have demanded one-fifth of the total amounting to £45m. leaving only £157m. to be divided between the States. In that year the Commonwealth financed capital works from revenue to the extent of £111m. and so it would have been possible for the Commonwealth to have required their full one-fifth of the total.

From the point of view of the States, it was therefore highly desirable that agreement should be reached and automatic distribution of the total amount prevented. Furthermore, since the agreement of the Commonwealth is necessary for unanimity of opinion, any suggestion by the Commonwealth would have to be agreed to by the States. Thus it is possible for the Commonwealth to impose its will on the States so far as the distribution of the total amount agreed to is concerned.

In fairness to the Commonwealth Government it must be stated that up to the present time it has not imposed its will upon the States to this extent. But the possibility does exist and undoubtedly the States' representatives have this aspect in mind when determining the allocation of available funds. It is significant that the formula has not yet been used as a means of distribution. Some compromise is always reached by the States rather than suffer the consequences of the operation of the formula. It can therefore be seen that even in this matter the influence of the Commonwealth is greater than the two votes afforded its representatives would suggest. Thus it must be argued that while the wording of the Financial Agreement in the sections dealing with the procedure of the Loan Council ostensibly protect State rights in the field of public borrowing, the Commonwealth can in fact determine the total amount to be raised in any year and influence its distribution between States. Whether the States were aware of the possibility of this situation arising at the time when the Agreement was being framed is doubtful, and even if the States did recognise the surrender of autonomy in this field to the Commonwealth, they had little alternative but to accept the proposals.

From the States' point of view, although some independence had been surrendered, if not to the Commonwealth, at least to the Loan Council, there are some definite advantages to a scheme for coordinating borrowing by all governmental authorities in Australia. Formerly each State determined independently its capital investment requirements for each year and then entered the market under the most advantageous conditions available. Thus there was considerable competition for investible funds, which, under most circumstances were limited in volume. There was inevitably some bargaining through interest rates and it would be safe to say that this independent action by the States did have the effect of maintaining a higher schedule of interest rates in Australia than would otherwise have operated. For example, at 30th June, 1927, the average rate on outstanding debt for all States of the Commonwealth was £4/18/2%; at 30th June, 1949, the corresponding rate was £3/4/-%. While this is not conclusive evidence of greater efficiency in borrowing, as no consideration is given to the nature or the term of the debt and other factors, it does seem to indicate that coordinated borrowing has had some effect on the terms upon which money is lent to governments in Australia. This is probably due partly to the lack of considerable competition in the market and also to the greater security enjoyed because of the establishment of adequate sinking funds for the ultimate redemption of debt in all States and the Commonwealth. It can be said that but for the Financial Agreement, the States' developmental programmes may have been less advanced, as they would probably have been able to raise less than they actually did through the Loan Council, or their annual charges for servicing their debt would have been greater following

the higher rates of interest, although this might conceivably have been offset by lower sinking fund provisions.

As mentioned earlier,⁵ under the principle of payment of grants to the States by the Commonwealth according to financial need, one of the fields in which it is desirable that equality between States be obtained is that of development of natural resources. The way in which this may be achieved is by coordination of public borrowing and provision that the States which are relatively under-developed should be given the opportunity to borrow a relatively greater amount than the more advanced States. There are two sides to the achievement of this equality, the first relating to the granting of power to the under-developed States to raise more public loan funds per head of population than the other States in a loan market which is usually limited, and the second to the provision of the additional amounts necessary to meet annual debt charges which will result from the greater than average borrowing. The first of these will be considered here, and the second later in the Chapter when dealing with the impact of the Financial Agreement on the relative financial positions of the States.

A State which is poorly endowed with natural resources will probably find that its rate of development will be retarded compared with one which has an abundance of resources. Private capital will be attracted to the States which offer a greater yield for investment, and the average incomes of the poorly endowed State, and hence the income of its government will be lower than in the wealthier States. Therefore the States which have greatest need for public capital development will be the States which have least readily exploitable natural resources, to which private capital is not attracted in any considerable quantity. Furthermore, those States will find greatest difficulty in raising public capital, not only because of limited income with which to meet annual debt charges, but also because investors will be reluctant to lend to the government of a poorly endowed State when more attractive investments, so far as security is concerned, are offering in other States. It will probably be found that higher rates of interest will have to be offered to attract even the amount of borrowing that can be afforded. If one of the objects of the establishment of the federal form of government is to bring all States to a common level as regards development, standard of living, etc., then the payment of grants to the weaker States indirectly from the revenues of the stronger States will be only a palliative unless some attempt is made to smooth out the fundamental inequalities which exist in the extent to which each State is in possession of easily exploitable natural resources.

The establishment of the Loan Council to coordinate public borrowing in Australia offered the possibility of the develop-

5. See above, pp.30 ff.

ment of a scheme for assisting the weaker States to develop their resources at a greater rate than hitherto. If it is accepted that in most years the combined borrowing programmes of the States exceed the capacity of the loan market, then some form of rationing between States will be needed. Undoubtedly there will be many occasions when the market potential will exceed the total requirements, but in these circumstances, the poorer States can borrow as much as their revenue will permit, and therefore they may be able to maintain a rate of development comparable with that in the wealthier States independently of loan Council decisions. Where available funds are limited, however, the opportunity exists for the adoption of a principle of distribution which will permit the poorer States to borrow relatively more than their more fortunate neighbours. This does not mean that consideration should be given only to the relative stages of development of the various States. It would be impracticable to encourage the development of resources which offered little opportunity of productivity or improvement of standards at the expense of development in another State where the return would be much greater. However, within the bounds of reason, a policy could be adopted which would permit development of the weaker States which has been overlooked by private enterprise because the returns are not immediately forthcoming or because of the size of the capital investment required.

If it is accepted that this is to be the policy which a body such as the Loan Council in Australia should adopt with regard to the distribution between States of available loan money, then consideration should be given to its composition with the object of achieving the desired results. It would appear that its present composition - that is, the State Premiers and the Federal Prime Minister - does not offer much possibility for the adoption of this type of policy. It has been shown, however, that the Commonwealth representatives on the Loan Council are in a position to wield considerable influence over the distribution of loan funds which are to be raised, and it would be possible to achieve the desired results if the Commonwealth consciously adopted the policy of allowing the smaller States a greater than proportional share of the total amount available. However, it can be said that generally the present membership of the Loan Council is not conducive to the successful operation of such a policy. The representatives of the wealthier States will probably be jealous of their positions and anxious to retain leadership for political, if not economic reasons.

Since the decision to raise and spend money must be made by the elected representatives of the people, the power to determine loan programmes and allocate scarce financial resources can not be delegated by politicians to some other body such as a committee of experts. If such a body is established, it can act in an advisory capacity only. There seem to be two alternatives open in the selection of such an advisory body. The first is that it could be composed

of civil servants who are already advisors to the individual members of the Loan Council, while the second is that it could be an entirely independent body whose members have no direct responsibility or affiliation to any particular government. The first alternative suffers from the defect that, as in the case of the Loan Council made up of the State Premiers and the Federal Prime Minister, the decision would be influenced by State affiliation. The second does not suffer from this disadvantage and therefore has more to recommend it. Such a body could establish a series of principles and methods for the determination of the loan raising potential of the market and the need for public capital investment in each State in relation to that potential.

Difficulty might be experienced in obtaining effective operation of such a body where the Commonwealth Government, or any authority under its control represents a large portion of the investment market. When this situation arises it should be possible for the body of experts to determine, before making its recommendations to the Loan Council, the extent to which the Commonwealth is prepared to assist the market in the particular year for which the decision is required. This is the only way in which it would be possible for the power of the Commonwealth, whether real or potential, to use its position of influence in deciding the level of borrowing in the country, as a lever with which to influence the decisions of the Loan Council. The procedure would then be for the States and Commonwealth to submit their programmes to this body which would determine, by independent investigation, the market potential if the Commonwealth plays no part. If this potential was found to be less than the total programme, it would then approach the Commonwealth Government to determine the extent to which it or its agencies would support the market. If this is still insufficient to meet the total of proposed borrowings, the amount available from the open market and from Commonwealth sources could be divided between the States according to their needs. A report would be submitted to the Loan Council, and it would then rest with the Council to accept or modify the recommendations of the body of experts.

In this way it should be possible to overcome the major defects of the present system whereby the Commonwealth is in an omnipotent position and the State Premiers are unable to challenge Commonwealth estimates of the state of the loan market. All members would know within reasonable limits the amount of funds that would be available and it would be difficult for an individual authority to oppose a distribution determined by an expert body according to established principles, although some minor modifications would be inevitable. The Commonwealth representatives would still retain the power given to them by the operation of the automatic formula in the event of failure to reach unanimity, but there would be greater possibility of unanimity being reached without coercion, and

and consequently less chance of the will of the Commonwealth being felt unduly in decisions emanating from the Loan Council.

These are the main aspects of the provisions of the Financial Agreement relating to the establishment and procedure of the Loan Council. The suggested method of overcoming the disadvantages associated with the functioning of that body - the transference of sovereignty in the field of public borrowing from the States to the Commonwealth by way of the Loan Council - has been designed to operate within the framework of the existing Financial Agreement. It may be thought to be more effective to amend the present Agreement to give to the States more authority in Loan Council decisions, but the handicap will always be the extent of Commonwealth powers in other fields, particularly its superiority as a revenue raising authority which permits it to finance capital expenditure from revenue and its association with the central banking system. The permanent modification of Commonwealth powers in these fields would mean a complete recasting of Federal-State financial relations in Australia. Under existing conditions this would not be practicable.

The second major implication of the introduction of the Financial Agreement relates more directly to the current financial positions of the States. That is, to the effect it had on the current revenue position as opposed to the long-term debt position. The Agreement provided that for a period of fifty-eight years, the Commonwealth would pay to the States annually a fixed sum towards the interest on their debts as they existed at 30th June, 1927. Actually the terms of the Agreement in this respect were that the Commonwealth would take over the management of the debt but the States would still be responsible for the interest payments to which the Commonwealth would contribute the fixed sum mentioned above. In addition, the Commonwealth would contribute an amount equal to 2/6% on the existing debt towards a sinking fund designed to eliminate the debt over a period of fifty-eight years. The States were required to pay 5/-% on the debt into the same fund which was to be controlled by a National Debt Commission. On future borrowings, both the Commonwealth and States were to contribute 5/-% to amortise the loan over fifty-three years.

The amounts which the Commonwealth proposed to pay as a subsidy towards the interest bills to be met by the States represented the amounts which each State received in 1926-27 under the per capita method of distribution of surplus Commonwealth revenue. As seen in the previous Chapter, the introduction of the per capita payments had been a definite improvement over the book-keeping method, which had represented the application of the compensation principle in its purest form, and which had operated in the initial years of Federation while there had been no conscious move towards the adoption of the principle of distribution according to relative financial needs, the

acceptance of the per capita method had meant that there was some redistribution in favour of the financially weaker States.

One of the important aspects of the incorporation of the payments of surplus Commonwealth revenue to the States in the Financial Agreement was that the grants which had formerly been unconditional were now to be conditional in two respects. In the first place, they became special purpose grants which had to be used for the purpose of meeting the annual interest commitments. However, there was no serious limitation on the financial freedom of the States in this regard. Before 1927, each State had received a grant from the Commonwealth which was then paid into Consolidated Revenue where it lost its identity. In all cases, interest charges which had to be met from revenue exceeded the amount of the grant, and therefore the grants could even then be regarded as being used to meet interest charges. After the adoption of the Financial Agreement there was no change in the procedure except that the grant was specifically allocated to meet interest payments. Thus it can be said that the State actually lost nothing from the imposition of this condition on the grants they received.

A more serious condition, however, was that the grants were only payable in the event of the States agreeing to accept the other provisions of the Financial Agreement. That is, if the States agreed to submit their loan programmes to the Loan Council and abide by its decisions, contribute to a sinking fund at a fixed rate in order to amortise their debts, and abide by the other conditions, they would receive a certain sum as a contribution towards interest payments and sinking fund provision. It is apparent that there would have been no significant difference to the operation of the Financial Agreement if the provisions relating to grants had been omitted and the same amount paid to the States as an unconditional grant outside the Agreement. It must be concluded that its ability to make payments to the States from its surplus revenue was used by the Commonwealth to force the States to accept the Agreement which gave the Commonwealth some influence over State policy as regards public borrowing. It is not proposed to debate whether this action was justified or not. Undoubtedly there was need for some coordination of borrowing but it would probably have been more desirable for a scheme to be designed which the States would accept voluntarily rather than a scheme be imposed from above by the Commonwealth. The conditional aspect of the grant is not in accordance with the principles which it has been shown should operate to govern payments from the Commonwealth to the States, but the only condition which was of any significance was that which made payment conditional upon acceptance by the States of provisions which did not relate directly to the current financial position. In other words, this condition was not related to the way in which the grant was used and is not, therefore, of immediate relevance. The

condition providing that the money be used for interest payments is, as mentioned earlier, inconsequential.

From the point of view of their conformity with the most desirable principle of payment from surplus Commonwealth revenue, the grants included in the Financial Agreement cannot be considered in isolation. In fact, the fixed payments as contributions towards interest charges, the subsidised towards the establishment of sinking funds to amortise debts, and also the special grants which were being paid at this time under section 96 of the Constitution must be considered together. In the years preceding 1927, the use of per capita grants had gone some distance towards putting into practice the principle of payment according to relative financial needs. This had been supplemented by special financial assistance under section 96 to the two States, Tasmania and Western Australia and was extended to South

Australia in 1929 - 30.

The payment of a grant which is fixed in size for a period as long as fifty-eight can only be justified under any principle of

payment of surplus revenue if it is supplemented by other grants which are subject to some variation. In the first place it is inconceivable that a fixed amount would represent exactly the surplus revenue of the Commonwealth in future years. While it might represent the true surplus in the first year, inevitably in successive years the total payment would be either more than or less than the true surplus. Furthermore, it is highly improbable that the relative needs of the States would remain unchanged over such a long period. Therefore, if the interest payments had been the only form of payment, it could be said that they represented the application of the compensation principle without any definite attempt to determine the exact amount of compensation necessary. However, these grants were supplemented first, by Federal contribution to a sinking fund, and secondly by payment of special grants.

The inclusion of the provisions relating to payments by the Commonwealth of sinking funds contributions had the effect of increasing the amount which the Commonwealth would pay under the

Financial Agreement and ensuring that the Commonwealth contribution to the States' revenue would increase as their debts increased, and to some extent follow the increase which would have occurred had the per capita payments of twenty-five shillings continued. The following table compares the amount each State received from the Commonwealth under the Financial Agreement in 1951-52, and the amount they would have received in that year had the per capita payments of twenty-five shillings continued.

From this table it can be seen that so far as State revenue is concerned, the three less-populated States are slightly better off under the Agreement than under the per capita method of distribution. In total in 1951-52, the Commonwealth paid about £500,000 less under the Financial Agreement than under the method which operated

before 1927, but the total amount had been slightly redistributed in favour of the three numerically smaller and financially weaker States.

Payments to States under Financial Agreement - 1951-52

State	Payments under Financial Agreement (£'000) 6.	Equivalent of 25/- per Head (£'000)
New South Wales	3,898	4,195
Victoria	2,656	2,877
Queensland	1,430	1,526
South Australia	1,020	912
Western Australia	746	739
Tasmania	393	373
Total	10, 142	10,633

One other aspect of this matter is that under the Financial Agreement, the States were compelled to contribute to a sinking fund at the rate of 5/-%. Prior to 1927, some States at least were not providing for amortisation of debt at that rate.⁷ While it is undoubtedly desirable that regular contributions should be made for sinking fund provision, the introduction of the Financial Agreement probably meant that some States were suddenly called upon to pay more than previously from revenue for this purpose. In New South Wales, for example, in 1926-27 payments in interest and sinking fund contributions on a debt of £241m. were £8.7m; in 1929-30, the comparable figures were £13.7m. on a debt of £270m. This arose partly because provision for amortisation had been relatively low before 1927. Conversely, Western Australia formerly made high sinking fund provisions, but these were continued after 1927.

It can be said that so far as the relative financial positions of the States were concerned, the basis of payment under the Financial Agreement produced very similar results to those which would have been seen had the per capita method continued. It has been shown that there was some slight alteration and that this appears to have favoured slightly the smaller States. To that extent they improved their financial positions compared with the larger States. The reason for this was because the smaller States had chosen, and been permitted to increase their relative debt position compared with the larger States, as seen from the following Table:

Indebtedness per Head - 1927 and 1952 - by States⁹

State	30th June, 1927 £	30th June, 1952 £	Increase £
New South Wales	101	155	54
Victoria	82	129	48
Queensland	116	151	35
South Australia	155	239	79
Western Australia	164	230	67
Tasmania	111	237	126

6. Commonwealth Budget Papers, 1952-53, p.92.

7. Commonwealth Year Book no. 18 p.406.

The three States whose receipts under the Financial Agreement exceeded twenty-five shillings per head in 1951-52 were those whose rates of public borrowing and investment were higher and which are, by most tests, the financially weaker members of the Australian Federation. Most of the additional burden resulting from the higher borrowing rate had to be met from their own funds, however, and this meant a greater divergence between the standards of services given in other fields and severity of taxation in those compared with the larger States. In other words, the greater borrowing in the financially weaker States was financed at the expense of the provision of other services or by greater taxation. This is subject to the qualification that these three States, South Australia, Western Australia and Tasmania were receiving special grants under Section 96 of the Constitution which may have permitted this expansion without undue effects in other fields. This aspect will be considered more fully in the next Chapter.

It can be appreciated that the incorporation of payments to the States by the Commonwealth in the Financial Agreement did virtually nothing to hasten the process of transfer from the principle of payment as compensation for loss to the principle of payment according to relative financial needs. So far as these payments are concerned, they were designed to compensate the States for part of the financial loss which they suffered as a result of the transfer of powers to the Commonwealth Government, and because they have continued until the present day, it must be considered that the principle still operates. There can be no doubt that although they were related to debt management charges, they bore no relationship to the level of such charges in each State. This point is brought out by the following table¹⁰ which shows interest commitments and the Commonwealth subsidy to each State at the time of the introduction of the Financial Agreement.

Interest Commitments and Commonwealth Subsidy -- by States -- 1927

State	Outstanding Debt (£m.)	Interest Charges (£'000)	Commonwealth Subsidy (£'000)	Commitments
New South Wales	242	12,072	2,917	24.16
Victoria	146	7,190	2,127	29.58
Queensland	106	5,076	1,096	21.59
South Australia	90	4,538	704	15.51
Western Australia	72	3,272	475	14.46
Tasmania	25	1,203	267	22.19
Total	680	33,351	7,584	22.74

¹⁰ From this table it is apparent that in determining the distribution of the total amount available for disbursement from

8. Commonwealth Year Book no. 21 pp. 380 and 383 and No. 24 pp. 274 and 277.
9. Commonwealth Year Books No. 21 p. 384 and No. 40 p. 726.
10. Commonwealth Year Book No. 21 pp. 386/7 and "Financial Agreement between Commonwealth and States" p. 10.

Commonwealth revenue, no attention was paid to the relative size of the public debt and interest charges of the States. The amount of subsidy each would receive represented approximately twenty-five shillings per head, and therefore the States with the highest interest bill per head would receive relatively least financial assistance by way of Commonwealth grant under the Financial Agreement. At the time, the interest payable per head ranged from £8/9/11 in Western Australia to £4/3/4 in Victoria. To some extent the amount of the debt per head is a measure of the need for capital development in a State from public resources. If the object of the grant was to assist the States to meet their annual debt charges it would have been more appropriate to relate the grants to the interest charges per head. In this way it would have been possible to bring about some measure of equalisation of the burden of interest payments between States. For example, one approach might have been to allocate the available amount on a percentage basis according to the amount of interest for which each State was committed. If such a procedure had been adopted, the interest payments to which the subsidy was to be related would necessarily be the net burden. A large part of the interest payable in each State was not a net charge on revenue but was recouped from other instrumentalities. For example, almost half the outstanding debt of the States in 1927 was debt incurred on behalf of railways and tramways, and the interest on this portion of the debt was payable by those instrumentalities. Where they were profitable concerns, the interest would not be a burden on Consolidated Revenue. Thus the appropriate figure to use would be the net burden of interest payments on Consolidated Revenue.

By relating the grant to interest payments, it would have been possible to equalise the net burden of debt management charges as they existed in 1927. It is realised that this might not have been the best method of application of the principle of payment according to relative financial needs because no consideration would be given to the relative importance of the interest burdens on the revenue of each State. Nevertheless, the payments under the Financial Agreement, by the very fact of their association with the Agreement, which was concerned mainly with the loan fund aspect of public finance, and that the payments were specified as contributions to the interest charges payable by the States, did suggest that in this field an attempt was being made to equalise development. While this is quite erroneous, as the earlier examination has shown, it was possible for this course to be adopted, although advantage was not taken of the opportunity.

Furthermore, the conscious application of the principle of relative financial needs would have called for adjustment to the grant according to future borrowing. If the aim had been to bring about equality in the field of development of natural resources, provision would have to be made for either an increase in contributions according to subsequent borrowings, or a redistribution of the total amount available for disbursement by the Commonwealth. So far as

equality between States is concerned, the total amount available for distribution is not of prime importance. What is significant is the proportion of the total which is allotted to each State. Thus, in one year the total amount available might be \$10m. and this is distributed in a certain way to give the desired equality. In the following year the total amount might be lower, but provided that this is distributed correctly, equality can still be maintained but at a lower general level. The limit to this process is when, under the perfect distribution, one State receives no assistance. This procedure could have been applied to payments under the Financial Agreement. If the attainment of equality by these payments is limited to equality of development, then manipulation of the distribution of the total amount available, whether fixed or variable, could have achieved the desired result.

Earlier in this Chapter,¹¹ it was suggested that the whole arrangement could have been improved if an independent body had been established to advise the Loan Council on the loan market potential and the proper distribution of available loan money in each year between the States to produce the equality of development which, it is contended, should have been one of the objects of the establishment of the Financial Agreement. In addition to that function, the body suggested could have been given the power to distribute the total amount available from Commonwealth sources for assistance to States' revenues, to enable the States which needed greater than average development, to finance their additional borrowing. In this way it would have been possible to bring about a perfectly coordinated system of public investment between States which would, in the long run, lead to an improvement of the position of the weaker States and hence assist the attainment of the position where the relative financial needs of the States were in proportion to their contribution to Federal revenue.

Unfortunately, the opportunity was not taken, and to some extent at least, the inequalities which were then present are being perpetuated. An examination of the second table on page 133 reveals that there has been some improvement and the three weaker States have made some progress in this field towards equality with the remaining three States compared with the position as it was in 1927. It is suggested that this has only been possible because those three States were receiving special additional financial assistance from the Commonwealth and they realised that additional expenditure incurred in debt management charges would be recouped. This aspect cannot be fully appreciated until a study has been made of the principle adopted in the assessment of special grants.

The second aspect of the Financial Agreement⁶ that relating to the impact of grants under the Agreement - has now been

¹¹ See pp. 128/9 above.

covered and it remains to combine this with the former aspect which was considered - that relating to the implications of the establishment of the Loan Council - and to form a clearer picture of the provisions of the Financial Agreement in the system of Federal-State financial relations in Australia. So far as these payments were concerned, the idea of the distribution of the surplus Commonwealth revenue had disappeared. The powers of the Commonwealth had expanded to such an extent that it had absorbed all avenues of revenue relating which had been placed at its disposal, and had spread into the fields formerly held exclusively by the States. When the statutory period of the per capita grants had expired, the Commonwealth had suggested its retirement from certain fields of taxation and the complete cessation of grants to the States. Had this approach been adopted, it would have meant the end of any possibility of bringing about any general measure of redistribution of the total public wealth of the Commonwealth.

