

Benchmarking Australia's Intergovernmental Fiscal Arrangements

INTERIM REPORT

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Commissioned by
New South Wales Treasury

23 March 2006

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Executive Summary

This study compares and benchmarks Australian and international arrangements for the allocation of taxation powers and expenditure responsibilities between central and subnational governments, and mechanisms for fiscal transfers between governments.

The purpose of this study is to complement the Commonwealth's *International Comparison of Australian Taxes* study which will compare all forms of taxation collected in Australia at national, state and local government levels¹ with taxes in other countries. The Commonwealth study will not examine the assignment of tax powers and expenditure responsibilities between different levels of government. However, these assignments are the key to understanding why State tax systems in Australia have evolved into their present form.

This Interim Report finds that Australia performs comparatively poorly against many of the criteria which define best practice fiscal federalism. Australia's system of intergovernmental financial arrangements is characterized by very high vertical fiscal imbalance, inadequate State tax powers, and complex and high level equalisation. These arrangements hinder adjustments in the economy that are essential for the economy to develop and grow, as it must if we are to meet future challenges, including those of an aging population. International experience shows that fundamental reform to intergovernmental financial arrangements is being undertaken in many federations.

In relation to the allocation of taxes between the Commonwealth and States, Australia is characterised by a tax system that is highly centralised at the national level in comparison to other federations. The broadest tax bases – personal income, corporate profits, and goods and services – are held by the Commonwealth for a number of constitutional and Commonwealth policy reasons. States are highly reliant on comparatively narrow-based and inefficient taxes such as stamp duties, while payroll tax and land tax bases are limited in their application. Sharing designated tax bases is much more common in other federations.

In relation to the way expenditure responsibilities are allocated between the Commonwealth and States, expenditure responsibilities are generally allocated between the different levels of government in a relatively consistent pattern across all federations considered by this study. The main points of difference between Australia and the other federations considered in this study relate to health and education. Health and education spending in Australia is shared almost evenly between the Commonwealth and States in contrast to most other federations where those responsibilities are allocated almost exclusively to one level of government.

In relation to the extent of the imbalance between expenditure responsibilities and taxation powers Australia has a very high level of vertical fiscal imbalance compared to comparable federations. In Australia, States' own-source revenues account for only 40 per cent of their own-purpose outlays which is a lower proportion than any other federation studied. State

¹ <http://www.treasurer.gov.au/tsr/content/pressreleases/2006/008.asp>

governments in Australia are much more dependent on fiscal transfers from the Commonwealth than are comparable federations.

In relation to domestic and international arrangements for transfers from national to subnational governments, Australia's transfer system, characterised by horizontal fiscal equalisation, is arguably the most complex of any federation. Equalisation in Australia is applied to both expenditures and revenues whereas most other federations equalise only revenues. It would appear that other federations acknowledge more fully than does Australia a likely trade-off between the inter-jurisdictional equity benchmark and achievement of other benchmarks such as efficiency, transparency and simplicity. Australia appears to practice a much more extensive equalisation system than other federations, pursuing a goal of absolute equality for States. Furthermore, there is no objective benchmark to assess whether Australia achieves interstate equity.

The reforms to Commonwealth-State financial relations associated with the GST, as set out in the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, have exacerbated vertical fiscal imbalance – the States are now even more reliant on Commonwealth grants. While GST revenue grants from the Commonwealth replaced financial assistance grants and compensated States for the abolition of several of their own taxes, the reforms have left the States with more limited control of and discretion over their revenue.

From this review emerges a set of key findings, putting Australian intergovernmental financial arrangements into an international context. This review finds:

1. All federations have a commitment to the principle of fiscal equalisation.
2. There is an international trend to decentralisation.
3. Most countries regularly review their inter-governmental financial arrangements.
4. Ensuring tax assignment follows expenditure responsibility is important to ensure that subnational tax instruments are adequate to meet subnational government commitments.
5. The fiscal autonomy of States in Australia is much more heavily circumscribed than those of second tier governments in other comparable federations.
6. There is an overseas trend towards assigning primary expenditure responsibility to one level of government.
7. Distribution of shared revenues from national taxes is a common practice where independent taxing powers are not assigned. This often applies across all major central government taxes.
8. Most fiscal equalisation methodologies in other comparable federations are significantly less complex and more transparent than in Australia.
9. Other federal systems have equalisation processes which avoid, to a much greater extent than Australia, hampering necessary structural adjustment, and disincentives to efficiency-improving public expenditure.

10. The overriding importance which has been assigned in the Australian federation to the goal of full interstate equalisation, in contrast to most other federations, has led to diminished performance against other benchmarks of a federal fiscal system.

The conclusion of this study is that Australia performs comparatively poorly in international comparisons of intergovernmental arrangements and reform in the national interest is overdue and essential if we are to adequately meet the challenges of an ageing population. It should be possible, by implementing transitional safety net provisions, to reform the current arrangements without disadvantaging any jurisdiction.

Reform will take a commitment from all levels of government and requires an effective political champion to initiate it. The Council of Australian Governments (COAG), in recognising the demographic challenge, has already shown leadership with the recently agreed *National Reform Agenda*. It has the authority to initiate significant reform of Australia's intergovernmental fiscal relations by establishing an independent and ongoing review process.

This Interim Report uses the following benchmark framework to evaluate federal financial relations in Australia and those adopted by comparable developed federations:

Expenditure Responsibilities

- Benchmark 1* Subsidiarity: Subnational governments should be responsible for those services whose benefits are confined primarily to their geographic area and for which residents should have a choice over both the quantity and quality of service.
- Benchmark 2* Transparency of expenditure responsibilities: When expenditure responsibilities are shared among jurisdictions, responsibilities of each tier of government should be clear and appropriate coordination mechanisms should be established.

Tax Assignment

- Benchmark 3* Tax assignment should follow expenditure responsibilities
- Benchmark 4* Economic efficiency of tax assignment
- Benchmark 5* Fiscal need: Tax revenues should be robust and able to expand in line with expenditure needs

Intergovernmental Transfers

- Benchmark 6* Equity of intergovernmental transfers: Subnational governments with equal fiscal needs should be treated equally
- Benchmark 7* Neutrality of intergovernmental transfers: Subnational governments should not be able to influence the grants they receive by manipulating their expenditure or tax decisions
- Benchmark 8* Predictability and flexibility: Subnational governments need to be able to budget and plan for the future but, at the same time, have the flexibility to respond to changing circumstances
- Benchmark 9* Simplicity and transparency: The transfer mechanism or allocation formula should be readily understandable and easy to administer

Benchmark 10 Autonomy: Subnational governments should have the independence to set priorities and manage services to respond to local needs

Benchmark 11 Incentive for sound management: The transfer mechanism should not penalise subnational governments for sound economic management

Benchmark 12 Accountability: The transfer system should enhance the accountability of the subnational government to its citizens

Dynamic Federalism

Benchmark 13 A federal financial system should be adaptable, flexible and responsive.

1 Background

Australia has been well served by its federal structure, enjoying more than a century of economic growth, and political and social stability. In recent years, the COAG has been the forum in which federal-state issues have been discussed and negotiated between the Prime Minister, State Premiers, the Chief Ministers of the Territories and the President of the Australian Local Government Association.

At the most recent COAG meeting, in February 2006, all governments agreed to collaborate on a *National Reform Agenda*. This agenda embraces reform in the areas of human capital, competition and regulatory reform, to ensure that Australia is able to deal with the challenges of demographic change and global competition.

Adding to this, the Commonwealth Treasurer has announced an *International Comparison of Australian Taxes* study. This study 'will cover all forms of taxation collected in Australia at national, state and local government levels. This is OECD standard practice for international tax comparisons'². However, in its studies of fiscal federalism, the OECD also compares and contrasts tax assignment with expenditure responsibilities. This aspect is not planned for coverage in the *International Comparison of Australian Taxes*.

The purpose of this study, *Benchmarking Australia's Intergovernmental Fiscal Arrangements*, is to complement the Commonwealth study by benchmarking tax and expenditure assignment and transfer mechanisms in comparable (developed country) federations.

The study recognises that Australia's ability to deliver on COAG's *National Reform Agenda* depends on effective performance of the system of intergovernmental fiscal relations. It studies the potential implications for the performance of that system of:

- the way expenditure responsibilities and taxation powers are allocated between national and subnational governments; and
- the mechanisms for transfers between levels of governments.

How Australia performs in managing these issues compared to other mature federations is the focus of this study. It develops a set of benchmark criteria against which to evaluate fiscal federalism arrangements in Australia. This enables identification of areas where Australia leads or lags other countries.

The range of issues considered in this review includes:³

- a. expenditure responsibilities;
- b. taxation and other own-source revenue; and
- c. fiscal transfer mechanisms.

