

Chapter 3

A Voyage Towards Responsible Government The National Commission of Audit and Reform of the Federation

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It is fitting we find ourselves meeting in Melbourne a stone's throw from Victoria's Parliament where, 124 years ago, a Conference of Ministers convened to debate whether the time was ripe to proceed with federation.

That conference is memorable for the quality of the representatives and the eloquence of their speeches. Bernhard Ringrose Wise wrote of it:

The Melbourne Conference was very different from anything of the kind yet known in Australia. Its meetings were open to the public; and for the first time men saw the problem of Federation as a whole, and realised that the Union of the Colonies was an aim to be sought after for its own sake, and not only to meet the accident of some urgent need. Each speaker presented the question in a different light – Sir Henry Parkes was supremely confident, Sir Samuel Griffith cautious, Mr Playford critical and dubious – yet all agreed that Union was both desirable and possible.¹

Sir Henry Parkes emphasised his belief that “national life is a broad river of living water” and that when it comes to federation there is no natural difficulty before us. “The path is plain and bright with the genial sunshine of our own blue heavens, with no impediment in it whatever.”²

Sir Samuel Griffith highlighted that the object of the Conference was to exchange ideas as to how far federation is practicable at the present time. Ever the realist, he explained “that the advantages of federation, like everything else, would have to be paid for” while, at the same time, pointing out that “the work left for provincial parliaments would still be large and important”.³

Honest Tom Playford implored the Conference to “build up slowly and carefully a public opinion in favour of federation”. He reminded those present “that harmony is sometimes improved by inserting a little note of discord now and again into the music”, and that perhaps he could “insert one or two notes of discord regarding the colony of New South Wales on the one hand and the colony of Victoria on the other hand”.⁴

Throughout, the formulation of the federation involved friction and strain. And, since the outset, the settling of the finances has usually been protracted and chaotic. But our federation has endured and, though battle scarred, remains loyal to us today.

This conference is occurring amidst a heightened debate on the roles and responsibilities of government in Australia. It is a debate that has at its core a tension between what our citizens want their governments to do and what governments can or should do. There are also tensions around which level of government should do what and who pays for it all.

One of the lessons we learn in life is the benefit that comes from reflection – pausing with intention to allow the lesson to catch up with us. It is rare for governments to pause and reflect

but, from time to time they do, in a fashion. They can take stock of the scope and effectiveness of their affairs through a Commission of Audit process.

The latest National Commission of Audit was convened in October 2013, some 17 years after the last such exercise at the Commonwealth level. The Commission of Audit comprised five competent, energetic and patriotic commissioners who had Australia's best interests at heart. They were given a comprehensive remit focused on reviewing the Commonwealth's finances and advising on steps to ensure Australia's long-term budget strategy is responsible and sustainable.

The Commission was asked to assess the current split of roles and responsibilities between and within the Commonwealth Government and State and territory governments. It was invited to consider and comment upon the current architecture of Commonwealth-State financial relations.

The Commission's report – *Towards Responsible Government* – contained some strong views on improving the Federation and I am delighted to share them with you.

Responsible government was a central theme of the Commission's report. In the eyes of constitutional specialists, "responsible government" is about the people's control of their government – that the power of the Crown is exercised in accordance with the will of the people as reflected in the composition of Parliament. But responsible government has wider connotations and an everyday meaning. For many Australians, it accords with the idea of governments behaving in a correct, proper and responsible manner when making decisions.

The Samuel Griffith Society, for example, has the achievement of a greater sense of financial responsibility on the part of all governments as one of its objectives.

As the National Commission of Audit set about the task before it, it articulated a number of principles of good government to help shape its approach and to ensure the country's financial goals could be achieved in a way the community understands.

Key among those was that transparency and honesty are fundamental to accountability, recognising that Australians have the right to information on what their tax revenues are used for, what the Government's program and policy objectives are, and whether these objectives are being achieved.

The Commission also highlighted, as a core principle, the need to harness the benefits of the Federation, recognising that the States and Territories should be free to compete amongst themselves respecting the regional differences of a big continent.

I want to address two areas of the Commission's Report. First, I will make some comments on its findings on government in Australia today and the current division of responsibilities.

Second, I want to talk you through the proposals from the Commission of Audit to reform the operation of the Federation.

