CSES Working Paper No. 7
November 1996

FEDERALISM AND FISCAL EQUALISATION: SHOULD INDIA FOLLOW THE AUSTRALIAN PATH?

Bhajan S. Grewal

Centre for Strategic Economic Studies
Victoria University
Melbourne

ISSN: 1322-5138 ISBN: 1-87533-880-2

CSES Working Paper No. 7
November 1996

**FEDERALISM AND FISCAL EQUALISATION:
SHOULD INDIA FOLLOW THE AUSTRALIAN PATH?**

ABSTRACT

In most federations, the distribution of intergovernmental financial transfers is based on the principle that relatively weaker jurisdictions (in fiscal terms) receive more resources per capita than the other jurisdictions, although not every country has put in place a systematic approach to the application of this principle, and the practice differs from one case to another. In Australia, Canada and Germany, relatively more formal and systematic approaches are adopted for this purpose, even though there are important differences in each country's coverage of fiscal equalisation and the associated institutional arrangements. In India too, there is a strong redistributive element in the distribution of central government grants to the States, but the approach is again different from that in the other countries.

Not only do Australia and India share the objective of geographic redistribution, but in recent years suggestions have been made to modify some features of India's approach to grant distribution, which, if implemented, would bring the two countries' approaches closer. In particular, this would be the case if the work of the Finance Commission were to cover the entire revenue budget of the States, not just the non-plan revenue budgets, and if the Finance Commission were to be either made a permanent body or serviced by a permanent secretariat. The Finance Commission could then become an organisation similar to the Commonwealth Grants Commission in Australia in terms of its coverage and tenure. The main question posed in this paper arises because even then important differences will remain in what each commission is required to do and how it approaches its brief. Focusing on these substantive differences, the paper considers whether or not they should be maintained in future.

Bhajan S. Grewal
Centre for Strategic Economic Studies
Victoria University of Technology
PO Box 14428 MCMC
Melbourne VIC 8001
Australia

**FEDERALISM AND FISCAL EQUALISATION:
SHOULD INDIA FOLLOW THE AUSTRALIAN PATH?[1]**

1. Introduction

In most federations, the distribution of intergovernmental financial transfers is based on the principle that relatively weaker jurisdictions (in fiscal terms) receive more resources per capita than the other jurisdictions, although not every country has put in place a systematic approach to the application of this principle, and the practice differs from one case to another. In Australia, Canada and Germany, relatively more formal and systematic approaches are adopted for this purpose, even though there are important differences in each country's coverage of fiscal equalisation and the associated institutional arrangements. In India too, there is a strong redistributive element in the distribution of central government grants to the States, but the approach is again different from that in the other countries.

Not only do Australia and India share the objective of geographic redistribution, but in recent years suggestions have been made to modify some features of India's approach to grant distribution, which, if implemented, would bring the two countries' approaches closer. In particular, this would be the case if the work of the Finance Commission were to cover the entire revenue budget of the States, not just the non-plan revenue budgets, and if the Finance Commission were to be either made a permanent body or serviced by a permanent secretariat. The Finance

[1] An earlier version of this paper was presented at the international colloquium Federalism: Comparative Perspectives from India and Australia, hosted by The National Centre for Australian Studies, and The Centre of South Asian Studies at Monash University, Melbourne, 4-5 July 1996.

Commission could then become an organisation similar to the Commonwealth Grants Commission in Australia in terms of its coverage and tenure. The main question posed in this paper arises because even then important differences will remain in what each commission is required to do and how it approaches its brief. Focusing on these substantive differences, the paper considers whether or not they should be maintained in future.

The organisation of the paper is as follows. An overview of the approach to fiscal equalisation in Australia is provided in section 2. Section 3 discusses the relevant features of India's approach. The controversial issues raised about Australia's approach in recent years are discussed in section 4. The relevance of fiscal equalisation for interstate economic disparities over time is noted in section 5. Concluding remarks are offered in the final section.

2. Fiscal Equalisation in Australia

2.1 The Period of Benign Equalisation

The Grants Commission was established in 1933 in response to the increasing concerns of the less populous States about the adverse effects on their public finances arising from the financial provisions of the Federation, in particular the effects of the tariff policy, the conciliation and arbitration system, the Navigation Act, as well as the differential effects of the Great Depression of 1930 (Commonwealth Grants Commission 1995). Based on its recommendations, special grants (the equalisation-driven assistance) were made between 1934-35 and 1980-81 to those States which applied for such assistance. From time to time, the so-called claimant States (i.e. those receiving special grants) included Western Australia, South Australia, Tasmania and Queensland, although not all of them at the same time. Throughout this period, there was at least one claimant State receiving special grants; in earlier years, two or three States were in this category at the same time but Queensland was the only claimant State from 1976-77 onwards, when the other States withdrew from the fiscal

equalisation framework in favour of direct (bilateral) arrangements with the Commonwealth for special financial assistance.