² <http://www.treasurer.gov.au/tsr/content/pressreleases/2006/008.asp>

³ As defined in "Intergovernmental Fiscal Relationships: An International Perspective", February 24, 1998, A Report by *Institute On Governance*, 122 Clarence Street, Ottawa, Ontario K1N 5P6 (613) 562-009

This review focuses on the arrangements in Australia and comparable developed federations including Austria, Germany, Canada, United States, Switzerland and Italy⁴. However, the paper first reviews recent fiscal federalism trends in Australia and overseas.

2 Fiscal Federalism Trends

While Australia's federal arrangement have considerable benefits, they also present some unique challenges. In order to function effectively, the systems and structures underpinning the federation must support cooperation between the various levels of government. These systems and structures, including the supporting institutional arrangements, have evolved over time as the Federation has matured.

Australia has been characterised by a substantial vertical fiscal imbalance (VFI) – broadly defined as a mismatch between revenue raising and expenditure responsibilities between the Commonwealth and State (and Territory) governments. The States have substantial line responsibilities (e.g. the provision of services such as health, education, transport and policing) but do not have sufficient own-source revenue to fund these responsibilities. They must rely on fiscal transfers from the Commonwealth, which controls most of the national tax base, for the additional revenue needed to fund their responsibilities.

Transferring the Commonwealth's surplus revenue to the States was implemented in *ad hoc* ways prior to the creation in 1933 of the Commonwealth Grants Commission (CGC). The CGC is one of the key finance-related bodies of the Federation, along with the Loan Council and more recently COAG and various Ministerial Councils. The *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (IGA) set up a Ministerial Council which deals with, among other things, the transfer of GST revenue to the States and Territories.

States' reliance on fiscal transfers from the Commonwealth results from the constitutional arrangements that underpin the Federation. The Australian Constitution provides that the Commonwealth may grant financial assistance to the States on such terms and conditions as it thinks fit. This has allowed the Commonwealth to take over Australia's biggest tax base – income tax – which was shared between the Commonwealth and the States from the end of the First World War until 1942. The Commonwealth subsequently provided annual grants of financial assistance to the States on condition that they did not impose their own income tax. The range of taxes available to the States has also been severely limited by section 90 of the Constitution and the High Court's interpretation of that section, which has effectively denied the States access to their own broad-based sales taxes.

Australia is not alone in dealing with the benefits and challenges of a federal system. Federal systems also apply in Austria, Belgium, Brazil, Canada, Germany, India, Mexico, Switzerland and United States. However, the challenges of dealing with the fiscal arrangements between central and subnational levels of government are not unique to federations – they are also relevant to unitary countries such as Italy, Japan, Spain and the United Kingdom.

⁴ Italy is not technically a federation, but its regional arrangements are federation-like.

Over the past few decades, radical reforms to the fiscal relations between central and subnational governments have been carried out in many countries. While there has been diversity in national experiences, a clear trend has emerged toward decentralisation.⁵

In Austria a constitutional convention was established in 2004 with the task of making proposals for constitutional reform to simplify federal fiscal relations.⁶ During the last decade, the Italian system of intergovernmental fiscal relations has undergone an as yet uncompleted process of radical reform that has assigned the Italian regions new taxing powers and introduced a new system of interregional transfers. In Spain, the process of assignment of healthcare and social services spending to Autonomous Communities has been completed. In France, the constitutional reform of 2003 provides the general framework for a massive decentralisation of public functions in fields such as higher education, industrial policy and regional infrastructure.

With regard to the revision of subnational government financing systems, the reforms pursued have the general aim of improving decentralised governments' accountability, by assigning them more tax autonomy and by removing the constraints on the destination of central government fiscal transfers. In Italy, Spain and France decentralisation has been coupled with the assignment of new taxing powers to subnational governments.

However, the route to greater tax autonomy appears to be less certain than the route to expenditure decentralisation, given the difficulty of finding revenue-raising powers that can be transferred to subnational levels of government without raising distributional and efficiency concerns (such as tax competition and sensitivity to cyclical economic fluctuations). A trade-off seems to exist between the degree of decentralisation and the degree of tax autonomy. Spain's experience indicates a partial solution in giving subnational governments significant room for discretion in setting surcharges on taxes shared with the central government.⁷

International experience suggests that fundamental reform to intergovernmental fiscal arrangements is being pursued and adopted. Clearly this takes a commitment from central and subnational governments to a serious dialogue on ways to improve existing intergovernmental fiscal arrangements.

3 Benchmarking Intergovernmental Fiscal Arrangements

What are good intergovernmental fiscal arrangements? The answer is far from simple and is coloured in large part by the historical (and political) background to the fiscal federalism arrangements agreed to by the federated regions. However, there is broad agreement that the fundamental driver should be the assignment of expenditure responsibilities agreed by

⁵ *Designing Intergovernmental Fiscal Relations: Some Insights from the Recent Italian Reform*, Giampaolo Arachi and Alberto Zanardi, Institute for Fiscal Studies, 2004.

⁶ *Reforming Federal Fiscal Relations in Austria*, Andres Fuentes, Andreas Worgotter and Eckhard Wurzel, OECD Economics Department Working Papers No. 474.

⁷ *Designing Intergovernmental Fiscal Relations: Some Insights from the Recent Italian Reform*, Giampaolo Arachi and Alberto Zanardi, Institute for Fiscal Studies, 2004.

federation members. It is upon this foundation that the fiscal federalism arrangements must be built. The key question then is what is the *best practice* for developing fiscal relationships between national and subnational governments given the subnational government's expenditure responsibilities.

Considerable attention has been given to this issue from the perspective both of how best to design (ideal) fiscal federalism arrangements and how to evaluate established arrangements. The OECD⁸, IMF, World Bank, ADB and the EU have devoted considerable time and resources to identifying best practice criteria and any tradeoffs involved in achieving the criteria.

It would appear that other federal countries acknowledge more fully than does Australia a likely trade-off between the inter-jurisdictional equity benchmark and achievement of other benchmarks. In particular, aiming at full inter-jurisdictional equalisation is likely to make it more difficult to meet other benchmarks, especially those of efficiency, transparency, simplicity and economic management.

This study compares Australia's performance against the benchmark criteria for tax assignment, subnational expenditure responsibilities and intergovernmental fiscal transfer arrangements across a number of comparable OECD countries. In this way, it complements the current Commonwealth study into Australia's tax system by benchmarking the tax and expenditure assignment and intergovernmental transfer arrangements in comparable (developed country) federations.

The following four sections outline a benchmark framework for evaluating federal financial relations. These benchmarks are considered under the headings of expenditure responsibility, tax assignment, intergovernmental transfers and dynamic federalism.

4 Expenditure responsibilities

Benchmark 1 Subsidiarity: Subnational governments should be responsible for those services whose benefits are confined primarily to their geographic area and for which residents should have a choice over both the quantity and quality of service.

Services that have traditionally been thought to be appropriate for subnational governments include primary and secondary education, health care, local transportation networks and care of the elderly. On the other hand, for some services it is not feasible or appropriate to tailor the quantity and quality of service to suit subnational tastes. These services are more effectively delivered by the central government. They may include services that generate benefits or spillovers that extend across the country, and services where uniform national standards are expected.

COAG's *National Reform Agenda* recognises that policies aimed at building human capital, such as health and education, generate positive spillovers and, in the longer term, generate benefits that extend across the country. This may have implications for the local (best

⁸ See (OECD, 1999, 2001, 2002, 2003, 2005, 2006)

practice) delivery of these services, such as the under-provision of health and education services.

Across all federations considered by this study, expenditure responsibilities are generally allocated between the different levels of government in a relatively consistent pattern. The main points of difference between the Australian system and the other federations considered here relate to health and education [refer Table 1].

Responsibility for funding health services in Australia is shared almost evenly between the central (52 per cent) and state (48 per cent) governments. In contrast, Canada, Switzerland and Germany allocate that responsibility almost exclusively to one or other level of government, while Austria is much like Australia in terms of sharing of fiscal responsibility [refer Figure 1].

Similarly, in Canada, Switzerland and Germany — but not Austria — education services are delivered almost exclusively by state and local governments, with a very limited role for central governments. By contrast, Australia's central government is responsible for 40 per cent of total education expenditure. [refer Figure 2]

Benchmark 2 Transparency of expenditure responsibilities: When expenditure responsibilities are shared among jurisdictions, responsibilities of each tier of government should be clear and appropriate coordination mechanisms should be established.

It is important that shared services are properly coordinated to ensure that the most efficient and effective mix is provided. This coordination mechanism must be sufficiently transparent to allow citizens to determine whether they are satisfied with the mix of services, and which government is responsible for its individual elements.

As noted above, Australia has unusually high levels of federal/state overlap in the areas of health and education. In relation to health, the lack of coordination between Commonwealth and State programs is widely recognised, as is the opportunity for cost shifting between levels of government.