I will also offer some comments on how reform of the Federation might be made to come about – perhaps taking a lead from the Honourable John Macrossan's remarks to the Melbourne Conference that "it is the leaders who begin reforms, and the people take it up from them".⁵

The role of Government

In the first part of its Report, the National Commission of Audit looked at what Australians *want* their governments to do and outlined some views on the role governments *should* play. It also undertook an examination of what governments actually do in Australia today.

In terms of expectations about government, the Commission highlighted a number of features.

- Australians expect their governments to set and maintain sensible laws and provide for law and order. They expect the government to take responsibility for the defence of the nation, for national security and for protecting our borders.
- Australians see governments as having a central role in providing access to essential services such as basic health and education, especially for children. They look to governments to ensure important infrastructure such as roads, railways and bridges is provided in a timely and efficient manner.
- There is an expectation that governments will provide a social safety net which helps protect the poor, the vulnerable, the elderly and the truly disadvantaged as this is the Australian way.
- Australians expect their governments to play a role fostering long-term economic growth and economic stability by ensuring a sound policy framework is in place. Where necessary, they should aim to help ensure that markets work efficiently, that incentives align private actions with the public interest and that people and businesses face as wide a range of choices as the economy can reasonably provide.
- Australians also look to their governments to reduce the overall risk in society, with many looking further, wanting governments either to solve all of society's risks or protect them from the inherent risks of everyday life.

In terms of what governments actually do in Australia today, the Commission found that in total the Commonwealth, State and Territory governments spend some \$500 billion in delivering services to Australians. The reach of government is seen through many avenues:

- In the area of law and order we have some 1,000 judges, magistrates and coroners who deal each year with around 800,000 criminal cases and 500,000 civil cases. There are 60,000 sworn police officers and 21,000 fire and emergency workers.
- In the area of Defence, there are 58,000 members of the Defence Force along with over 20,000 reservists deployed across 43 bases.
- Each school day more than two million primary school children and one and a half million secondary school children attend the nation's 6,700 public schools and 2,700 Catholic and independent schools where they are taught by some 290,000 teachers. State and Territory governments operate, subsidise and regulate 7,600 pre-schools and kindergartens which provide early childhood learning for around 300,000 children.
- Some 900,000 Australian students and 300,000 international students attend Australia's 39 universities.
- Australia has 753 public hospitals and just under 600 private hospitals that provide around 86,000 hospital beds. In a typical year, nine million Australians are admitted to our

hospitals for an average stay of three to six days. Some 70,000 medical practitioners and 250,000 nurses attend to our health needs with the Commonwealth Government providing more than 340 million rebates per annum under the Medicare System.

- Australian governments provide assistance to the 680,000 Australians with a significant disability who require daily care with the States having primary responsibility for delivering these services. The Commonwealth provides the Disability Support Pension every fortnight to 820,000 people who are mostly unable to support themselves through employment.
- Assistance to the unemployed is a key component of Australia's social safety net and, at present, the Newstart Allowance supports approximately 740,000 people without a job.
- Some 2.4 million Australians receive the Age Pension at a cost of \$40 billion per year and the Commonwealth spends over \$20 billion each year on assistance to 1.9 million families with children.
- Australia's governments provide much of the nation's infrastructure including 900,000 kilometres of roads, 33,000 kilometres of rail, 750 kilometres of public rail networks in our capital cities, 50 major ports and 400 water treatment plants.⁶

The provision of these and other services is divided between Commonwealth, State and Territory governments. Our Constitution sets the basic rules of government – rules which were conceived and approved by Australians and characterised by a federal system.

Simple rules and arrangements are best for managing complexity. The shared roles and responsibilities between the Commonwealth and the States have been problematic and the Commission of Audit found they remain problematic to this day, however.

The division of responsibilities (or the lack of such a division) that currently prevails contributes to a less functional Federation. They are a fertile ground for reduced efficiency, effectiveness and fairness of service delivery. They contribute to a lack of accountability over the quality and cost of services provided.

In health, for example, the Commonwealth has responsibility for primary health care (including doctors and pharmaceuticals) and largely funds private hospitals while the States have responsibility for managing public hospitals.

Funding arrangements between the Commonwealth and the States for public hospitals are complex, resulting in a lack of clarity when it comes to political responsibility and accountability.