However, the move was opposed by the States and Commonwealth payments from what was, in effect, surplus revenue continued. Excluding special grants under section 96, these grants were fixed and related to the borrowing programmes of the States. They were conditional upon the States surrendering independence in this field to the Loan Council, in the decisions of which in recent years the Commonwealth has had a dominant voice. No attempt was made in the distribution of this portion of surplus revenue to adopt the principle of payment according to relative financial needs, but the continuation of what was, in effect, the per capita method did involve some deviation from the compensation principle and there was some redistribution in favour of the weaker States.

For the principle of payment according to financial needs to be adopted inside the framework of the Financial Agreement, it would appear to be necessary to establish a body to determine the developmental needs of the States. This is a function which could be adequately performed by the Commonwealth Government itself if it so desired. Even under the present arrangement, the Commonwealth can influence the distribution of available funds, and it adopted a policy of permitting the weaker States to have a greater share of those funds it would receive the support of at least three States. This would entail making a larger grant from revenue to those States to permit them to carry the extra debt burden, and there is no provision for this in the Financial Agreement. This is a criticism of the Agreement as it was originally devised. The Commonwealth still has power to assist any State under section 96, and as will be seen later, it has used that power.

It is undoubtedly true to say that at the time when the Financial Agreement was introduced, the Commonwealth had no thought of incorporating the principle of financial needs. In other words,

although there was recognition of greater need by certain States, there was a lack of appreciation of the real reason underlying this need. Consequently there was no provision in the Agreement to permit those States to expand at a relatively greater rate with the object of reducing their relatively greater need for assistance. The Financial Agreement still operated and perpetuates the thought of Federal-State financial relations that existed in 1927. Conditions and outlooks have changed since then and while the States and Commonwealth continue to be bound by the provisions of the Agreement, some modifications have been effected by other means.

Nevertheless, so far as the finances of the States are concerned, the basic criticisms of the Financial Agreement still remain. These are that the grants to the States from the surplus revenue of the Commonwealth are conditional upon the surrender of exclusive power in the field of public borrowing by the States, and that no provision was made to ensure that the States with the greatest need for capital development received proportionately more than the other States in the distribution of available funds. In short, the Agreement as it now stands could have no place in an adequate scheme for the adoption of the principle of distribution of surplus revenue of the Commonwealth according to relative financial needs. The ideal solution would be, of course, to reform the Agreement along the desired lines, and if necessary reallocate the distribution of powers between the States and the Commonwealth. However, such a scheme would probably be impracticable at the present time and therefore it is necessary to devise some method which would operate within the present constitutional framework and within the provisions of the Financial Agreement, but with some amendments. One possible scheme has been suggested in the establishment of an advisory body with powers such as those outlined above. An alternative would be to hand complete control to the Commonwealth but safeguard the rights of the States by prescribing the conditions and principles under which it would operate in the Financial Agreement. This matter will be taken up again in the concluding chapter of this essay.

CHAPTER 8

THE COMMONWEALTH GRANTS COMMISSION

The early development of the payment of special grants under Section 96 of the Constitution has been examined in a previous Chapter.¹ Generally it can be said that these grants had been made to the two States which were least developed and which had the smallest populations, as compensation for the loss which they incurred as a result of the transfer of power to collect customs revenue from the States to the Commonwealth. The amounts paid in this type of grant had been determined by the Commonwealth Government after investigation had been made by various Royal Commissions. The method adopted had been to fix a certain amount to be paid over a period of years and usually there was no review during the period. The best that can be said of this method was that the recipient States were aware in advance of the amount of assistance they would receive over a number of years. The amount of financial assistance to be given to each State was determined by the Federal Parliament and it may be assumed that the individual members of Parliament were not fitted to assess the financial needs of the States. They had neither the necessary experience nor time at their disposal. Admittedly, some assistance was given by the Royal Commissions which inquired at infrequent intervals into the financial position of the weaker States, but again, these Commissions were not composed of the types of people who were competent to make such investigations.

Until 1928-29, only two States, Western Australia and Tasmania were claiming financial assistance under Section 96. The amounts involved had increased slightly over the years, but even then they were not unduly high. In 1912-13, for example, Western Australia received £230,000 and Tasmania £95,000; in 1928-29, they had increased to £300,000 and £220,000 respectively. These amounts were relatively insignificant compared with total Commonwealth expenditure, which at that time was in the vicinity of £75m., but to the States concerned, the size of the grant was of vital importance. The position was complicated in the following year, 1929-30, when South Australia claimed and was granted special financial assistance under this Section of the Constitution. Another Royal Commission was appointed to investigate this claim and it recommended that an amount of £500,000 per annum be paid to South Australia for two years. Apart from the findings of the Royal Commission concerning the amount of assistance the State should receive, a recommendation was made for the establishment of a permanent

1. See above, pp. 114 ff.

body to carry out a continual investigation of the financial positions of the States of the Commonwealth. The full text of the statement was:

" In one respect we have to confess some disappointment. Remembering that this was the third State to make appeal for help to the Federal Government on the ground of alleged Federal disabilities, we hoped to find, in the course of our enquiries, some formula or principle which could be readily applied to the changes arising out of future financial relations of the Commonwealth and States. Although we have searched diligently to this end, we are forced to confess that so far we have failed to find it. In the absence of this we are strongly of the opinion that the time has come when some provision should be made for a continuous study of the financial relations of the Commonwealth and the States. The duty should be delegated to a small body of men, specially qualified for the purpose who would be able from time to time to inform the Commonwealth and States authoritatively of the interactions of their policies and financial proposals. It seems fairly certain that in the future, following the example of other governments, these financial relations will continue to change as a result of the internal prosperity and development of the individual States as well as the legislation. The experience and knowledge acquired by such a body should in time suggest some sound working principle or formula which could be applied with expediency to these evolutionary changes."

In 1929-30, the Commonwealth Government made a special grant of £360,000 to South Australia, and undertook to pay £320,000 in each of the two following years. Thus, the £1m. recommended by the Royal Commission to be paid over two years was to be spread over three years. In the following year, 1930-31, the Government of South Australia claimed £1m. and the Joint Committee of Public Accounts of the Commonwealth Parliament supported this claim. Eventually the Commonwealth Government agreed to pay a further £850,000 in addition to the £320,000 to which they were already committed, making a total of £1,170,000 for the year. In that year, the Public Accounts Committee also urged the institution of a permanent Commission so that: "... in fairness to the Commonwealth and States, uniform methods and procedure in relation to financial assistance to the States should be evolved."

Finally, in 1933, the Commonwealth Government passed the Commonwealth Grants Commission Act which established a permanent Commission to inquire into and report upon :-

- (a) Applications made by any State to the Commonwealth for the grant by Parliament of financial assistance in pursuance of Section 96 of the Constitution;
- (b) Any matters relating to grants of financial assistance made in pursuance of that Section by the Parliament to any State which are referred to the Commission by the Governor-General; and
- (c) Any matters relating to the making of any grant of financial assistance by the Parliament to any State in pursuance of that Section and referred to the Commission by the Governor-General.

The Commonwealth Grants Commission, which consists of three members and a trained staff, has since examined claims made in

2. Report of the Royal Commission on the Finances of South Australia as affected by Federation, 1929, p.33, paragraph 61.
3. Joint Committee of Public Accounts - Report on the Finances of South Australia as affected by Federation - June, 1931. p.30.

each succeeding year from the three States, South Australia, Western Australia and Tasmania, and has recommended specific annual grants to be paid in each of its twenty-one years of existence. The first two years of the Commission can be regarded as a formative period during which it examined alternative possibilities of securing a permanent basis upon which the amounts of the grants to be paid to necessitous States should be determined.

As early as 1930, L. F. Giblin, then Ritchie Professor of Economics at Melbourne University, stated in a memorandum submitted to the Committee of Public Accounts enquiring into Tasmanian disabilities that "any State requiring help from the Commonwealth should show its good faith by satisfying the following conditions:-

- (1) It should be taxing its people with considerably greater severity than the Australian average,
- (2) It should not be attempting social provision on a more generous scale than the average,
- (3) Its costs of administration should be below average, and
- (4) It should, for some years at least, have shown moderation and caution in loan expenditure.

If these conditions are satisfied, I submit that the responsibility is on the Commonwealth to make up what is required to enable revenue to balance expenditure. It is not a question of making a contribution towards it. If the above conditions are fairly satisfied, the obligation is on the Commonwealth to make up the deficiency in full as a vital condition of the effective working of the Federation." 4.

This statement would appear to be the first clear pronouncement of any basis for the assessment of the amount of financial assistance to be given to the poorer States and was in fact the only practical alternative that had been suggested. Without doubt, the adoption of this method as a means of determining the grants to be paid would have represented the adoption of the principle of payment according to relative financial needs, although there are some points which could be criticised. Professor Giblin was one of the original members of the Commonwealth Grants Commission and as will be seen, the ideas incorporated in this statement were also to be seen in the principle and methods later adopted by the Commission.

In its Third Report to the Commonwealth Government made in 1936, the Grants Commission enunciated in the following words, the principle which it has adopted as a basis for the calculation of the amounts it recommended for payment to the three States as special grant "Special grants are justified when a State through financial stress from any cause is unable efficiently to discharge its functions as a member of the Federation and should be determined by the amount of help found necessary to make it possible for that State by reasonable effort to function at a standard not appreciably below that of other States." 5.

The enunciation of this principle, which has been followed by the Commission down to the present time, was the first occasion on which the principle of payment according to relative financial needs

4. The Case for Tasmania, 1930, Appendix J, p.69

5. Commonwealth Grants Commission, Third Report p.75.

was officially stated in any form and therefore it marks the beginning of a new era in Federal-State financial relations in Australia. Embodied in the ⁸statement is the full recognition of the principle of equality, as it may be called. The operative words are "Special grants ... should be determined by the amount of help found necessary to make it possible for that State... to function at a standard not appreciably below that of other States". This almost completely embraces the equality principle. Had the words "not appreciably below" been replaced by "equal to", it would have represented the complete adoption of the principle which has been shown to be the most desirable in determining the amounts of grants from the Commonwealth to the States. This, however, is not the complete story. Although the Commission stated a principle which is in reasonable accord with the principle which has been shown to be the most advantageous both to the States concerned and to the Federation as a whole, and which has been followed to the present time, it does not necessarily follow that the principle is being applied in the way designed to give the best possible results. In order to determine this, it will be necessary to conduct a fairly exhaustive examination of the methods which the Commission uses in the application of its stated principle.

The method which the Commission has used to assess the financial needs of the three States which have been consistently claiming financial assistance under Section 96, and which are referred to by the Commission as the claimant States, have varied slightly over the twenty-one years of its operation. The change can be regarded as having been brought about partly by the development of new thought on certain aspects of the application of the principle, and partly by changing circumstances within the Federation. Therefore it has been thought advisable to consider first the method used at the time of the Third Report, 1936, and then at the time of the Twenty-first Report, 1954. This will bring out both the changes in approach and the changes necessitated by altered circumstances.

Generally, the Commission adopted the approach to the measurement of relative financial needs as that suggested by Professor Giblin in the "Case For Tasmania, 1930." which was quoted above. The first problem with which it was faced was actually a statistical one relating to the delay which was inevitable before necessary statistical data became available. If the method suggested by Professor Giblin was to be used, then the fundamental basis of assessment of grants would be the deficit in Consolidated Revenue account in each year. This implied that the financial needs of any State would not be known until the end of the financial year to which the grant would relate. In order to resolve this problem, the Commission adopted the method of assessing the needs for a particular year on the basis of experience two years earlier. Thus the assessment for 1936-37, for example, was made on the data available for 1934-35. Such a procedure is subject

to the criticism that over the period of the time-lag, substantial change may take place in the relative financial positions of the States. The alternative was for the Commission to estimate needs for the year to which the assessment related on the basis of such information as was available and make its recommendation accordingly. The Commission recognised this alternative, but rejected it on the grounds that it "would lead into realms of most uncertain speculation, and would quite reasonably cause grave dissatisfaction."⁶ It can be said that the method actually adopted, involving the time-lag of two years, would be reasonably satisfactory if economic conditions were comparatively stable. Where they were changing rapidly, this method could cause even greater dissatisfaction.

The next problem to be faced was the determination of a standard by which to judge the financial needs of the claimant States. In this, the Commission was fortunate that only three States, those with the smallest populations, were claiming financial assistance. The three larger States were sufficiently well-endowed to ensure their independence of Commonwealth assistance of this nature. Consequently, the interpretation by the Commission of its principle governing the assessment of relative financial needs was to recommend grants to the claimant States sufficient to permit them to function at a standard "not appreciably below" the average standard operating in the three remaining States, called for convenience the "standard" States. Thus, the commencing point of the assessment was that, all other things being equal, the claimant States should receive in any one year, an amount sufficient to bring their budget results of two years earlier to equality with the average result in the three standard States.

During the first three years of its operations, the Commission did not adopt this approach in its complete form. The standard was determined by reference to conditions in Victoria and Queensland alone. New South Wales was excluded because it exhibited "so many disturbing features".⁷ This was a serious deviation from adherence to a principle which at first might have offered the possibility of achieving the most favourable results. However, in the Fourth Report, (1937), the Commission used the results of all three standard States and so this possible objection was forestalled.

The derivation of the budget standard was by correction to the published budget result, surplus or deficit, of each State in order to bring them to a comparable basis. In arriving at the corrected budget results of the claimant States, the special grant received in the year under review was disregarded. The object was to determine financial need irrespective of special assistance received by the States from the Commonwealth in that year. The next step was to correct the published results of all States. Corrections other than that already made for the special grant received in the case of the

6. Third Report p.98.

7. Third Report p.91.

the claimant States were of two types:- 8

- (a) An allowance for items which were brought into account in the budget of some States but not in the case of others, and
- (b) Adjustments of the items of revenue and expenditure so that they referred only to activities in the year in question, and elimination of the effects of windfalls of revenue, emergency expenditure, and of variations in accounting practice.

By the application of these corrections, the Commission would arrive at a notional budget result for each State which would probably be quite different from the actual or published budget result. However, it must be agreed that this procedure was necessary to bring the accounts of the different States on to a common basis after taking into account the different methods of recording revenue and expenditure transactions. The result obtained by the Commission can be regarded as the true picture, as opposed to the picture shown by the published results of the States which were distorted by different practices and procedures in the application of accounting practice.

The corrected budget result of each State was then expressed in terms of its population, and the average of the three standard States adopted as the standard. For example, the grants for 1937-38, (Fourth Report) were based on the financial results of the States in 1935-36, in which year, New South Wales had a corrected deficit equivalent to £0.729 per head, Victoria a surplus of £0.049 per head and Queensland a deficit of £1.066 per head. The mean of the three States was thus a deficit of £0.582 per head and this became the standard for that year. In other words, the first approximation to the grant would be an amount sufficient to enable the claimant States to produce a deficit of £0.582 per head. Actually in that year the corrected deficits of the claimant States were South Australia - £2.388; Western Australia - £1.659 and Tasmania - £2.457 per head.

This, however, was merely the first approximation to the grant. The Commission had propounded in its statement of principle of determination of the amounts to be recommended, that a claimant State was required to make reasonable effort to achieve financial independence of the Commonwealth. In other words, the Commission had to be sure that the severity of taxation in the claimant States was at least equal to that in the standard State, that standards of services supplied were not comparatively extravagant, and so on. Obviously, if the assessment of the grant stopped at the stage of producing corrected budget results comparable with those in the standard States, the claimant States could enjoy a much higher standard of living than the standard States, but at the expense of the standard States.

The first approximation to the grant, as determined by the procedure outlined above, had then to be adjusted to take into account the effort each claimant State was making towards balancing its budget independently of special financial assistance from the Commonwealth. The aspects of financial policy to which the

Commission gave attention in this regard were:-⁹

- (a) The maintenance of capital equipment,
- (b) The standard of economy in expenditure involving
 - (i) The cost of administration, and
 - (ii) The scale of social services,
- (c) The standard of effort in raising revenue, involving
 - (i) The severity of taxation, and
 - (ii) The scale of payment for services.

The method of application of adjustments to the first approximation to the grant was to calculate from statistical data, wherever possible, the difference which would have taken place in the levels of revenue and expenditure in the budgets of the claimant States had those States taxed with equal severity and supplied the same standards of services as operated, on average, in the standard States. Of the five types of adjustments specified above the first, relating to maintenance of capital equipment and the last, relating to the scale of payment for services, were relatively unimportant. In the former case, an adjustment was made to the base amount of the grant recommended for payment to Tasmania to permit increased maintenance expenditure during the first two years of the Commission's operations, but thereafter, this type of adjustment was discontinued. Until recently the Commission made no specific adjustment for the relative severity of charges for services supplied by public utilities.

The adjustments which affected the determination of the size of the grants to the claimant States were therefore limited to three types of State financial policy, the relative severity of taxation on the side of revenue, and on the expenditure side, economy or extravagance in the provision of social services and costs of administration. The method of determining the severity of taxation in each State was to relate an index of taxation collections per head of population to an index of taxable capacity. The former was based on actual collections of taxation from all sources in each State, and the latter on statements of income contained in income tax returns lodged for Commonwealth income taxation purposes. The severity of taxation for each State was then shown as an index number with a base of 100 equal to the average severity in all States. The average of the index numbers of the three standard States was adopted as the standard to determine the percentage by which the severity in each claimant State deviated from the standard. This percentage deviation from the standard was then applied to the actual collections in each claimant State to determine the adjustment which should be made. This adjustment could be either positive or negative resulting in an addition to or a reduction from the base amount of the grant.

For the purpose of determining the adjustment for expenditure on social services, the Commission used statistical data prepared for it by the Commonwealth Statistician. This data was a compilation of the net expenditure on social services in each State

expenditure per head of population, and the simple average of such expenditure per head in the three standard States represented the standard by which expenditure in each claimant State was measured. The possibility was recognized, however, that the States with the smaller populations might experience some greater difficulty in providing the same standards of services for the same cost per head as in the standard States, and therefore allowances for social density, expressed as percentages of standard expenditure per head were allowed. At the time of their introduction, these allowances were arbitrarily determined as 3% for South Australia and Tasmania and 7% for Western Australia. The standard thus became the average expenditure per head in the standard States, plus the allowance for social density, and this was compared with the actual expenditure in the relevant claimant State in order to determine the necessary adjustment. Again, this could be either positive or negative.

The adjustment for the level of expenditure on administration was less precisely determined than either the previous adjustments. In this regard, the Commission informed itself as far as possible from available statistical data, but the actual adjustment was based on the intuitive judgment of the Commission. In addition to these three types of adjustment which could be either positive or negative adjustments to the first approximation to the grant which had already been determined from the corrected budget results, the Commission made certain other adjustments which were inevitably unfavourable to the claimant States. It will be remembered that the statement of principle upon which the Commission proposed to determine the amounts of the grants it would recommend said that the grant should be sufficient to enable the claimant States, by reasonable effort, to function at a standard not appreciably below that of other States. The Commission decided that it would be ¹⁰appropriate for a grant to be paid which was sufficiently great to enable the claimant States concerned to operate at precisely the same standard as the standard States on average, and therefore it introduced the concept of providing that the claimant States made a special effort to reduce their dependency on the Commonwealth for financial support.

In other words, the Commission introduced an adjustment that would ensure that the standard in the claimant States would be below, but not appreciably below the standard in the other States. This adjustment was made in two ways. First, the average expenditure on social services in the three standard States was reduced by 10% to give the standard by which comparable expenditure in the claimant States was to be judged, and secondly, the standard severity of taxation, as determined by relating taxation collections to taxable capacity in the standard States was increased by certain percentages. In the Third Report, for example, the average as determined by the method outlined above was increased by 7% in order to judge South

Australian severity and 5% for Western Australia as special additional effort required by these States. No additional effort was required by Tasmania. This latter adjustment was of the nature of a penalty imposed to meet that portion of the deficit of a claimant State caused by past extravagance or mistakes, particularly with reference to the annual burden resulting from unnecessary past borrowing..

In this manner the Commission arrived at a figure which represented, as far as the calculations permitted, the amounts which the claimant States should receive to permit them to operate at standards somewhat comparable to those in the standard States. No attempt has been made to examine the statistical techniques involved in this assessment as, while not irrelevant, this aspect is relatively unimportant from the point of view of understanding the broader implications of the adoption of certain methods in relation to the stated principle. Before analysing these implications, it will be convenient to consider the changes in method which have since taken place in order to appreciate the method in operation at the present time.

The greatest changes were brought about by the impact of the 1939-45 war on the finances of the Australian States. In the immediate post-war period, Australia experienced rapid inflation, and the method of assessing relative financial needs based on the budget result of two years earlier became unsatisfactory as the differences in the amounts necessary to overcome differences in relative financial need between two years grew. In its Fifteenth Report (1948) the Commission introduced a new method of determining the amount of the grant for any particular year. By this new method, called the "two-part" method, an estimate is made of the financial needs of a claimant State in the year to which the payment is related. This estimate is based on budget estimates of the States concerned and estimates by the Commission of adjustments it will be required to make to the actual budget result when that year becomes the year of review. A margin of safety is allowed, and the amount so determined is recommended to be paid as an advance to be finally adjusted when the year in which the payment is made becomes the year of review - that is, two years hence. In other words, the Commission's estimate will be corrected when the information become available to permit it to assess, by the methods it has adopted, the amount which the State should have received to permit it to reach the required standard. Thus, in any one year, a claimant State would receive a grant made up of two parts, the first to be regarded as an advance to be applied to the accounts for the year in which the payment is made, and the second to be applied to the accounts of the year of review. Under this method it is possible for the second part of the grant to be a negative amount if the Commission overestimated the needs of a claimant State, in which case, revenue from the accounts of the year of review have to be transferred to the accounts of the year of payment to ensure that the full amount of the advance is available for use in the year of payment.

After the introduction of Uniform Taxation, to which reference will be made in the following Chapter, several modifications were made to the way in which adjustments were made to the base amount of the grant. The adjustment for economy or extravagance in expenditure on administration was discontinued on the grounds that employment, and hence salary costs in the public services of the States had been differently affected by the impact of war conditions. The transfer of income taxing powers from the States to the Commonwealth necessitated the adoption of an entirely new approach to the measurement of the relative severity of taxation, and because this transfer limited the field in which the claimant States could reduce their dependence on the Commonwealth by special effort, the special effort required of two States to compensate for past mistakes in capital expenditure, and the special effort required of all claimant States merely because they were claimant States and which was formerly equal to 10% of standard net social services expenditure, was gradually reduced and finally discontinued entirely.

In its Sixteenth Report (1949), the Commission introduced a new adjustment which related to the relative impact on the financial results of State business undertakings on the budgets of the States. These adjustments are based only indirectly on statistical data. A strict statistical comparison in this field is not easy to make, and therefore the Commission had to rely largely on its intuitive judgment after consideration of all statistical data which it had available.