In 2005, Austria reformed its health system which was fragmented between levels of government, leading to cost-shifting and perverse incentives. Now, a new federal health care agency is responsible for policies in relation to planning, sector wages, quality standards and health promotion. Hospital funding is pooled in state level funds, combining the financial resources of the federal and state governments and health insurance providers.

The reforms to Austria's health system are particularly interesting from an Australian perspective, as the health systems in both countries are the constitutional responsibility of the States, but the respective national governments have significant overlapping responsibilities. The Austrian model of pooled funding for a jointly managed system is one of a number that have been proposed as a way of addressing problems in Australia, but no agreement has been reached on how best to consider the full range of reform options.

5 Tax Assignment

Benchmark 3 Tax assignment should follow expenditure responsibilities

Expenditure responsibilities should be closely matched with revenue generation capacities to reduce the need for intergovernmental fiscal transfers and to provide greater public accountability. The percentage difference between own-source revenues and own-purpose expenditure represents the level of VFI. The higher a subnational government's own-purpose revenues are as a proportion of its own-source outlays, the lower is VFI and the more accountable subnational governments become and the greater is the potential for economically efficient outcomes.

Australia has a very high level of VFI by international standards. The Commonwealth collects around 80 per cent of national taxation revenue (including the GST), but is responsible for around 54 per cent of total expenditures. The States collect around 16 per cent of total taxation revenue but undertake about 40 per cent of all government outlays [refer Figure 3]. The GST and associated reforms, including the abolition of some State taxes, have further increased the degree of VFI in Australia. Since Federation there has been a trend to greater concentration of taxing powers in the hands of the Commonwealth [refer Figure 4].

The degree of VFI in Australia is very high compared to the USA, Canada, and Switzerland, where subnational governments' own-source revenues are equivalent to around 80-90 per cent of their own-purpose outlays [refer Figure 5]. This means that subnational governments in Australia are much more dependent on fiscal transfers from central government than some comparable federations [refer Figure 6 and Table 2].

Australia has among the highest concentration of taxing powers in central government of any federation. Conversely, subnational governments in Australia have among the lowest level of own-source revenues expressed as a percentage of total government revenues. Subnational governments in the USA and Germany account for 30-35 percent of total government revenue, increasing to 50-60 per cent for Canada and Switzerland [refer Figure 7 and Table 3].

On the spending side, subnational governments in Australia are responsible for a higher proportion of total government expenditures (46 per cent) than either the USA or Spain (around 30-40 per cent) but are responsible for a lower proportion of expenditures than subnational governments in Germany, Canada and Switzerland (around 60-70 per cent) [refer Figure 8 and Table 3].

Benchmark 4 Economic efficiency of tax assignment

The literature on fiscal federalism suggests that subnational governments should minimise the use of highly mobile tax bases, redistributive taxes, and taxes subject to sharp cyclical fluctuations⁹. It thus excludes corporate income taxes and personal income taxes which are *both* imposed at the subnational level *and* subject to large interstate differentials. It also excludes redistributive personal income taxes at the State level but does not exclude a subnational surcharge on a national tax. Consumption taxes could be candidates for

⁹ *Fiscal Relations Across Government Levels*, OECD Economic Studies No.36, 2003/1.

subnational taxes, but administrative considerations (compliance and collection costs) and the mobility of the base with differential rates (cross-border shopping in boundary areas and inter-jurisdiction trade) reduce their attractiveness. Property taxes avoid some of these pitfalls, making them attractive for subnational government use.

State governments in Australia are forced, through tax competition, constitutional constraints and Commonwealth policies, to rely heavily on narrowly-based and sometimes highly cyclical transactions based taxes such as stamp duties, rather than more broadly-based consumption and income taxes which in Australia are central government taxes. The more economically efficient State taxes in Australia are the payroll tax and land tax. Payroll tax is relatively efficient as labour is a widely used component of production and so the tax base is relatively broad. Land tax is relatively efficient as its fixed supply means that taxes will not typically reduce the ownership of land. However, while a broad based payroll tax and land tax are theoretically efficient, in practice their economic efficiency is reduced by their selective application which narrows the potential tax base considerably, although harmonisation of bases¹⁰ by States and Territories could address some of these inefficiencies.

This contrasts with the broader bases available to subnational governments in other federations. For example, in the USA, State governments can impose sales and income taxes. In Austria, Germany and Italy, there is revenue-sharing of income and sales taxes according to criteria such as the location of the population, economic activity, consumption or source of income. In contrast, Australian GST revenue is shared exclusively according to an equalisation formula.

Benchmark 5 Fiscal need: Tax revenues should be robust and able to expand in line with expenditure needs

An important attribute for any tax is robustness. This refers to a situation in which revenue grows in line with economic activity. Taxes whose revenues increase at rates less than the rate of economic growth, or which are volatile and potentially change countercyclically, pose problems for government budget management [refer Table 4].

The single most important tax for Australian States is the payroll tax. The revenue from this relatively broad-based tax is more predictable than from many other State taxes as it tends to grow steadily in line with wages and employment growth. In contrast, stamp duties, which are the second largest source of State tax revenue, are more sensitive to transaction volumes which can change independently of broad economic conditions. If the tax system is not robust, there is an ongoing need to identify new sources of revenue to maintain tax collections.

Subnational governments in other federations have access to broadly-based taxes, such as income and sales taxes, that are more robust than many of the taxes available to State governments in Australia. While Australian States share GST revenue, they cannot unilaterally alter the GST base and rate and so do not have the discretion available to adjust

¹⁰ Harmonisation of tax bases includes common definitions, allowances and exemptions, and uniform approaches to administration. A more extended definition could include common tax rates and thresholds.

their tax revenues to meet their expenditure needs. In contrast State governments in the USA can alter the rate and base of their sales taxes and in Canada the Provinces and Territories have direct access to either their own Provincial Sales Taxes or their share of the Harmonised Sales Tax¹¹.

6 Intergovernmental Transfers

Benchmark 6 Equity of intergovernmental transfers: Subnational governments with equal fiscal needs should be treated equally

An important component of most federal systems is horizontal fiscal equalisation – a policy designed to correct for economic disabilities experienced by some subnational governments. These disabilities result in horizontal fiscal imbalance, a situation in which there exist differences between subnational jurisdictions in their ability to provide comparable levels of government services while imposing comparable tax burdens. These differences may arise from tax-raising disabilities (as a result, for example, of lower *per capita* taxpayer incomes) and/or cost disabilities in the provision of government services (as a result, for example, of different population age structures). Equalisation is fundamentally based on the principle of equity between subnational jurisdictions and this principle has been accepted by the Australian community.

In Australia, despite implementing equalisation, there is considerable dispute as to whether the process is successful in achieving equalisation or whether, in practice, there is overcompensation for some States. This focus on inter-jurisdictional equity in transfers from the Commonwealth to the States contrasts with the tradeoffs evident in the tax system between the competing objectives of equity, economic efficiency, transparency and simplicity.

Internationally, federal countries tend to concentrate on the equalisation of revenue capacities only, ignoring or paying less attention to cost disabilities in the provision of public services. In many cases the goal is the achievement of *minimum standards* of the services, rather than *full equalisation* [refer Table 5].

It would appear that other federal countries more fully acknowledge a likely trade-off between the equity benchmark and achievement of other benchmarks. Aiming at full equalisation is likely to make it more difficult to meet other benchmarks, particularly those of efficiency, simplicity and economic management.

Benchmark 7 Neutrality of intergovernmental transfers: Subnational governments should not be able to influence the grants they receive by manipulating their expenditure or tax decisions

Australian States rely on substantial federal general revenue grants to fund their expenditure programs. The size of the general revenue grants stems from the IGA and their allocation

¹¹ In Canada the federal GST rate is 7 per cent and the Provinces and Territories have the option of imposing an additional 8 percentage points of tax in place of their own Provincial Sales Tax (PST), resulting in a Harmonised Sales Tax (HST) with a rate of 15 per cent.

between States by the Federal Treasurer after recommendations from the CGC following the principle of horizontal fiscal equalisation.

Fiscal equalisation grants may influence a State's behaviour because its taxes and expenditures can affect the parameters of the grant formula and, as a result, the size of its grants. The problem here lies in the construction of the grant allocation formula. If grants are based on a formula which includes variables able to be influenced by the recipient, then neutrality in the allocation of grants cannot be assured.

Other federations are less exposed to such concerns about the equalisation arrangements because of their greater use of revenue-only sharing arrangements. That is, they are not equalising on the expenditure side. In Italy and Germany, some taxes are distributed on the basis of the economic activities generating the tax base and therefore the tax revenue. Other countries have sought to harmonise their state taxes and assign responsibility for their collection to the national government (as with the Canadian Harmonised Sales Tax).