In broad terms, the aim of the special grants was to equalise per capita revenue-raising capacity and unit costs of government services in a claimant State to the standard per capita revenue-raising capacity and unit costs. The 'standard' was derived from the average of the relevant variables in New South Wales and Victoria (initially Queensland was also part of the standard for a few years).

Special grants during this period were funded out of the Commonwealth budget and did not directly affect Commonwealth grants for New South Wales and Victoria. Typically, special grants also remained a small proportion of total outlays of either the claimant States or of the Commonwealth. It is not surprising, therefore, that during this period of benign fiscal equalisation neither of the two larger States took much notice of the principle and of the methodology of the Grants Commission or of its possible implications for their own public finances.

2.2 Fiscal Equalisation at the Centre Stage

This benign form of fiscal equalisation changed dramatically from 1982-83, when, as a result of an agreement reached at the 1982 Premiers' Conference, the Grants Commission's procedures began to determine the distribution of the entire pool of tax sharing grants (subsequently called financial assistance grants or general revenue grants), and thereby started to impact on the budgetary position of *all* States. Some States received more than the equal per capita share of the grants while other States received less. Thus, for the first time, Australia's became a truly horizontal equalisation system because the equalisation payments to the weaker States were effectively funded by the other States, not by the Commonwealth Government.

Predictably, the new status of fiscal equalisation drew opposition from the larger States and fiscal equalisation was challenged on both theoretical and practical grounds. These challenges were disputed, equally predictably, by the less populous States and, where the Commission's procedures were in question, by the Commonwealth Grants Commission also. These controversies led to a formal inquiry into the Commission's methodology in 1989-90 [which was somewhat anomalously also conducted by the Commission itself (Commonwealth Grants Commission 1990) because the Commonwealth and the States could not agree on any other suitable organisation], several specialised studies commissioned by the various parties to focus on specific issues, and a report by the Heads of Treasuries of Commonwealth, State and Territories (Heads of Treasuries 1994).

Since 1982-83, therefore, Australia has adopted arguably the most elaborate and comprehensive approach to horizontal fiscal equalisation (HFE) in the world. The distribution of practically all revenue grants, including those for specific purposes, is directly or indirectly subjected to the criteria of HFE. State per capita relativities are assessed by the Commonwealth Grants Commission on the basis of comparisons of not only revenue raising capacities but also unit costs of public services provided by the States and territories. Virtually the whole of the recurrent budgets of the States are included in the assessments of the standards and the (assessed) needs. Since 1988, a major review of the whole methodology is conducted every five years in which all States participate vigorously. These assessments are also updated each year. Finally, a somewhat less rigorous approach is also applied to the distribution of Commonwealth funds for local government authorities; in this case the State Grants Commissions assessing the relativities. From 1984 onwards, the Commission has also conducted inquiries into the appropriate levels of Commonwealth funding for the Cocos and Christmas Island communities (Commonwealth Grants Commission 1995).

The extent of fiscal equalisation in Australia can be gauged from Table 1 which shows that in 1993-94, when a grants pool totalling $17,400 million was distributed, New South Wales, Victoria and the Australian Capital Territory received less than equal per capita distribution while the other States and the Northern Territory received more than their equal per capita shares. A total of $1.64 billion or a little less than 10 per cent of the total pool was redistributed in that year due to fiscal equalisation.

The entitlement of a State for these grants is basically the sum of its per capita share of the available pool *plus* its revenue need *plus* its expenditure need. If a State has above average revenue-raising capacity, its revenue need is assessed as negative; for a State with below average capacity, revenue need is positive. Similarly,

Table 1 : Some Indicators of the Impact of Fiscal Equalisation

	Distribution of general revenue grants	Equal per capita distribution	Difference (1) - (2)	Distribution using income tax collected (a)	Difference (1) - (4)
	$m (1)	$m (2)	$m (3)	$m (4)	$m (5)
New South Wales	5046	5916	-870	6117	-1071
Victoria	3658	4386	-728	4805	-1148
Queensland	3367	3085	283	2507	860
Western Australia	1842	1651	191	1581	262
South Australia	1752	1437	315	1315	437
Tasmania	686	464	222	395	291
Northern Territory	795	166	628	144	651
Australian Capital Territory	255	295	-40	537	-282
Total	17401	17400	1	17401	0

Notes: (a) Distribution based on data from 1990-91; Australian Taxation Statistics, 1990-91.
Source: Heads of Treasuries (1994).