One other aspect of the assessment of financial needs and hence the amounts of the grants which is of great importance from the point of view of the principle involved, relates to the adoption of the budget standard from which the first approximation to the grant is derived. In the earliest years of its existence, the average budget results of the three standard States was inevitably a deficit, and therefore the Commission decided that it was appropriate to recommend grants which would produce comparable corrected deficits in the claimant States. From the point of view of producing equality, this was undoubtedly the correct approach. During the war years, however, the budgets of the standard States showed substantial surpluses. Nevertheless, the Commission decided that while this situation offered the possibility of adopting a surplus standard, it considered that this was inappropriate to the purpose of special grants and it would only recommend grants which enabled the claimant States to produce a balanced budget. Thus, whenever a surplus standard appears warranted by the Commission's procedures, a balanced budget standard is adopted.

In other respects, the methods used by the Commission in its earlier years of operation have not been altered. The adjustment for expenditure on social services has continued unchanged, with the exception that the allowance for social density has been altered to an allowance for special difficulties and the percentage allowances

increased to 5% for South Australia, 11% for Western Australia and 9% for Tasmania.¹⁰ Summarising the method at present used by the Commission, it can be said that the basic amount of the grant to a claimant State in any year is the amount of its deficit unless the budget results on average in the standard States is a deficit, in which case the base amount of the grant is an amount equal to the difference between the standard deficit per head and the actual deficit in the State concerned. This base amount is then corrected for differences in accounting practices between States, and the result so obtained is adjusted for differences in severity of taxation and other State charges, and differences in the level of expenditure on social services. This amount is determined two years after the financial year to which it relates, but portion of the amount has already been received by way of an advance in the year to which the calculation related. The difference, when finally paid is credited against the deficit of the year to which it relates, or if no deficit remained after receipt of the advance, then it is applied to the accounts of the year in which it is actually paid and will be regarded by the Commission as part of the advance for that year to be finally adjusted two years later.

It is now possible to analyse the principles and methods used by the Commonwealth grants Commission to determine the amount of the grants it recommend should be paid annually to the claimant States in the light of the principles and methods which have been shown as the most suitable for a federation such as that which exists in Australia. Before reaching this aspect, however, it is necessary to comment briefly on the way in which the establishment of the Commission itself fits into the general scheme which has been suggested. Generally, its composition appears to be quite satisfactory for the purpose. It is composed of three men who are experts in their own field and who operate in a part-time capacity. One improvement could possibly be the appointment of a full-time Commission, or at least a full-time Chairman, as the task they are called upon to perform is of the utmost importance both to the claimant States and the Federation as a whole. This shortcoming, if it is a shortcoming, is partially overcome by the fact that they are assisted by a full-time secretariat. The whole body, comprising the Commission and the secretariat is appointed by the Commonwealth Government and to this extent must be regarded as an agent of the Commonwealth. Inevitably the Commonwealth is associated with the body responsible for the making of grants to the States and tends to create the impression that the object of the Commission is to keep the size of the grants to a minimum compatible with the use of the stated principle. The impression is probably quite erroneous, but unfortunately it must exist while the Commission and its staff is answerable only to the Commonwealth Government. Nevertheless, it appears that it is the only way in which it can function successfully. The alternative is for it to be an agent employed

10. Twenty-first Report (1954) p.36.

by the States themselves, and this would raise insuperable difficulties in appointments, salaries etc. In all events, the establishment of such a Commission is far preferable to leaving the determination of the grants to the Commonwealth Government which would mean, in practice, to the officers of the Commonwealth Treasury. The selection of Commissioners of high integrity can always ensure that the interests of the claimant States are protected. Generally, it may be agreed that the establishment of a Commission of this type to determine the relative financial needs of the States and make recommendations to the Commonwealth is in accordance with the operation of the principle.

The next step is to determine whether or not the stated principle which the Commission has adopted to arrive at its conclusion is in agreement with the principle of payment which has been decided is the most equitable in a federation such as that which has developed in Australia. It is apparent that whatever principles and methods the Grants Commission adopts, it will never be able to bring about equality between all States under the circumstances which exist at present. The extent to which it could influence the achievement of this situation would depend on the number of States which claimed financial assistance from the Commonwealth under Section 96 of the Constitution. In the event of all States claiming such financial assistance, it would then be possible, provided always that the revenue potential of the Commonwealth Government was sufficient to enable it to make grants to at least five of the States to permit them to achieve equality with the sixth State. Where, however, only three States are dependent on this type of financial assistance, it is possible for the Commission to influence the achievement of equality between those three States and equality of those three States with some preconceived standard. The remaining three States will inevitably be operating with different standards of services and severity of taxation and other charges, and the problem to be faced is the determination of a standard to which the three claimant States shall be raised. In all probability, the three standard States can be classified in descending order according to the standards of services operating in each, and arguments can be advanced for the use of each of these three States as a standard to which the three claimant States shall be raised.

The main objective of the adoption of the principle of payment according to relative financial needs is to produce equality of standards in all States. In the first instance, the average standard adopted by the Grants Commission will probably be lower than the highest standard operating in any one State before its adoption. It would be appropriate, therefore, in the particular case of the extent of the equality which can be achieved by the workings of the Grants Commission, to attempt to raise the three claimant States to the level of the highest standard State. However, it must be remembered that the three claimant States are the smallest States if measured by population size and the size of their annual budgets, and the amount

which would be necessary to raise their standards to the level of the highest would be small compared with the size of the budgets of the larger States. In effect, the assistance given to the claimant States would be contributed in the main by the standard States, and the reduction in standards in those States resulting from the making of this contribution would be comparatively small as it would be spread over a much larger population. For example, an amount of £1m. contributed from New South Wales to Tasmania, if such a direct contribution can be envisaged, represents a reduction in services supplied in New South Wales equivalent to less than 6/- per head, while the gain to Tasmania is equivalent to over £3/6/- per head. Consequently, it would be possible, in the situation in which the Grants Commission found itself, to use as a standard to which to raise the claimant States, the standard State with the highest net standards of services, although this might result in some small reduction in those standards. It could then be argued that the claimant States would be enjoying standards which were higher than those in the two standard States which were in fact contributing to the grants which enabled the claimant States to reach that level. It would seem appropriate, under this argument, that the claimant States should be raised to the level of that standard State with the lowest standards of services. Finally, it could be said that a compromise could be reached by using as the standard the standard State which occupied the middle position. This is, in effect, what the Commission has done, but instead of using solely the position of the standard State in the middle position, it has used the average of all three standard States. Consequently, the aim has been to raise the claimant States to a position where they will be able to function at a standard lower than the level of the highest standard State, but higher than the level of the lowest. Thus it is possible, by the methods the Commission has adopted, for one or two of the standard States to enjoy net standards of services which are lower than those enjoyed by the claimant States, while they contribute to the attainment of that standard. However, this can be regarded as the price which must be paid because the Commission operates in a limited field. It can be said that as a result of the establishment of the Commission, a greater degree of equality has been reached than would have been possible if the former method of determination of the amounts of special grants had been continued.

The principle itself, which has been quoted earlier in this Chapter,¹ upon which the Commission determines the amounts which it recommends to be paid to the claimant States, almost completely meets the requirements of the principle of relative financial needs. The Commission's principle is one which, if adopted in its entirety, can be regarded as a principle designed to produce a situation of near equality between the States as far as it could go within its terms of reference. At the time when it was first propounded, there were only

three States claiming special financial assistance, and while this situation has not yet changed, there is always the possibility of any or all of the remaining three States claiming financial assistance under Section 96. While the number of States claiming assistance is fewer than five, the adoption of the stated principle can only achieve equality between the States which have claimed financial assistance. When five States are claimant States however, it is possible to achieve equality between them and the sixth State. Thus the principle is designed to meet the situation if the number of claimant States increases beyond its present number, and at the same time to function adequately but not completely, with fewer than five claimant States. As pointed out above, it can do nothing to achieve equality between the standard States. The only criticism as it applies at present, is that it does not propose to raise the level of the claimant States to equality with the other States, but only to near-equality. That is, it proposed to enable them to function as a standard not appreciably below that of other States. There is no justifiable reason why the claimant States should not be raised to a position where they can function at a standard equal to that of other States, and in fact, with some qualifications which will be elaborated later, the methods which the Commission has applied to enforce the principle do actually provide for this. In the earlier years of its operation, the Commission made an adjustment equivalent to 10% of the standard expenditure on social services as a penalty for claimancy. That is, merely because a State was in a position where it found it necessary to claim financial assistance from the Commonwealth, it was required to function at a standard lower, by the equivalent of this amount, than the standard operating in the other States. This penalty has since been discontinued, and apparently with it went the concept of the requiring the claimant States to function at a standard slightly lower than that of the standard States, although it is possible that this penalty for claimancy has been introduced in other, but less obvious ways.

In the application of its principle, the Commission adopted the approach suggested by Professor Giblyn in 1930. That was that the financial needs of a claimant State should be related to its budget position with reference to such aspects of government financial policy as the relative severity of taxation, levels of expenditure on social services, costs of administration, and so on. In the first part of this essay,¹² it was suggested that there were two alternative approaches to the application of the principle of payment according to relative financial needs. The first was that relative financial needs could be determined by reference to the budget results of the States, as in fact the Commission has done, while the second was that it could be determined by reference to inherent differences between States.

¹²The relative merits of these two alternative approaches

12. See above, pp. 74 ff.

have already been examined, and it was shown that under certain circumstances, they could produce similar results. This would occur if, in the use of the budget result approach, every aspect of governmental activity in a claimant State and even those spheres of activity in which governments do not operate but which contribute to differences in standards of living, were taken into account by the Commission when determining relative financial needs. Differences in standards will occur in fields in which governments play no part, and if the assessment of relative financial needs is based only on budgetary results, then no consideration will be given to these extra-governmental aspects of inequality. For example, the housing facilities and conditions which residents of the several States enjoy will be influenced by the differences in resources of the States, but this will not be reflected in any way in the State budgets, and hence will be ignored when comparing financial needs from budget results alone. Thus, there are two ways of interpreting financial needs, the first relating to the financial needs of governments to permit them to operate at an approved standard in the fields of activity in which it is customary for all governments to operate, and the second relating to the financial needs of each community as a whole to enable them to enjoy standards of living comparable to those in other States. Obviously, if the first is adequately satisfied, then it will go quite a long way towards satisfying the second interpretation.

It is contended that while the second alternative is the more desirable, it might be impracticable to attempt to achieve that position. The problems of direct measurement would be immense, and any approach to measurement would probably need to be indirect. A suggestion was made earlier that perhaps the measure to be used could be the average levels of incomes in each State. That is, the object of redistribution of the total wealth of the Commonwealth would be to produce the same average level of income in each State. Again, there is the problem of measurement, but this could probably be overcome by the use of approved statistical techniques. Nevertheless, there are many arguments which could be advanced in opposition to such a scheme. Foremost amongst them would be the magnitude of the amounts involved. For example, it is estimated in the White Paper on Estimates of National Income for 1950-51 in Australia, that personal income per head in Tasmania in that year was £274 compared with an average of all States of £351. The increase in Tasmanian incomes necessary to permit it to reach the average in that year would thus be of the order of £23. A transfer of an amount of such magnitude would be fantastic, and in order to dispose of the additional revenue, the Tasmanian Government would need to enter all fields of economic and personal activity.

Such an approach would be feasible only if the differences between the States were comparatively small, but in present-day Australia, where the differences are great, attention must be concentrated in the more limited sphere of government budgeting, which is

spreading over a wider field each year. This would aim at bringing about equality in a restricted field, leaving the wider concept to change, if necessary, in the natural order which can be assisted by systematic investment programmes. In this restricted field, equality is sought to the stage where the governments provide the same standards of services at the same cost to the residents of the State and this can be achieved successfully by consideration of budget positions alone. However, the method of assessment should embrace all aspects of governmental activity, and in this respect the Commonwealth Grants Commission does not function as adequately as perhaps it should. There is a wide field of expenditure which receives but cursory attention in the estimation of needs and therefore it is possible that the desired equality, even in the limited field of governmental activity is not being achieved. Consider two claimant States, one which concentrates expenditure on the provision of services in the form of development of industrial potential, and the second on the provision of social services such as hospital services, education etc. Although the residents of both States may enjoy the same net standards of services, the State which concentrated on the provision of social services will probably have a permanent budget deficit equal to the extent to which its expenditure on social services is above standard, while the first State will probably balance its budget, because adjustments are made to the first approximation to the grant for expenditure on social services but not for other types of expenditure.

Another aspect of the problem of which approach should be used in determining the financial needs of each State is that when the budget approach is used, it inevitably means that there will be a time lag between the year to which the payment relates and the year in which it is received. The two-part method adopted by the Commission in recent years has overcome this to some extent, but unless the Commission has been very accurate in its estimate of relative financial need, the States concerned will finish the financial year with a deficit which must be carried for two years until the final result, based on the actual budget results in the claimant and standard States is known. The amount of the advance may in this way influence the final result, for any State will be hesitant to budget for a very large deficit, both for political reasons and because it may have difficulty in finding the ready cash with which to carry on at its proposed rate of expenditure, even if it aware that at some time in the near future this deficit may be reduced if the Commission determines that their estimate of financial needs was less than calculated needs. Where only portion of the expenditure field is subject to adjustment, it can well be that the limitation of expenditure thought necessary by the government of a claimant State because of the size of the advance received is received to the field of non-adjustable expenditure, and therefore no consideration will be given to the

consequent reduction in standards of services when the final assessment of financial needs is made.

However, apart from this aspect, which can be corrected by a full coverage of all fields of expenditure in the adjustments, there still remains the problem of the time lag, and so far as can be seen, it must remain while financial needs are assessed by reference to government budget results. If some way of estimating needs at the beginning of the financial year can be devised by reference to inherent differences, the amount of the grant could be determined in time for inclusion in the budgetary programme of the claimant States on the understanding that it was to be the final payment for the year. In that way the time-lag could be overcome, and the method of assessment and payment of special grants placed on a more satisfactory basis from the point of view of the recipient States.

In addition to these more general observations on the procedure of the Grants Commission in the light of the adoption of the principle of payment according to relative financial needs, there are several particular points relating to the methods adopted which have some bearing on the application of the principle and which should, therefore, be mentioned briefly. The first of these relates to the adoption of an appropriate budget standard when the standard States are shown to have achieved a corrected surplus. The Commission has decided that when such an average surplus is shown to exist, they will recommend grants that will, all other things being equal, permit the claimant States to balance their budgets. This appears to be a departure from a principle which is designed to bring about equality between States, and it is suggested that if a deficit budget standard is to be adopted when conditions warrant it, then a surplus budget standard should similarly be adopted. If a standard State achieves a surplus, it can be used to offset a deficit incurred in previous years held in reserve to meet future deficits, or used for capital expenditure. If the claimant States are not permitted to follow the same procedure, then there is some deviation from the accepted principle. It should be mentioned, however, that on several occasions the Commission has adopted a balanced budget standard when a deficit budget standard would have been warranted because it had refused to adopt a surplus standard in earlier years. It may be that in this regard there will be a balancing out over a period of years.

The second deviation from complete adherence to the principle is probably more serious. This has arisen from the adoption of the two-part method of assessment of grants and relates to the adjustment which is made to the advance when that year becomes the year of review. . It is possible for a balanced budget standard to be adopted and yet a claimant State to be shown to warrant payment of a grant sufficient to produce a surplus for that year. The first approximation to the grant will be the amount of the corrected deficit

which may, under certain circumstances, be the same or greater than the published deficit. If the adjustments made on account of revenue and expenditure policy are positive, then an addition should be made to the first approximation which could easily produce an amount more than the deficit. Under these circumstances, the Commission has decreed that despite the fact that it has been shown that the State has been operating at a level below the standard adopted, that State will not be permitted to achieve anything more than a corrected balanced budget. This argument can probably be better understood by reference to an actual example of the operation of the calculation.

In 1950-51, South Australia received a total grant of £5,332,000, of which £502,000 was to be applied to a corrected deficit incurred in 1948-49, and the remainder, £4,830,000, was to be regarded as an advance to be used in 1950-51, but to be later adjusted according to calculated financial needs in that year. In fact, South Australia showed a published surplus of £230,000 in 1950-51, and therefore the actual deficit excluding the advance was £4,600,000. This was subject to corrections which gave a corrected deficit of £4,573,000. The Commission determined that a net favourable adjustment for revenue and expenditure policy equal to an additional £428,000 was warranted, and this increased the corrected deficit from £4,573,000 to £5,000,000 which is the adjusted deficit. In other words, according to the Commission's calculations, an amount of £5,000,000, of which £4830,000 had already been advanced, was necessary to permit South Australia to operate at the same standards as those which were enjoyed in the standard States. The Commission has stated, however, ¹³ that a claimant State will not be permitted to produce better than a corrected balanced budget, irrespective of whether or not the standard States were able to produce a surplus corrected budget result. Consequently, in this particular instance, the Commission determined that in that year the advance to South Australia was £257,000 greater than was necessary to produce the necessary balanced corrected budget result, and therefore £257,000 had to be repaid. In actual practice, the grant for 1952-53 was made up of a negative first part of £257,000, and an advance of £6,600,000 giving a net grant of £6,343,000. This meant that £257,000 had then to be transferred from the accounts of 1950-51 leaving a published deficit in that year of £27,000, to the accounts of 1952-53, in order that the full advance of £6,600,000 be available in that year.

The implication of this procedure is that although the Commission has determined the amount necessary to give the desired equality, under certain circumstances it will then reduce the amount and prevent the equality being reached. The presence of a net favourable adjustment means that the Commission has assessed the levels of services supplied as being below standard, or the severity of State taxation as being above standard so that on balance, the residents of

13. See, for example, the Twenty-first Report, p.16.

that particular State enjoy standards which are below those of the standard States, and because it has decided not to permit a published surplus, the grant is lower than the amount necessary to permit the governments of the claimant States to raise standards to those operating in the standard States. One aspect of this problem is that the adjustment relates to a financial year two years earlier, and nothing that can be done will alter the standards of services received by the people in that year. However, by adopting the budget approach, the Commission has elected to permit governments of claimant States to supply net services which are comparable between States, and therefore it would be reasonable to consider the possibility of permitting claimant States to establish reserves, extinguish past debt or incur new capital expenditure from surplus revenue if the standard States are in a position to do so. The extent to which this type of deviation from the absolute operation of the principle of payment according to relative financial needs will occur, will depend on the extent to which revenue and expenditure policy in a claimant State deviates from the standard. If a claimant State is prevented from reaching equality with the standard States in any particular year by this procedure of the Commission, the procedure also permits alteration in subsequent years to eliminate the favourable adjustments by increasing expenditure on the provision of social services or decreasing the severity of taxation or other charges. For example, in the instance quoted above, if expenditure on social services in South Australia had been greater by £428,000, the corrected deficit would have been greater by this amount and so too would have been the first approximation to the grant. On the other hand, the favourable adjustment would have been eliminated and standards in that State would have been greater to the extent of the expenditure of this additional amount and which, by the Commission's methods of measurement would have had to be spent to produce equality of standards with the standard States. Thus, although the method may result in deviation from the principle, it may also give the desired result. If deviation does exist, it may be corrected by action of the claimant State.

It should be mentioned that under the present method used by the Grants Commission in assessing relative financial needs, expenditure incurred by a claimant State on debt charges lies in the field of non-adjustable expenditure. In other words, any level of this type of expenditure is permissible, irrespective of the size of similar expenditure in the standard States. It has been suggested that in order to achieve maximum equality between States it is desirable that adjustments be made for all types of expenditure, and if this were introduced, expenditure on debt charges would necessarily come under survey. Nevertheless, in this particular field of expenditure, the present method appears to be satisfactory, because the amount of public borrowing which a State may undertake is determined by the Local Council, and therefore it must be assumed that the Commonwealth

Government and the Governments of the standard States are fully aware of the impact on their budgets of Loan Council decisions which permit a claimant State to incur debt charges which are above average in their relation to State budgets. It would be unrealistic if the Loan Council approved certain borrowing and the Grants Commission disallowed the annual commitments resulting from those borrowings in the assessment of relative financial needs.

It can be seen from these few observations that the methods which the Grants Commission have adopted in the application of the principle upon which it calculates and recommends grants can result in some deviation from the apparent intended purpose of the principle. This could be either minimised or accentuated by a tendency which appears to have developed in recent years for the Commission to place less reliance upon purely statistical examination, and to depend more on intuitive judgment. No-one would claim that perfect results could be obtained by purely statistical analysis, if for no other reason than the fact that some of the magnitudes with which the Commission is concerned cannot be subjected to precise statistical analysis, and it is inevitable that judgment based upon statistical data must be used to some extent. However, it is conceivable that the intuitive method may lend itself to the possibility of greater deviation from the optimum than is apparent with the purely statistical method. Reliance must then be placed on the ability of the individuals concerned to correct the error which would arise if the result were related solely to statistical comparisons. It is essential, however, that a satisfactory balance be maintained between the two approaches. The trend towards assessment according to intuitive judgment, if carried to its ultimate, could make serious inroads into complete adherence to the principle of relative financial needs. From the viewpoints of both the Commonwealth Government and the claimant States, it is advisable that the manner in which the amounts of the grant recommended are determined, is revealed. It is desirable that the Commonwealth Government be aware of how the amounts are arrived at in order that the Commonwealth Parliament, which is the body responsible for making the grants, may exercise its control of expenditure in this field. The State Governments, on the other hand, should be satisfied that they are being treated equitably in the apportionment of surplus Commonwealth revenue. In the past the States concerned have been reasonably content with the approach used by the Commission, but if in future the grants become determined more and more by methods about which they are not fully informed, it will be difficult to maintain the harmony in Federal-States financial relations that is essential to the well-being of the Federation.

It must be remembered, however, that the Commonwealth Grants Commission is responsible only for making recommendations to the Commonwealth Government concerning the payment of grants under Section 96. It is only an advisory body. Irrespective of the

principles and methods used to determine the amounts the Commission will recommend, it still remains the prerogative of the Federal Parliament to accept, modify or reject the recommendations of the Commission. During the twenty years of its operation, the Commission's recommendations have been accepted unreservedly by the Commonwealth Government, but the possibility of amendment is always present. Any alteration would probably take the form of a reduction brought about by financial stringency in the Commonwealth Budget. If the Commonwealth Government has consciously adopted the principle of payment according to relative financial needs, then this situation should never arise. The alternative to a reduction in the amounts calculated to bring the claimant States into equality with the standard States is for the Commonwealth Government to increase the severity of taxation to produce the additional revenue necessary to enable the recommended grants to be paid in full. In other words, a greater contribution should be called forth from all States to enable the total amount to be disbursed to reach the level where it is possible to reach the desired equality between States. This procedure might not be followed for several reasons, including non-recognition by the Commonwealth of the principles involved, the political unpopularity of higher taxation, and the fact that the recommendations of the Commission may be made too late in the financial year to permit alteration of the budget. Consequently the possibility always exists that the amounts recommended by the Commission will be reduced by the Federal Parliament.

