

## Chapter Six

### Revisiting Proposals for a State Income Tax

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Friends, the text for today is from Saint Peter:

*A fundamental principle of responsible government in any system is that each government must raise the money it spends.* (Peter Walsh, 9<sup>th</sup> conference of The Samuel Griffith Society)

First, some potted history:

- In 1942, the Commonwealth excluded the States from the income tax field.
- In 1952, the Commonwealth abandoned land tax in favour of the States. Menzies had sought to return some income taxing powers, but the smaller and poorer States resisted.
- In 1971, the Commonwealth abandoned payroll tax in favour of the States, blunting State agitation for access to the income tax.
- In 2000, the Commonwealth abandoned its sales taxes and created the GST, the full revenue of which goes to the States (so far).
- In 2020, the Commonwealth abandoned its income tax in favour of the States, raised the GST to 20 per cent, and kept and spent all the GST revenues itself; and thus our Federation was saved.

Ah, another 2020 fantasy: each government funding its own spending, all its own spending, and nothing but its own spending.

To displace all Commonwealth grants, the States and territories would need to increase their own tax revenues by about 140 per cent, or their own taxes and charges by about 90 per cent.<sup>1</sup>

Less fantastic but still unlikely is for the Commonwealth to offer a swap of the following kind: Make room for the States to impose their own income taxes, in return for ending some of the grants to the States that are funded from Commonwealth income tax revenues. Malcolm Fraser put something like this to the States, and they did not welcome the offer, especially the smaller and poorer States. It would not have satisfied Peter Walsh's fundamental principle because it would not have put an end to Commonwealth grants to the States.

The fiscal-federal arrangements that cause most damage to political responsibility are Commonwealth specific purpose grants to the States, and the Commonwealth Grants Commission. Abolish both, and responsibility will return. Their complete abolition will be extremely difficult, because they are so heavily entrenched politically. However, something could still be done to improve political responsibility.

In the 1920s and '30s, almost all Commonwealth grants to the States were free of conditions: they were twenty-five shillings per head until the later 1920s, when they were converted to a fixed sum for each State.

A modern version of non-discriminatory, unconditional grants is desirable. It would mean that a State would have to find its own funding for any spending in excess of the fixed grants from the

Commonwealth. Although this fiscal arrangement would fail the stringent “Walsh test”, it would still be a great improvement. However, it is difficult to see how an end to all non-GST grants could be brought about politically, because it probably involves finding a bargain that is acceptable to all of the States.

Say, instead of complete abolition of non-GST grants, the States were offered a small or moderate reduction in grants, matched by a small access to their own income taxes. I suspect that it would not greatly change the political and fiscal incentives facing the States and the Commonwealth.

So: the 2020 vision of the States as fully self-financing is extremely desirable but extremely unlikely. A reinstatement of the 1920s system, under which the States receive fixed and unconditional grants, is desirable but difficult. Giving the States a bit of access to income taxes, offset by a fall in grants, is a bit more likely, but would not have a great effect on fiscal and political responsibility by itself.

In the remainder of this paper, I will first discuss non-GST grants, their effects, and what a State income tax would do. This leads to a discussion of vertical fiscal imbalance. I then turn to GST grants, and illustrate how the system of equalising the fiscal capacities of the various States and territories, via the Grants Commission, damages fiscal responsibility. There are brief conclusions.

## **Non-GST grants**

Non-GST grants are vehicles for Commonwealth influence on State and territory governments. In 2010-11, these are budgeted to be \$46 billion, or 14 per cent of Commonwealth revenues. Most of these grants carry conditions, and only very rarely has a State refused to comply and refused the money. These grants mean that there is shared and confused responsibility in the matters covered by the grants.<sup>2</sup>

The first effect of giving the States access to the income tax would be to reduce the size and importance of non-GST grants, and make it harder for the Commonwealth to insert itself into affairs of the States. The second effect would be that States would have to weigh the value of extra State spending against the need to find additional State revenues.

The Rudd Government consolidated and reduced the number of separate specific purpose payments, and created some new categories, to be administered via the COAG Reform Council. However, the continuing temptation to create new specific purpose grants was well illustrated during the last election, when Ms Gillard promised to fund 80 per cent of the \$2.6 billion cost of the Parramatta-Epping railway line.