Table 2 : Distribution of General Revenue Grants, 1993-94

	Equal per capita share of general revenue	Revenue needs (a)	Expenditure needs (b)	Adjustment for receipt of other Commonwealth payments (c)	General revenue grant requirement sum of (1) to (4)	Per capita relativities (d) (5)/(1)
	$pc (1)	$pc (2)	$pc (3)	$pc (4)	$pc (5)	(6)
New South Wales	980	-91	-66	13	836	0.853
Victoria	980	23	-203	17	818	0.834
Queensland	980	35	46	9	1070	1.092
Western Australia	980	-95	247	-39	1094	1.116
South Australia	980	203	40	-28	1196	1.219
Tasmania	980	335	177	-44	1449	1.478
Northern Territory	980	-4	4064	-356	4685	4.778
Australian Capital Territory	980	141	-296	21	847	0.864
Average	980	0	0	0	980	1.000

Notes: (a) Negative revenue needs means above average revenue raising capacity, and vice versa.
(b) Negative expenditure needs means below average expenditure requirements, and vice versa.
(c) Negative adjustment means above average receipt of relevant payments.
(d) These relativities differ slightly from the Premiers' Conference relativities due to a minor technical adjustment.
pc: per capita
Source: Heads of Treasuries (1994)

expenditure need is positive if a State is assessed to have above standard demand for, or unit costs of, a government service and negative if the opposite is the case. Revenue needs are assessed separately for 19 categories of tax and non-tax revenue (at one time there were 31 categories). Accordingly, it is not uncommon for a State to have positive revenue needs for some categories and negative needs for the others. But it is the sum of such needs across the 19 categories which represents its aggregate revenue need. In the same way, expenditure need is the sum of separate assessments across 41 categories of expenditure (once there were 70 of them). A final adjustment is made to these entitlements to account for the differences in the receipt of specific purpose grants by the States. This means that if a State had received more (less) than its per capita share of these grants, its entitlement for general revenue grant is correspondingly reduced (increased). The result of this procedure for 1993-94 is shown in Table 2.

3. Fiscal Equalisation in India: An Overview

The institutional framework for intergovernmental grants and revenue sharing in India is quite different from Australia's and consists of two separate bodies, the Finance Commission and the Planning Commission. Initially, there was some confusion, and even some tension, about the respective roles of the two Commissions in the field of federal finance, as exemplified by the Third Finance Commission's unsuccessful attempt to extend its role into the ' plan' finance (Grewal 1975). But the two Commissions have operated side by side for nearly half a century, their roles separated by the distinction between plan and non-plan outlays.

The States in India receive a share of the revenue raised by the Central Government from a variety of taxes, including income tax, central excise duties and a number of other taxes. The distribution of the States' collective shares from each of these taxes among individual States is determined by the Central Government after considering the recommendations of the Finance Commission. The revenue from each shared tax is distributed on the basis of a different formula, with the result that there are several formulas impacting upon the interstate distribution of shared

revenues. Each formula often consists of several criteria, increasing correspondingly the number of factors entering into the determination of State shares. For example, the shared revenue from income tax is distributed according to a formula in which:

- 20% weight is assigned to a State's share of total population;
- 60% weight is assigned to per capita income relative to that of the richest State;
- 10% weight is assigned to relative tax effort;
- 5% weight is assigned to an index of infrastructure; and
- 5% weight is assigned to the area of a State.

The Constitution of India, (Article 280) provides for the establishment of a Finance Commission at least once every five years to make recommendations in regard to:

(a) the distribution between the Centre and the States of the net proceeds of Taxes which are to be, or may be, divided between them and the allocation between the States of the respective shares of such proceeds;

(b) the principles which should govern the grants-in-aid of the revenue of the States out of the Consolidated Fund of India; and

(c) any other matter referred to the Commission by the President of India in the interest of sound finance.

Each Finance Commission's normal tenure of office is approximately one year and it expires after the completion of its report. There have been ten Finance Commissions between 1950 and 1994.

The States are also heavily dependent on the Centre for the financing of their programs of development embodied in annual and five year plans. On average, more than two-thirds of their plan outlay, which includes capital and recurrent expenditure on 'plan schemes', is met through Central assistance. This assistance is based on the recommendations of the Planning Commission. The Planning Commission was established by a resolution of the Cabinet in 1950 and has no standing in the Constitution of India.

The two Commissions work independently within their respective spheres and the lack of coordination between them, together with the consequential absence of a unified or coherent approach to intergovernmental financial transfers has been often criticised as a shortcoming of India's institutional framework. Recently, the Tenth Finance Commission (1994) added to the continuing commentary on this issues by claiming that 'the present artificial distinction between plan and non-plan expenditures, which runs across revenue and capital budgets shall be replaced by the simpler and conventionally well recognised distinction between revenue and capital', and that in future 'Finance Commissions may be required to examine the aggregate requirements on revenue accounts and recommend means to bridge the revenue gaps' (para 15.11). In the event this does happen, the Finance Commission's task will become similar to that performed in Australia by the Commonwealth Grants Commission, which deals with the entire revenue budgets of the States.