It is more than possible that the Commission is aware of the existence of this situation, and perhaps unconsciously takes into consideration the possible Commonwealth Government reaction when it is determining the amounts it will recommend. Representatives of the Commonwealth Treasury each year submit suggestions to the Commission, and in this way the Commonwealth viewpoint on certain aspects of the assessment of grants is made known to the Commission. It is possible for this influence to be felt much more easily if the assessment is made by the Commission according to its intuitive judgement rather than by the direct statistical approach. Furthermore, if this does take place, it inevitably means that there will be some deviation from the application of the principle of payment according to relative financial needs. It is impossible to estimate the extent to which this has operated in the past as it is purely a subjective matter. It may have played no part whatsoever, but in any case, the proper procedure would be for the Commission to recommend the full amounts necessary to bring the claimant States into equality with the standard States and if any pruning is necessary because of the Commonwealth budgetary position, then it should be carried out by the Commonwealth Government which is in a position to know exactly the amount available for distribution to the States and the advisability or otherwise of raising additional revenue.

Briefly summarising the foregoing comments, it may be said that so far as it is able within its terms of reference, the Grants Commission has adopted a policy of assessing grants which are designed to bring the three claimant States to a position of equality with the three standard States. The methods of assessment which it has adopted to give effect to this principle may not produce exactly the desired result, and this may have been occasioned partly by the necessity to have recourse to assessment based on intuitive judgement when statistical data are not available, and partly by the knowledge that recommendations are subject to amendment by the Commonwealth Government if the necessary revenue with which to make the grants to the claimant States is not available. Generally however, it may be said that the establishment of the Commission for the purpose of making recommendations concerning grants under Section 95 of the Constitution, and the adoption by the Commission of the principle of payment according to relative financial needs, was a step towards the establishment of a satisfactory system of redistribution of the total wealth of the Commonwealth. Although the Commission has been functioning for twenty years, its methods have been modified from time to time, and presumably this process will continue, aiming always at perfection of the application of the stated principle under which it operates.

Throughout this Chapter, the aspects of Federal-State financial relations which stem from Section 95 of the Constitution have been dealt with in isolation. A full appreciation of their importance can only be gained by consideration of this type of grant in conjunction with others.

CHAPTER 9UNIFORM TAXATION AND TAX REIMBURSEMENT GRANTS

Section 51 (11) of the Constitution provided that the Commonwealth Parliament should have power to impose taxation "but so as not to discriminate between States or parts of States". It was to enjoy this power concurrently with the States. So far as taxation of incomes was concerned, the States entered the field between 1884 and 1907. In the years before Federation, the amounts collected as income taxation were not very significant, but after 1901, with the loss of customs and excise revenue, they began to assume greater importance in State budgets as a means of compensating for the difference between the community loss and the Treasury loss occasioned by transfer of power to levy customs duty to the Commonwealth. With the greater financial burden placed on the Commonwealth, which was given exclusive defence powers during the 1914-18 war, the Commonwealth entered the field in the financial year 1915-16, and thereafter all States and the Commonwealth levied income taxation concurrently. While the severity of income taxation levied by the States varied considerably between States, that imposed by the Commonwealth, as stipulated by the Constitution, was uniform throughout Australia. In the years immediately preceding the 1939-45 war, the people of Australia were paying approximately £50 million in income and related forms of taxation, and of this about £16.5 million, or approximately one-third, was collected by the Commonwealth.

As a consequence of the 1939-45 war, the Commonwealth found it necessary to assume control of all income taxation. From the purely financial viewpoint, increased commitments for defence expenditure made it necessary to increase revenue considerably, while from the broader economic viewpoint it was necessary to adopt a policy which involved drawing off a large portion of income to prevent possible inflationary pressures. However, effective action was hampered by the presence of the States in the field, with each State levying different rates of taxation. For example, the amount of State income taxation payable on an income of £500 in 1938-39 ranged from £15.35 in Victoria to £35.58 in Queensland. It was apparent that the severity of Commonwealth taxes, which was required to be uniform in all States, was limited by the highest rate levied in any one State, and when this limit was reached, there would be a large untapped source of revenue and means of control of spending in the States where State rates were comparatively low. The Commonwealth, therefore, proposed to the States that it should assume complete control of income taxation for the duration of the war, and in return make annual reimbursement payments to the States to compensate them

for their loss of income.

The preliminary overtures by the Commonwealth Government were summarily rejected by the States on the ground that the proposal, if effected, would represent an invasion of State rights. A Committee was appointed by the Commonwealth Government to investigate the implications of the continuation of the existing system, and its recommendations were to the effect that the system of both States and the Commonwealth levying income taxation concurrently was not in the best interests of the nation's war effort, and that a single taxing authority, the Commonwealth Government, should have power to levy and collect income taxation for the duration of the war and for one year thereafter,¹ and that the States should be compensated for their retirement from the field of income taxation.

Legislation was passed in the Federal Parliament providing for a high level of taxation and payment to the States of fixed reimbursement grants on condition that they did not impose taxation on incomes. The actual amounts of the reimbursement grants were recommended by the investigating Committee, and represented the average collections in each State from that source in the two preceding years, 1939-40 and 1940-41, less the saving in administration costs. This meant that the collections in that year would be perpetuated for the duration of the war at the levels operating in those years, while the severity of taxation would be equalised in all States. The implication of this was that a formerly low-taxing State, such as Victoria, would be contributing to Federal Revenue proportionately to the other States and yet the amount that State would receive by way of reimbursement would be governed by the rates of taxation imposed by the State in the years preceding Uniform Taxation. In other words, the contribution of these States increased considerably with no corresponding increase in services. The amounts of compensation recommended by the Committee were:

State	Gross Compensation £'000	Administration Costs £'000	Net Compensation £'000
New South Wales	15,991	208	15,783
Victoria	6,666	119	6,547
Queensland	5,982	161	5,821
South Australia	2,417	48	2,369
Western Australia	2,576	53	2,523
Tasmania	823	12	811
Total	34,455	601	33,854

It was also recommended that if a State found itself in financial difficulties, it should be able to claim an increased reimbursement and that this claim should be investigated by an independent authority which would report to the Commonwealth Government. A further suggestion was that the Commonwealth should be responsible for the

collection of arrears of taxation due to the States and the amounts so collected held as a loan to be repaid at the conclusion of the scheme.

Subsequently the Commonwealth Government introduced legislation which imposed taxation at a high rate, gave the Commonwealth priority in the collection of income tax, and undertook to compensate the States by amounts which differed only slightly from the recommendations of the Committee. These payments were to be made only on the condition that the States did not levy an income tax. In addition, minor recommendations of the Committee, such as those relating to the collection of arrears and their retention by the Commonwealth till the end of the scheme were adopted. The provisions relating to reimbursement, which were contained in the States Grant (Income Tax Reimbursement) Act, 1942, were to operate until the last day of the first financial year after the cessation of the war. Four of the States, Victoria, Queensland, South Australia and Western Australia challenged the constitutional legality of the legislation, but the High Court upheld the action of the Commonwealth not simply as a defence power which could be invoked in time of war, but as a constitutional right at all times.² That is, the Court ruling made it possible for the Commonwealth to introduce uniform taxation as a permanent peace-time measure.

Later in 1942 the State Governments agreed to vacate the field of Entertainments Taxation to the Commonwealth for the duration of the war and one year after. In return the Commonwealth was to reimburse the States by annual payments of £765,787, which was the total amount the States collected in Entertainments Tax in 1941-42.³ The history of Uniform Taxation during the war can be told briefly. All States withdrew from the field of income taxation and the amounts prescribed for payment as compensation in the Act, less an amount equal to arrears of State tax collected by the Commonwealth on behalf of the States, was paid to the States by the Commonwealth. The Act provided that the Treasurer of any State could inform the Commonwealth Grants Commission if it considered that payments under the Act were insufficient to meet the revenue needs of the State. Tasmania made early application for a revision of the base amount and from the outset its reimbursement grant was increased from £811,000 to £888,000. In 1944-45, South Australia applied for an increased grant, and its grant was increased by £553,000, and in the following year, the three claimant States were granted increases totalling £2,123,920. During the period 1942-43 to 1945-46, fixed amounts were paid to five States as Entertainments Tax Reimbursement. Queensland did not participate because no State Entertainments Tax was previously levied in that State.

2. *South Australia v the Commonwealth*, 65 C. L. R. 373.

3. Entertainments Tax Reimbursements as such, were discontinued from 1946. The amounts formerly paid in this type of grant were included in the Tax Reimbursement Grant. Subsequently, the Commonwealth vacated the field of Entertainments Tax from 1st. October, 1953. Three States, Victoria, Western Australia and Tasmania have since reimposed the tax.

This briefly, was the position that existed at the end of the war. It is thought that the implications of Uniform Taxation in Australia up to this stage, and the related question of the determination of the amounts of Tax Reimbursements as it affected the principles of Commonwealth payments to the States can safely be ignored. It was introduced as a war-time measure, and the original intention was that it should be continued only until one year after the cessation of the war, at which stage the Commonwealth and the States would again both share the field of Income and Entertainments taxation. Under the circumstances, it could be expected that the motives of the Commonwealth Government were not necessarily to introduce an equitable distribution of the additional revenue collected as a result of the transfer of income taxing powers from the States, but rather it was intended that the Commonwealth should be given control of this form of taxation in order that it should be able to drain off effectively excess purchasing power at a time when goods available for civilian consumption were restricted, and unfettered spending could increase inflationary pressure. Furthermore, the ability of State Governments to carry out their normal functions were restricted, and the pattern of public finance became distorted. For these reasons it has been thought unnecessary to examine in detail the scheme of tax reimbursement as it operated during the war.

The Commonwealth legislation relating to uniform taxation and Tax Reimbursement grants was due to expire on 30th June, 1947 - that is, the end of the first complete financial year after the end of the war. However, at a Premiers' Conference in August, 1945, the Prime Minister expressed the view that it was important that the existing uniform system of assessment and collection of income and entertainments taxation should be continued subject to a review of reimbursement grants payable to the States under the States Grants (Income Tax Reimbursement) Act, 1942, and the States Grants (Entertainments Tax Reimbursement) Act, 1942. The reason given by the Commonwealth for desiring to continue Uniform Taxation was given at a Premiers' Conference in January, 1946. It was said that:-

"... there are two major reasons why the continuation of uniform taxation is essential. In the first place the continuation of uniform income taxation is necessary not only to ensure that sufficient revenue is raised in the most economical way to finance the increased commitments of the Commonwealth, but also by reason of uniformity in the incidence of income taxation, to assist the Commonwealth to implement successfully the requisite financial policies in connection with matters (such as the maintenance of high levels of employment) which affect the Australian economy as a whole.

Secondly, the fact that Commonwealth rates of income taxation will necessarily be higher than before the war, and that priority will be accorded to Commonwealth assessments would, if uniform taxation were abandoned, leave to the States a much narrower field than previously in which their rates would operate.

Under such conditions it seems certain that some, if not all of the States would find it embarrassing, if not impracticable, to impose separate income taxes adequate to their requirements." ⁴

⁴ Statement issued by Commonwealth Government at the Premiers' Conference - 22nd. January, 1946 ; pp 2 and 3.

In addition, the Commonwealth statement listed certain merits of uniform taxation so far as the taxpayer was concerned.

All States opposed the continuation of Uniform Taxation but the right of the Commonwealth to priority of collection of taxes as verified by the High Court in its 1942 judgment mentioned earlier, ensured that the Commonwealth could impose uniform taxation upon the States by the simple expedient of imposing taxation at rates sufficient to exclude the States from the field. Furthermore, payments to the States could be made conditional upon their remaining out of the field of income taxation. Consequently, in the face of the Commonwealth's determination to continue Uniform Taxation, the States had no alternative but to accept the proposals and endeavour to obtain the most favourable system of reimbursements.

In determining such a system of reimbursements, there were two major problems to be faced; the determination of the total amount to be distributed to all States and the distribution of that amount between States. Under the original arrangement, a formula was devised which was intended to solve both these problems automatically in each year for some undefined period. The Commonwealth agreed to pay to the States, as Income Tax and Entertainments Tax Reimbursements a total sum of £40m. in each of the years 1946-47 and 1947-48. The total amount to be paid in 1948-49 and subsequent years was to be £40m divided by the population of Australia at 30th. June, 1947 and multiplied by the population at the beginning of the financial year to which the reimbursements relate, and the amount so obtained to be increased or decreased by half the percentage increase or decrease in average wages between 1946-47 and the financial year in which the reimbursements are made. This fixed the total amount to be paid by the Commonwealth in each successive year according to the economic conditions current at the time.

In the first two years, when the total reimbursement was fixed at £40m., the distribution was to be proportionate to the distribution which had been made during the war years and which was based on the average collections in 1939-40 and 1940-41. From 1948-49 to 1956-57 inclusive, the distribution between the States of the total reimbursement amount as determined by the method outlined in the preceding paragraph was to be determined by the weighted mean of (i) the percentages indicated by the "adjusted population" for each State, and (ii) the percentages of the 1946-47 and 1947-48 distribution, giving the latter a weight of nine-tenths in 1948-49, eight-tenths in 1949-50 and thus decreasing regularly by one-tenth to one-tenth in 1956-57. In 1957-58 and subsequent years, the distribution was to be based on the adjusted population of each State. For the purpose of the distribution, the adjusted population was to be calculated by adding four times the number of children aged 5 - 15 years inclusive to the actual population of each State at the beginning of the financial year in

in which the reimbursements are made, and increasing the population so as to be justified by an allowance for density, which was calculated according to a stated formula.

The original legislation operated in its entirety for only one year, 1946-47. In the following year, the base amount of £40m. was increased by £5m. which was to be divided in the same proportions as the £40m. but was not to be subject to future adjustment according to changes in population and average wages. However, in the following year, 1948-49, the two amounts were combined and the total was to be subject to future adjustment. In that year also, the provisions of the Act which specified that the base amount was to be increased by half the percentage increase in wages, was altered to provide that the increase should be in accordance with the full increase in wages. The amended formula has operated in each of the years 1948-49 to 1951-52, but in each of the last five years of this period, the Tax Reimbursement grant has been supplemented by special financial assistance.

In 1950-51, the total amount to be distributed was slightly more than £70m. and the State representatives at the annual Premiers' Conference urged the Commonwealth Government to increase the base amount. The Commonwealth agreed to pay to the States an additional amount of £5m. distributed in the same proportions as the £70m. In December, 1950, the Commonwealth Court of Conciliation and Arbitration increased the basic wage in Australia by .1 per week and in recognition of the additional burden this placed on State budgets, the Commonwealth Government agreed to grant a further £15m. to be distributed after "having regard to the financial needs of the States in that year",⁵. In fact the States were required to supply the Commonwealth with estimates of added cost for that year resulting from the rise in the basic wage, and this formed the basis of the distribution.

The application of the formula in 1951-52 would have yielded a total reimbursement grant of approximately £86.4m.. This was substantially less than they received in the previous year, if the special financial assistance of £20m. given in that year was taken into consideration. The States were outspoken in their claim that their financial requirements had risen and that the amounts they received from the Commonwealth should rise accordingly. The Commonwealth agreed to increase the total amount available for distribution from £86.4m. to £120m. and of this the former amount should be distributed as determined by the formula, and the remaining £33.6m. was allocated at a Premiers' Conference by mutual agreement between the Premiers. A similar procedure was adopted in the following year when the formula grant was £108.8m. and was increased to £135.9m. and the distribution of the additional amount made by agreement. Again, in 1953-54, the formula grant was £120.5m. and was increased to £142.4m. by the addition of special financial assistance.. In 1954-55, the formula grant of £130.5m. was increased to £150m. 6.

5. Treasurer's Budget Speech, 26th. September, 1951, Appendix p.10
6. Treasurer's Budget Speech, 18th. August, 1954, Appendix p.11.

This brief account of the history of Uniform Taxation in Australia has been thought necessary as a preliminary to an examination of the extent to which this aspect of Federal-State financial relations, and in particular the basis of the distribution of the total amount of the Tax Reimbursement Grant is in accordance with the principles which have emerged as being the most satisfactory in a Federation such as that which exists in Australia. The part played by the determination of the total amount of the grant is not strictly relevant to the discussion but some attention should be given to it, if only for completeness. The thesis which can be developed is that, although the amount is more or less arbitrarily determined, it will still be in accordance with a system of Federal-State financial relations designed to implement the distribution of surplus Commonwealth revenue according to the principle of relative financial needs. It is apparent that the total amount raised by the Commonwealth Government will be determined by the severity of Commonwealth taxation. In the 1946 legislation relating to Tax Reimbursements, the total amount to be paid as Tax Reimbursement Grants was fixed at £40m. for two years and was to increase thereafter according to population and wages changes. Assuming that the base total amount was fixed according to some satisfactory measure, subsequent changes would be roughly in accordance with changes in the national income. This determination of the total amount for some time ahead by means of an automatic formula would appear to indicate that there would be no complete distribution of surplus Commonwealth revenue in the true sense of the phrase. However, it must be taken into consideration that the exact amount of surplus revenue, or revenue available for distribution to the States can be determined with reasonable accuracy by the Commonwealth Government at the commencement of the financial year.

When preparing its budget, the Commonwealth will first determine its own financial needs, and then the amount that it considers should be paid to the States in the various types of grants. If the current rates of taxation and other charges are estimated to yield less than the total amount required, the Commonwealth Government can adopt one or both of two courses of action. It is assumed that items of expenditure other than payments to the States are inescapable commitments, and if this is so, it may either reduce the amounts it has decided should be paid to the States, or increase rates of taxation in order to yield the additional revenue necessary to make the payment full. If the payments have been determined according to the accepted principle of distribution, any reduction in the total amount will probably distort the pattern, but provided the total amount available is sufficient to permit an adequate distribution, it is possible to maintain the desired equality by some modification of the original distribution. It would not be sufficient, for example, to reduce all grants by the same percentage, as such a procedure would assume that the services which could be supplied from financial assistance from the Commonwealth, vary in the same proportion in each State. It

would require a complete re-allocation of the total amount available.

On the other hand the Commonwealth could increase revenue by increasing rates of taxation and so maintain the originally proposed distribution. From the point of view of the community as a whole, there would be no gain or loss from the adoption of such a procedure, but there will be some further redistribution between States and between individuals in each State. The additional revenue to be raised will be contributed by each State according to its taxable capacity, and it is reasonable to assume that the wealthier States will contribute relatively more than the States with a relatively low taxable capacity. Similarly, within a State the recipients of the services supplied from the additional grant would not necessarily be the individuals who contributed most in additional taxation.

Applying this to the case of surplus Commonwealth revenue it can be seen that if a policy is adopted which aims at producing the nearest possible approach to equality by way of Commonwealth grants, the minimum amount which should be raised by the Commonwealth to produce surplus revenue which, if distributed equitably between States, will be sufficient to bring about equality in the desired fields is that amount which, when distributed between five States according to their relative financial needs will raise the standards in those States to those operating in the sixth State. Any additional amount above this minimum should be distributed between all six States, and if the distribution is sufficiently accurate, it will not alter the relative positions of the States, but will almost certainly improve the absolute level of services given in all States. Thus, so long as all States are receiving some assistance, the total amount can be safely reduced below the level of the amount first determined, provided that the distribution of the new total is made independently of the initial distribution. It is apparent that if the total amount is reduced by a certain percentage, it would not be sufficient for the proposed grant to each State to be reduced by the same percentage, for if such reductions continue, the stage would never be reached where one State received no grant, and this is a prerequisite of the minimum total amount to be distributed by the Commonwealth. This does not purport to say that absolutely there would be no difference in the standards enjoyed by the States, but rather that it is possible to obtain equality at some level, given a minimum total amount available for distribution.

Where, however, the principle of payment according to relative financial needs is not being invoked to its full extent, but rather that some rough approximation is being achieved, it would seem that the greater the amount available for distribution, the greater the possibility of reaching the optimum position of maximum equality. In the case of the amounts available for Income Tax Reimbursement payments, this argument would appear to be reasonable, and that in this particular case, it would be safe to say that the larger the

total amount available for payment to the States, the lower would be the differences in standards operating in the States. Consequently, in the interests of reaching this position, it would be preferable for the Commonwealth to determine first the needs of the States according to the chosen standards and then, if necessary, increase taxation rates to meet the requirements. Since the total amount to be paid to the States in reimbursement grants was fixed according to the operation of independent influences, the Commonwealth had no alternative but to raise the required amount once the base amount was fixed, and under the circumstances, it is thought that this was the proper approach. This formula imposed a minimum which it could be expected would permit a distribution which would allow the State Governments to operate at approximately the same level. So long as this minimum was maintained, and it is probable that it would alter from year to year, the principle was satisfied. The absolute level of services supplied as a result of the determination of the total amount is not directly relevant, but it can be mentioned that by the loss of income taxing powers, the States lost their most flexible source of revenue, and if in future the general standards of services were to be raised absolutely in the States, they would be reliant upon the Commonwealth Government for increased tax reimbursement, or some other form of grants.

Main concern, however, should be concentrated on the method by which the total amount decided upon as being available was to be distributed between the States, for it is in that field that the principle upon which grants are made must be considered. As mentioned earlier, in the period before 1946, the distribution was determined by the extraordinary circumstances prevalent at the time. Basically the States were compensated for the Treasury loss involved in the transfer of income taxing powers, but in all cases the amount involved was considerably different from the community loss. The immediate effect of the transfer of income taxing powers was actually to reduce the burden of taxation (with a few minor exceptions) yet the amounts received by the State Treasuries in reimbursement grants, and hence the level of State services supplied, was roughly the same as before. However, the extent of the reduction varied widely between States. For example, in some income ranges in the case of the Victorian taxpayer, the amount to be paid under Uniform Taxation was greater than the amount paid in the previous year, and in some other cases, particularly the less-populated States in the lower income ranges, there was considerable reduction. The implication of this variation in the effect in the different States was that the residents of those States where the reduction was greatest continued to enjoy the same standards of State services with a considerable reduction in the severity of taxation, while the residents of those States where the reduction was least, also enjoyed the same standards of State services as before, but contributed more by way of taxation payments. In other words, all other things being equal, the States which enjoyed least immediate

reductions were forced to contribute more than proportionately to Federal Revenue in relation to the size of the grant they received. However, it must be remembered that the conditions at the time were extraordinary, and that during the next few years, the increases in taxation rates generally were so substantial that the differences in State rates which existed before the introduction of Uniform Taxation, became small when compared with the total burden of taxation in those years.

The situation was quite different after the end of the war. As a temporary expedient to assist in the furthering of the nation's war effort, an arbitrary distribution could be condoned, but when it appeared that uniform taxation was to become a permanent feature of Federal-State financial relations it became necessary for the distribution to be determined by some method acceptable to both the Commonwealth and the States. The method which had been used during the war period had, in fact, been the adoption of the compensation principle, with the amount of the compensation based on the actual Treasury loss incurred. It has been stated earlier,⁷ that the adoption of the compensation principle involves the payment by the Commonwealth to the States of the community loss and then, if the Treasury loss is greater than the community loss, the Treasury can recoup the difference by levying higher rates in the fields of taxation remaining to it, and if the community loss is greater than the Treasury loss, the Treasury may remit the difference by reducing taxation in other fields. In the particular circumstances pertaining to the adoption of uniform taxation in Australia, it was the Treasury loss which was paid in Tax Reimbursement grants, and therefore there could be no reallocation by the Treasuries, because they were placed in approximately the same position as before. They had no surplus to remit or no taxable capacity with which to take up any difference that may have existed between Treasury loss and community loss. Before Uniform Taxation, there was probably some rough balance between the standards of services supplied and the severity of State taxation between States. Income taxation collections formed a large part of total taxation collections, and therefore the introduction of uniform taxation brought about equality of severity of taxation in this field, but there was no corresponding alteration in standards of services supplied. Thus there were two approaches which could be made in attempting to devise a new method of distribution of the total amount available. The first arose if it were decided to adopt the principle of compensation for loss in which case it would be necessary to introduce a distribution which would compensate the States for community rather than Treasury loss, and the second, if the principle of payment according to relative financial needs were adopted, a complete redistribution was needed to take into account the relative financial needs of each.