A poorly designed division of responsibilities creates incentives for cost shifting between governments. Patients discharged from State government-run public hospitals are often referred to their local general practitioner who is subsidised by the Commonwealth. Separately, a lack of Commonwealth-funded aged care places in a particular area can result in public hospital beds being inappropriately occupied by elderly people.

The States operate public schools on a day-to-day basis, including running their own systems and regulating non-government schools. While the Commonwealth does not have specific constitutional responsibility for schools, it has, since the 1970s, taken an increasing role in schools funding. However, the Commonwealth largely funds independent schools, so here, too, responsibilities overlap.

In housing, the Commonwealth has no constitutional power. The States take the lead in provision of public housing and, along with community-based organisations, in addressing homelessness. Nevertheless, the Commonwealth spends a significant amount on housing through rent assistance and through direct payments to the States for affordable housing and alleviating homelessness. Moreover, mental illness is a substantial contributor to homelessness. Again, there are overlapping responsibilities between the Commonwealth and the States.

Commonwealth and State governments both direct significant funding towards Indigenous affairs, through both mainstream and Indigenous-specific programs and services. While funding is almost equally split, there is substantial overlap and duplication in Indigenous programs provided by the Commonwealth and the States.

In the town of Roebourne in Western Australia, for example, the 1,150 predominantly Indigenous residents are serviced by some 400 different programs funded variously by both the Commonwealth and State governments.

Perhaps nothing characterises the blurred roles and responsibilities of the Commonwealth and States better than the formal framework of revenue assistance, national agreements and national partnership payments that currently exists under the *2008 Intergovernmental Agreement on Federal Financial Relations*.

This agreement governs total Commonwealth funding to the States and Territories which, in the financial year, 2013-14, comprised:

- \$51 billion in untied general revenue assistance (largely revenue from the goods and services tax);
- \$31 billion in semi-tied funding through a number of national agreements and associated specific purpose payments in areas like schools and hospitals; and
- \$14 billion through national partnership agreements on matters of supposed national importance which have varying degrees of conditionality attached.

The extent of vertical fiscal imbalance in Australia today is apparent in the fact that total Commonwealth funding to the States and Territories, at around \$96 billion, represents about one quarter of Commonwealth outlays and provides the States with some 40 per cent of their revenue.

The *2008 Intergovernmental Agreement* aimed to simplify arrangements through a smaller number of financial transfers from the Commonwealth to the States and to provide the States with greater flexibility to spend the money provided by the Commonwealth.

While there was an initial decrease in the number of funding agreements with States, the number grew again as Commonwealth ministers sought to prescribe particular policy directions or categorise policies and projects as being of significant national importance. This was manifested mostly through a proliferation of national partnership agreements.

At latest count, the current structure of intergovernmental relations in Australia constituted six national agreements, 144 national partnership agreements, 230 separate implementation plans, a dozen COAG standing councils, select councils and Legislative and Governance Forums and many more associated regulatory and oversight bodies. Within this mix, there are 19 agreements that are active, under development or recently expired which together total only \$33

million in funding. The administrative cost of developing such agreements and complying with reporting requirements is confounding.

Indeed, the overall architecture can only be characterised as unruly and confused – even chaotic.

Speaking at the 2007 meeting of the Samuel Griffith Society, Professor Geoffrey Blainey highlighted how “praise and blame form the gearbox of democracy” and that “it is vital that a government responsible for creating chaos or letting chaos reign should be pinned down”.⁷

A suggested approach to reforming the Federation

Any approach to reforming intergovernmental arrangements will, of necessity, require a significant correction of the Federation’s vertical fiscal imbalance, as well as a complementary reallocation of functional responsibilities and a significant reduction in tied grants.

This was the path pursued by the National Commission of Audit.

Rationalising roles and responsibilities

In reassessing roles and responsibilities across levels of government – determining “who should do what” – the Commission emphasised the key principles of subsidiarity and sovereignty.

Subsidiarity

Under the principle of subsidiarity, policy and service delivery should, as far as practicable, be devolved to the level of government closest to the people receiving the services. This recognises that sub-national governments are likely to have greater knowledge about the needs of citizens affected by their policies. It allows programs to be tailored to meet community needs.

Subsidiarity contributes to greater competition and experimentation within the Federation, which should make us better at solving policy problems.