The multiplicity of separate pools of funds which are distributed on the basis of different formulas, consisting of multiple factors, makes the approach of the Finance Commission complex and rather diffused (in contrast to the Commonwealth Grants Commission's approach). In principle, the lack of a sharp focus must also impact adversely on the effectiveness of the Commission's approach in achieving its objectives. In practice, however, it is not possible to assess the extent of such loss of effectiveness simply because there is no well-defined target for the Finance Commission to achieve. In other words, unlike the target of fiscal capacity defined by the Commonwealth Grants Commission for equalisation, there is no single target or a set of variables which the Finance Commission seeks to equalise.

In recent years, however, a consensus has been developing in India for replacing the multiple separate pools with one pool consisting of a stipulated share (around 25 per cent) of the Centre's total tax receipts. The Chelliah Committee on Tax Reform (1991), the Tenth Finance Commission (1994), the Central Government's Ministry of Finance and many of the States favour such a change. It is widely acknowledged that the current situation, in which as much as 85 per cent of the income tax receipts must be passed on to the States, creates a strong disincentive for the Central Government for fully exploiting the revenue potential of this tax. Similar reasoning applies to other shared taxes also. A major advantage of the proposed change is considered to be the removal of any such disincentives from the formulation of the Central Government's taxation policy. The States also expect to benefit from the added certainty of the annual flow of funds from the Centre, once their percentage share is known in advance. The stipulated share of the States would remain unchanged for 15-20 years before being reviewed. The proposed replacement of the multiple revenue pools with one consolidated pool might also open the way eventually for the application of a more coherent and targeted approach to the distribution of the pool among the States. In view of the special features of Australia's approach to fiscal equalisation noted above, it would be natural to consider its relevance for developing a more targeted approach for India.

The short-term tenure of the Finance Commission has also been generally regarded as another shortcoming of the institutional framework of fiscal federalism in India. Proposals for addressing this issue have ranged from the establishment of a permanent Finance Commission (see Rao and Chelliah 1996) to the setting up of a permanent secretariat for the Finance Commission (e.g. Tenth Finance Commission 1994, which also cites a similar proposal made by the Eighth Finance Commission; para 15.14)

The Ninth Finance Commission made an attempt, for the first time, to estimate capacities and needs of the States for determining their entitlements for financial transfers. This could be another important pointer towards greater potential similarities between the two countries as measurement and comparisons of revenue-raising capacities and expenditure needs of the States is a key feature of Australia's approach.

It is against this background that Australia's recent experience with fiscal equalisation is considered in the following section.

4. The Australian Approach Under the Spotlight

As noted above, the entry of fiscal equalisation to the centre stage in Australia was not smooth. The first report of the Commonwealth Grants Commission in which relativities were assessed for the distribution of the entire pool of tax sharing grants was considered by the 1981 Premiers' Conference. The Commission had found that as the less populous States were receiving more than their equalisation-based shares, there needed to be a redistribution from these States to the larger States of New South Wales and Victoria. Following opposition from the four States that stood to lose funds if the 1981 report was implemented, the Commonwealth decided not to act on it and instead asked the Commission to prepare another report for the 1982 Premiers' Conference, to be based on a slightly longer period of four years data - instead of three years as in the 1981 report. The 1982 report also recommended the same direction of redistribution, although this time involving a smaller amount to be redistributed.

For the first time, tax sharing grants were distributed in 1982-83 on the basis largely of an equalisation-based formula, although the Commonwealth Government gave certain guarantees of minimum growth to the States, which diluted the effect of fiscal equalisation. Following the 1985 Review of State relativities, the Commonwealth Government adopted the assessments of the Commission as virtually the only basis for the distribution of what were then called financial assistance grants (see Mathews and Grewal 1995).

The extended application of the fiscal equalisation principle also occurred at a time when the Commonwealth Government was pursuing a vigorous policy of budget deficit reduction, primarily through cutbacks in grants to the States. The States of New South Wales and Victoria found themselves to be losing Commonwealth grants on two fronts; first, to the Commonwealth (as the pool of general revenue grants available for the States was shrinking in real terms), and second to the less populous States (as the application of fiscal equalisation was further reducing their shares of that shrinking pool). Spurred partly by the effect of these factors on their finances, and partly by their concerns about the opportunity costs of fiscal equalisation (awareness of which was lacking in the political process which considered the CGC's assessments), the two States challenged the theoretical and operational aspects of fiscal equalisation. As the questions raised in the ensuing debates were progressively refined, the Commonwealth Treasury also joined them on some of the issues. The other States predictably rallied to the defence of fiscal equalisation and of the Commission's procedures.

In 1989, the Commonwealth Government initiated a special inquiry into certain issues relating to the methodology used by the Commonwealth Grants Commission in its *Report on General Revenue Grant Relativities 1988*. Given the background and the purpose of that inquiry, it was, as noted above, unusual that the Commonwealth asked the Commonwealth Grants Commission itself to conduct the inquiry. Nevertheless, the Commission conducted the inquiry with a characteristically high standard of professionalism, and presented a report in 1990 which is a valuable source of reference on this particular chapter in the history of fiscal equalisation in this country.