At the meeting of Premiers held in January, 1946, the Commonwealth Government submitted a proposal for reimbursement which

7. See above, pp. 50 ff.

was based on the actual expenditure on social services in each State. In essence, the Commonwealth proposal was that the grants which operated during the war should be subject to automatic increases as social services expenditure increased above the 1944-45 level. The effect of the proposal would have been to make the grants to the States equal to the then existing grants plus the whole of the increase in social services expenditure since 1944-45, up to a specified amount higher than the largest expenditure hitherto incurred by any State, and thereafter on a contributor basis. In addition, in order to meet the position of those States whose reimbursement grants were relatively low due to relatively low levels of social services expenditure, and hence low rates of income tax in the base years 1939-40 and 1941-42, the Commonwealth Government proposed that the reimbursement grant to any State should not be less than 95/- per head in the year upon which the grant would be based. The proposal also included a maximum grant of 97/6 per head. Thus, as social services expenditure in each State increased past the maximum, a certain stage would soon be reached where the per capita grants would be stabilised, and the absolute amounts would increase only in proportion to the population.

This scheme was not acceptable to the States, and the alternative suggested was the system that was eventually adopted. At that time, the indications of the post-war inflation which was to come, were just becoming apparent, and the States were concerned lest they should be caught with a major portion of their income fixed at a time when prices and costs were rising sharply. It was thought that this possibility would be provided for adequately if the total amount of reimbursement grants fixed for the initial year was to be increased proportionately to the increase in population, which would govern any absolute increase in the real cost of providing services, and to the increase in average wages which would be influenced by changes in prices and costs. On the other hand, the Commonwealth Government was fearful that if the States were given too much by way of reimbursement grants, they could accentuate any inflationary pressure that might exist, and therefore it was thought desirable that the automatic increases be restricted to the increases in the population plus only half the increase in average wages.

As far as the distribution of the total amount was concerned, it would appear that from the outset the Commonwealth Government recognised both the principle of relative financial needs and the principle of payment as compensation for loss. Their suggestion called for the continuation of the existing reimbursement grants, which were related to the compensation principle, and their subsequent alteration according to expenditure on social services, which gives a hint of recognition of relative financial needs. That scheme was not acceptable to the States, although it was realised that it was within the power of the Commonwealth to impose upon the States any scheme of reimbursement it chose.

It was generally recognised that under the distribution which had operated between 1942-43 and 1945-46, several States, and particularly Victoria and Tasmania were receiving considerably less than if the total amount had been divided proportionately to the contribution made by those States or certain other measures such as the relative sizes of population in each State. This required correction, but the problem to be faced was that the amount involved, by any measure was, in the case of Victoria, so substantial that the sudden increase in revenue at the expense of other States might cause difficulties in the management of State finances for a few years. Therefore it was proposed that the substitution of the new method of distribution for the old should take place gradually. This led to the adoption of the procedure of basing the distribution during the first ten years on a combination of both methods.⁸ This again was to be but a passing phase and it was intended that the distribution according to the adjusted population alone would operate to the full extent by 1956-57. It is informative to consider the percentage distribution of the total as it stood in 1952-53, when 50% of the total available was divided according to the original distribution and 50% according to the adjusted population, compared with the percentage distribution if the total amount had been divided according to the original distribution, or a per capita distribution. These three possibilities, compared with the actual division, are shown in the following table:-

Distribution of Tax Reimbursement Grant Between States - 1952-53

State	Actual Distribution %	Original Distribution %	Adjusted Population %	Per Capita %
New South Wales	39.99	41.19	38.79	39.49
Victoria	23.99	22.15	25.82	27.09
Queensland	16.08	16.50	15.66	14.37
South Australia	8.59	8.65	8.54	8.58
West. Australia	8.04	8.46	7.62	6.96
Tasmania	3.31	3.08	3.57	3.51
	100.	100.	100.	100.

From the point of view of analysis, regard should be given mainly to the formula distribution - that is, the distribution according to the adjusted population - for it is this aspect of Tax Reimbursement Grants which could be expected to influence Federal - State financial relations permanently. Under the scheme which was finally adopted, the basis for distribution of the total amount was to be the population in each State adjusted for differences in the number of children in the school-age group, 5 - 15, and the relative density of the States, or the area of the States which were socially served. It can be appreciated that the original proposal of the Commonwealth Government that Tax Reimbursement Grants should be related to expenditure on social services was being continued in this

8. See above, p.165.

formula with the significant difference that the Commonwealth proposition had been that payments should be related to actual expenditure, with a provision as to the maximum amount payable, whereas in the latter proposal they were to be related to differences in expenditure on social services which could be expected to arise because of fundamental differences in the operation of factors which influence the level of expenditure on the provision of social services in each State.

Under the former method, the situation could arise where a State which is favourably situated as regards relative costs of providing a certain standard of services could raise its standards above those operating in other States and still operate within the maximum provision of the proposal, whereas another State might be spending at a rate well above the level necessary to obtain the maximum reimbursement, and yet be providing a lower standard of services than enjoyed in the more favourably situated State. Under the second alternative, which was eventually adopted, the possibility of this eventuality was taken into consideration, in part at least. The major criticism of the use of the adjusted population to determine the distribution between the States of the total amount available is that it relates only to factors influencing expenditure in part of the field of government expenditure. Not only did it ignore a wide field of social services expenditure, but it completely disregarded expenditure on services other than social services. Nevertheless, it must be acknowledged as a considerable advance on the adoption of the principle of payment as compensation for loss. However, it must be criticised because it went only part of the way towards adoption of the principle of payment according to relative financial needs.

The use of the formula method does have the advantage that it proposed that after the expiration of ten years, the distribution would be completely divorced from the payments made as compensation for loss incurred by the States at the time when income taxing powers were transferred to the Commonwealth. It is, however, open to criticism on the grounds that there would be a long period before the distribution would be made entirely according to the adjusted population. The reason for this was that at the time when the formula was introduced, it was anticipated that the total amount payable from year to year would increase slowly, and that an alteration, if made suddenly, might cause some disruption to the pattern of State finances. For that reason it was decided to spread the alteration over a period of ten years. It was soon apparent, however, that the effect of inflation would be to cause the amounts payable to the States to increase rapidly, and that the transition period could have been very much shorter. The State which stood to lose most from the introduction of the formula method of distribution was New South Wales, and between 1947-48 and 1952-53, the grant to that State under the formula rose from £18.5m. to £43.5m. Had the distribution in 1952-53 been according to the adjusted population and completely divorced

from the former method of distribution according to the loss which the State suffered at the time when taxing powers were transferred, New South Wales would have received £42.2m. Thus, no very great hardship would have been inflicted had the change been completed by 1952-53. As soon as it was seen that the amounts involved were increasing rapidly, the period of transition could have been shortened considerably.

It has been pointed out previously⁹ that if the principle of payment according to relative financial needs is to be adopted, it is impossible to reduce the distribution of surplus Commonwealth revenue to a simple formula, and it is here that the inadequacy of the existing method of determining income tax reimbursements is revealed. The financial needs of a State are influenced by a multitude of factors, and if a true measure of their influence is to be obtained, it is essential that every one be taken into consideration. Some of the factors cannot be subjected to statistical measurement and therefore must be ignored or treated inadequately in any formula, no matter how carefully devised. Furthermore, the relative importance of each changes from time to time and no account can be taken of this unless the formula is revised after it has been in operation for a comparatively short period of time. Thus, it is evident that if any formula is devised for the distribution of the total amount available for payment of income tax reimbursement grants it will be highly complicated if it is to be at all satisfactory for the purpose, and at best it will ignore some important factors which should be taken into consideration and will require modification after it has been functioning for a short period to take account of alteration in the basic conditions.

The formula used in calculating Tax Reimbursement grants suffers from all these defects, but it must be remembered that its intention was not necessarily to bring about equality between the States, but rather to iron out certain inequalities which had arisen from the introduction of uniform taxation. Nevertheless, uniform taxation did offer an excellent opportunity for the introduction of the principle of payment according to relative financial needs, and to some extent the formula which was adopted was a step in the right direction. So far as the three claimant States were concerned, to the extent that the methods used by the Commonwealth Grants Commission brought about equality between each of the these three States and a standard equal to the average operating in the three standard States, it was immaterial which method was adopted for determining the distribution. In the claimant States, the Tax Reimbursement Grant is taken into Consolidated Revenue account, and thereby influences the budget result upon which the first approximation to the special grant is based. However, there is no such guarantee in the case of the three standard States, and it is here that the Tax Reimbursement Grants could play an important part in producing the desired equality. The only factors taken into consideration were the

9. See above, p.88.

numbers of children in the school-age-group and the density of the population in each State, and the influence of these two factors is probably only a minor portion of the total forces at work to produce a complex pattern of financial needs. It is suggested that these two factors were chosen because their influence was the most apparent cause of differences in the ability of State Governments to provide a given standard of social services at a cost similar to that incurred in all States on the average, and secondly because it was possible to apply statistical measurement to the operation of these two factors. There was no doubt that a more satisfactory result could be obtained by extending the scope of the formula to include other factors, but the difficulties involved in their inclusion would be too great for solution in a simple formula.

It is apparent that while it is intended that the distribution be made by reference to a formula which will operate automatically, it can safely be asserted that it will be impossible to achieve a distribution that will satisfy the principle of payment according to relative financial needs. The most that will be achieved will be a hybrid which has the advantage of rejecting the principle of payment as compensation for loss, but which goes only part of the way towards adopting the best possible alternative. Probably the only satisfactory method which can be used to put into effect the principle of financial needs is for the distribution to be determined as a recommendation to the Federal Government by a body of independent experts who can devote their full time and resources to the problem of measuring the relative financial needs of each State. It would be quite compatible with the principle for the total amount to be decided by some arbitrary method such as according to Commonwealth budget or general economic policy, or even by an automatic formula, provided that the distribution is made according to relative financial needs.

The task which would confront such a body of experts would be very great. It would differ from the operation of the present Grant Commission in that it would be required to examine, not only the relative positions of the States, but also the absolute levels of services provided, severity of taxation, etc. in all States. To a large extent, its operation would probably be of the nature of trial and error until some sort of picture was formed, and thereafter its function would be to adjust the existing picture to conform to changes in the relative financial positions of the States. This is probably an over-simplification of the problems which would face such a body, but generally it is thought that it would probably yield the most satisfactory results in the long run. The attainment of a reasonably accurate distribution would probably take some years to perfect, but with each successive year it would be approaching nearer and nearer to the optimum as statistical techniques were perfected and the members of the body gained more knowledge of the problem. The composition and organisation of such a body which would best suit the purpose has

already been outlined in Part 1,¹⁰ and there is no need to elaborate at this stage. It will be given further consideration when coordination of all types of grants is being considered in Part 3.

The remaining matter relating to income tax reimbursement grants which should be treated in detail is concerned with the distribution of amounts which have been paid to the States as "Special Financial Assistance." In each year since 1947-48, the Commonwealth Government has supplemented the total amount of the grant which should have been paid to the States according to the formula, by substantial sums. In 1951-52, this amounted to £33.6m. and in 1952-53 to £27.1m. In 1953-54, the additional amount was £21.9m and in 1954-55, £19.5m. The distribution of these amounts was decided by the Commonwealth Government after consideration of opinions of the several State Premiers. The distribution of the total amount of special financial assistance, compared with the actual distribution of the total amount available for reimbursement determined according to the formula is shown in the following table for two representative years:-

Distribution of Tax Reimbursement Grants by Percentages - 1951-52 and 1952-53.

State	Original Distribution	Adjusted Population	Actual Tax Reimbursement 1951/2	Special Financial Ass. '51/2	Actual Tax Re. 1952/3	Special Financial Ass. '52/3
N. S. W.	41.19	38.79	40.27	38.94	40.08	38.74
Victoria	22.15	25.82	23.59	27.17	23.98	26.20
Queensland	16.50	15.66	16.19	14.91	16.08	15.50
Sth. Aust.	8.65	8.54	8.59	8.31	8.55	8.49
W. Aust.	8.46	7.62	8.11	7.12	8.00	7.75
Tasmania	3.05	3.57	3.25	2.55	3.31	3.32
Total	100.	100.	100.	100.	100.	100.

From this table it can be seen that the additional amount was not distributed according to any of the possibilities arising from the formula. For example, in 1951-52, Victoria received 23.98% of the total amount of £108.8m. as determined under the formula. In that year 50% of the total amount was divided according to the proportions which operated during the pre-1946 period of uniform taxation, referred to for simplicity, as the original distribution, when Victoria's share was 22.15%, and the other 50% according to the adjusted population, with Victoria receiving 25.77%. Of the additional amount available in that year, Victoria received 26.28%, and hence it is apparent that the distribution was not in accordance with any of the predetermined measures. In fact, the distribution was decided during the course of a Premiers' Conference after the Prime Minister had announced that the specified amount would be made available by the Commonwealth, and requested that the Premiers agree between themselves as to its distribution. The distribution was a compromise and followed roughly the pattern of the division of the total tax reimbursement grant proper. Special consideration was given to Victoria which had

10. See above, pp. 82 ff.

suffered most from the adoption of the compensation principle in the earlier years.

The distribution of the additional amount by this method cannot be supported on any grounds. If it assumed that the major amount as determined by the formula, has been apportioned between the States according to some design, then the division of the additional amount according to some other criterion can only act as a disturbance to the original pattern. Furthermore, the distribution was made by the bargaining of political leaders who, at this stage, could not be interested in the principles involved, but only in gaining the maximum financial assistance for their own States. Even if they were advised in their actions by public servants acting in the capacity of expert advisers, there is still the probability of bias influencing decisions in these matters. If the procedure can be condoned at all, it must be on the grounds of urgency. The meeting at which the extra amount which the Commonwealth will make available is announced after the commencement of the financial year to which the grants relate, and the decisions must be made at short notice in order that State Governments should be in a position to prepare their budgets for presentation to Parliament early in the financial year. Nevertheless, it would be a simple matter for the additional amounts to be paid in the same manner as the major amount. If it is intended that the principle of payment according to relative financial need is to be followed, and the total amount to be disbursed is altered, the original distribution should be disregarded and needs recalculated on the basis of the new amount.

In the case of income tax reimbursement grants, however, the principle of financial needs has only been partially adopted. Equality can be produced only to a limited extent, and the equality can easily be offset by inequalities in other fields. Under the particular circumstances, it is suggested that there would be no significant disturbance to the intended effect, if the additional amount had been distributed in proportion to, if not the adjusted population, at least the original distribution and adjusted population together. Of the two alternatives, it is suggested that the adjusted population method would have been better, as its application to the distribution of the additional amount would have lessened the effect of the long transitional period which could have been shortened with advantages.

It should be mentioned that it is not necessary to associate the supplementary grants with income tax reimbursement grants. Technically there is no direct connection between them, although it was claimed by the States that the amounts as determined by the formula were insufficient for them to continue State services at the standards they had been able to afford in previous years because of the effects of inflation. It was stated that the States were unable to expand revenue to meet higher costs because their most flexible source of income had been taken over by the Commonwealth. In recognising the claim, the Commonwealth automatically placed the special

financial assistance payments in the same category as income tax reimbursement grants. They are also similar in that they are only payable on condition that the States do not levy an income tax, and they are both unconditional in that they are block grants which may be taken into revenue and used for whatever purpose the States choose.

So far as the conditional nature of the grants is concerned, it can be said that since the conditions apply, not to the manner or purpose for which the grant is used, but to the undertaking given by the States not to levy an income tax, there is no serious limitation on freedom of action by the States. It has been asserted¹¹ that a grant from the Commonwealth Government to the State Government should be unconditional in order that the States may retain the maximum degree of independence, but with the type of condition which has been applied to tax reimbursement grants, there is a different principle involved. At the outset, when uniform taxation was first introduced, this was thought necessary to enable the Commonwealth to conduct its defence policy with maximum efficiency, and it was continued in the post-war period because of increased Commonwealth commitments and the necessity to levy a higher rate than in pre-war years. An associated reason, which was not specifically stated but which was implied at the time was that the Commonwealth Government desired to maintain its overall control of State expenditure in the interests of the economy as a whole, and in particular to prevent the occurrence of inflation. Apart from this, the Commonwealth Government would have been quite justified in retaining uniform taxation purely for the purpose of raising sufficient revenue to enable it to make grants to the States of sufficient magnitude to enable the distribution to bring about equality between the States in any chosen fields. In fact, this may have been one of the motives which prompted the Commonwealth to retain uniform taxation, but if such was the case, it would have been politically advisable to give the reason in those words.

In 1953-54, the total amount of assistance given to the States by the Commonwealth in all forms was £224m. and of this, £142m. represented tax reimbursement grants and special financial assistance. Had uniform taxation not operated in that year, Commonwealth grants would have totalled £82m. and in view of the size of the State budgets approaching £500m., it is doubtful whether £82m. would have been sufficient to produce any degree of equality when distributed according to relative financial needs. Furthermore, the abandonment of uniform taxation would, from the point of view of the principle of relative financial needs, have been a retrograde step in that uniformity in one important field, namely severity of income taxation, would have been lost. With uniform taxation, it is safe to assume that the burden of taxation is spread fairly equitably throughout all States. Admittedly, there still remains a large field of taxation in which the States operate, but its significance is relatively small. In 1953-54,

11. See above, p.96.

State taxation revenue, where differences in severity can arise, totalled £50m. while Commonwealth taxation, which must be uniform throughout all States, yielded revenue totalling £898m. of which £528m. was revenue from income taxation. It can be seen, therefore, that the possibility of considerable differences in severity of taxation arising while uniform taxation operates is remote. However, if taxing powers were to be returned to the States, it is more than probable that the severity of taxation between States would again be different, and hence the inequality to be corrected by the distribution of Commonwealth revenue would be increased, and the means which the Commonwealth could use for this purpose would be reduced. Consequently, it would appear that, apart from any other considerations, the present method of uniform taxation and income tax reimbursement grants is desirable merely as a means of providing the Commonwealth with sufficient surplus revenue to permit an allocation between the States which would permit equality of standards of services and severity of State taxation and other charges.

Summarising the implications of uniform taxation and tax reimbursement grants as they affect the adoption of a principle upon which grants are made to the States, it may be said that its introduction offered the possibility that a distribution of surplus revenue would be possible which would bring about greater equality between the States. In the initial years of its operation, it can be appreciated that because of the peculiar circumstances operating at the time, no serious attempt was made to do more than maintain the revenue positions of the States irrespective of the alterations in the relative burdens of taxation. In 1946, however, when it appeared that uniform taxation was to become a permanent feature of Federal-State financial relations in Australia, it should have been possible to introduce a method of distribution of the total amount available according to the principle of relative financial needs. The formula which was introduced went only part of the way towards achieving this position, and while it had some advantages over the principle of payment as compensation for loss, if the principle of financial needs is to be adopted, the only successful method of determining an adequate distribution seems to be by the appointment of a body of experts who are fitted to determine the relative financial needs of each State, and who would advise the Commonwealth Government on the best way to distribute surplus revenue between the States. The necessity for the appointment of such a body has been accentuated by the practice which has grown up in recent years of distributing any amounts additional to those indicated by the operation of the formula by agreement between State Premiers. Such a procedure can be detrimental to a planned distribution according to relative financial needs. Further reference will be made to the manner in which a satisfactory solution may be reached in Part 3.

CHAPTER 10SPECIAL PURPOSE GRANTS

In addition to the major types of grants from the Commonwealth to the State Governments which are basically unconditional in that they are taken into Consolidated Revenue Accounts and from that stage lose their identity, there are a number of minor special purpose grants made to the State Governments which must be used for specific purposes, and hence can be called special purpose or "ad hoc" grants. They may be made only in one year, or they may be of a permanent nature. In 1953-54, the total amount received by the States in direct financial assistance from the Commonwealth amounted to £224 m. and of this, the three types of grants which have been dealt with in the preceding Chapters, Grants under the Financial Agreement, Special Grants under Section 96 of the Constitution and Tax Reimbursement Grants, accounted for £169m. or 75% of the total. The remainder was divided between the special purpose grants paid to the State Governments referred to above, and a group of grants paid as assistance to primary producers, and which were paid directly to the producer or consumer in some form but which were independent of the finances of the State Governments. While this latter form of special purpose grant will influence the relative financial needs of the several communities, they will have only an indirect effect on State budgets. For this reason they will not be considered in detail in this Chapter, although reference will be made to them at a later stage. Attention will be concentrated on the special purpose grants made directly from the Commonwealth to the State Governments, and it will be necessary to spend some time on examining the different purposes for which the grants are made and the method used for determining the relative amounts which each State will receive.

(1) Federal Aid Roads.

In 1922-23, the Commonwealth Government first made a grant to the States to assist them in the development of their main roads. The total amount provided was £1,750,000, and this was made conditional upon the States spending £1,500,000 for the same purpose. The distribution of the total was to be three-fifths according to population and two-fifths according to area. A similar amount on the same conditions was provided in each of the two following years and in 1926, the Commonwealth passed the Federal Roads Act, which provided that the Commonwealth would pay to the States a sum of £2m. in each of the ten years commencing 1926-27. The distribution of this amount was to be the same as before, three-fifths according to population and two-fifths according to area, and was again conditional upon the

States spending £1,500,000 for the same purpose. Thus the original payment was placed on a permanent basis and the Commonwealth contribution increased by £250,000 per annum.

During the early years of the depression of the 1930's, the States found difficulty in meeting their obligations in this field due to the economic stringency of the times, so in 1931, the agreement of 1926 was altered to provide that for the remainder of the ten-year period, the Commonwealth should pay to the States an amount equivalent to 2½d. per gallon customs duty and 1½d. per gallon excise duty on all petrol entered for home consumption in each year. No corresponding contribution was required of the States. The immediate effect of this change was to reduce the total amount payable from £2m. in 1930-31 to £1,812,000 in 1931-32, but by 1933-34 the fixed amount of £2m. which had previously existed was exceeded by £220,000. The distribution between States was continued as before. The agreement was renewed in 1937 for a further period of ten years but the Commonwealth contribution was increased to the equivalent of 3d. per gallon customs and 2d. per gallon excise duty on all petrol entered for home consumption. The distribution was also changed slightly, and under this agreement, Tasmania was to receive 5% of the total, and the remaining 95% was to be shared between the other five States on the basis of three-fifths according to population and two-fifths according to area.