This rail line did not appear in the list of proposals that New South Wales previously put forward for consideration by Infrastructure Australia. Yet suddenly funding is promised. Presumably, the New South Wales Government would have preferred capital funds to go elsewhere. But the prospect of winning a western Sydney seat proved too much for Ms Gillard.

For the Commonwealth Government to offer funding for some specific project or purpose, there must be some net positive payoff to the Commonwealth. The Commonwealth has to do the taxing, so it wants some political advantage from the spending. The obverse is that the State is relieved of having to collect sufficient tax revenue, but it has to share the political kudos, and to re-order its spending priorities.

Now here is a funny thing: this \$2.1 billion grant may add only \$0.6 billion to the funds of New South Wales, less than one-third of what Ms Gillard promised – a pea and thimble trick. Unless the Commonwealth pre-empts the CGC decision on the matter, the CGC is likely to treat the \$2.1 billion grant “by inclusion”: in effect, putting the \$2.1 billion in with the pool of GST funds to be distributed across the States and territories.<sup>3</sup>

If all non-GST grants were treated by inclusion, it would nullify attempts by the Commonwealth to control the spending decisions of the States and territories. Alternatively, treating all non-GST grants by exclusion would make the extent of Commonwealth control over State spending decisions plain. For political accountability, the worst situation is when some non-GST grants are treated one way, and some the other.

When he was Commonwealth Treasurer, Peter Costello said that he would agree to any change in Grants Commission processes that had the unanimous support of the States and territories. The States and territories did not unanimously ask Treasurer Costello to instruct the CGC to treat all non-GST grants by inclusion. One must conclude, therefore, that State and territory governments, by keeping alive the prospect of retaining a larger share of non-GST grants than the CGC would recommend, showed that the States prefer to avoid taking more responsibility for their own spending.<sup>4</sup>

### **Satisfying Peter Walsh's principle of responsibility**

One way for the States to finance their own spending from their own-source revenues is by a sufficient *transfer of areas of State spending* to the Commonwealth. Presumably, this is something that the proponents of a State income tax want to avoid.

Alternatively, through new or higher State taxes and charges, the *States could generate sufficient additional revenue* to cover all State recurrent spending. The latter course would be political suicide for any State government, unless there was an offsetting reduction in the Commonwealth tax take. The most obvious ways to achieve such a reduction in the Commonwealth's tax take is for the Commonwealth to transfer some of its taxing powers to the States, or to share those powers with the States. Two such transfers were mentioned earlier: land tax and payroll tax.<sup>5</sup>

### **The whys of vertical fiscal imbalance**

It is rare for States in a federation to be fully self-financing. Usually, there is some centralisation of tax collection in the hands of the national government, together with a significant degree of decentralisation of spending decisions to the States, which are partly funded by federal grants.

This kind of arrangement – which results in vertical fiscal imbalance – receives solid support from the standard economics texts on fiscal federalism.<sup>6</sup>

On the spending side, the “principle of subsidiarity” suggests that some significant decisions should be made “locally”, close to those affected.<sup>7</sup> On the taxing side – where I will focus attention – the case for centralisation of high-yielding taxes depends on an analysis of the effects of interstate tax competition on the size and economic cost of taxation.

A centralised tax monopoly or cartel can gather more revenue than can a set of competitive governments.<sup>8</sup> In wartime, when the income tax was centralised, the objective of maximizing tax revenue was easily justified. Otherwise, a tax cartel or monopoly may sound unambiguously bad for the taxpayers generally. However, in tax matters, things are rarely so simple.

A tax monopoly or tax cartel has more choices than do tax competitors, over the mix of taxes and over the tax rates imposed. As a result there is a trade-off facing tax-payers generally: a tax cartel or tax monopoly collects more tax revenues but maybe at a lower economic cost per dollar collected; a set of tax competitors collects lower revenues but maybe at a higher economic cost per dollar collected.

From the economy in aggregate, tax payments are transfers from the taxpayer to the Treasury: in themselves, transfers neither create nor destroy economic value. But taxes change the economic behaviour of the taxpayers, and these tax-induced responses are the economic cost of the tax. (Some taxes are intended to reduce activity judged to be detrimental to self or others, like smoking; or to stimulate activity judged beneficial to self or others. For simplicity, I ignore them.)