In spite of the Commission's best efforts, and of the other parties involved, the issues raised in these debates remained largely unresolved. In 1992, in recognition of the importance of the unresolved questions, the Premiers' Conference issued a reference to a Heads of Treasuries Working Party to undertake a review of the 'adequacy of the current fiscal equalisation scope and methodology, and the principles on which it is based' (Heads of Treasuries 1994). At the same time, these debates raised the general level of awareness about the issues in the country and the subject of fiscal equalisation attracted comments from the Industry Commission (1993), the National Commission of Audit (1996), and many others.

The major issues raised in these reviews included the relationship between fiscal equalisation and allocative efficiency, interpersonal equity, and the complexity of the Commission's model and assessment procedures. These are discussed in some detail below.

<u>Allocative Efficiency and Fiscal Equalisation.</u> The possible loss of efficiency was raised as an issue arising from the equalisation of the costs of government services. It was argued (by Government of Victoria 1988) that any differences in unit costs of government services should, as they normally would in the absence of fiscal equalisation, cause the governments to find ways of economising on the provision of such services or to invest in alternative (lower-cost) technologies or to reduce expenditure in some other areas if the demand for the high-cost services was for some reason inelastic. In other words, the cost differences normally serve as price signals for governments to react to, and when they are equalised, the argument ran, the price

signals would be distorted and the State governments will be responding not to the true costs, but the shadow costs (i.e. costs affected by equalisation). Shadow costs would be lower (higher) than the true cost if a particular State is assessed to have a disability (an advantage) vis-a-vis the standard. It was argued that loss of efficiency would occur for the States on both sides of the equalisation equation (i.e. the gainers as well as the losers).

Counter arguments were put up by some of the less populous States (and by the Commission), arguing that as the equalisation grants were unconditional payments, they did not affect relative costs, and that there was no empirical evidence of such distortions actually occurring.

Three separate studies attempted to estimate the efficiency cost to the national economy of equalising the so-called location-based factors (e.g. dispersion of population, and diseconomies of small scale provision). The first study was commissioned by the Commonwealth Grants Commission and it put the estimated loss of efficiency at 0.008 per cent of GDP or $30 million a year. This was regarded by all concerned as insignificant.

A second estimate was made in a study commissioned by Victoria's Treasury, and put the loss of efficiency at $500 million a year. A third estimate, made by the same group of consultants which conducted the first study (but this time commissioned jointly by New South Wales and Victoria), put the efficiency cost at around $920 million, or about 0.23 per cent of GDP a year.

As these three estimates captured different effects on national output, they are additional to, not substitutes for, the estimated dead-weight losses reported below.

It is remarkable that all empirical studies confirmed the existence of a conflict between allocative efficiency and fiscal equalisation, although the magnitude of the estimated loss (and hence their significance for future policy) varied widely.

However, the less populous States continue to deny any possible conflict between allocative efficiency and fiscal equalisation. Thus, in a submission made to the Industry Commission, which considered the regional effects of fiscal equalisation in 1993, one State argued that without fiscal equalisation, locational decisions would be distorted due to the fact that tax rates would differ across the States on account of factors other than differences in costs, such as differences in taxable capacity or relatively higher demand for services due to demographic differences. Another suggested that fiscal equalisation assists efficiency by keeping low the congestion costs of large cities of Sydney and Melbourne. A third State noted that the issue of any efficiency costs arising from fiscal equalisation was a very minor area of concern in comparison with the potential gains to efficiency from reducing vertical fiscal imbalance (between the Commonwealth on the one hand and the States on the other).

The Industry Commission (1993) noted that, referring to the debates on this issue, the Commonwealth Grants Commission also acknowledged that:

> The consensus to have emerged to date from these attempts is that the equalisation transfers *must* be having some effect on population between States and between regions within States. (CGC quoted in Industry Commission 1993, p. 327, original emphasis)

Complexity of the Equalisation Procedures. The high degree of complexity of the Grants Commission's procedures has been a major target of criticism. The main source of the complexity is the so-called factor assessment method, which is applied by the Commission to assess relative disabilities for each of the 19 revenue categories and 41 expenditure categories for each State. As noted earlier, these assessments are used for determining revenue and expenditure needs of each State. Each of these assessments requires detailed information about policy and non-policy factors impacting on a State's revenue base and/or expenditure levels. For expenditure equalisation, the impact of each of the several disability factors (such as dispersion, diseconomies of scale, urbanisation, physical environment, age-sex composition of population) on the demand for and the costs of public services is assessed. This lengthy and detailed procedure is repeated over each category and for each State.