Benchmark 8 Predictability and flexibility: Subnational governments need to be able to budget and plan for the future but, at the same time, have the flexibility to respond to changing circumstances

It is important that a subnational government's total pool of available resources be predictable in absolute terms, as well as flexible enough to meet changing budgetary demands. This can be achieved through a combination of grants and own-source revenue. Predictability can be achieved through sharing a general revenue pool and flexibility through changes to own-source revenues.

In the case of general revenue grants, predictability requires certainty about both the size of the available pool and each subnational government's share of this pool. Uncertainty can arise here from changes in the grant allocation formulae or changes in the aggregate grant pool.¹²

In Australia, general revenue grants are made from the GST revenue pool. An individual State's allocation from this pool depends upon three factors:

1. The size of the total GST revenue pool,
2. The size of the population; and
3. The State's fiscal equalisation relativity, recommended by the CGC.

In practice, the size of the total GST revenue pool has proved to be relatively predictable although, like all taxes, the GST is subject to some forecasting error. Nevertheless, the broad base of the GST makes its revenue relatively more predictable than revenues from the typical narrowly-based State tax. As an example, revenues from the purchaser transfer duty are more difficult to predict because of its narrower base and higher volatility through the economic cycle. Payroll tax revenues have proven to be more predictable than the revenues of other

¹² *Intergovernmental Fiscal transfers; Some Lessons from International Experience*, Richard M Bird and Michael Smart, International Tax Program, Rotman School of Management, University of Toronto, January 2001, revised March 2001, p.17.

State taxes because the payroll tax is the only own-source broad-based tax to which the States have access.

In relation to the second factor influencing a State's allocation, population growth has proven to be relatively predictable.

On the other hand, the complex formula used to distribute the GST amongst the States makes prediction of the level of untied grants *for any individual State* considerably more problematical. A State's grant can vary, for example, by up to 2 per cent year to year. This can result from changes in its revenue bases and expenditure needs relative to other States and from changes in the distribution formula or corrections in its application. When the distribution formula is periodically subject to more thorough CGC review (usually every five years), the variations can be up to ten per cent of the total grant. Recommended State relativities can also change significantly as a result of revisions in the underlying data on which the CGC bases its calculations. By their nature, the impact of possible future data revisions is difficult to predict.

The arrangements applying in Austria provide some predictability but at the price of less flexibility because of the preponderance of revenue-sharing arrangements.¹³ Federal transfers in Canada use a stand-alone equalisation scheme based on formulae which are adjusted from time to time¹⁴, and this indicates there is some degree of flexibility in Canada's arrangements in the medium to long term. If flexibility is required in the short term, Canadian Provinces have recourse to own-source taxes, one of which is a personal income tax surcharge. As with Australia's arrangements, Canada's arrangements are also subject to forecasting errors like any other tax, but the broad federal tax base makes it relatively more predictable than narrower subnational tax bases.

Benchmark 9 Simplicity and transparency: The transfer mechanism or allocation formula should be readily understandable and easy to administer

Simple transfer mechanisms and allocation formulae lead to transparency of outcomes and ease of administration. This is not simplicity for simplicity's sake. Complexity in the grants allocation methodology can be justified if it leads to efficient outcomes. However, there is no evidence that the great complexity and the data-intensive requirement of the CGC methodology are justified by the reliability of its outcomes.

Equalisation in Australia is applied to both expenditures and revenues. This involves around 40 categories of State expenditure with many factors applied to each, resulting in Australia having some 359 expense factor assessments. In the case of tax capacity, 37 revenue component assessments form the basis of the revenue capacity calculations in the formula. It also requires the use of judgement. Australia arguably has the most complex transfer mechanism of any federation.

¹³ *Reforming Federal Fiscal Relations in Austria*, Andres Fuentes, Andreas Worgotter and Eckhard Wurzel, OECD Economics Department Working Papers No. 474.

¹⁴ *Autonomy or Dependence: Intergovernmental Financial Relations in Eleven Countries*, Ronald Watts, Queens University, Working Paper 2005 (5).

Practices in most other federal countries are considerably less complex than in Australia. Canada equalises only on the revenue side, with the objective of 'reasonably comparable levels of public services at reasonably comparable levels of taxation across provinces'. This process apparently requires only two people¹⁵. Switzerland has proposed a new equalisation program effective from 2006 which reassigns responsibilities between the federal government and Cantons and is an attempt to simplify a frequently *ad hoc* system that led to complexity and loss of the wider vision of equalisation. Germany's equalisation arrangements are relatively simple and transparent.

Benchmark 10 Autonomy: Subnational governments should have the independence to set priorities and manage services to respond to local needs

In order to realise the benefits of a federal system, subnational governments should be able to exercise their powers independently of interference from other governments in the federation, as long as any spillover effects are properly recognised. When spillover effects arise, it is the proper responsibility for the national government to ensure that these effects are incorporated into the decisions of subnational governments.

In Australia, the Commonwealth Government uses tied grants, known as specific purpose payments or SPPs, to steer the policies of subnational governments. These transfers from the Commonwealth to the States are made pursuant to agreements between the two levels of government on particular policy areas.

SPPs also serve as a vehicle for the extension of Commonwealth policy into areas for which the States are held accountable. In some cases, they are little more than a mechanism for the Commonwealth to direct funds towards the Commonwealth's areas of priority rather than pursue matters of higher priorities to a particular State. Current Commonwealth policy towards SPPs is seen by the States as highly inflexible and focused on input controls rather than what is achieved. The States have argued for some time that the focus in SPP agreements should be on outcome/outputs measures, in order to ensure greater focus on service delivery and to encourage efficiency improvements.

The level of State funds becoming tied up in SPP agreements is significant, constituting around 15 per cent of States' total revenues. However, through their matching and maintenance of effort conditions, SPP agreements can control up to 33 per cent of State budget outlays. This has a significant impact on States' budget flexibility [refer Table 6].

While other federations also have arrangements comparable to SPPs, SPPs appear to be more important in the Australian Federation. In the case of the USA, transfers from the central to State governments are mostly earmarked and relate to health – but they are far less important as a portion of State expenditure responsibility. Grants allocated to subnational levels in other federations are more often unconditional and therefore less likely to lock in State tax revenue to specific national expenditure priorities. This arises from a trend towards exclusive

¹⁵ Shah, A., 2004, *The Australian Horizontal Fiscal Equalization Program in the International Context*, World Bank, Presentation to the Heads of Australian Treasuries Forum, Canberra, Australia, September 23, 2004

assignment of major expenditure responsibilities to one tier of government or another, thus making recourse to tied grants less relevant.

Benchmark 11 Incentive for sound management: The transfer mechanism should not penalise subnational governments for sound economic management

In most federations, it is typical to find shared responsibilities between the central and subnational governments with the potential for ambiguous and often contradictory policy objectives. This can result from poorly defined roles and responsibilities which overlap and produce duplication and confusion about the functions, interactions and responsibilities of different levels of government. The result can be policy competition and inconsistencies that have the potential to discourage prudent subnational fiscal management. It might also encourage subnational governments to undermine national objectives through the use of tax concessions or funds from off-budget sources.

Australia performs well on a sound budgetary management criterion. The budgetary performance of the States has in recent years been subject to the discipline of a much greater degree of external scrutiny by, for example, international rating agencies. There is no guarantee (actual or implied) that subnational deficits will be funded centrally and any deficit financing arrangements agreed with central government are open to public scrutiny through the Loan Council.

Other countries have had to resort to agreements such as the implementation of a Balanced Budget Rule, a Borrowing and Debt Rule or a Tax and Expenditure Limitation Rule. Australia has not had to resort to such explicit rules, which are effectively exercised through the Loan Council arrangements. Interstate competition also limits the scope for any one State to move beyond comparable practices in other States.

Subnational economic management should not conflict with national objectives and the equalisation system should not hinder policies that encourage economic development and growth or impede structural adjustment which is essential if the economy is to adapt to changing circumstances. The Australian system has the risk of impacting on national and subnational economic development, especially where grant entitlement is not independent of subnational policies or economic activity. Beggar-thy-neighbour policies are therefore possible and can jeopardise the efforts of the national government to achieve economic stabilisation and expand the economy.

A common concern about equalisation and VFI policies is their potential to discourage or hinder economic growth as a result of the way they can adversely interact with government programs encouraging regional economic growth. The problem is that the more sophisticated are the equalisation arrangements designed to achieve equity, the greater is the opportunity for economic neutrality (or efficiency) to be compromised. Fiscal equalisation as practiced in Australia effectively redistributes the benefits of improved economic efficiency to other States by changes in the disability calculation.

Benchmark 12 Accountability: The transfer system should enhance the accountability of the subnational government to its citizens

The relative funding responsibilities of Australia's levels of government are very poorly understood. This is largely due to the fact that many services are jointly funded by both the States and the Commonwealth.