Governments should also operate at their natural levels. Policy oversight for national issues should go to the Commonwealth with responsibility for regional and local issues predominantly going to State and Territory governments.

Sovereignty

Under the principle of sovereignty, as far as practicable, each level of government should be sovereign in its own sphere. This is what the founders had in mind when they envisaged a move to “coordinate federalism” – that is, a system in which there was a well set-out, comprehensive allocation of responsibility.

When reviewing roles and responsibilities, government activities should be allocated to one level of government where possible. This will provide greater clarity and accountability.

It will be essential that the States have a deep involvement in any review of roles and responsibilities. Most substantial reforms will require the Commonwealth and State governments to work together to determine which is the appropriate service provider. Having done that, an assessment can be made of the required level of funding. It would then be incumbent on governments to explain this to the broader public.

Key areas where roles and responsibilities should be reviewed include:

- Areas where constitutional responsibilities lie with the States, but where the Commonwealth currently has a significant financial contribution, such as schools funding;

- Areas of State responsibility where the Commonwealth currently has sub-sectoral responsibilities such as for specific environmental outcomes and regulation; and
- Areas where Commonwealth transfers to the States are growing at an unsustainable rate, such as payments associated with hospital funding.

Addressing Vertical Fiscal Imbalance

The pressing need to rectify the extent of vertical fiscal imbalance was close to the hearts of the members of the National Commission of Audit. This is not altogether surprising. Two Commissioners, Peter Boxall and Tony Cole, had a deep involvement in the Working Party on Tax Powers that reported to the Special Premiers Conference in November 1991.

This Working Party provided a broad assessment of possible options which sought to increase the fiscal autonomy of the States, recognising “that it is a basic tenet of a democratic system that the success with which governments perform their roles depends a great deal on the extent to which they are accountable to the community”.⁸

Twenty-two years later, the National Commission of Audit could not have agreed with this sentiment more. The Commission considered a number of options that could be used to address the vertical fiscal imbalance, including:

- Introducing additional State taxes;
- Adjusting the rate and/or base of the goods and services tax;
- Providing additional untied funding to the States; and
- Providing the States with access to part of the Commonwealth’s personal income tax base.

In its deliberations, the Commission of Audit determined that the best option would be to increase State and Territory revenue capacities by providing them with access to the Commonwealth’s personal income tax base.

There is no constitutional or legal limitation on the States imposing their own income taxes. There would be, however, substantial administrative and compliance costs in each State and Territory levying its own income tax.

Giving the States access to the Commonwealth’s personal income tax base would provide them with another growing revenue source, but should not significantly affect compliance costs for Australian taxpayers. All income taxes would continue to be collected by the Australian Taxation Office.

Under such an approach, the Commonwealth would reduce its income tax rates by a certain amount and the States would then replace this reduction with an income tax surcharge.

A starting point would be to require a similar surcharge for all States with the State surcharge exactly offsetting the reduction from the Commonwealth.

By way of illustration, the Commonwealth could permit States to access the personal tax base directly by reducing the current personal income rate of 32.5 per cent (which applies on incomes from \$37,000 to \$80,000) by 10 percentage points to 22.5 per cent.

A 10 percentage point “State income tax surcharge” could be introduced to bring the overall rate back to 32.5 per cent. This 10 percentage point State surcharge would be hypothecated to the States providing them, in this example, with an estimated additional revenue source of

around \$25 billion per year. In this case the overall personal income tax rate faced by Australians would not change.

The impact of lower revenue collections for the Commonwealth would be offset through an equivalent reduction in the payment of other Commonwealth financial assistance to the States. In other words, the financial implication would simply be a substitution of a new untied source of revenue to the States to replace a series of tied grants.

A more ambitious variant of this approach would be to extend the income tax sharing arrangement by allowing the States, individually, periodically to adjust the surcharge rate (either up or down by several percentage points).

This has the potential to inject further competitive tension into the Federation as States would have the autonomy to set rates and compete amongst themselves. State governments would then be more accountable because the link between their taxing and spending decisions would be clearer to the electorate.

The Commission recognised that such a change would represent a substantial shake-up of the current federal financial arrangements. There would be considerable legal, technical and administrative details to resolve. This should not, however, stand in the way of genuine reform.