A new agreement was made in 1947 under the Commonwealth Aid Roads and Works Act, which continued the existing agreement for a further three years and also provided that the total amount as determined was to be increased by a further £1m. In 1948-49, this extra amount was increased to £2m., and in 1949-50, to £3m. In that year, a new agreement was made to cover the next five years. The total amount was to be determined as the equivalent of 6d. per gallon customs and 3½d. per gallon excise duty on petrol entering the country for home consumption and the distribution was to be as before. In 1954 the legislation was again amended to provide that the total amount payable to the States should be equivalent to 7d. per gallon on both customs and excise duties on petrol. The immediate effect was to increase the total amount of the grant from £17.3m. in 1953-54, to £24m. in 1954-55. The following table shows the total amounts paid in certain years:

Amounts Paid by the Commonwealth as Federal Aid Roads

Year	Amount £m.	Year	Amount £m.
1922-3 to 1925-6	1.75	1947-48	6.3
1926-7 to 1930-1	2.0	1948-49	7.6
1931-32	1.8	1949-50	9.3
1932-33	2.2	1950-51	14.1
1937-38	4.1	1951-52	15.2
1946-47	4.8	1952-53	15.6
		1954-55 (est.)	24.0

The distribution of the total amount, which has operated with the minor exception of the proportion payable to Tasmania, since the inception of this type of grant, gave the following amounts to each State in 1953-54:-

New South Wales	-	£4,685,000	South Australia	-	£1,828,000
Victoria	-	£2,892,000	Western Australia	-	£3,191,000
Queensland	-	£3,191,000	Tasmania	-	£ 831,000

The method which has been adopted to determine the portion of the total amount which each State receives has some merits. The object of the grant was to place each State on an equal footing so far as development of its roads system was concerned, but later the Commonwealth agreed that portion of the grants should be used for repair and maintenance purposes. However, the measure used to determine needs for finance for roads development and maintenance does not appear to be very precise. The simple measure which takes into account only population and area leaves much to be desired, for the size of the population may be unrelated to the need for roads and there may be large parts of the States which have no road requirements whatsoever, as, for example, large parts of Western Australia. Unless the error arising from the operation of these factors is proportionate between States, the measure which has been adopted will give only a rough approximation to the perfect result.

Furthermore, such a measure gives no consideration to the ability of the States to meet road development and maintenance costs from their own revenue. The main source of funds for these purposes at the present time in most States is taxation on motor vehicles, and the amount received will depend on the number of motor vehicles registered in each State and the rates of taxation on those vehicles. In a densely populated State which is highly industrialised, the number of vehicles will be proportionately greater, and the need for funds for road maintenance purposes proportionately smaller than those of a State with a large area and a small population which is well dispersed. The measure used by the Commonwealth in distributing the total amount available assumes that the number of vehicles and hence taxable capacity in this field, is proportionate to the population of each State, and that the need for roads varies with the areas of the States. Neither of these assumptions is strictly valid, but nevertheless it is probable that the method used has given a result which is fairly close to the distribution which would have been achieved if every factor had been taken into consideration. The most pleasing feature of the method is that it bears no relationship to the amounts which the individuals of each State contribute in customs and excise duties. Assuming that petrol consumption varies directly with the number of motor vehicles registered, it can be shown that the people of Victoria contributed approximately four times the contribution of the people of Western Australia, yet in 1951-52, the grant to Western Australia was greater than that paid to Victoria. Thus it is apparent

of each State rather than the relative amounts contributed by the residents of each State.

(2) Hospitals Benefits Agreement Grants.

In 1945, an agreement was reached between each State and the Commonwealth, whereby the Commonwealth agreed to pay to the States the equivalent of six shillings per day for each occupied bed in public hospitals on condition that no charge was made to patients in public wards of the hospitals, and the fees in non-public wards reduced accordingly. At the outset, only portion of the total amount was to be used for maintenance costs, while the remainder was to be used for capital expenditure. As a result of representation by the States in 1947, the Commonwealth agreed that the whole of the amount of six shillings per occupied bed per day could in future be used for maintenance purposes. As from 1st July, 1948, the amount was increased to the equivalent of eight shillings per occupied bed per day for both public and non-public beds. From the outset, the agreement also applied to private hospitals which were also required to reduce fees to patients by the amount of the subsidy from the Commonwealth, but these payments are not relevant to a consideration of financial relations between the Commonwealth and State Governments.

In February, 1951, the Commonwealth gave notice of its intention to terminate the agreement at the earliest possible date according to the terms of the legislation. The Commonwealth and State Hospitals Benefits Agreements Act provided that eighteen months notice of termination should be given, and therefore the arrangements were due to expire in August, 1952. In that year, new agreements were entered into between the Commonwealth and the States under which the States agreed to charge at least eighteen shillings per day for public hospital beds. Of this charge, the Commonwealth agreed to subsidise patients to the extent of eight shillings per day, and a further four shillings per day if the patient is a member of an approved hospitals benefits society which pays benefits of at least six shillings per day. Thus, in the case of an insured person, there would be no direct cost involved, as combined Commonwealth and insurance payments would total eighteen shillings per day. Where the patient has not insured, he would be required to meet charges of ten shillings per day, and the Commonwealth the remaining eight shillings. The revenue of the hospitals would therefore be increased by at least ten shillings per day as a result of the new arrangement, although the grant from the Commonwealth would only be increased by four shillings in certain cases.

So far as the amount paid by the Commonwealth to the State is concerned, there is little difference between the schemes which operated before and after 1952, with the exception that the conditions upon which the payments are now made are more severe than those which previously governed these payments, and therefore the scheme of payment since its inception up to the present time can be treated in

general terms. From the point of view of principles upon which the payment of grants is made, it is concerned only with the relative amounts paid to each State. The amount which each State receives, is determined solely by the number of patients treated and the length of their stay in hospital. The principle of payment as compensation for the relative amount contributed to Federal revenue does not arise, but as in other cases of a similar nature, the principle of payment according to relative financial needs has been only partially adopted. It can be expected that differences in the relative costs of supplying hospital services between the States will depend on the relative incidence of sickness, diseases etc, the existence of private hospital facilities, the relative distribution of the populations, and the average size of hospitals in each State. Of these factors, the effects of the first three will be reflected in the number of bed-days in public hospitals in each State, and to this extent the method of determining the reimbursement adopted by the Commonwealth appears to be satisfactory. However, no recognition is given to the fourth, and it is possible that this is the cause of considerable difference in the relative cost of providing the same standards of service in the States.

In the case where a State has a large population concentrated in a few centres, it is possible to organise all hospitals so that they operate at the most efficient level. It could be expected that as the size of a hospital grows, the cost per patient per day will fall until, at a certain size, costs will reach a minimum, and from then onwards as size increases, relative costs will also increase. Thus the total cost will be minimized if all hospitals are of an optimum size. In a State with a small population, however, it will be impossible for this state of affairs to be organised, and it is quite conceivable that all hospitals will be less than this optimum. Thus, if there is any special need in the finances of a State arising from the operation of this factor, it is not recognised in the present scheme of Hospitals Benefits Payments. Nevertheless, the method adopted does take into consideration a large part of differences in relative financial need arising from the provision of this service, and it has the advantage that no consideration is given to the relative amounts which the residents of each State contributed to the revenue of the Commonwealth in determining the amounts to be paid to each State.

The scheme can be criticised, however, on the grounds of the conditions upon which the grant is made. The amount which the patient is now required to pay for the service, either directly or through an insurance scheme, is uniform throughout all States. If the principle of relative financial needs is being adopted, then this assumes that the ability of persons to pay for even a portion of the cost of the service they receive is uniform throughout all States. This is obviously not so, and by any measure, the ability of the residents of a State such as Tasmania to pay for the services they receive will be less than the ability of the residents of a State such

as New South Wales. To this extent, the insistence of the Commonwealth on a minimum charge of eighteen shillings per day per bed in public wards, has tended to create more differences in the net standards of services received in each State. This is not intended as a criticism of the National Health Scheme as such, but rather as a criticism of the requirements being the same in each State. Consideration should also be given to the relative ability of residents of each State to provide part of the services from their own resources.

(3) Mental Hospitals Benefits Grants.

The Mental Hospitals Benefits Agreements were between the Commonwealth and each State separately during the years 1948 and 1949, and were to operate for a minimum period of ten years. Under these agreements, the Commonwealth Government undertook to pay to the States a fixed amount for each patient day in mental hospitals on condition that the States ensure that no means test is imposed upon, and that no fees are charged in respect of any patient in a mental hospital in that State. The amount payable to each State was the amount collected by the State for the provision of this service in the period prior to the introduction of the Agreement. The amounts ranged from 8d per day in Western Australia to 1/2 per day in Victoria and have continued unchanged until the present time.

The effect of the introduction of this scheme was to place the States, so far as net mental costs were concerned, in approximately the same position as before, except that henceforward their incomes would be fixed whereas before the agreements were instituted, the authorities could raise charges to meet rising costs. The only concern of the Commonwealth was to provide that mental hospital services should be given free of cost to patients in each State and no regard was paid to the possible reasons why revenue from charges differed between States. For the same reasons that were mentioned in the case of public hospital services,¹ relative costs of the provision of mental hospital services would vary between States, and therefore in determining the amount that would be paid to each State, the Commonwealth should have been interested in differences in costs rather than differences in revenue, if it was intended that the principle of relative financial needs should be used. As the position stands at present, the relationship between costs and revenue which existed in 1948 will be continued so long as the agreement is in force.

It is interesting to compare the cost of the provision of mental hospital services per patient per day with the amount of subsidy per patient per day in each State in 1951-52:

	Cost per day	Subsidy per day
New South Wales	16/5	1/-
Victoria	13/9	1/2
Queensland	12/5	-/10
South Australia	12/1	-/10
Western Australia	14/-	-/8
Tasmania	17/3	-/9

1. See above, p.184.

It can be seen that the Commonwealth subsidy represents only a small portion of the total cost in each State, and that there is little relationship between the cost and the amount received. For example, in Victoria the cost was 13/9 per patient per day and the subsidy 1/2 per patient per day, while in Western Australia the figures were 14/- per day and -/8 per day respectively. If the payment was according to relative financial needs, and the same standards of services are being supplied in each State, it could be expected that the cost and the subsidy per patient per day would vary uniformly between the States. As it stands at present, the method of distribution of this portion of surplus Commonwealth revenue is perpetuating the inequalities which existed before 1948.

(4) Tuberculosis Subsidy.

The Tuberculosis Act (1948), provided that the Commonwealth could enter into an arrangement with a State for the provision by the State of services and facilities for the diagnosis, treatment and control of tuberculosis. Any such arrangement was to provide for the reimbursement of the State by the Commonwealth in respect of capital expenditure by the State on or after 1st. July, 1948, in the provision of land, buildings, furnishings and equipment for diagnosis, treatment and control of tuberculosis, and net maintenance expenditure to the extent that it exceeds maintenance expenditure incurred during 1947-48 for the same purpose. Agreements were made with all States in 1949 and 1950, and payments have continued since that time. Again, this was a function of government which resided solely with the States, and if the Commonwealth wished to play any part, it had to be through the agency of the States. The method which the Commonwealth chose to ensure that the service was given in all States was this form of subsidisation.

Main consideration must be given to the subsidy for maintenance expenditure, for if the assistance from the Commonwealth for the provision of capital works were not forthcoming, this expenditure would be met from loan funds and the burden on the State budgets would be comparatively small. The Commonwealth agreed to meet any expenditure on maintenance over the level of State expenditure which was incurred on the provision of this service in 1947-48, and by adopting this measure tended to perpetuate the inequalities which may have existed at that time. A hypothetical case can be envisaged where, before the introduction of such a scheme, the net standards of services received in all States were the same but the distribution of the services was different so that, for example, one State concentrated on the provision of health services and another on education, but on balance the net benefits received by the residents of each State as a whole were the same. Under such circumstances, it could be that one State was spending a much greater amount on tuberculosis control

than another, and so the introduction of a scheme which provided for the subsidisation of all excess expenditure on tuberculosis control over the level in the base year would raise the relative standards of the State which formerly spent less on this service, but compensated for it by greater expenditure in another field. The subsidisation would permit all States to reach a common level in the provision of this specific service, but would ignore differences of standards in other fields which were partly caused by the levels of relative standards of this particular service in the base year. Consequently, it can be stated that this form of grant does nothing more than permit an increase in the differences in standards of net services which existed between the States, if the States concerned chose to take advantage of the method adopted to determine the amount of the subsidisation.

(5) Grants to Universities.

In the immediate post-war period, the finances of the Universities of Australia were improved by the increase in the numbers of students enrolled under the Commonwealth Reconstruction Training Scheme. The revenue of the Universities is derived from several sources of which the main one is the annual grant from the respective State Governments. This is supplemented by donations and benefactions which vary considerably between States, student fees, and in recent years, grants from the Commonwealth Government to meet the cost of Reconstruction students and for research purposes. Through the Reconstruction Training Scheme, the Commonwealth Government was giving financial support to the Universities, but by 1950, the numbers of students enrolled under the scheme was declining rapidly. The University authorities were finding it difficult to meet their commitments because of rising prices and costs. It was suggested that the Commonwealth might relieve this position by additional grants to the States, and in 1950, a committee was set up to inquire into and report upon the financial position of the Universities. As a result of its recommendations, the Commonwealth Parliament passed legislation to make grants to the States for assistance to the Universities.

The States Grants (Universities) Act, 1951, provided that in each of the calendar years 1951, 1952 and 1953, the Commonwealth would pay to the States as a whole, an amount of £803,000, divided between the States according to the number of full-time students, with an adjustment to make allowance for special difficulties in the smaller States, as it was recognised that the cost per student in smaller Universities, such as the University of Tasmania, is very much greater than in the larger Universities. The payment of these amounts was to be conditional upon each State spending the equivalent of three times its proportion of the base grant of £803,000 from its own resources upon the provision of University services. In addition to the basic grants, the Commonwealth agreed to pay "second-level" grants equivalent to £1 for every £3 by which the State grant, plus fees received by the University, exceeds the qualifying amount for the basic

grant, with a maximum second level grant payable to all States of \$300,000. The legislation was amended in 1953 to double the maximum second level grants. All money received was to be spent on maintenance. There were other minor points of the agreement, but the main financial points were those mentioned above.

This is one of the few examples in Australian Federal-State financial relations where a grant is made to the States on the principle of the matching grants - that is, where expenditure by a State on a particular service is matched by a proportionate grant by the Commonwealth. In Part 1,² the part of the matching grant in Federal-State financial relations was examined briefly and it was shown that this method can only be justified when the several States are capable of providing the same standards of services from their own resources. If this position does not exist, the matching grant may lead to the concentration of expenditure in the field which is subsidised at the expense of expenditure on other types of services. In the particular case of grants to assist Universities, however, there are peculiar features which tend to lessen the likelihood of this happening. The amount which the Commonwealth will provide is limited to £1,403,000 irrespective of the expenditure by the States in excess of three times this amount, and therefore there is no inducement to the States to exceed this figure once it has been determined.

The method of determining the distribution of the total basic grant appears to satisfy the principle of payment according to relative financial needs, for it has been stated that it is distributed "according to the number of full-time students, with an adjustment to make allowance for smaller universities."³ It can be expected that, all other things being equal, the cost of maintenance of a University will vary according to the number of students. However, there is probably an optimum size where the cost per student is lowest. When a University is less than this size, or expands beyond it, the cost per student will be greater than in a University of the optimum size.

It is extremely doubtful whether some of the smaller Universities approach anywhere near this optimum size, and therefore their relative costs will be greater than those of the larger Universities. This is apparently recognised in the distribution of the basic grant. However, the condition which provides that the States must find three times the basic grant to qualify for assistance means that the government of a State containing one of the smaller Universities must find three-quarters of the difference in costs arising from the operation of this size factor. If the principle of relative financial needs were being enforced in its entirety, provision would be made to ensure that all differences arising from this source would be met by the Commonwealth Government. In other words, the States would be

2. See above, p.93.

3. Statement by the Prime Minister during the debate on the States Grants(Universities) Bill, Hansard, 27th November, 1951 p2786.

required to find that proportion of expenses which arises from the operation of factors which are common to all States, while the proportion arising from the operation of factors which differ in the severity of their impact on the several States will be found by the Commonwealth. If any balance remained in the amount available for distribution to the States after the Commonwealth had made these payments, this could be divided between the States according to the number of full-time students, which is the main determinant of costs after the size factor has been excluded. To the extent that this operates, the present method of distribution is defective, but apart from this, the method adopted seems to be reasonably satisfactory.

(6) Miscellaneous Grants.

In addition to the grants which have been mentioned above in 1953-54 the Commonwealth Government made the following payments to the States:⁴

Grants to assist in importing houses ..	£ 615,400
Coal Mining Industry - Long Service Leave ..	578,903
Encouragement of Meat Production ..	413,011
Western Australian Waterworks ..	333,047
Price Control Reimbursement ..	83,609

There were also some payments for assistance to primary producers in the form of bounties and subsidies, but since they were made to the producer or consumer independently of the State Governments they need not be considered here.

Some of the amounts are small, some are of the nature of non-recurring grants, others relate to payments to one particular State, and the field covered is very wide. It is not considered necessary to examine each in detail, but merely to state that they are all special purpose grants which the Commonwealth Government has deemed advisable to assist a particular branch of industry or governmental activity.

It is now possible to consider the role that the different types of grants for special purposes which have been considered above can play in a scheme of payments from the Commonwealth Government to the States based on the principle of relative financial needs. Some attention was given to this matter, insofar as the principle involved was concerned, in the First Part of this essay.⁵ It was pointed out that while this type of payment could be in harmony with the principle of payment according to relative financial needs if the distribution of the total amount available between the States was calculated according to some predetermined method which took into consideration all the factors which caused the relative financial needs of each State to differ

but it would be completely effective only if special purpose grants were calculated in relation to all fields of economic activity. However, the very nature of this type of grant

4. Commonwealth Budget Papers, 1954-55, p.146

5. See above, p.91 ff.

was that the payment was conditional upon its being used for the purpose specified, and this implied a restraint on the financial independence of the States. This restraint would be far greater than would be evident if the method of block unconditional grants were used.

The use of special purpose grants, if carried out completely, implies that the Federal Government aims at forcing the States to achieve equality of standards of services supplied in all fields of governmental activity. On the other hand, the use of the block unconditional grant implies that States are permitted to achieve overall equality by a judicious expenditure policy, but the decisions as to how the funds are to be expended remains one of their sovereign rights. An additional deficiency of the special grant method of disbursing surplus Commonwealth revenue, even when the method is followed completely, will be that it can not take into account differences in the severity of State taxation while the Federal Government is compelled to levy taxation at uniform rates in all States.

A general examination of the use of special purpose grants in the Australian Federation can be approached from two different viewpoints, the first relating to the method of distributing the total amount available between the States, and the second to the conditional nature of the grants. It may be said that in all cases, in determining the relative amounts which each State is to receive, even in the case of Federal Aid Roads which operated from 1922-23, the principle of payment as compensation for loss or according to the actual amounts contributed by each State to Federal revenue was not adopted. From the outset recognition was given to special circumstances which caused different needs between the States, and in this way the principle of relative financial needs was adopted, in part at least.

However, it invariably happened that this principle was only partially adopted in that when the amount which each State was to receive was being determined, not all the factors which would be expected to influence the relative levels of the cost of providing the specific service at a common standard, to which the grant related were taken into consideration. For example, in the case of Commonwealth Aid Roads, the factors which are considered are the relative sizes of population and the relative areas of the several States. Obviously there must be other factors which will help to determine variations in the cost of providing the same standards of road services in all States, and because they are not taken into consideration, there is an implied assumption that the effects are relatively the same in all States. The cumulative effect of the operation of the unknown factors may have considerable effect upon the distribution based upon the measure of area and population alone, if they too were taken into account. Similarly, in the cases of other special purpose grants which have been mentioned above, the omission of the effects of certain influential factors has probably had the effect of producing a

distribution which varies in some way, small or large, from the distribution which would have been obtained if the principle of relative financial needs had been fully incorporated in the formula governing the distribution of the total amounts available.

The other condition which would make the use of special purpose grants compatible with the principle of payment according to relative financial needs, is that this type of grant should cover the whole field of governmental activity. It has been seen from the foregoing analysis that in Australia at the present time, there is only a restricted field of coverage. In fact, the total amounts paid by the Commonwealth to the States as financial assistance in the form of special purpose grants form only a small proportion of the total amount of financial assistance given. The bulk of the remainder is paid under Tax Reimbursement Grants and Special Financial Assistance Grants and it has already been explained that these grants are unconditional in the sense that there is no compulsion upon the States to use the funds for the provision of any particular service or services. It is possible that the adverse effects of the special purpose grants, covering only a limited field, may be modified as a consequence of this, but the interrelationship of the various forms of grants will be considered in greater detail in the next Chapter.

Related to this aspect of the special purpose grant are the implications of the use of the "matching grant", which has been used in one particular case, that of financial assistance to the Universities. It has been emphasised that this type of financial assistance is definitely in opposition to the principle of financial needs,⁶ as in its purest form it gives preference to those States which are in a position where they may be relatively independent of the Commonwealth for financial assistance. In this particular case, however, the adverse effects are modified in that the base amount which must be spent by the States before they qualify for the assistance, takes into consideration to some extent, the ability of the States to spend money on the provision of University education from their own resources. Nevertheless, it contains many of the undesirable features inherent in the matching grant, and therefore must be condemned as a method which takes very little notice of the principle of payment according to relative financial needs. It could easily result in the poorer States transferring available funds from the provision of other services to the provision of University education in order to qualify for the Commonwealth assistance, thus causing a net reduction of relative standards compared with the position in other, wealthier States where the transfer might be effected without causing any great disturbance.

Generally it may be said that the methods which have been adopted to distribute available funds between the States by means of special purpose grants have not represented the complete application of the principle of relative financial needs. The second factor

6. See above, p 93 ff.

which must be taken into consideration before a complete assessment can be made as to the adequacy or otherwise of this type of grant, is the conditional nature of the grants. The general condition upon which the payments are made is that they shall be used solely for the purpose for which they are specified - for example, the maintenance of roads in the case of Commonwealth Aid Roads. By itself, this does not appear to be a very stringent condition, for it could be argued that even if the grants were made unconditionally, the money would be taken into Consolidated Revenue and in all probability an amount approximately equal to the grant from The Commonwealth would be used for the specified service. However, even if this were true, and there can be no positive assurance on the point, there is a major aspect of the nature of the grants which must be taken into consideration and which relates to the Constitutional division of functional and financial powers between the Commonwealth and States.

The division of functional and financial powers under the Constitution was such that the Commonwealth was given potential financial powers which would yield revenue considerably in excess of that necessary for the adequate performance of its functional powers. The States were in the reverse position with their financial potential less than their financial needs. A system of grants was the only satisfactory way to correct the disbalance, since it must be assumed that the division of powers, both functional and financial, which was adopted under the Constitution was the most desirable for the efficient conduct of the Federation as a whole. As soon as such grants became conditional in the sense that they must be used for the provision of some specific purpose, the Commonwealth is endeavouring to overcome the disbalance of the Constitutional division by taking over, as far as possible, certain functional powers properly belonging to the States. The extent to which it can assume control is determined by its financial superiority and its Constitutional right to make conditional grants. It can dictate that grants shall be conditional on the States expending a certain amount on a function determined by the Commonwealth.

In other words, the Commonwealth, by distributing portion of its surplus revenue in the form of special purpose grants, is endeavouring to assume some measure of control over the functions which were allotted to the States under the Constitution. At the time when the Commonwealth is determining the payment of a special purpose grant, it is prone to overlook the point that the amounts involved are in fact portion of surplus Commonwealth revenue which is revenue available for distribution to the States after the Commonwealth has met its own necessary expenditure. The same effect could be achieved without conditions, if say, grants in aid of Universities were discontinued and the same amount paid as additional Tax Reimbursement Grant or Special Financial Assistance Grant. Alternatively, the Commonwealth could reduce taxation by the equivalent of the same amount and thus widen

the field available to the States, although this approach would tend to increase inequalities between States. It can be seen, therefore, that there is no justification for the adoption of the special purpose grant unless it can be shown that it is advisable for the Commonwealth to have some control over certain functions which were given to the States under the Constitution. If this is not shown, then it must be contended that the imposition of conditions by the Commonwealth on grants made to the States is an unjustifiable intrusion into the fields of State independence, and this results from an unwillingness by the Commonwealth to recognise that its ability to produce surplus revenue is merely an incidental accompaniment to a logical distribution of functional powers.