Due to constitutional restrictions on its activities, many programs funded by the Commonwealth are delivered through tied grant arrangements with the States, usually with additional State funding. In addition, all State governments receive untied funding from the Commonwealth, which subsidises all State activities.

Whilst the distribution of tied grants is generally determined by the responsible Commonwealth minister, these distributions are often overruled by the CGC. 'For most [tied grants] the CGC effectively sets aside the allocations determined by the Commonwealth under legislative and ministerial authority in the portfolio area concerned – typically in consultation with the States – and substitutes its own assessment.'¹⁶

The net result is a confused mix of responsibilities where, for almost any service delivered at the subnational level, each level of government can seek to avoid accountability by blaming the involvement of the other.

7 Dynamic Federalism

Benchmark 13 A federal financial system should be adaptable, flexible and responsive

While the responsibilities of the different levels of government may be outlined in a Constitution or some agreed statement, changing circumstances in the federation may necessitate changes to the roles of the different levels of government in a federation. The federal financial system in such circumstances should be capable of being adapted to respond to these new challenges along with demands to facilitate national welfare-enhancing changes to the system.

COAG is the peak intergovernmental forum in Australia. It initiates, develops and monitors the implementation of policy reforms that are of national significance and which require cooperative actions by Australian governments. COAG therefore is the key body available to States to press for reform of intergovernmental financial arrangements. However, in order for COAG to be an effective mechanism for reform in this area, national leadership from the Commonwealth supported by State governments is required.

In other federations this leadership comes from their more consultative approach to fiscal federalism where arrangements are regularly subject to review and renegotiation. In Austria, the fiscal equalisation law is reviewed and renegotiated between governments every four years. Canada, while having no formal provision for regular review of inter-governmental financial relations, has undertaken extensive independent review of its fiscal equalisation process in recent years. In Germany, the Solidarity Pact between central government and the States was recently reformed. Italy has seen a recent period of extensive reform to intergovernmental fiscal relations, as has Switzerland.

¹⁶ Garnaut R, and FitzGerald V, *Review of Commonwealth-State Funding Final Report*, August 2002.

8 Conclusion and Key Findings

Australia performs comparatively poorly against many of the criteria which define best practice fiscal federalism. International experience shows that

- Compared with other federations, the Australian federal financial system is clearly in need of reform in the national interest;
- Fundamental reform of intergovernmental financial arrangements has been recently undertaken in many federations; and
- It is possible to reform federal financial systems without significantly disadvantaging any individual jurisdiction.

This report identifies a set of benchmarks, or criteria, against which the performance of the Australian federal financial system is evaluated. It also examines how comparable federal countries organise their relationships between national and subnational governments. From this review the following key findings have been identified, putting Australian practices into an international context.

1. **Commitment to the principle of fiscal equalisation.** In all countries studied, with the notable exception of the USA, there exists a strong commitment to the principle of equalisation – the need to improve the ability of disadvantaged subnational governments to provide adequate levels of public services. Australia has a clear commitment to the *broad principle* of inter-State equalisation. However, the exact nature of the equalisation objective (whether full or partial equalisation) and the means of achieving that objective vary from country to country, and not the principle itself, Australia has the most ambitious objective of full inter-jurisdictional equality.
2. **Trend to decentralisation.** There is an evident trend among federal countries comparable to Australia towards decentralisation – devolving expenditure responsibilities and/or tax powers. This decentralisation has often arisen out of reviews of federal fiscal arrangements. Australia, on the other hand, has been moving towards greater centralisation, with the Federal Government playing an increasing role in revenue-raising and taking increased expenditure responsibilities.
3. **Review of inter-governmental financial arrangements.** In recent years, many federal countries have undertaken extensive reviews of their federal financial arrangements and, in the light of these reviews, reformed their financial relationships between national and subnational governments. In Australia, on the other hand, there has been no recent wide-ranging review of inter-governmental financial arrangements and the review of horizontal fiscal equalisation, to be completed by 2010, promises to be much narrower in scope than reviews undertaken in other federations.
4. **Adequacy of subnational tax instruments:** In Australia, there is a relative paucity of broad-based tax instruments available to the States. In some countries (e.g. Canada and the USA) broad-based taxes are available to States. In others (e.g. Germany, Austria, Italy and Switzerland), States share the revenues from such taxes with the national government, with a high proportion of the revenues being assigned to the state of

origin of the tax base (using information on population, consumption or value-added by business). On the other hand, GST revenue-sharing in Australia requires that all revenue be distributed according to an equalisation formula. For own-source revenue, States are forced to resort to narrow-based taxes which have potentially high compliance costs, economic inefficiencies and inequities.

5. **Fiscal Autonomy.** The Australian States have inadequate tax instruments and, compared with other federations, are almost uniquely reliant on grants whose size and distribution are recommended by the CGC but ultimately entirely at the discretion of the Federal Government. The Australian States therefore have less fiscal autonomy than second tier governments in comparable federations.
6. **Assignment of primary expenditure responsibility.** There is an overseas trend towards assigning primary expenditure responsibility to one level of government. In the case of health, it is largely confined to a single level of government, whether national or subnational. In Australia on the other hand, health responsibilities are shared almost equally between Federal and State Governments.
7. **Distribution of shared revenues from national taxes.** In federal systems in which institutional arrangements exist to share the revenues from designated national taxes with subnational governments, Australia stands out from comparable federal countries in that GST revenue is distributed 100 per cent according to a fiscal equalisation formula. In other countries, shared revenue is, at the very least, partially distributed according to such bases as population shares or location of the consumption or production tax base.
8. **Complexity of fiscal equalisation methodologies.** Formula-based methodologies for fiscal equalisation are significantly less complex and more transparent in other comparable countries than in Australia and there is no evidence that high levels of complexity lead to more efficient outcomes.
9. **Efficiency effects of equalisation.** Other federal systems have equalisation processes which avoid, to a much greater extent than Australia, disincentives to efficiency-improving public expenditure such as infrastructure investment, and barriers to structural adjustment that facilitates economic development. Other federations confront this issue to a lesser extent because their equalisation processes focus more on revenue capacity and less on cost disadvantage.
10. **Primacy of equity benchmark.** The overriding importance which has been assigned in Australia to the goal of full interstate equalisation, rather than the achievement of minimum standards, has led to diminished performance against other benchmarks of a federal system. Australia's current system attempts to achieve full equalisation, in contrast to most other federations. The result in Australia has been a high level of complexity, economic inefficiencies and a lack of transparency.

An important conclusion to be drawn from this comparison of international experience is that Australia needs an effective political champion to review and reform current arrangements. Yet Australia, unlike most other federations, seems unwilling to set up an independent and

disinterested body to critically review its intergovernmental financial arrangements with a view to reform. COAG, having the authority to initiate significant reform of Australia's intergovernmental fiscal relations, could consider establishing an independent review of intergovernmental financial arrangements.

9 Statistical Appendix

Table 1 Spending by sub-national governments by main categories

In % of total sub-national governments' expenditure 2003 or latest year available

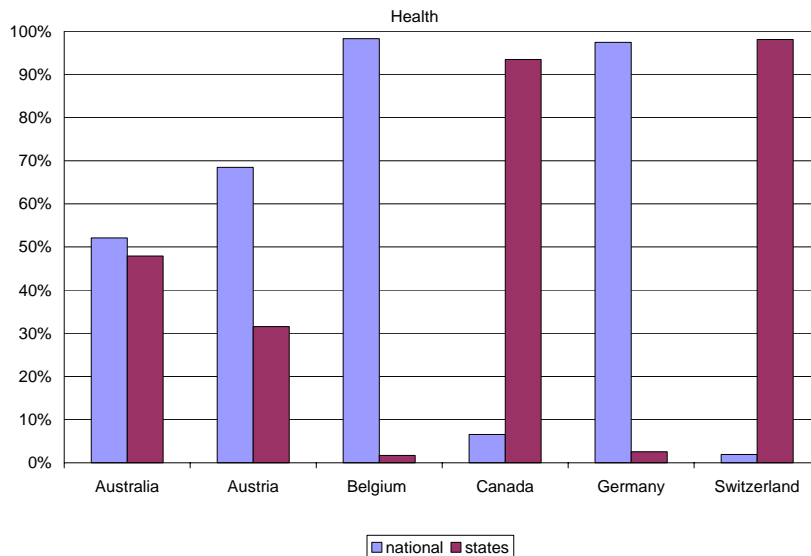
	Public order and safety		Education		Health		Social security & welfare	
	State, Region or Province	Local	State, Region or Province	Local	State, Region or Province	Local	State, Region or Province	Local
Federal countries								
Australia (2002)	9.2	2.0	25.7	0.3	22.9	1.5	6.0	5.3
Austria	0.6	2.3	20.1	17.2	19.7	17.1	20.4	18.2
Belgium	0.2	11.9	41.3	19.9	0.7	2.0	16.5	16.1
Canada (2002)	3.7	9.7	22.6	41.8	32.7	1.4	16.7	6.5
Germany	8.8	4.6	23.4	16.3	1.2	1.8	23.1	31.0
Switzerland (2001)	7.9	4.6	24.5	23.2	17.3	18.6	17.4	14.0
United States (2001)	4.4	10.4	30.9	44.8	22.0	8.4	17.9	7.3
Non-weighted average	5.0	6.5	26.9	23.3	16.6	7.3	16.9	14.1
	General public services		Housing & community amenities		Economic services		Other	
	State, Region or Province	Local	State, Region or Province	Local	State, Region or Province	Local	State, Region or Province	Local
Federal countries								
Australia (2002)	10.5	22.3	5.2	12.6	17.2	29.9	3.3	26.1
Austria	11.0	17.2	4.1	3.4	20.9	14.6	3.1	10.1
Belgium	17.0	23.5	1.7	1.8	15.8	11.2	6.8	13.6
Canada (2002)	12.4	9.6	1.3	5.9	9.6	18.5	0.9	6.7
Germany	25.8	14.7	3.7	6.8	11.6	11.9	2.5	13.1
Switzerland (2001)	11.6	15.9	2.1	8.0	16.8	9.8	2.4	5.9
United States (2001)	13.2	16.2	0.7	2.1	10.3	7.4	0.4	3.4
Non-weighted average	14.5	17.1	2.7	5.8	14.6	14.8	2.8	11.3