The economic cost of a tax depends on the extent to which it stimulates tax-avoidance activities; and this cost rises more than proportionally with the tax rate—the usual economic shorthand is that the “excess burden of taxation” is proportional to the square of the tax rate. Therefore, a nationally-uniform tax is less costly, economically, than is a set of non-uniform State taxes that collectively raise the same revenue as does the nationally-uniform tax.

This kind of reasoning lies behind the common prescription in fiscal federalism, that the national government should levy income and sales taxes; and the States should levy taxes on land and other

relatively immobile tax bases. If the reverse assignment were made, interstate tax competition would damage the taxing capacity of the nation, or decrease the economic efficiency of the tax system. (Those who accept these generalisations can afford to skip the next section.)

### **Interstate tax competition**

Economists commonly recommend that the central government should levy taxes on readily-relocatable tax bases – like incomes; and leave the less mobile tax bases – like land – to the States. Naturally enough, the financial incentive to move interstate or internationally for reasons of tax depends on the size of the tax burden thereby escaped, relative to the cost of moving. To make the point simply, I will compare situations in which the State or Commonwealth impose the same revenue burden on the taxpayer, so that what matters is the feasibility and cost of moving.

A high income tax imposed by one State on a business can be avoided by moving the business to a lower-taxing State; similarly, for high personal income tax rates. But if that same high rate of State income tax were extended to the nation as a whole, then the income tax could be avoided only by leaving the country altogether, presumably a more costly move. Thus we would expect that a nationally-uniform income tax would have higher rates than would occur if the States had exclusive access to the income tax.<sup>9</sup>

In contrast, a high tax imposed by one State on a vacant piece of land cannot be avoided by moving the taxed object, land, to another State; and the situation would be no different if that rate of land tax had been imposed nationally.

However, the economic cost of any tax depends on how the taxpayer responds to the tax, by changing his or her behaviour, in order to avoid it fully or partly. Other than successfully lobbying for an exemption, there is nothing that the taxpayer can do to avoid the tax bill on a piece of land. Yes, the land can be sold, but then the new owner is liable for the land tax bill.<sup>10</sup>

This is not to deny the fact that the States have used land tax concessions as a means of attracting or retaining businesses, but it is to argue that the scope for interstate tax competition in land taxes is less than for taxes on the incomes or sales or payrolls of businesses, or the incomes or spending of persons. A State land tax incentivises the interstate migration of land-intensive activities; activities with a low land input are virtually unaffected. A State income tax stimulates the interstate migration of all income-intensive activities.

Therefore, interstate tax competition puts more downward pressure on income taxes, payroll taxes and sales taxes, than it does on land taxes (or on taxes on land and property transactions).

### **Intra-jurisdictional political competition**

There is no doubt that the States could raise considerably more payroll taxes and land taxes (but I hope no more from gambling taxes).<sup>11</sup> One reason they do not use their taxing powers effectively and efficiently is that the large and flexible revenue grants from the Commonwealth lessen the fiscal pressure on them. However, there are other forces in play: interstate tax competition; and intra-jurisdictional political competition. The standard theory of fiscal federalism – sketched above – emphasises the former and somewhat neglects intra-jurisdictional politics.

What economists regard as a “good” tax is often hard to sell politically. Margaret Thatcher imposed a poll tax, which is certainly a tax with the low excess economic burden. But politics – not inter-jurisdictional tax competition – defeated it and her.

Estate or death duties provide a nice Australian illustration. Most economists believe that death duties are relatively efficient taxes. As is well known, under Premier Bjelke-Petersen, Queensland abolished these taxes, partly to attract retirees to the State; all other States and territories followed suit. Here was inter-state tax competition in operation. However, it is important to remark that the Commonwealth did not step in and impose its own estate duties; and that the recent report on

*Australia's Future Tax System* merely recommended that the “Government should promote further study and community discussion of the options”.<sup>12</sup>

As was noted, there has been some interstate competition to attract or retain businesses through land tax concessions or “tax holidays”. However, it does not seem to explain why land taxation is so greatly underutilized, while very inefficient taxes are levied on the transfer of land titles—*intra*-state politics is probably a more significant factor. Julie Smith noted that, by the end of the 1950s, all land used in primary production and for the primary residence was exempt from State land taxes. For NSW, five-sixths of private land, by value, was exempt: land tax revenue could have been increased by a factor of five if the tax had been levied on all private land. But that was politically impossible.

