

equalisation process does not promote reform' (p21).

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

4. The holding of the current *Senate Select Committee on the Reform of the Australian Federation*
<http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=reffed_ctte/index.htm>
5. The recently announced (9 February 2011) House of Representatives Joint Committee of Public Accounts and Audit (JCPAA) *Inquiry into National Funding Agreements*
<http://www.aph.gov.au/Parliamentary_Business/Committees/House_of_Representatives_Committees?url=jcpaa/natagree/report.htm>
6. Recent COAG discussion on health funding (13 February 2011) which saw considered a proposal for health specific purpose grants (specific purpose grant) and States own-source funded expenditure to be 'pooled' for redistribution amongst States using an activity based model and agreed levels of servicing

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

2. LESSONS IN INTERGOVERNMENTAL GRANT DESIGN

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

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

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

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

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

Where Australia performs better is through its focus on achieving equity (5c) and having in place institutional arrangements designed to manage intergovernmental

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

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

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

A possible solution is to make explicit the objectives and principles that underpin each type of grant and to identify and acknowl

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

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

4. INCENTIVISING STATE POLICY REFORM

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

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

Pillar 2 what States collectively do (on average);

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

Pillar 4 *practicality*; and

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

An important outcome of this CGC approach is to effectively pool specific purpose grants and general purpose grants and allocate this pool on HFE principles (Warren 2012, 2010a). This is most simply represented by F in Figure 1, which is the proportion of specific purpose and VFE allocated grants added directly to a State’s fiscal capacity when determining the allocation of by8.34fw(dtributtEs5(m)8.1(o)-1.9(st a7-18.0546

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

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

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

If history is any lesson, introducing the approach outlined above could confront political resistance across the States. However, the inertia against change can be overstated. As highlighted in Section 1, there is a growing recognition that change is necessary to current intergovernmental fiscal arrangements. This is also clear in the commentary by States such as New South Wales, Victoria and Western Australia in their submissions to various CGC Reviews. It is also clear from inquiries in various States⁹ and recommendations by business groups¹⁰.

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

5. INCOME TAX BASE SHARING

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

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

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

- (1) Quarantine additional revenue from selected State tax reforms;
- (2) Quarantine any Australian Government tax reform incentive grants;
- (3) Limit CGC redistribution of any agreed fiscal dividend through backcasting¹²;

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

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

¹¹ AFTS 2009, Pt 2, Vol 2, p675.

<http://www.taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm>

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

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

It is (5) that the UK government is soon to introduce as part of its recently revised funding arrangements with Scotland. Here, ten percentage points of the UK Personal Income Tax basic and higher rates on the Scots is attributed to Scotland whether or not it decides to set that rate above or below ten percentage points (Warren 2010c). In effect, this is an application of VRE principles with ‘average’ and imputed rather than actual rate and where higher (or lower) than the ‘average’ rate is effectively ignored and to the benefit (or cost) of the State. In Canada, VRE is applied through a province’s per capita equalisation entitlement being equal to the amount by which their fiscal capacity is below the average fiscal capacity of all provinces – known as the ‘10 province standard’. Those provinces with above average fiscal capacity receive no equalisation entitlement¹³.

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

If instead an approach was taken which operated on the VRE principle with the average set at ‘what ought to be’, then a State would have no reason not to impose the minimum and every reason to increase their rate above the average – since this would not be subject to equalisation. In Canada, such an arrangement effectively applies to natural resource revenues. Provinces receive a grant equal to the greater of either the amount they would otherwise receive by fully excluding natural resource revenues, or by excluding 50% of natural resource revenues. This adjustment to equalisation ensures that provinces receiving revenue from natural resources receive a net fiscal benefit from their resources equivalent to half the per capita resource revenues of the receiving provinces¹⁴.

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

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

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

6. HEALTH FUNDING REFORMS

While there might not as yet be an active public debate directly on the issue of funding the federation, there is in effect an active debate on the need to improve State public service delivery. It was in fact just this debate which motivated the health reform discussion at the 13 February 2011 COAG meeting. In the eleven-page communiqué following the meeting (*Heads of Agreement – National Health Reform*), 'transparency' was mentioned fourteen times and 'performance' fifteen times¹⁵. The issue is that health is both a State and a Commonwealth priority and funded by States through own-source revenue, and by the Commonwealth through specific purpose grants and by States allocating a proportion of their general purpose grants to health.

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

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

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

¹⁵ See <http://www.coag.gov.au/coag_meeting_outcomes/2011-02-13/docs/communique_attachmentA-heads_of_agreement-national_health_reform.rtf>

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

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

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

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

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

A benefit of this particular approach for the Commonwealth is to force actual and assessed State health expenditure to become aligned since 'what States do' would become 'what States ought to do' according to the Commonwealth. With such an

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

The VCE approach to health also has the advantage of addressing an ongoing criticism of the CGC HFE methodology that Pillar 2 rewards disability, doing nothing to encourage States to reduce it – an accusation most commonly made of States with large indigenous populations¹⁷. If VCE grants fund ‘what States ought to do’, have attached performance conditions, and are quarantined from consideration when allocating general purpose grants, then addressing disabilityit – aneVTm.pse]TJ-172J-12.50ec.07u.

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