Source:

OECD National Accounts for Austria, Belgium and Germany; IMF, Government Finance Statistics Yearbook, 2003, for the others.

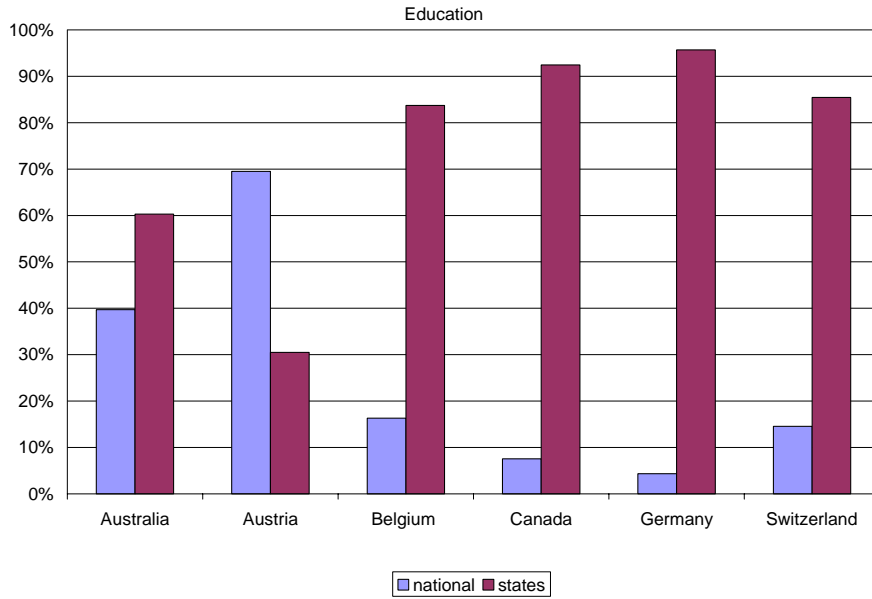
Fuentes, A., A. Wörgötter and E. Wurzel (2006), "Reforming Federal Fiscal Relations in Austria", OECD Economics Department Working Papers, No. 474, OECD ECO/WKP(2006)2

Figure 1 Health Expenditure by level of government



Source: IMF Government Finance Statistics Yearbook, 2004

Figure 2 Education Expenditure by level of government



Source: IMF Government Finance Statistics Yearbook, 2004

Figure 3 Vertical Fiscal Imbalance in Australia

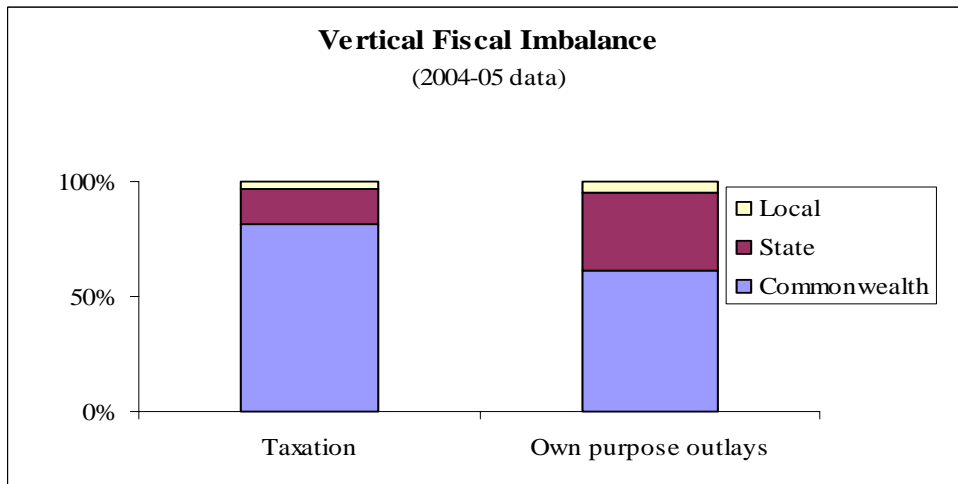


Figure 4 Share of total taxation revenues by level of government in Australia¹⁷

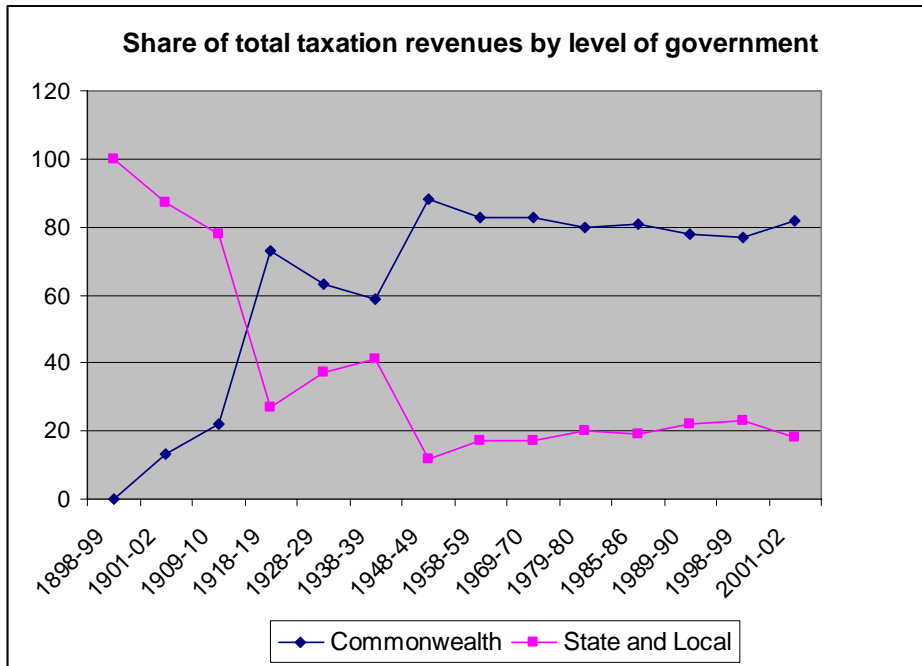
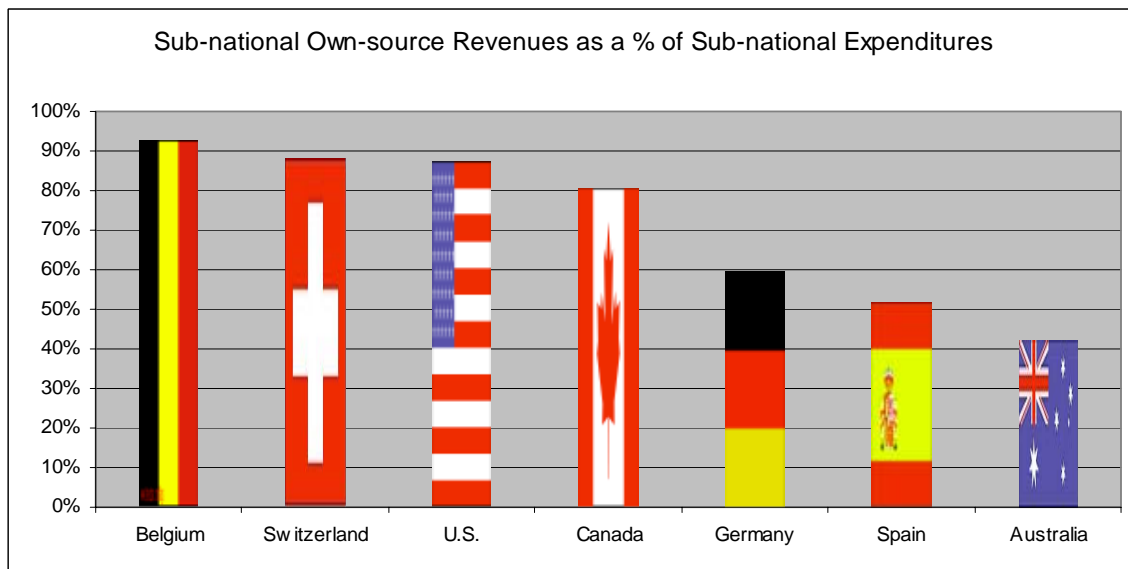


Figure 5 Sub-national own-source revenues as a percentage of sub-national expenditures¹⁸



¹⁷ Bhajan Grewal and Peter Sheehan, *The Evolution of Constitutional Federalism in Australia: An Incomplete Contracts Approach*, Centre for Strategic Economic Studies Working Paper No.22, November 2003, p.3.