When the Commonwealth handed over payroll tax, it had a flat rate of 2.5 per cent and was comprehensively applied. However, the States soon created payroll taxes with progressive rates, and with many exemptions and thresholds. Inter-state competition can explain only part of what has happened to the land tax and the payroll tax, and why they collect so much less than it could and should (from the purely economic point of view). Why would we not expect the same to occur if the States regained access to income taxes?

Thus, some proponents of State income taxes want the States not to be able to change the tax base, but to be able to decide on State-specific variations in the tax rates. Some economists have suggested something similar for the payroll tax: a nationally-uniform definition of the taxable payroll, with no exemptions or thresholds; and for each State to choose its single rate.

## **Fiscal equalisation**

Whatever the strength of the arguments just put, in fact Australia has an extraordinarily high degree of vertical fiscal imbalance and centralisation of tax collection. Almost half the spending of the States and territories is funded by Commonwealth grants (and more than 80 per cent in the Northern Territory). The Commonwealth collects over 80 per cent of all tax revenues. For 2010-11, the Commonwealth has budgeted to provide the States with \$94 billion in payments. This equals 6.7 per cent of GDP and just under 30 per cent of Commonwealth tax revenues. The grants are about 50/50 GST and other; and approaching half of the “other” get pooled with the GST for purposes of fiscal equalisation.

The GST monies are distributed according to the recommendations of the Commonwealth Grants Commission, which has been set the objective of equalising the fiscal capacities of the States and territories. Roughly, the goal of the CGC is to fund each jurisdiction so that it can afford to provide the average level of publicly-provided goods and services if it levied the average level of taxes and charges (and achieved the average net public financial assets). In the next subsection, I provide examples of how the CGC processes distort political decisions. But, first, I will look at the theory of fiscal equalisation.

For many decades, fiscal equalisation has been advocated mainly on three grounds: it is more equitable; it makes the economy more efficient, mostly through influencing the patterns of settlement; and it affiliates citizens of the smaller and poorer States to the federation. I will discuss each in turn.

Equity is a criterion that usually applies to people, not governments. Moreover, the equity argument for fiscal equalisation must depend primarily on a claim about there being immobile sections of populations who would otherwise be unreasonably disadvantaged by the operation of the fiscal system.

First, we need to consider the equity consequences of inter-jurisdictional mobility. If otherwise-similar people are not treated similarly in the various States and territories, and if those differences are sufficiently great, then people will consider moving to another jurisdiction. There are no legal restrictions on interstate migration; the cash costs of moving have fallen over time; cheap travel and communications assist in the maintenance of links back to the former location; laws, regulations and school curricula have become more uniform across the nation, so the degree of disruption, attendant

on moving, has fallen; and Australia has steadily become more of a single national economy than a set of separated and disparate State economies. And data supports the conclusion that the dispersion of personal income in Australia is relatively small, looking across jurisdictions.

Therefore, no great differences can persist in the ways in which otherwise-similar people are treated in the various States and territories, unless they are immobile between jurisdictions.

However, even without fiscal equalisation there would be a substantial degree of inter-state redistribution, from the richer States to the poorer, mostly through the progressive income tax system, and through the Commonwealth government's provision of nationally-uniform social services and social security payments, both probably redistributing disproportionately towards locationally-immobile sub-populations. And if grants were made equal per capita, then they also would be redistributive towards the poorer States, via the taxes that fund the grants.

Even if the claim were true that immobile sub-populations are unfairly disadvantaged in some jurisdictions, we need to explain how and why grants will change the situations of these badly-served sub-populations in their home States or territories. The first thing to note is that there are two mismatches between this kind of equity argument and the methods of the Grants Commission: the distribution of the grants is not determined solely by considerations of the size and nature of locationally-immobile elements of populations; and there is no guarantee that the grants will benefit those elements of population (and, in the case of remote Indigenous peoples in the Northern Territory, good evidence to the contrary). Secondly, if sub-populations are badly served because their immobility lessens their political weight, then how will equalising grants alter that situation? Specific purpose grants may do the job, but not general revenue grants.