One other matter which should be considered with respect to special purpose grants, and which has some association with the conditional nature of this type of grant, is the custom adopted by the Commonwealth of imposing a time limit on the period during which the States shall receive assistance for special purposes. In some ways a time limit is a desirable feature of a grant, not so much as regards the limitation of the period during which the grant will be paid, but rather with regard to the distribution between the States of the total amount available. It has been shown that the methods used to determine the portion of the total amount which each State shall receive, is only partially in accordance with the principle of payment according to relative financial needs, and therefore leaves much to be desired. It can be appreciated, however, that there will be a certain amount of trial and error involved in obtaining the perfect distribution according to the accepted principle, and with the aim of achieving this perfect distribution, it may be desirable to reconsider the methods at periodic intervals. If a time limit were imposed merely for the purpose of reconsidering the methods at periodic intervals, then it could be an acceptable part of a system of special purpose grants.

It is suspected, however, that this has been only partially the reason why the Commonwealth has imposed a time limit. Probably the Commonwealth has been reluctant to commit itself to make grants during an indefinite future period. Most of the legislation governing the payment of grants of this nature, has contained some provision stating the total amount which shall be paid to all States, or the precise way in which this amount shall be determined. In other words, the amount which the Commonwealth is required to find is predetermined. It can be understood that any Commonwealth Government would be unwilling to commit itself to make grants of unspecified amounts for unspecified period. However, there could be no objection to legislation authorising the payment of a sum to be determined from time to time within wide limits on a permanent basis. As it stands at present, the States are constantly aware of the possibility of any special purpose grant being discontinued as soon as its period of currency expires. The complete cessation of a grant, such as

Commonwealth Aid Roads, could seriously disrupt the financial stability of a State, yet under the present arrangement, this could occur quite easily. Therefore, if a specified time limit is necessary, it should apply, not to the grants themselves, but to the total amounts of the grants and their distribution between States. The States would then be assured of some revenue from this source which, if necessary, could be at the expense of deficit financing in times of depressed economic conditions.

Summarising the foregoing comments on special purpose grants, it may be said that, when regarded in isolation, the distribution of the total amount available for this type of grant should be strictly in accordance with the principle of payment according to relative financial needs, if it is found to be necessary in the system of Federal-State financial relations. However, the inherent conditional nature of the grants is not in accordance with the basic concept of a Federation - that is, the retention of the maximum amount of independence by the States, and even should the optimum distribution be achieved, it will always be apparent that by the use of this method, the Commonwealth is tending to assume the responsibility for the performance of certain functions which are Constitutionally the prerogative of the States. In short, the use of special purpose grants introduces a tendency towards the breakdown of Federalism and a movement towards a unitary form of government where the States become merely agents of the Commonwealth.

PART 3

GO CLERK

A PROGRAMS FOR NAVISION OF

EXISTING FINANCIAL

RELATIONS

CHAPTER 11A PROGRAMME FOR REVISION OF EXISTING FINANCIAL RELATIONS.

In the first Part of this essay, the nature of the particular financial problem which arises in a Federation was outlined. Particular reference was made to the problem which has arisen in the Australian Federation. It was suggested that where the powers of the Federal and State Governments respectively are rigidly defined by a Constitution, there will inevitably be a lack of balance between functions requiring expenditure from revenue, and revenue raising powers. This lack of balance will give rise to a need for redistribution of public revenue from the governments which have superior revenue raising powers to governments with revenue raising powers which are insufficient to meet expenditure requirements. In the Australian Federation, the distribution of functions is such that payments of grants from the Federal to the State Governments have become necessary. This situation appears to be paralleled in the other major Federations of the world.

The financial problem referred to above relates to the determination of the distribution of the total amount which the Federal Government has available for distribution to the several State Governments in any particular year. The two major alternatives as principles of distribution were shown to be available for adoption. The first was that payments to the State Governments could be made in proportion to the amounts contributed to Federal revenue by the residents of the respective States. The second was that the grants could be determined according to the relative financial needs of each State. The conclusion reached was that only the adoption of the second of these alternatives could satisfy adequately the principal policy objectives of governments in the modern State. These objectives were first, the achievement of an equitable distribution of goods and services between the people of the Federation, secondly the encouragement of a balanced use of available resources and coordination of capital investment and thirdly, the achievement and maintenance of full employment in the Federation. It was shown that the redistributive objective of government policy can be achieved through the imposition of progressive rates of income and other types of taxation, and the provision of services and transfer payments according to individual needs. The other objectives entail some control by the Federal Government over the total of revenue and expenditure of all governments.

In the second Part, the existing practice in Australia was examined to determine the extent to which it satisfied the principle of distribution according to relative financial needs. It was seen that the present practice is for the Federal Government to pay to the State Governments several types of grants ranging from small special purpose grants to large unconditional grants. This practice has developed gradually over the years as a result of the interaction of political and economic forces. Some small recognition has been given to the fact that the financial needs of the several States are substantially different, but this recognition is indeed small. It follows that if the earlier reasoning is sound, the principal financial policy objectives of the governments can be more fully implemented by a reorganisation of Federal-State financial relations in the light of the principles and methods of redistribution which have been evolved in the preceding chapters. The object of the concluding chapter is to try to suggest practical ways by which this aim might be achieved.

It would not be reasonable to expect that a complete revision of the whole system of Federal-State financial relations in Australia could be made in a very short time. The system has grown with the Federation, and any attempt to bring about a sudden and substantial reorganisation would meet with strong resistance. Further a successful scheme for revision would take some time to develop. It is essential that care be taken to ensure that the revision, when fully introduced, satisfies completely the criteria which have been established. For these reasons it would be advisable that changes be introduced gradually so that the immediate effects of each alteration will be small.

In other words, it would not be practicable to devise a new scheme to determine the financial assistance which the six States are to receive from the Federal Government and expect the revision to be worked out in a short time and introduced at the commencement of the next financial year. Such an approach would be doomed to failure. It is suggested that instead of attempting the complete revision in one step, immediate action should be taken to improve the position, but this action should involve the minimum of alteration to the existing system. This would be the short-term revision which would be merely a step towards major revision and complete introduction of the principle of distribution according to relative financial needs.

Once the short-term revision has been completed, steps can then be taken to prepare a plan for complete adoption of the principle. This will be brought into operation over a number of years and when fully operative, will ensure that all the conditions of the principle of relative financial needs are satisfied. Recognition must also be given to the possibility of the need for a longer-term plan to meet long-term changes to the whole structure of the Federation.

The approach which is considered to be practically sound for each of the periods, the short, medium and long terms, will be considered separately. However, attention will be focused on the plan for revision in the "medium" period - the period during which the principle of distribution according to relative financial needs is fully invoked.

A programme for revision in the short-term is one which could be put into operation immediately. It will not represent a complete solution to the problem, but will be a partial solution which will have some corrective effects during the period which must elapse before a more complete solution can be worked out and put into operation.

In the short period, the existing forms of grants from the Federal to the State Governments can be accepted. The different types of grants in operation in the Australian Federation at the present time have been explained in Part 2 of this essay,¹ and it was there shown that only in a few cases, and there quite inadequately, is the principle of distribution according to relative financial needs employed for the purpose of determining the grants. It is suggested, therefore, that the programme for revision in the short period should involve the retention of the present grants structure but with alteration to the methods of calculation of the different types of grants to follow more closely the principle of distribution according to relative financial needs.

The first approach which might be suggested is a revision of the method of calculation of each type of grant. It would be possible to revise the legislation to provide either that each type of grant made by the Federal Government should be paid according to a prescribed formula, or that the distribution should be made at the discretion of the Federal Government. In the former case it would be necessary for a different formula to be devised for each type of grant, particularly in the case of special purpose grants. In the latter case, the agents of the Federal Government would be responsible for the making of the necessary calculations to ensure that each grant paid to the State Governments was an approximate measure of the relative financial needs of each in the particular field of expenditure to which the grant related.

Such a procedure would involve some amendment to existing legislation. If the former alternative were adopted, the amendments would be considerable. It is thought that any programme for immediate revision should avoid, if possible, the need for legislative action. Apart from the delay which would inevitably occur, the inclusion of formulae in existing legislation would probably make it more difficult to amend or repeal the legislation at a later date when further changes had become desirable in order to bring into action permanent arrangements for assessing grants.

1. See above, p.100 ff.

It would appear to be sufficient for the purpose that in the short period, when it is possible to satisfy only some of the criteria, if only one or a few of the several types of Federal grants were calculated according to the principle of relative financial needs. The Australian system of federal grants includes several special purpose grants, grants under the Financial Agreement of 1927, Income Tax Reimbursement Grants, ~~Special Financial Assistance Grants~~, and Special Grants under Section 96 of the Constitution. Only one of these types of grants, provided it represents a substantial portion of the total, can be calculated according to the principle of relative financial needs, and it will take into account other types of grants paid to the States. In short, one type of grant can be used as a balancing grant to bring about greater equality between States and to correct errors or omissions contained in the remaining grants.

To the extent that the are calculated according to the principle of relative financial needs, the present grants under Section 96 of the Constitution can be said to be designed to achieve this result so far as the three claimant States, South Australia, Western Australia and Tasmania are concerned. Special grants are designed in such a way as to give each claimant State sufficient revenue to permit it to function at a standard not appreciably below that operating in the three standard States, New South Wales, Victoria and Queensland.² In calculating the necessary amounts, the Commonwealth Grants Commission takes into consideration revenue collected by both claimant and standard States from most of the types of grants provided by the Federal Government. In short, the Special grant is a balancing grant which is supposed to raise each claimant State to the level of the three standard States.

Under the present method of determining grants, there is no comparable balancing grant between the three standard States. To some extent the Income Tax Reimbursement Grant does take account of certain differences between States, but only to a limited extent.³ The first step which should therefore be taken to correct the deficiencies of the present grants system is to recognise a type of grant which is at present paid to all States as a balancing grant and calculate this grant according to the principle of relative financial needs. To achieve the desired objective, this grant should be comparatively large, so that it may be sufficient to permit natural differences, and differences accentuated by not calculating other forms of Federal grants according to the principle of relative financial needs, to be corrected. For simplicity of introduction, it would be advisable for the grant envisaged as performing the function of a balancing grant to be free from legislative restrictions. That is, it should be a grant which is determined annually by the Federal Government at its own discretion.

2. See Third Report of the Commonwealth Grants Commission p. 75.

3. See above, p.173.

At the present time there is only one type of grant which appears to satisfy all these criteria. This is the Special Financial Assistance Grant which has been paid to the State Governments since 1950-51 as a supplement to the Income Tax Reimbursement Grants. This grant is made entirely at the discretion of the Federal Government, and in 1953-54, the total amount distributed was £22m.

There appear to be two alternative methods whereby the Special Financial Assistance Grants could be adapted for use as a balancing grant to be calculated according to the principle of relative financial needs. Both involve combination with the Special Grants paid under Section 96 of the Constitution to the three claimant States. In the first place, the Federal Government could announce that as from a specific date, Special Financial Assistance Grants would be discontinued. The size of these grants is such⁴ that those States would probably find it necessary to apply for financial assistance from the Federal Government under Section 96 of the Constitution. In fact, the Federal Government could announce that its intention was to discontinue the Special Financial Assistance Grants for the purpose of inducing the three larger States to adopt this approach and formally claim financial assistance under Section 96.

If this happened, the Federal Government would, if existing practice is continued, refer the claims for financial assistance to the Commonwealth Grants Commission which was formed for the specific purpose of examining and reporting on such claims to the Federal Parliament. It would be expected that the Commonwealth Grants Commission would extend its methods of calculating grants according to the principle of relative financial needs to include the three standard States. This would provide all States with a balancing grant which would take into account the relative financial needs of each.

The elimination of standard States would, however, necessitate a revision of the methods of the Commission. At the present time, the Commission assesses the relative financial needs of the three claimant States by reference to the conditions in the three standard States. A grant is recommended which will permit each claimant State to function at a standard approximately equal to that operating in the standard States. If all States were to claim financial assistance in this way, this standard would no longer exist. It would thus become necessary for the Federal Government to advise the Commonwealth Grants Commission of the total amount which it is prepared to make available to all States by way of Special Grants. The function of the Commission would then be to distribute the total amount between the States according to the relative financial needs of each.⁵

4. In 1953-54, New South Wales received £8.6m.; Victoria, £5.7m. and Queensland, £3.5m.

5. The details of existing Grants Commission procedure are given on p.144 ff.

The alternative approach which could be adopted by the Federal Government in order to produce a greater degree of equality between the State in the short run would be to retain the existing system of grants but calculate the Special Financial Assistance Grant according to the principle of relative financial needs. If this approach were adopted, it would again be necessary to amalgamate the Special Financial Assistance Grants and the Special Grants at present recommended by the Commonwealth Grants Commission, or restrict the Special Financial Assistance Grants to the standard States. In the former case, the need for the Commonwealth Grants Commission as such would no longer exist if the Federal Government undertook to calculate the distribution of the total amount available. Alternatively, the whole task of calculation could be handed over to the Grants Commission. If this latter approach were adopted, the result would be similar to that which would be produced if the Special Financial Assistance Grants were discontinued, with the exception that there would be no claim for financial assistance by the several State Governments.

The restriction of Special Financial Assistance Grants to the standard States would be practically impossible. It would mean that one group of States would be claiming financial assistance and the amount received would be dependent upon the investigations and recommendations of the Commonwealth Grants Commission. The other group would not be claiming such assistance but would be receiving comparable grants which would be determined by the Federal Government.

Either of the two approaches suggested above could be put into practice without any great difficulty. The choice between the two would then have to be made by reference to some other criterion. This could possibly be the extent of administrative adjustment involved in the new approach, or the attitude of the various State Governments to the alteration. It is felt that the present standard States would be extremely reluctant to become claimant States in the existing meaning of the term. Claimancy, as it operates at present, involves the loss of a certain degree of independence as a result of the investigations and subsequent "adjustments" made by the Grants Commission. This reluctance would not appear if all that was involved was the distribution of the Special Financial Assistance Grants according to new methods. This approach could lead to the abandonment of the Commonwealth Grants Commission in its present form, which might be viewed unfavourably by the present claimant States.

Whatever objections are made to such a scheme in official circles, it should be emphasised by the Federal Government, when announcing the change, that the alteration would be purely an intermediate step in the eventual development of a new system of Federal-State financial relations. It would be a short-term programme for revision which would ultimately be replaced by an alternative which will invoke the necessary principles to the fullest degree.

When some revision such as this has been made, it will be possible for the Federal Government to commence preparation of a longer term programme of revision. During this longer period, careful attention can be given to all aspects of the grants system and a new scheme prepared with the object of fitting it into the general scheme of government financial policy. It is with respect to this longer-term revision that attention will be concentrated in this analysis.

The practicability of any suggestion for improvement is important. One recommendation which might be made is for the whole structure of Federal-State financial relations to be redesigned to minimise the need for grants to be paid by one authority to another. Such a suggestion would imply substantial amendment to the Constitution, and this may be impracticable, even over a fairly long period. It is notoriously difficult to amend the Constitution unless the proposed amendment to the Constitution receives the support of all political parties.⁶ The amendments necessary under such circumstances would be so far-reaching that it is doubtful whether the move could be made with any hope of success.

Alteration to the present system should also be designed so that it could be instituted by the Federal Government. This is also necessary to avoid political complications. If the introduction of a new scheme of Federal-State financial relations were dependent upon cooperation between the Federal and State Governments, it would almost certainly be doomed to failure. Inevitably the political party holding power in the Federal Parliament is opposed to that which is in power in some State Parliaments, and although this problem and its successful solution should be above party politics, it is feared that unanimous agreement would not be obtained.

There is always danger that the Federal Government itself will be reluctant to institute any changes in the existing relationships. This will be particularly so if the introduction of change brings with it any diminution of powers or spheres of influence of the Federal Government. The tendency over recent years has been for the Federal Government to use its position of financial superiority to increase its authority in the fields of activity which were constitutionally restricted to State Governments. Proposals for improvement might be suggested which would tend to reverse this trend. Under these circumstances, it may be difficult to persuade the Federal Government that it is desirable to implement the proposals.

Although it has been suggested above that it would be almost impossible to obtain unanimous agreement between the State and Federal Governments, any such scheme for improvement would usually have to be acceptable to a majority of State Governments before the Federal Government would introduce it. Occasions have arisen where

6. So far, 23 proposals have been submitted for referenda, and the consent of the electors has been received in four cases only.

schemes which affect the finances of the States which have been imposed by the Federal Government against the wishes of all State Governments. The outstanding example was the introduction of Uniform Taxation and Income Tax Reimbursement Grants in 1942,⁷ but this can be regarded as having occurred under exceptional circumstances - that is, as a national security measure in time of war. An opposing reaction under peace-time conditions was seen in 1952 when the Federal Government was prepared to hand back income taxation powers to the State Governments. Because some State Governments were unwilling to accept this responsibility, no further action has been taken.

No definite conclusion can be reached on the question of whether the Federal Government would introduce substantial alterations to the existing structure without reference to, or receiving approval from the State Governments, or whether the Federal Government would be influenced in adopting a scheme sponsored by State Governments. The answer must remain a matter for conjecture.

This, then is the background against which suggestions for improving the present system must be made. However careful one might be in framing these suggestions from the practical viewpoint, there will always be some danger that forces will arise at a particular moment which will make the suggested solution impossible, at least until there is some alteration in existing institutional conditions. Any proposition must therefore be construed, not in the light of conditions which exist at the moment, but rather in the light of the most favourable conditions which are likely to arise in the future.

The deficiencies in the methods used to determine the amount of grants payable to the State Governments in the Australian Federation have already been outlined.⁸ Briefly restated, the method in use at present is for the Federal Government to commit itself to pay to the States, for a limited period, certain grants for specific purposes and in some cases, for general purposes. Thus, in any particular year, the Federal Government is bound to find a certain amount of revenue for payment to the State Governments. This amount is the sum of the different types of grants which the Federal Government has statutorily committed itself to pay. These grants include payments under the Financial Agreement, Commonwealth Aid Roads, Hospital Benefits, Grants for Universities, Income Tax Reimbursement Grants and to a certain extent, Special Grants under Section 96 of the Constitution. In fact, there are very few grants which the Federal Government has not committed itself to pay for a number of years and which do not have the total amount determined by some automatic formula. The most important exception is the Special Financial Assistance Grant which has been paid in recent years only and which is regarded as supplementary to the Income Tax Reimbursement Grants.

7. See above, pp. 162/3.

8. See above, Part 2, p.100 ff.

It can be appreciated that in any one year, the extent to which the Federal Government can control the total amount which it will pay to the State Governments is considerably restricted. For example in 1952-53, direct payments by the Federal Government to the State Governments totalled £183m. Of this total, at least £140m. was provided for in legislation passed in previous years and under which the total amount payable was predetermined. Of the remaining £43m., Special Financial Assistance grants accounted for £27m. and Special Grants under Section 96 of the Constitution accounted for £16m. This latter grant is recommended by the Commonwealth Grants Commission and although subject to variation by the Federal Government, is customarily accepted without serious question, and therefore it can be regarded as predetermined. The Federal Government thus had effective control over only about 15% of the total amount of grants in 1953-54.

These commitments of the Federal Government are made only by Federal legislation, and could therefore be rescinded by the passage of the necessary amending legislation. The present attitude is, however, that the Federal legislation in this respect is in the nature of a contractual commitment, and any attempt to reduce the total amount would be regarded by the States as a breach of contract, although legally such a procedure would be quite within the powers of the Federal Government. It is felt that the political reaction would be sufficiently strong to prevent the Federal Government from taking this line of action if it were found necessary to reduce the total amount which it has promised to pay to the State Governments.

It was shown earlier that for the effective implementation of a full employment policy, the Federal Government should be in a position to determine the total amount which shall be raised by taxation by all governments, and the total amount which should be expended by all governments on the provision of services. The taxation aspect is adequately covered under the existing system, where the Federal Government is responsible for the collection of income tax and customs and excise duties. On the expenditure side, however, there can be no such assurance while the Federal Government is committed to pay to the State Governments a large percentage of the total amount which it does actually pay. It must be recognised that the Federal Government can always offset these effects by manipulation of its own expenditure. If, for example, commitments in the form of grants to State Governments taken in conjunction with expenditure by those Governments from their own resources, and anticipated expenditure by the Federal Government in exercising federal functions will be greater than necessary to maintain full employment, the Federal Government can restrict its own expenditure. Such a procedure may, however, be entirely unsatisfactory from other points of view. The relative urgency of federal functions compared with State functions

must also be considered.

Thus, in order for control to be effective, the Federal Government should be free to vary the total amount which it will make available to the States during any particular period in the light of the particular economic conditions of the time. Under present conditions, the Federal Government does not possess this power fully, and therefore one of the necessary corrections should be to reorganise the present grants system to restore this power to the Federal Government.

At this stage, mention should be made of the part played by capital expenditure from loan funds in a full employment policy. It would be true to say that in Australia government financial policy can be used to influence the level of employment far more effectively by control over expenditure from loan funds than by surplus and deficit budgeting in the revenue accounts. In order to implement a full employment policy completely, it is thus necessary to have regard to public investment expenditure as well as public revenue expenditure. It has been shown that through its grants system, the Federal Government could influence the total of public revenue expenditure, but greater difficulty may be experienced in obtaining the same degree of influence over public investment expenditure.

In a previous Chapter,⁹ the part which the Federal Government plays in determining the total amount which the State Governments shall receive from loan funds in any financial year was discussed. It was suggested that although the Financial Agreement of 1927 gave to the Federal Government only one quarter of the total voting power necessary to determine the total loan programme, the Federal Government's position in relation to the central banking system in Australia has given it almost complete powers in deciding the total loan programme. Furthermore, it would appear that the Federal Government has consciously used this power in recent years as part of a policy designed to combat inflation. It would not be proper to discuss here the propriety of the action of the Federal Government in using its influence with the banking system for this purpose, but the existence of such power does mean that the Federal Government can, if it so desires, determine the total amount of public borrowing, and hence the extent of public investment activity in any year.

The Federal Government thus has direct or indirect influence over the amount of taxation revenue which will be raised, and the amount of loan money which will be raised. It can never, of course, compel a State Government to spend money, either from revenue or loan funds, but it can set an approach to the upper limit

9. See above pp 123/4.

to expenditure from both sources, through its grants system in the former case, and through its domination of decisions of the Loan Council in the latter case. It can also influence the lower limit through its own expenditure policy. Therefore, if the amount which it shall pay to the State Governments by way of grants is predetermined, one of the important elements for full employment policy is missing so far as correcting or preventing the occurrence of a situation of over full employment is concerned. Thus the first requirement for permanent improvement is to free the total amount which the Federal Government will pay to the States in any year. The Federal Government must be free to fix the total amount which the States as a whole will receive.