¹⁸ Shah, A., 2004, *The Australian Horizontal Fiscal Equalization Program in the International Context*, World Bank, Presentation to the Heads of Australian Treasuries Forum, Canberra, Australia, September 23, 2004

Figure 6 Transfers as a percentage of sub-national expenditure¹⁹

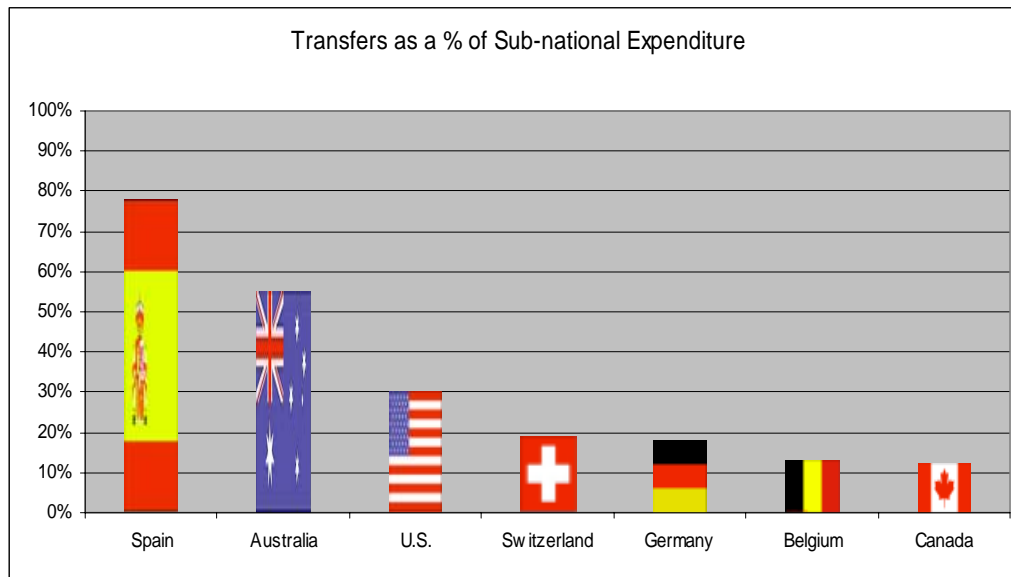


Table 2 Central Transfers as Percent of Total Constituent Unit (States and Local) Revenues

Country	Total Transfers	Conditional Transfers
<i>Mature Federations:</i>		
Australia	45.3	21.3
United States	29.6	29.6
Germany	43.8	9.8
Canada	19.8	15.8*
Switzerland	24.8	17
<i>Transitional Federations:</i>		
Spain	72.8	41.9
South Africa	96.1	11.0
Brazil	30.0	7.5
India	46.0	18.7
<i>Mature Unitary Systems:</i>		
Japan	37.2	16.2
Sweden	15.8	4.4

Note: Figures are mostly for 2000 and 2001 except for those for Canada, United States and Germany which are for 1995 or 1996 (derived from previous studies for this project).

* If CHST transfers are considered as unconditional, the percentage for Canada would be 0.9%.

Sources:

IMF *Government Finances Statistics Yearbook*;

R.L. Watts, *The Spending Power in Federal Systems: A Comparative Study* (1999), pp.53, 57; see also sources for Table 1.

Source: Watts, R., 'Autonomy or Dependence: Intergovernmental Financial Relations In Eleven Countries', IIGR Working Paper 2005 (5) Queen's University, Canada, <http://www.iigr.ca/pdf/publications/362_Autonomy_or_Dependence_I.pdf

¹⁹ Shah, A., 2004, *The Australian Horizontal Fiscal Equalization Program in the International Context*, World Bank, Presentation to the Heads of Australian Treasuries Forum, Canberra, Australia, September 23, 2004

Figure 7 Sub-national own-source revenues as a percentage of total government revenues²⁰

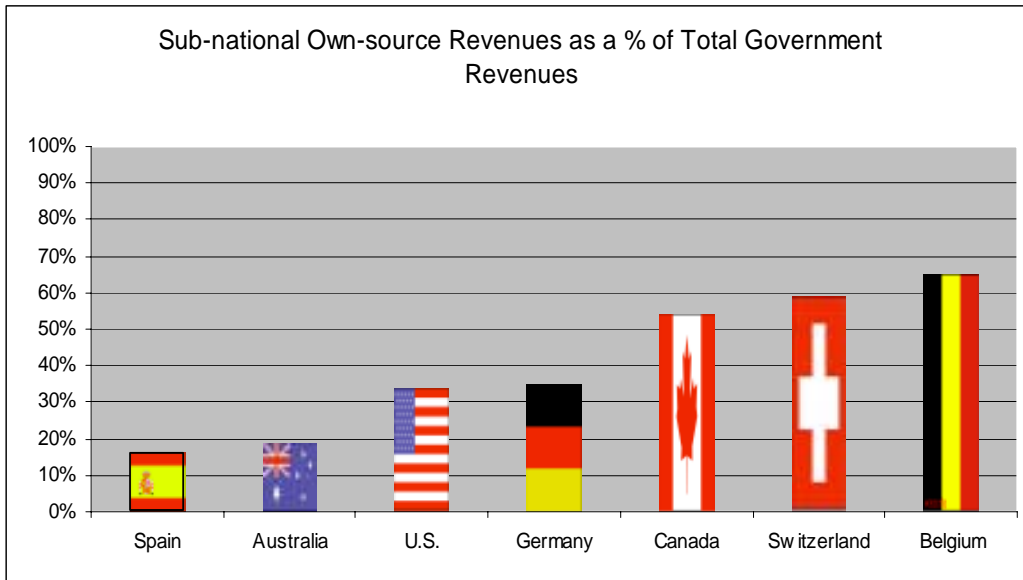
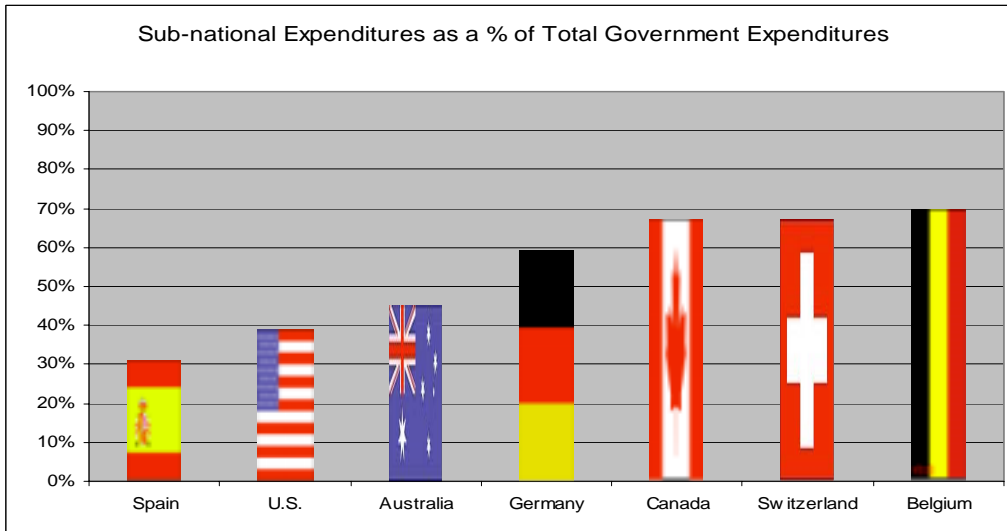


Figure 8 Sub-national expenditures as a percentage of total government expenditures²¹



²⁰ Shah, A., 2004, *The Australian Horizontal Fiscal Equalization Program in the International Context*, World Bank, Presentation to the Heads of Australian Treasuries Forum, Canberra, Australia, September 23, 2004