Therefore, I conclude that the equity argument is weak.

Considerations of inter-jurisdictional mobility, which weaken the equity argument, are central to the efficiency argument for fiscal equalisation. For example, say Western Australia retained all of its mineral taxes, and used them to provide superior State services or lower State taxes. Then workers and businesses, even if they would be more productive in the State of origin, could be attracted to Western Australia by its better fiscal offerings: by moving to Western Australia, the workers and businesses in effect become part-owners of Western Australian mineral wealth, without buying a single share in a mining company. Fiscal equalisation means that all Australians become part-owners of Western Australian mineral wealth, without having to move to Western Australia.

The same kind of argument can be made on the expenditure side. Say that Tasmania has a high proportion of retired folk, so that it has relatively high expenditure on services to the retired, and a relatively low payroll tax-base to fund them. Then firms may tend to avoid locating in Tasmania, even if they would have been more productive there.

But these efficiency arguments, based on inter-jurisdictional mobility and incentives for locational choice, do not seal the case that fiscal equalisation improves economic efficiency. Account has also to be taken of claims that fiscal equalisation distorts public decisions, in ways illustrated below.

(The most determined effort at estimating the net effects for Australia of horizontal fiscal equalisation came up with an answer indistinguishable from zero.<sup>13</sup> However, the modelling technique was perhaps too crude to capture some of the effects that *a priori* reasoning suggests could be important.)

Finally, is it not strange that a system of fiscal equalisation, originally devised to affiliate the less populous States more closely to the federation, especially Western Australia, is now itself a source of disaffection with the federation.

## **The Commonwealth Grants Commission**

I now turn to some examples of how the Commonwealth Grants Commission operates. My point is that any system of horizontal fiscal equalisation, and especially a determinedly equalising one, will inevitably distort the policy choices of the State and territory governments, and sometimes very substantially.

### ***Mining***

The first example relates to mining, a matter of current political interest. Say that South Australia overcomes “green” and “NIMBY” concerns and approves a new uranium mine. The State requires the miner to pay royalties, which go into the SA government’s coffers. But a couple of years later, the Grants Commission completely socializes those revenues, and distributes them to all of the States, so as to equalize fiscal capacities. The State bears all the political cost of agreeing to a mine but, after a couple of years, it retains only a fraction of the mining royalties, equal to its share in the Australian population.

Naturally enough, this encourages the State to offer the miner a lower royalty rate in return for the miner providing works or services of high political but low economic value, and of the kind not captured in the arcane calculations of the Commission.

### ***Making New South Wales the Greece of the Federation***

Until now, the Grants Commission has constructed a hypothetical current budget for each State. Depreciation is a charge on the current account. Having distorted incentives on current account – in ways that I have illustrated – the Commission now tries to offset those effects, through a new set of calculations, on the capital account. Its objective is to assess “. . . how much States would need to invest to give them comparable levels of such infrastructure in a year and having that reflected in the GST distribution in that year”; and to give each State the capacity to “. . . keep its net financial worth per capita at average levels . . .” (pp. 6-7).

The Commission supports this change with various arguments, the main being that differential rates of population growth put different pressures on the States to spend on new or additional infrastructure; and that States have used GST monies to fund infrastructure spending.<sup>14</sup>

Under Treasurer Egan, the NSW Government claimed that it borrowed only for those projects that made a commercial return, and which serviced their own debt. That is, NSW used recurrent income to fund the building of hospitals and schools. That would have bequeathed to subsequent NSW governments a larger total of net financial assets than otherwise. To the extent that other States did not assiduously follow the Egan line, then they ended up with smaller net financial assets.

The Grants Commission is now setting about to negate the effects of these past decisions on how to fund infrastructure. Citizens of New South Wales now have more reasons to regret the actions of their Labor governments: if only Treasurer Egan had foreseen this change in the basis of the division of the GST, no doubt he would have financed more of State capital works through debt. Possibly, other Treasurers have arrived at this conclusion.

But of course States can borrow for recurrent spending as well as for capital works. Greece did, and now is being bailed out by other of the European Union governments. Is this a scenario that the Commonwealth Grants Commission has envisaged?