Objective information is not always available or sufficient and the Commission often relies on its own 'broad judgement' in arriving at final assessments. The reliance on broad judgment has been a feature of the Commission's work since its establishment in the 1930's and was acknowledged by Giblin in his candid evidence in 1938 before the Canadian Royal Commission on Dominion Provincial Relations:

> The thing is dressed up in arithmetical terms as much as possible, and that perhaps is politically useful. But it must be admitted that in a good

> many instances the actual decision as to how much allowance must be made for this or that depends not on the strictly arithmetical computation, but on the broad judgment of the Commissioners as to what is a reasonable figure ... I believe that the calculations ... do indicate the figure, but with a fairly wide margin of error. (cited in May 1971, p. 70)

In spite of considerable improvements in the availability of relevant data since the days of Giblin, outsiders often find it difficult to understand or replicate the Commission's assessments. A former Prime Minister is reported to have described the Commission's model as a 'black box'. The Heads of Treasuries Working Party (1994) also noted that the complex nature of these procedures had restricted their accessibility to only those who could afford to invest a considerable time and effort in making use of the available information. It said that there is considerable ignorance about these processes even in government (p. 24), and that there is a perception that:

> elements of the Commission's calculations are based on dubious assumptions, poor data and a substantial element of judgement. In the same vein, the Commission's approach to fiscal equalisation is said by some to be, at times, inconsistent. (p. 25)

These and many other similar observations suggest that the desire, on the part of the Grants Commission, to put in place the most comprehensive system of assessing revenue and expenditure needs, category by category, has resulted in loss simplicity, transparency and in some cases even the credibility of its assessments.

The category by category assessment of needs also makes it possible that a State's grant entitlement could be affected appreciably by a reclassification of an item of revenue or expenditure from one category to another. A recent example of such an affect is that a State's share of general revenue grant increased by $8 million when the non-inpatient expenditure of another State was reclassified by the Commission from the Community Health Services to the Hospital Services category (Commonwealth Grants Commission 1996, p. 29). This example also indicates the scope for a State to influence the size of its grant by either persuading the Commission to adopt a particular classification or by concentrating on expenditure or revenue in some categories and not in others. A study commissioned by New South Wales and Victoria claimed that this particular aspect of the Commission's model encouraged a State to over-provide services for which its cost structure was relatively expensive and to under-provide those services in which it had a relative cost advantage (Swan and Garvey 1996, p. ii).

Interpersonal Equity and Fiscal Equalisation. The relationship between horizontal equity and fiscal equalisation, or more appropriately the absence of any relationship between the two, has been the focus of critical comment in the Australian debates, although no clear workable solutions have emerged so far. In the theoretical literature on fiscal federalism, the case for horizontal fiscal equalisation follows Buchanan's articulation that if per capita income levels of the subnational units in a federation were unequal, the principle of equal fiscal treatment of equals would be violated, unless corrective actions were taken (1950). Possible corrective actions included a discriminatory income tax (which would be impracticable in any federation) or unconditional intergovernmental, rather than interpersonal, grants to the states with lower incomes. Indeed, a similar argument had been made in 1925 in Australia by Giblin and others for the Tasmanian Disabilities Committee and was the basis of a recommendation for differential per capita grants from the Commonwealth to the States (Mathews and Jay 1972).

Achievement of interpersonal equity is not an objective of the fiscal equalisation schemes in Australia or India. In both countries, as elsewhere wherever horizontal fiscal equalisation is applied, the objective is to remove some of the effects of income differences on the public finances of the states. The conceptual basis of the fiscal equalisation scheme in Australia is that 'each State should be given the capacity to provide the average standard of State-type public services, assuming it does so at an average level of operational level of efficiency and makes an average effort to raise revenue from its own sources' (Commonwealth Grants Commission 1995). Over the years, the precise statement of the principle has been refined but its central idea has remained essentially intact. As explained by Mathews (1977):

> ... under fiscal capacity equalisation, governments are merely put into a position where they may provide services on a standard scale whilst imposing taxes and other charges at standard severity. They *are not obliged* to match the standard revenue effort; indeed governments receiving equalisation payments are free to impose below-standard

> services, or conversely to combine above-standard taxes and above standard services. (added emphasis)

It has been pointed out by the critics that such an approach to fiscal equalisation does not address what ought to be the ultimate concern of such a scheme – the interpersonal equity across the States. If interpersonal equity were indeed the concern of an equalisation scheme, the distribution model would need to deal with issues such as effective tax rates in the States, interstate shifting and the patterns of incidence of taxation and of Commonwealth policies which affected differentially the disposable incomes in the States. The Commonwealth Grants Commission's response to these criticisms has been that interpersonal equity should be advanced through the taxation-transfer system (Commonwealth Grants Commission 1990).