²¹ Shah, A., 2004, *The Australian Horizontal Fiscal Equalization Program in the International Context*, World Bank, Presentation to the Heads of Australian Treasuries Forum, Canberra, Australia, September 23, 2004

Table 3 Indicators of fiscal decentralisation

	Sub-national government spending and employment				Sub-national government revenues			
	Share in general government spending ¹		Employment as a share of total public employment		Share in general government revenues ²		Attribution of tax revenues as percentage of total tax revenue ³	
	1985 ⁴	2001 ⁵	1990 ⁶	2001 ⁷	1985 ⁴	2001 ⁵	1985	2001
Federal countries								
Australia ¹²	..	49.9	76.7	83.3	..	18.2	18.6	17.2
Austria ⁸	28.4	28.5	62.6	62.3	24.6	21.4	23.8	18.9
Belgium	31.8	34.0	..	..	11.4	11.3	4.8	28.6
Canada ⁹	54.5	56.5	84.7	86.0	50.4	49.9	45.4	44.1
Germany	37.6	36.1	87.6	88.5	31.9	32.4	30.8	29.2
Mexico	..	..	..	..	..	..	1.0	3.1
Switzerland	..	..	..	..	..	..	44.1	40.4
United States	32.6	40.0	81.8	85.5	37.6	40.4	32.7	31.7
Unitary countries								
Czech Republic	..	..	32.3	34.0	..	..	..	10.6
Denmark	53.7	57.8	..	..	32.3	34.6	28.4	33.8
Finland	30.6	35.5	74.7	77.8	24.8	24.7	22.4	22.4
France	16.1	18.6	..	45.8	11.6	13.1	8.7	9.3
Greece	4.0	5.0	..	87.8	3.7	3.7	1.3	1.0
Hungary	..	..	65.5	65.1	..	..	..	5.5
Iceland	..	..	..	..	..	..	18.6	24.3
Ireland ⁹	30.2	29.5	13.2	11.3	32.3	34.6	2.3	1.9
Italy	25.6	29.7	..	20.6	10.7	17.6	2.3	12.2
Japan	46.0	40.7	..	..	26.8	26.0	26.0	25.9
Korea ⁸	..	..	32.3	34.8	..	..	..	17.8
Luxembourg	14.2	12.8	94.8	92.5	8.0	7.4	6.6	5.6
Netherlands	32.6	34.2	27.5	25.6	11.4	11.1	2.4	3.5
New Zealand	..	..	12.2	9.5	..	..	6.5	5.6
Norway ¹⁰	34.6	38.8	..	..	22.5	20.3	17.7	16.3
Poland ⁸	..	..	6.5	6.2	..	..	..	18.3
Portugal	10.3	12.8	..	..	7.6	8.3	3.5	6.5
Slovak Republic	..	..	..	..	..	..	..	3.8
Spain	25.0	32.2	47.1	63.6	17.0	20.3	11.2	16.5
Sweden	36.7	43.4	..	..	34.3	32.0	30.4	30.8
Turkey	..	..	84.2	85.5	..	..	10.2	13.1
United Kingdom	22.2	25.9	..	..	10.5	7.6	10.2	4.1
Average¹¹	29.8	32.2	55.2	57.0	21.5	21.9	16.4	17.8

1. Excluding the transfers paid to other levels of government. National Accounts data.
2. Excluding transfers received from other levels of government and including tax sharing arrangements. National Accounts data.
3. Including tax sharing arrangements. Revenue Statistics data.
4. Or earliest year available: 1986 for Ireland; 1987 for the Netherlands and the United Kingdom; 1990 for Japan, Luxembourg and Norway; 1991 for Germany; 1993 for Sweden; 1995 for Austria, Belgium, Denmark, Finland, Greece, Portugal and Spain.
5. Or latest year available: 1996 for Ireland; 1997 for Canada; 1999 for Portugal; 2000 for Japan, Luxembourg and the United Kingdom.
6. Or earliest year available: 1991 for Germany and New Zealand; 1994 for Poland; 1996 for the Netherlands; 1997 for Czech Republic, Hungary and Turkey.
7. Or latest year available: 1998 for Greece and Italy; 1999 for France; 2000 for Austria, Germany, the Netherlands, Poland, Turkey and the United States.
8. Public sector employment data are registered in full time equivalent.
9. Data based on SNA68 methodology.
10. The share in general government revenues is expressed in per cent of mainland government revenues.
11. Simple average of federal and unitary countries. Under each heading, the average takes into account only countries for which data are available for both years.

Source: OECD National Accounts database; OECD Public Sector Pay and Employment database; OECD Revenue Statistics. Source: OECD National Accounts database; Statistics Norway; Statistics Canada; US Bureau of Economic Analysis.

12. Government Finance Statistics, 2000-01, ABS No. 5512 Table 1.

Table 4 Volatility of tax revenues

Standard deviation of the real growth rate of tax revenues, 1985-2000						
	Personal Income	Corporate Income	Social Security Contributions	Property Income	Consumption	Total
Australia	6.51	11.26	---	2.83	9.21	3.87
Austria	6.05	14.32	1.44	2.98	4.74	1.98
Canada	4.83	13.84	3.97	3.12	3.11	2.31
Germany	6.90	13.07	5.12	2.97	5.49	4.79
Italy	5.52	12.45	5.77	4.41	4.75	3.03
Switzerland	5.58	8.12	2.64	3.11	5.11	2.24
USA	4.34	8.59	1.71	1.61	1.80	2.14

Source: OECD Economic Studies No.36, 200301, *Fiscal Relations Across Government Levels*, Isabelle Joumard, Per Mathis Kongsrud, p.190.

Table 5 Equalization Arrangements

Austria	<p>Elaborate system of tax sharing, transfers and co-financing</p> <p>Aimed at achieving roughly equal living standards across country</p> <p>Shared taxes with rates set by federal legislation and revenue distributed according to weighted populations</p> <p>No other acknowledgment of expenditure disabilities</p> <p>States have no power to set tax rates</p> <p>Arrangements renegotiated every four years</p>
Canada	<p>Federal grants to achieve minimum, not equalised, levels of public services</p> <p>Based on standards in five "middle rich" Provinces</p> <p>Equalises revenue capacities, no account taken of expenditure disabilities</p> <p>Design of equalisation is responsibility of federal Minister of Finance</p> <p>Comprehensive review currently being undertaken</p>
Germany	<p>Constitution allocates taxing powers and lays down rules for revenue-sharing</p> <p>All states have the same taxing powers</p> <p>Three part equalisation system:</p> <ul style="list-style-type: none"> • Sharing of VAT revenue • HFE funded by states to maintain minimum (not equalised) financial capacities • Supplementary federal grants to raise minimum financial capacities close to national average <p>New "Solidarity Pact II" recently negotiated between Federal Government and the states</p>
Italy	<p>Recent radical restructuring of federal financial relations</p> <p>Devolution of some taxes to regions (regional business tax and surcharge on personal income tax)</p> <p>VAT revenue-sharing via untied grants distributed among regions according to regional consumption</p> <p>New horizontal equalisation between regions based on:</p> <ul style="list-style-type: none"> • Fiscal capacities • Health needs • Cost disabilities <p>Aims at full equalisation by 2013</p>

Switzerland	Undergoing radical restructuring of HFE arrangements Reassignment of expenditure responsibilities Reform of equalisation process which does not aim for full equalisation Based largely on equalisation of fiscal capacities Equalisation includes both vertical and horizontal transfers
USA	Substantial cost and revenue disabilities across the states But no mechanism for formula-based equalisation

Table 6 Conditional Grants as Percentage of Total Central Transfers

(Total Transfers = shares of central taxes plus unconditional grants plus conditional grants)

Country	Year	Percentage
<i>Mature Federations:</i>		
Australia	2000	47.1
United States	1996	100.0
Germany	1996	64.5
Canada	1996	43.6*
Switzerland	1997	73.1
<i>Transitional Federations:</i>		
Spain	1998	66.1
South Africa	2001/02	11.5
Brazil	2000	25.0
India	2001	40.7
<i>Mature Unitary Systems:</i>		
Japan	2003	43.5
Sweden	2003	15.7

Note: Figures are mostly for 2000 and 2001 except for those for Canada, United States and Germany which are for 1995 or 1996 (derived from previous studies for this project).

* If CHST transfers are considered as unconditional, the percentage for Canada would be 4.3%.

Sources:

IMF *Government Finances Statistics Yearbook* various years;

R.L. Watts, *The Spending Power in Federal Systems: A Comparative Study* (1999), p.56; see also sources for Table 1.

Watts, R., 'Autonomy or Dependence: Intergovernmental Financial Relations In Eleven Countries', IIGR Working Paper 2005 (5) Queen's University, Canada, <http://www.iigr.ca/pdf/publications/362_Autonomy_or_Dependence_I.pdf