### ***A school voucher system***

Say that, in an effort to improve the efficiency and effectiveness of education, a State moved to a voucher system for all schools, government and non-government; and simultaneously legislated to permit the creation of publicly-funded “charter schools”. This kind of arrangement has been successfully implemented in a number of countries, including Sweden.

Say that the reforms seemed to improve school efficiency and effectiveness. However, say they caused a flow of students out of government schools and into non-government schools. Under the Grants Commission’s methods for calculating for the cost of “standard” levels of publicly-provided services, this State would receive a lower percentage of the pool of GST funds, as a consequence of the decline in enrolments in government schools.

The State would be penalised for increasing school choice; as would parents, if the reduction in GST grants was passed on in the form of a reduced voucher.<sup>15</sup>

## Reform the Grants Commission, if you cannot abolish it

My preferred reform is for any grants to the States and territories to be made as equal *per capita* payments, so that each State and territory would bear the fiscal cost of additional tax-funded spending, or enjoy the fiscal benefit of any reduction in tax-funded spending.

This would provide stronger fiscal discipline and incentive to the States and territories, because it would abolish specific purpose grants and inter-state discrimination in general revenue grants; and render the Grants Commission redundant.

Table 1 shows the effects that this would have on budgets: not much for the three eastern States; a huge cut for the Northern Territory.

NSW	Vic	Qld	WA	SA	Tas	ACT	NT
1.0	1.3	1.6	6.2	-5.6	-12.3	-2.4	-50.9

Sources: CGC 2010; ABS 5512, 5506

Note: The estimates are the percentage difference between the 2010-11 grants proposed CGC and equal *per capita*, compared with the 2009-10 general government expenditures. The GST collection for 2009-10 was \$46.5 billion; the estimate for 2010-11 is around \$45 billion.

I recognise that such a reform may be too hard to implement soon, even with generous transitional arrangements, and so I offer a less radical alternative as an interim measure. The new system needs to be relatively simple and transparent, unlike the current one. Then it will be understood by more than a few specialists, which would improve the federal system of governance.

1. Grants should be made to equalise fiscal capacity for standardised populations.
2. On the expenditure side, account should be taken of costs of providing for a small number of locationally-immobile sub-populations or socio-demographic groups (e.g., five). However, no adjustment should be made for differences across the States in the unit costs of services to these sub-populations.
3. As to revenue capacity, the only factor to be taken into account should be natural resource endowments (adapting the method used by the UN Development Program to estimate “natural capital”).
4. All Specific Purpose Payments should be dealt with by the Commonwealth Grants Commission’s method of inclusion, except payments on account of remote Indigenous populations.

## Conclusions

The States and territories are under-using their taxing powers, including those given by the Commonwealth in 1952 –land tax – and in 1971 – payroll. They are under-utilised for ordinary political reasons, but in the background are the massive grants that the Commonwealth makes to the States and territories: the GST and a whole raft of other grants. Do State politicians believe, along with former Premier Joh Bjelke-Petersen, that the only good tax is a Commonwealth tax?

Any transfer of taxing powers to the States would come at the expense of some grants from the Commonwealth to the States. This would make the States and territories more fiscally responsible. However, the effects are likely to be much less, even insignificant, if conditional grants continue to



be offered in substantial amounts, and accepted by the States.

Will the Commonwealth ever voluntarily forgo sufficient income tax to enable the States to be self-financing? There is a strong tendency for federal politicians of all parties to assert that citizens do not care who has constitutional responsibility for a mess; citizens, they say, just want it fixed.

So long as the Commonwealth has the overwhelming fiscal power, then federal politicians can readily find monies to throw at a problem, indirectly or directly. The indirect means are specific purpose grants, and COAG: dangle money in front of the States, to be paid if they perform the trick that the Commonwealth wants performed: e.g., shorten the waiting lists at hospitals; raise school retention rates. The direct route is for the Commonwealth to deliver the fix itself: e.g., fund “super clinics”. Rather better is for the Commonwealth to fund private competitors to what is offered by the States, especially in health and education.

Many commentators criticise the overlap, duplication and unclear lines of responsibility that result from these kinds of Commonwealth interventions in the affairs of the States and territories. But at least such direct interventions are reasonably transparent.