A change in current arrangements to permit the States to levy an income surcharge would have to take account of the need for the Commonwealth to be able to continue to effect its broader macroeconomic and income distribution responsibilities, recognising the role that income tax may play in this regard.

Such an arrangement would require an agreement between the Commonwealth and the States on future changes to personal income tax brackets and thresholds.

The Commission considered that the option of providing the States with access to the Commonwealth's personal income tax base, and allowing them to compete on their surcharge rates, would be the best way forward to address vertical fiscal imbalance.

This option was preferred over increasing the rate or extending the base of the goods and services tax. As the States do not have control over either the rate or base there were unlikely to be benefits from this option in the promotion of greater competitive federalism.

Nonetheless the Commission did see merit in re-examining the goods and services tax within the context of broader taxation reform in Australia, recognising that it is one of the more efficient and less distorting taxes.

Some commentators viewed the Commission's proposal to provide the States with access to the Commonwealth personal income tax base as radical. But this is not the case. Variants of this idea have been considered before.

In January 1970, the Premiers of all States signed a document entitled *The Financial Relationships of the Commonwealth and the States* which envisaged a scheme whereby the States should have access to income tax.

At the subsequent Premiers' Conference, the Prime Minister rejected this proposal, citing a number of objections, including macroeconomic policy-making considerations and the "equitable" treatment of all Australians brought about by uniform taxation.

Conversely, in 1978, when the Commonwealth provided an opportunity to allow the States to levy marginal income tax surcharges or rebates, the offer was declined in part because the Commonwealth was not prepared to make room by lowering its rates.

What is different this time is the fact that the Commonwealth would make room and, in doing this, overcome any perception of double taxation occurring – an argument that was mounted forcefully in the past.

Improving Horizontal Fiscal Equalisation

The Commission of Audit also touched briefly on the difficult issue of horizontal fiscal equalisation. Under the current Intergovernmental Agreement on Federal Financial Relations, the States are entitled to receive payments from the Commonwealth equivalent to the revenue received from the goods and services tax with the allocation set in accordance with the recommendations of the Commonwealth Grants Commission.

In 2013-14, around \$5 billion or 10 per cent of the total \$50 billion in GST payments was redistributed among the States. This is a well-established process, but it is nonetheless contentious. For example, the 2012 GST Distribution Review – comprising a panel, ironically, of a South Australian and a former Premier from New South Wales on the one hand, and an ex-Premier from Victoria on the other hand – found that the “recipient” States support the existing equalisation system while the “donor” States see many problems with it (recognising that the donor States represent 90 per cent of Australia’s population).

That Panel, while presenting a comprehensive series of recommendations, did not suggest fundamental change to the equalisation system over the short to medium term. It noted that “it is not possible to closely replicate the outcomes of the current system in a dramatically simpler way”.⁹ Or, to paraphrase the Panel, the idea that a dispute over a fixed pot of money could be resolved happily seemed unlikely from the outset.

An important point to appreciate – and one made by the Panel – is the link between issues around vertical fiscal imbalance and horizontal fiscal equalisation.

If steps are taken to address vertical fiscal imbalance in the Federation, the States’ revenue raising capacity would be better linked to their service delivery responsibilities and a substantially simplified form of horizontal fiscal equalisation could apply.

The Commission of Audit picked up on this theme. It noted that, if a substantial reduction in vertical fiscal imbalance was achieved, then it would be possible to move to a model where there was minimal redistribution between the current donor States but with targeted distribution towards the current recipient States.

One option would be for all States to receive an equal per capita distribution of GST collected. Such a distribution would leave the fiscally-stronger States better off compared with existing arrangements

So as to preserve the current share of the fiscally-weaker States, it would be necessary for the Commonwealth Government to make “top up” payments to them. The Commonwealth would need to fund an additional \$5 billion in equalisation payments if the goal was to ensure that no State was worse off than is the case today.

The Grants Commission would retain a role in determining the basis for the allocation of this additional amount among the smaller States.

The Quid Pro Quo

As part of any agreement to move to new financial arrangements within the Federation, it would be necessary to negotiate a transfer of responsibilities for areas of spending where the Commonwealth currently makes tied grants.

As outlined earlier, total tied grants provided to the States in 2013-14 were around \$45 billion.