At the theoretical level, a solution was suggested by Dimasi (1989) who argued that equal fiscal treatment of equals could be achieved in a federation without the need for intergovernmental grants if the central government included the (differential) fiscal net benefits of the individuals in their taxable income for personal income taxation. In a recent paper, it has been claimed that:

> In the Dimasi framework, not only are like individuals treated equally at the federal level, but at the same time the fundamental weakness in the Buchanan justification for fiscal equalisation is revealed. There is no case for subsidising particular **States** via equalisation grants ... (Swan and Garvey 1996, pp. 39-40, original emphasis)

At the practical level, however, turning the focus of a fiscal equalisation scheme towards interpersonal equity appears to be extremely problematic, involving as it would the computation of net fiscal benefits for all individuals over all taxes and public expenditures. As most participants in the Australian debates realised the limited practical value of such proposals, the missing link between equity and equalisation has not been a major issue in the latest discussions. Nevertheless, the fact remains that fiscal equalisation is only an imperfect and inadequate response to the problem of horizontal inequity. The capacity equalisation approach adopted in Australia also allows the disconcerting possibility that a poor taxpayer living in a high-income State could well be subsidising a rich taxpayer living in a low-income State, as equalisation grants may well be used by the government of the latter to

reduce taxes of, or increase the level of services consumed by, the well-off taxpayers. Capacity equalisation is not concerned with equality in the actual provision of services.

4.1 Future Directions for Fiscal Equalisation in Australia.

The Report of the Heads of Treasuries Working Party (1994) canvassed several options for reform of fiscal equalisation. The Working Party was not required to make recommendations.

Two major themes dominate the Working Party Report. One is the sentiment that some commitment to horizontal fiscal equalisation must be maintained; its total abandonment is not considered to be an option. This sentiment has been important in Australia since the 1920s when, thanks to the work of Giblin, Brigden and others, it was accepted that special grants to some States were justified, not as a compensation for the disabilities caused by Federation but, to paraphrase Giblin, because every member State in the Federation had a legal and moral obligation to conform to the general standard, or at least not to fall seriously below it (May 1971; see also Mathews and Jay 1972). The same sentiment was echoed recently by Mathews (1994) when he described horizontal fiscal equalisation as the linchpin of the Australian federation. Conscious, however, of the fact that fiscal equalisation might entail efficiency costs, the Working Party recognised that the scope of fiscal equalisation might be restricted to only those States which really needed to be helped.

The second theme is the strong desire to simplify the procedures of fiscal equalisation, which are, as noted above, widely regarded to be too complex. Among the options considered by the Working Party is a possible discounting of the relativities assessed by the Grants Commission by combining them with equal per capita distribution, on 80/20 or some other similar basis. Considering the substantial redistribution this might lead to, a phasing-in of the new relativities has been suggested as a means of softening the impact on the losing States. Another option involves the exclusion of cost equalisation which, the report notes, would align the Australian approach with that of Canada and, with some exceptions, Germany. Such an approach would restrict the process to revenue equalisation, and could either continue to be based on the current procedures (involving tax by tax assessment of needs) or move to some global measure of revenue capacity (for example, Gross State Product). A partial per capita distribution approach is also considered, which would allow fiscal equalisation to be targeted at the most needy States of South Australia, Tasmania and the Northern Territory. Under this option, the available grants pool would be distributed first among these States according to the Commission's relativities and then between the other States on equal per capita basis. Needless to say, each of these options would involve a departure from full fiscal equalisation and the Premiers' Conference did not take any action in response to the report.

5. Is Fiscal Equalisation a Cure or a Palliative?

Whether or not fiscal equalisation contributes to the narrowing of interstate economic disparities over time is one issue that has not been debated in recent times in Australia. But it is a valid question for consideration in any country, especially if fiscal equalisation is assigned a role in removing from the State public sectors the effects of unequal State per capita incomes (or revenue-raising capacities).

In the 1920s, when the seeds of fiscal equalisation were sown in Australia, this issue was debated at length, particularly around 1925 and 1926 in determining the real nature of Tasmania's claims of disability. A good account of these deliberations is provided by May (1971), who says:

> The view that the small States could overcome their difficulties if only they could reach a take-off stage had, of course, been suggested by Lockyer and it was not without supporters in Tasmania. The British Economic Mission of 1929 revealed a similar attitude when, in commenting on special grants, it said, 'These subsidies, however, can only be regarded as palliatives of a system with which something is amiss'. (p. 17)

At the 1926 Premiers' Conference, where the problem of the small States was discussed in some detail, the Commonwealth also concluded that:

> The mere making of a money grant is not the solution to the problem The true principle ... is to discover the causes of the financial difficulties and to seek to provide means for their removal ... (May 1971, p. 17)

In India, there is greater explicit concern about interstate income inequality insofar as it figures as an important factor in the Finance Commission's distribution scheme. The so-called distance criterion (given 60 per cent weight by the Tenth Finance Commission, 1994) and the infrastructure index (5 per cent weight) can be regarded as indications of this concern. In Australia's fiscal equalisation approach, there is no recognition of any role that special grants might play in the process of the removal of the 'causes' of fiscal disabilities, instead of the fiscal disabilities *per se*. In neither country, however, has there been an attempt made to examine and assess the effectiveness of fiscal equalisation in reducing interstate income inequalities.