Not transparent are the calculations of the Commonwealth Grants Commission: Horizontal Fiscal Equalisation is the second barrier to greater fiscal and political responsibility. It should be abolished or greatly reformed.

For political accountability, the best long run solution is for Commonwealth grants again to be equal *per capita*.

## Endnotes

1. In 2007-08, State and territory tax revenues were \$53.1b; they spent \$161.3b; the Commonwealth made \$75.0b in grants (ABS 5506.0 – Taxation Revenue, Australia, 2008-09).
2. In “Commonwealth-State financial relations: the case for competitive federalism”, (*Papers on Parliament*, Department of the Senate, Parliament House, Canberra, June 2010, 13 – 26), I discuss vertical competition in a federation –between the central government on one side, and the States and territories on the other. Federal funding of alternatives to what the States offer is likely to be socially beneficial competition between governments (for example, federal funding of independent schools). In contrast, there are unlikely to be lasting and systematic benefits from “cherry picking”, or selective Commonwealth intervention in the ordinary operations of the States (for example, setting targets for school retention rates).
3. The CGC estimate of NSW’s share of GST grants in 2010-11 is 30.7 per cent (Commonwealth Grants Commission, “Report on Revenue Sharing Relativities”, Media Release, 26 February 2010, table 2). 30.7per cent of \$2.1b is \$0.6b.
4. Some State governments used the threat of loss of funds under the National Competition Policy to force through policies that, for political reasons, they could not implement otherwise. In “An Implicit Contract Theory of Intergovernmental Grants”, *Publius: The Journal of Federalism* 20 (Fall 1990), 129-144, Geoff Brennan and I discuss how the Commonwealth influences State spending by ways other than the imposition of explicit conditions on the grants.
5. The GST arrangements are best seen as a switch in the national tax mix towards indirect taxes. The Commonwealth created a new Commonwealth indirect tax, the GST, which collected more revenue than had been collected in aggregate from the taxes abolished, which were Commonwealth sales taxes and some State “nuisance” taxes. With the GST revenue hypothecated to the States (so far), there was a considerably reduced call on income tax proceeds as a source of grants to the States, and so scope was created for a reduction in income taxation.

6. I outlined the arguments at the 13<sup>th</sup> meeting of the Society. In light of subsequent developments, I have refined my conclusions (a.k.a. changed my mind). I remain sanguine about vertical fiscal imbalance on average, but I paid too little attention to VFI on the margin; and thus too little attention to the damage to political responsibility. I paid too little attention to the effect of fiscal imbalance on the extent of fiscal equalisation. Here I especially thank Henry Ergas for his comments, criticisms and ideas.
7. Theodore J Lowi, an American political scientist, asserts that conservatives support devolution of spending decisions because “local” decisions are more likely to please right-wingers and racists (see “Think Globally, Lose Locally”, *Boston Review*, April/May 1998, at <http://bostonreview.net/BR23.2/lowi.html>). Myself, I believe that the principle of subsidiarity is incompatible with the principle of competitive federalism.
8. Government spending in unitary countries was 13 per cent higher than in federations, 1988-2000 (Anne Twomey and Glenn Withers, *Australia’s Federal Future*, report for the Council of the Australian Federation, 2007, 13.
9. Julie Smith discusses the variations in State income tax rates in Chapter 4 of her 2002 ANU PhD thesis, *The Changing Redistributive Role of Taxation in Australia Since Federation*.
10. For completeness, note that economists expect the sale price of land to be reduced by the full amount of any land tax, so that selling the land does not help the owner avoid the burden of land tax.
11. The Commonwealth Grants Commission does not attempt to take gambling tax into account in its calculations of tax capacities. Maybe this has encouraged the States and territories (other than WA) to look increasingly to gambling taxes for more revenue.
12. *Final Report, Australia’s Future Tax System*, recommendation 25.
13. P. M. Dixon, M. R. Picton and M. Rimmer, “Efficiency Effects of Inter-Government Financial Transfers in Australia” *Australian Economic Review*, vol. 35 (3), 2002, 304-15.
14. This latter poses a puzzle: the States have significant sources of current revenue in addition to the GST; how then does the Commission know “the” source of current account funds for infrastructure spending?
15. The Commission has considerable discretion and could change the way that it treats expenses on schooling, if this became a political issue.