Of this total, around \$14 billion is for National Health Reform Funding (that is, hospitals funding), just over \$13 billion is for specific payments in education (that is, schools funding) and \$4 billion in other payments for specific purposes for skills, disability and housing. The remaining \$14 billion is made up of payments under 144 different national partnership agreements.

It would be a matter for negotiation as to how, in the Commission's illustrative example, the additional \$30 billion in revenue received by the States – that is, the \$25 billion from accessing the personal income tax base and the \$5 billion in additional equalisation payments – would be offset by lower tied grant payments.

One possibility would be for responsibility for schools funding to be transferred from the Commonwealth to the States. The \$13 billion that the Commonwealth currently provides through the National Schools specific purpose payment would no longer be paid, with the States instead using the proceeds from having access to the personal income tax base to fund this area of activity.

Other existing tied grants, including many of the National Partnership Agreements, could also be abolished. To the extent that the proportion of tied grants from the Commonwealth reduces substantially, State governments will enjoy greater budget flexibility – with flow-on effects for the efficiency and effectiveness of government and increased accountability.

A Way Ahead

In establishing the National Commission of Audit, the Abbott Government noted that any views and recommendations made would help inform a White Paper on Reform of the Federation. The terms of reference for that process were released by the Prime Minister, Tony Abbott, in June 2014.

They make sense, seeking to achieve a more efficient and effective Federation, clarifying the roles and responsibilities for States and Territories and aiming for less Commonwealth intervention in areas where States have primary responsibility. They recognise the importance of addressing the vertical fiscal imbalance.

A process has been outlined for progressing this White Paper – it will be developed within the Department of the Prime Minister and Cabinet and overseen by a steering committee of senior bureaucrats at the Commonwealth and State levels. It will be a standing item on the agenda of the Council of Australian Governments. Relevant background papers are to be released later in 2014 with the White Paper completed by the end of 2015.

A sound and transparent process is essential for the development and implementation of good policy. And it is good policy to reform the operation of the Federation to make it more effective. But we need to be wary of processes that get subsumed within the Council of Australian Governments – an institution that has in recent times shown itself to be a ship

without a compass, with a rudder often entangled in seaweed. Undue and complex processes have enveloped it and thwarted the passage of good government and an effective Federation.

If reform of the Federation is to succeed, the States and Territories must be genuine partners and the Commonwealth must not be permitted to over-reach.

Perceptions from Canberra that the Commonwealth is the only capable financial and policy fixer should be disabused. We have to overcome the notion that it is only the Commonwealth that has an appetite for reform and that only it possesses robust policy insights. But the States will also have to step up to demonstrate that they, too, can be reformist and are prepared to take on powerful vested interests.

Overcoming these challenges is not easy. The general public, as Sir Samuel Griffith wrote, “wanted to know – as unfortunately they do in most cases – what money there is in it, and beyond that it was of no interest to a majority”.¹⁰ To this day, federalism as an ideal struggles to capture the public’s imagination.

There is much at stake. Giving fresh life to the Federation will lead to better and more accountable government in Australia.

Reforming the Federation will take considerable political will. Inertia is difficult to overcome and people are hard to convince. At the same time, partisan politics is blowing a fierce and unpredictable gale.

But we need to recognise that our political parties are passengers on board the same ship. If they wreck it, all will perish. When it comes to the Federation and furthering the cause of responsible government in our country, we need our leaders to map out a picture of the future and then chart a path to get us there.

It is part of our national folklore that Samuel Griffith brought the Queensland Government yacht, *Lucinda*, to Sydney for the 1891 National Australasian Convention. She was put to historic use when the final stages of the 1891 draft of the Constitution were completed while cruising the Hawkesbury River.

Today, we appreciate that it is only great men and women who leave a visible wake for any length of time after their passage.

The high enthusiasms and fervent hopes of our founding fathers should inspire us again. They remind us that to have common glories in the past, to have a common ideal in the present, to have achieved great things together, to be determined to achieve more – that is what makes a nation great.

Endnotes

I would like to acknowledge the Commissioners of the National Commission of Audit: Tony Shepherd, Peter Boxall, Tony Cole, Robert Fisher and Amanda Vanstone as well as the dedicated women and men drawn from the Australian Public Service who staffed the Secretariat and helped to prepare the Commission’s report. I am grateful for comments provided by Henry Ergas, Jarrod Ball, Pero Stojanovski and Rebecca Austin.

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