If this position is to obtain, then future legislation relating to the payment of grants of any type to the States must be non-committal so far as the actual amount to be paid in future years is concerned. This may be difficult to bring about in view of the nature of existing legislation, particularly so far as Income Tax Reimbursement Grants and payments under the Financial Agreement are concerned. However, in all cases, and particularly in the case of the more important types of grants, there will be political difficulties in effecting reductions. While specific sums are associated with specific purposes, there can always be political reaction to reducing the total amount of the grant, particularly when revenue is buoyant.

For these reasons, it might be preferable to discontinue the present multiplicity of grants, and replace them all with a single grant which embraces all avenues of expenditure previously covered, but with no specific reference to any purpose for which it may be used. In other words, to introduce a single unconditional grant. The total amount of this grant could be determined each year after consideration of the particular circumstances operating at the time. In this way, the Federal Government could vary the total amount available without the political repercussions which might arise with reduction of the total amount of a particular special purpose grant.

The second major shortcoming of the present method of redistributing public financial resources is that the determination of the relative amounts which each State shall receive, follows no particular pattern. It was shown earlier,¹⁰ that all governments have a redistributive function to perform. One of the accepted methods of achieving this objective is by bringing about greater equality of incomes of residents of the community. In a Federation, the choice must be made between attempting to achieve greater equality within each State separately, or within the Federation as a whole. If the decision is left entirely to the State Governments, then the achievement of greater equality of incomes will be restricted to each State separately. Thus, although a deliberate policy may be adopted by each State Government to bring about the desired redistribution of wealth by this method, there will still be inequalities, and hence the need for

¹⁰.. See above, p 20. ff.

further redistribution between States. This lies within the sphere of influence of the Federal Government.

Because of its superior financial position, the Federal Government can choose between the two alternatives. In distributing the total amount which it has available for the purpose, it can elect to apportion it according to the amount which the residents of each State contributed to the total, in which case redistribution can be achieved only in each State separately. On the other hand, it can ignore the contributions of the residents of each State and distribute the total amount between the States in such a way that a greater degree of equality can be obtained. That is, it can contribute according to the relative financial needs of each.

It has been suggested in an earlier Chapter¹¹ that this latter alternative is the most appropriate one to adopt. It was argued that in this instance there seems to be no real reason to distinguish between different sections of the community because of the existence of State boundaries. In fact, under the Australian Constitution, the Federal Government is debarred from discriminating between States.¹²

If these arguments are accepted, it would appear to be reasonable to expect the Federal Government to distribute the total of funds available for the purpose according to the relative financial needs of each State. At the present time, with a large number of different types of grants, there is very little attention paid to strict adherence to any particular principle. In only one case, that of Special Grants under Section 96 of the Constitution, is recognition given to the principle of distribution according to relative financial needs. In other cases, such as the formula used to calculate the Income Tax Reimbursement Grant and Grants for Universities, there is implied partial recognition of this principle. In many other cases, as explained in earlier Chapters, the distribution is determined more or less arbitrarily. A very great improvement could therefore be achieved if each different type of grant were to be calculated in future according to the principle of relative financial needs.

It was suggested earlier in this Chapter,¹³ that as an immediate remedial measure, an approximation to this result could be achieved if one type of grant (provided that in total it is sufficiently large) were distributed according to the principle of relative financial needs. In the process of calculation, deficiencies which evolve from the arbitrary distribution of other types of grants would be corrected. Thus, in total, each State Government would receive an amount which would permit the net burden of benefit of government financial policy, impinging on the residents of the Federation as a whole, to be more equitably distributed.

11. See above, Chapter 2, p.20 ff.

12. See above, Chapter 4, p.63 ff.

13. See above, p.199.

That is, in total the resident of each State would pay taxes and receive benefits according to relative needs rather than according to the size of incomes. However, while such a procedure would be quite acceptable as a short-term remedial measure, it suffers from two defects which would require correction over a longer period. The first of these is that the total amount of the grant chosen as the balancing grant may not allow sufficient flexibility. It was suggested that the Special Financial Assistance Grants, taken in conjunction with the Special Grants under Section 96, would be adequate for the purpose. Their adequacy could well be restricted to a very short period, however. In 1954-55, the total amount of these two grants is only £32m. It can be expected that in 1955-56, the Tax Reimbursement Grants will automatically rise by about £5m., and if the grant total of all grants to be distributed by the Federal Government remains unchanged, the total amount of these two specific types of grants may well fall to about £27m. Such an amount may be insufficient both for the purpose of introducing flexibility to the total commitments of the Federal Government and permitting an adequate distribution between the State Governments.

The second deficiency of this temporary expedient is that it retains certain specific inequalities which are being perpetuated by an arbitrary distribution by the Federal Government. For example, the distribution of the total amount available for the payment of Commonwealth Aid Roads is partially a per capita distribution and partially a distribution according to area. It can be expected that relative needs for finance for road maintenance bears only an approximate relationship to population and area, and therefore some States will be receiving relatively more than they require. This will be taken into account in the calculation of the final balancing grant, but under Federal legislation, the amounts received as Commonwealth Aid Roads must be used for expenditure on roads. Therefore, in States which benefit from the present form of distribution, the amount available for general purposes will be lower than it would be if the Commonwealth Roads Grants were distributed according to relative financial needs. In short, in those States, the standards of roads will be relatively high, but the standards of services in other directions will be relatively low. In the other States the reverse position will exist.

The solution of these problems appears to lie in the combination of all grants into one all-purpose grant. This has already been suggested as a solution to the problem of deciding how to give the Federal Government sufficient flexibility in deciding the total amount it shall distribute. One grant, distributed according to the relative financial needs of each State would allow the Government of each State to decide the manner of expenditure and the type and extent of the services it will provide. Obviously there would not be uniformity between States although the Federal Government would be competent to advise the State Governments on the extent to which standards of

particular services varied between States and suggest programmes for bringing about greater uniformity in this respect. One State Government may decide to concentrate on the provision of education services. When these services are above the average level in the remaining States, other services will be below average, and vice versa.

If the problem is looked at from another viewpoint, under the present system of federal grants in Australia, the principle of distribution according to relative financial needs will only be fully invoked when each type of grant is calculated according to need. If this were to be done, the problem would be greatly simplified if all the present types of grants were combined into one single grant. The only justification for retaining the present multiplicity of grants, each calculated according to need, would be to give the Federal Government control over the avenues of expenditure by the States of the amounts received from the Federal Government. In view of the nature of a federation, it is difficult to see how such control by the Federal Government can be justified.

The conclusion which has been reached is that, as a long-term policy, Federal-State financial relations in Australia could best be improved by amalgamation of all grants at present made by the Federal to the State Governments into a single grant. The total amount of this grant will be determined by the Federal Government as part of its ordinary budget programme, and the distribution made between the several State Governments according to the relative financial needs of each. Before proceeding to discuss the methods which could best be employed if such a procedure were adopted, it may be advisable to consider in rather more detail the implications of the amalgamation of the present miscellany of grants into one unconditional block grant. In particular, it will be necessary to examine any possible difficulties which might arise and assess whether or not they are insuperable.

In the first place, some legal difficulties might be encountered. At present, all grants paid by the Federal Government to the State Governments are prescribed in legislation by the Federal Parliament. It may be assumed, therefore, that all such provisions may be repealed and replaced by legislation which provides for the payment annually of a single grant. However, there will undoubtedly be some complications. For example, the provisions of existing legislation relating to Income Tax Reimbursement Grants provide for grants to the States according to a prescribed formula,¹⁴ for so long as the State Government refrain from imposing an income tax on their residents. This is an arrangement which has been accepted by the States as the "price" of their retirement from the field of income taxation. The present legislation is in the nature of a contract between the Federal and State Governments which fixes not only the distribution of the total amount between the States, but also the total amount itself. It could be argued by the States that if these grants were incorporated

14. See above, p.165.

in a general grant, there would no longer be an assurance that the total amount indicated in the formula would be forthcoming, and that each State would receive at least as much as they would have received under the operation of the formula.

On the other hand, the conditional nature of the present Income Tax Reimbursement Grants would no longer be present. That is, the payment of a single all-purpose grant could not be conditional upon the State Governments refraining from imposing an income tax. Thus, if the Federal Government reduced rates of taxation and as a result had to reduce the total amount available for distribution to the States, the State Governments could impose their own taxation to restore the total to the position which would have existed before the Federal reduction in income taxation rates.

Difficulty would also be experienced in altering the present arrangement concerning grants paid to the States under the Financial Agreement of 1927. At present, grants are paid as subsidies towards interest and sinking fund charges on borrowings by the State Governments and are conditional upon the State Governments abiding by decisions of the Loan Council concerning public borrowing. If the amount of the grants at present made in this way were to be incorporated in a single unconditional grant, there would no longer be any inducement to the States to participate in the decisions of the Council.

However, even if the inducement were no longer present, there are two reasons why the present organisation concerning public borrowing would probably continue. In the first place there would be an implied condition that portion of the grant was related to continuance of the existing Loan Council structure, and if any States were to withdraw, that portion of the grant would be retained by the Federal Government. Such an implied restriction would, however, be contrary to the nature of the unconditional grant and should therefore be avoided if possible.

The second reason is that since before 1927,¹⁵ the Federal Government has acted as the borrowing agent for the State Governments, and although it would not be impossible, the State Governments would probably find difficulty in raising their own loan money. Furthermore the relationship between the Federal Government and the Central Bank is such that the Federal Government enjoys a large measure of control over the total amount which can be raised at any one time by open market borrowing. It could be expected that if one State decided to withdraw from the Financial Agreement, it would find considerable difficulty in raising its requirements in competition with the Federal Government. At the least, it would have to offer more attractive borrowing terms, and if to this is added the possibility of a reduction in the Federal Grant it receives, it is likely that a decision will be made to remain within the Financial Agreement.

15. See above, p.126 note 2.

It would seem that in all other cases no difficulty would arise. The legislation provides for the payment of grants for a period of years. When the existing provisions expire, the legislation can lapse, and the amounts formerly included in that legislation would then be included in the general all-purpose grant which, for the purposes of exposition, may be called General Grants. Eventually, all the present special purpose grants would be absorbed in the General Grant with the exception of Income Tax Reimbursement Grants and Grants under the Financial Agreement, both of which are not restricted by a time limit.

At the appropriate time, these could also be incorporated in the General Grant. In order to make the change-over agreeable to all parties, it would probably be advisable to choose a year in which it is economically desirable that the total of government expenditure be increased substantially. The payment of the additional amount could be offered as an inducement to accept the final incorporation of all existing grants into one General Grant.

One other aspect of the introduction of the block grant remains to be considered, namely, the extent to which such a scheme would affect the relative importance of the State and Federal Governments respectively in the field of Federal-State financial relations. This aspect is relevant because a diminution of the power of either the Federal or State Governments could jeopardise the introduction of the scheme. If either party felt that such a scheme would transfer part of its sphere of influence to the other, there is no doubt that it would be vigorously opposed. Although the final decision must rest with the Federal Government, concerted opposition by all State may have sufficient political repercussions to prevent the Federal Government taking the necessary steps. Similarly, if the Federal Government feels that the proposal will increase the power of State Governments, it will probably not be introduced.

In one respect, the introduction of a General Grant would appear to increase the power of the Federal Government, but this increase would be more apparent than real. Under the suggested scheme of a General Grant which would be distributed according to the principle of relative financial needs, the total amount would be decided at the discretion of the Federal Government. It has been shown that this is essential for the implementation of a policy designed to achieve or maintain full employment, but the State Governments may regard it as a diminution in their authority and therefore be reluctant to place this power in the hands of the Federal Government. It might be thought that it would present too great an opportunity for Federal expansion at the expense of powers of the State Governments.

In fact, there would be very little more opportunity than exists at present under a system where there are a considerable number of special purpose grants. The only difference would be that while

under the present system where the total amounts are fixed periodical or fluctuate according to a formula, any reduction would call for amending legislation, under the proposed scheme the total amount would be determined each year. It would, however, be very much simpler for the Federal Government to reduce the General Grant and leave decision as to where the actual reductions are to be made to the State Governments, than reduce the separate totals of several special purpose grants.

It may be thought desirable, at the inauguration of the change-over, to place some limit on the extent to which the Federal Government could reduce the total amount which it shall pay to the State Governments. The situation could arise where, when a reduction in the total of government expenditure is called for in the interests of the national economy, the Federal Government, through its power over the total amount of the General Grant, could ensure that the reduction is made solely in the level of expenditure of the State Governments. This could be prevented if an assurance were given that in any year the total of the General Grant should be at least a given percentage of the total revenue of the Federal Government. However, for such a provision to have any permanence it would need to be inserted in the Federal Constitution.

While these arguments are predominantly concerned with the case where it becomes necessary, in the interests of the economy of the Federation as a whole, to reduce the total amount paid to the State Governments, it can work also in the reverse direction when the Federal Government finds it desirable to increase the amount it wishes to disburse to the State Governments. It would be true to say that a method of determining grants would permit the Federal Government to increase the total amount to be paid to the States without any difficulty. However, where the grant takes the form of a single unconditional grant, the Federal Government is relieved of the problem of increasing individual special purpose grants. Under existing circumstances, the Federal Government may be reluctant to pass legislation increasing the total of one or several of the special purpose grants because of the knowledge that it may be necessary to reduce the total in the following year, and that such a reduction would be unpopular. When only one General Grant is concerned, an increase in one year may be followed by a reduction in the next without any such difficulty.

Although the Federal Government may consider that, in the interests of the national economy, it is desirable for public expenditure levels to be raised, an increase in the total amount which it makes available to the State Governments will not necessarily achieve that result. There can be no compulsion upon a State Government to spend money received from the Federal Government. Experience has shown however, that in the Australian Federation, the lack of balance between constitutional functions and the finance necessary to perform these functions will ensure that the State Governments will not

usually produce a surplus of any significant size in their Consolidated Revenue Accounts. For all practical purposes, it may be assumed that grants paid by the Federal to the State Governments will be spent during the year in which they are paid.

From the point of view of the recipients of the Federal Grants, the State Governments, the substitution of a General Grant for the present system of a series of conditional grants would have one outstanding advantage. It would give back to the States greater independence of action in that decisions concerning avenues of expenditure would henceforward rest with the State Governments more completely than at present. In short, the Federal Government would surrender power to determine the way in which some grants shall be spent, and gain more complete power to vary the total amount which is to be paid to the State Governments. Conversely, the State Governments would lose some of the certainty which at present attaches to the total amounts they will receive and in return they will gain greater independence of action in the field of determining avenues of expenditure.

For the suggested procedure to function smoothly, it would probably be necessary for the Federal Government to keep the State Governments more fully informed on the reasons why the total amount to be made available should be varied in any particular year. It would also be advisable for the Federal Government to accept responsibility for attempting to bring about greater coordination between States so far as expenditure policy is concerned. While it is realised that if Federal grants are made unconditionally the State Governments are free to spend the grant in any way they choose, the proximity of States to each other and the ease of transfer from one to another would probably ensure that great differences in policy between them would not arise. It could be expected, for example, that the standards of roads in each State would be roughly comparable even if Commonwealth Aid Roads Grants were incorporated in a General Grant. However, the Federal Government could play a more important part in an advisory capacity and bring about closer cooperation by collecting comparative information for the use of the State Governments.

If the concept of a single, all-purpose grant were adopted, the second major problem which would be encountered would be the method of determining the distribution of the total amount between the States and more particularly, the agency which would be responsible for making the distribution. In an earlier Chapter,¹⁶ the alternatives available were examined in some detail. It was shown there that the choice must be made between a body of experts established within the framework of the Federal Public Service, and a similar outside body. The conclusion there drawn was that at the present time in the Australian Federation, the former alternative would be the more practicable although under certain circumstances, an independent body of experts, such as the Commonwealth Grants Commission might be practicable.

16. See above, Chapter 5 p.83 ff.

In fact, the decision will probably be made before the complete introduction of the scheme. It was suggested earlier in this Chapter that as a temporary measure the Federal Government should make the existing Special Financial Assistance Grant act as a balancing grant. If this step were taken it would be necessary at that stage to decide whether the distribution of this grant should be made by the Federal Government through its Treasury or a newly established agency within the framework of the Federal Public Service, or by enlarging the scope of the Commonwealth Grants Commission.

Subsequent consolidation of special purpose grants into a General Grant would mean only that the General Grant, which at the beginning would include only the Special Financial Assistance Grant, would gradually be enlarged. The body entrusted with its distribution would be dealing with a total amount available for distribution which would be growing larger and larger as more and more special purpose grants were included. Finally, all existing grants would be incorporated in the General Grant without change in the body responsible for the distribution.

A major difficulty which must be overcome if this procedure is to be adopted is the problem of budgetary timing. The first step in making the annual grants would be made by the Federal Government when it determines the total amount to be distributed as part of the normal budgetary process. Normally the Federal budget is introduced about two months after the commencement of the financial year. The several State budgets are usually brought down within the month following the Federal budget. At the present time, the size of almost all Federal grants are known by the State Governments before the introduction of the Federal budget and therefore there is little delay.

The introduction of a single all-purpose grant to replace the many existing grants would mean that the total amount available to all States will not be known until the introduction of the Federal budget. There would be some further delay while the distributing body determined the allocation of the total amount between the States. The State Government would then need some little time to draw up their budgets in the light of this distribution. It is conceivable, therefore, that under this system, the introduction of State budgets would be delayed until fairly late in the financial year unless it is possible to make the system more flexible.

The first possible refinement would be the earlier introduction of the Federal Budget. There seems to be no good reason for the long delay which has become a feature of Australian public financial practice. However, if this were altered, the State Governments would probably wish to adopt the same procedure. Nevertheless, while it would mean the earlier introduction of the State budgets, there would still be a long delay between the introduction of the Federal and State budgets. Perhaps a better solution would be for the

Federal Government to inform the distributing body some time before the introduction of the budget of the approximate amount which will be available for distribution to the States. That body could then proceed with the necessary calculations so that the delay between the time when the total amount become publicly known and the time when the distribution between States is determined is reduced to a minimum.

It would be expected that greatest difficulty would be experienced in the initial years of the operation of the scheme. After several years have elapsed, the several State Governments would probably be able to estimate fairly accurately their share of the total amount available once this total becomes known. This would be sufficient for budget purposes, and a delay of several months in the actual calculation would not then be of great significance.

Inevitably the foregoing explanation of the processes involved make the problems seem simpler than they really are. Both phases of the process involve extremely difficult decisions. First the Federal Government must decide the total amount in the light of existing conditions, the relative needs of the Federal and State Governments, and other factors which will arise from time to time. The distributing body must then determine the relative financial needs of all States in order to calculate the proportion of the total amount available which each shall receive. The calculation of relative financial needs is itself a tremendous task, but the body of experts envisaged should be able to reach conclusions which are sufficiently accurate for the purposes intended.

This, then is the programme which could be introduced over a fairly short period with a minimum of change in the existing structure. It can all be introduced by the Federal Government in the ordinary course of legislative business, and no constitutional alteration is necessary. In short, it has been designed to continue existing relationships between the Federal and State authorities.

It is possible, however, to visualise the necessity for more substantial alteration over a longer period, and the longer-term programme may be regarded as a programme designed to eliminate rather than resolve the financial problem in a Federation. It envisages a reallocation of functions between the Federal and State Governments so that the need for financial redistribution is reduced to a minimum. It should be emphasised that if perfect balance is to be achieved at any point of time, it will be quickly lost as the relative importance of function of the Federal and State Governments change.

For greater balance to be achieved, either certain functions at present carried out by the State Governments should be handed to the Federal Government, or certain revenue raising powers held by the Federal Government should be handed to the State Governments. The simplest of these approaches is the handing over by the

Federal Government of certain revenue raising powers to the State Governments, as with this approach, no constitutional amendment would be necessary. The present annual revenue obtained by the Federal Government from income tax alone, for example, is far in excess of the total amount paid annually to the State Governments. If part of the power to collect income tax were surrendered by the Federal Government, the need for financial aid to the States would disappear.

But if this approach were adopted, so too would disappear the power of the Federal Government to redistribute the total wealth of the Federation between the States. In fact it would increase the degree of inequality which exists at present. Income taxation rates are at present imposed uniformly throughout the Federation, and in determining the amount of the grant to be paid to each State in the scheme for revision suggested earlier, the relative financial needs of each State would be taken into account. If the State Governments were to impose portion of the income tax in lieu of Federal grants, uniformity of rates of taxation between States would almost certainly be lost. The States with the lowest relative taxable capacity would find it necessary to impose higher rates of income taxation compared with other States in order to derive the same amount of revenue as previously received as Federal grants.

Any action which would increase inequality between States without offering any means or opportunity for offsetting the increased inequality must, it is felt, be rejected. It is not a solution to the financial problem but merely eliminates the problem whilst leaving differences between States which are in direct opposition to the successful operation of the suggested objectives of government financial policy. The only occasion when such an approach could be justified would be in the event of inequalities between States disappearing. In the final analysis, this is the ultimate objective of a system of redistribution between States. It would be expected that, with consistent equality being artificially produced, eventually the States would become more naturally equal. If this did occur, it would be over a very long period of time, and until this time arrives, any reallocation of functions designed to eliminate the need for grants from the Federal to the State Governments should be discouraged.

This is not meant to imply that partial reallocation of functions should be discouraged. All that is required for the success of a scheme of financial redistribution is that the total amount to be distributed by the Federal Government is sufficiently large to permit equality between States to be reached.

The alternative to a transfer of revenue raising power back to the States is a transfer from the State Government to the Federal Government of certain functional powers. This could be done in either of two ways. First the State Governments could voluntarily hand over the selected functions to the Federal Government, and

secondly, the constitutional provisions which at present restrict the range of functions to be carried out by the Federal Government could be amended. In this latter case, the proposed amendment would require agreement by a majority of electors and in a majority of States.¹⁷

Again, the transfer of functions to the Federal Government would not necessarily resolve the problem in its entirety. At the present stage of development, and within the foreseeable future the transfer of functions alone would still leave some degree of inequality between States in the functions remaining with the States. It would, of course, be possible for the States most in need of financial assistance to transfer to the Federal Government more powers than the States least in need of financial assistance.¹⁸

Although such a procedure would be extremely unpopular with the State Governments, it may be that such a conclusion is inevitable. The history of Federation in Australia has revealed a pronounced trend towards the expansion of Federal functions at the expense of State functions. Greatest impetus has been given to this trend by national disasters, particularly two World Wars and, to a lesser extent, the depression of the 1930's. During these periods, organisation on a national basis was found to be necessary, and through this medium the Federal Government strengthened its position.

In the opinion of an eminent authority on Federalism,¹⁹ Australia is even now a Federation in name only. He has suggested that the superior financial power of the Federal Government has destroyed the basic concepts of federation which are provided for in the Australian Constitution. It may well be that the future will see a continuation of this trend and the eventual disappearance of the States as independent entities with the substitution for the States of a new form of regional government. In this respect the English pattern may be followed and a unitary form of government with a strong regional or local form of government emerge. If such a structure were to emerge, the financial problem, whilst still existing would be quite different. The regional governments would be purely agents of the central government and would be subject to direction as to revenue raising and expenditure policy. It would, however, be quite beyond the scope of this essay to devise schemes of financial relationships based upon such hypotheses.

17. Commonwealth Constitution Act, Section 128.

18. For example, in the Australian Federation, Tasmania has handed power to collect statistics to the Federal Government as an economy measure.

19. E. C. Sheare, "Federalism."