A recent study of the Australian States (Harris and Harris 1994) has, however, reported that between 1977-78 and 1991-92, Queensland, South Australia and Tasmania had below average real GDP at factor cost per head in all 15 years, Tasmania had the lowest real GDP at factor cost per head for 14 out of the 15 years. This finding raises the question why have these States failed, in spite of being the recipients of fiscal equalisation grants for many years, first under the special grants arrangements and since 1982-83 under the current arrangements, in lifting the rates of real per capita output to above average levels, even for some years of this period? In this context, it appears unwise to continue with the current system of fiscal equalisation, arguably at a cost to national output, regardless of its impact on inter-state economic disparities.

6. Concluding Remarks

It should be clear from the above that, by any account, all is not well with fiscal equalisation in Australia. It remains an equity-based principle whose contribution to inter-personal equity remains unconvincing and is at best rather weak. Nevertheless, at least the Australian experience confirms that there is an element of truth about the binding power of fiscal equalisation in a federation. Even in the midst of the vigorous debates over this issue, a certain commitment to assist the weaker units of the federation has always been acknowledged in this country.

The problem, however, is that this commitment does not automatically translate well into a practical approach to fiscal equalisation. One lesson of the Australian experience is that beyond a certain point, the desire for detail and comprehensiveness is likely to turn into complexity and the equalisation process becomes a liability, as it detracts from the crucial virtues of simplicity and ease of understanding.

Another lesson is that the costs of fiscal equalisation, to particular States as well as to the national economy, cannot be ignored. The recent debate about the nature and the magnitude of such costs in Australia leaves little doubt that fiscal equalisation comes at a price; perhaps this realisation is Australia's unique contribution to the wider literature on fiscal equalisation. How big that price is depends upon the specific features of a country's approach and its economic structure.

A separate point made in this paper, although not much debated so far even in Australia, is that the effectiveness of an approach to fiscal equalisation needs to be judged, at least in part, in terms of its contribution, over time, to the narrowing of interstate economic disparities. For otherwise, the principle of fiscal equalisation simply becomes an inert response to the symptoms of the problem (of economic disparities) rather than addressing its root cause.

In relation to the institutional framework, the issue of the temporary tenure of the Finance Commission in India was noted above. While the establishment of a permanent secretariat will no doubt facilitate the on-going monitoring of and research into State finances which is clearly beyond the capacity of a Finance Commission at present, the Australian experience suggests that the benefits of the creation of a permanent commission are not altogether clear (see Grewal 1975 for a contrasting view). Permanency of tenure will certainly add to the continuity of the Commission's work but there is also a risk that the establishment of a permanent body could create a strong stakeholder in the equalisation process, preventing critical scrutiny and injection of fresh perspectives into the process. One advantage of the current situation in India is that there is a regular turnover of personnel who can bring fresh

perspectives and new ideas to bear upon the issues. This type of dynamism may be lost under a permanent Finance Commission, especially if the same members are able to hold office for long periods.

In conclusion, there seems to be no reason for India to venture towards the Australian model of fiscal equalisation. Indeed, it is clear from the recent debates on this subject that in Australia, momentum is building up for retreating towards a less ambitious, simple and, importantly, an affordable approach to fiscal equalisation. A question which both countries need to rigorously examine, in this context is whether interstate redistribution of grants makes a lasting contribution to the growth rates of the weaker States' economies; at this stage, there is no evidence that it does so.

References

Buchanan, J. (1950), 'Federalism and Fiscal Equity', *American Economic Review*, 40.

Chelliah, R. (1992), (Chairman), *Report of the Tax Reform Committe*, Department of Revenue, Ministry of Finance, Government of India, New Delhi.

Commonwealth Grants Commission (1990), *Report on Issues in Fiscal Equalisation*, Vols. I and II, AGPS, Canberra.

______(1995), *Report on General Revenue Grant Relativities: 1995 Update*, AGPS, Canberra.

______(1995), *Report on General Revenue Grant Relativities: 1996 Update*, AGPS, Canberra.

Dimasi, J. (1989), 'The Impact on Fiscal Equalisation of State Business Undertakings and the User Pays Principle', in C. Walsh (ed.) *Fiscal Equalisation, Allocative Efficiency and State Business Undertakings: The Commonwealth Grants Commission 1988 Report on Relativities, Centre for Research on Federal Financial Relations*, The Australian National University, Canberra.

Dixon, R. and A. P. Thirlwall (1975), 'A Model of Regional Growth - Rate Differences on Kaldorian Lines', *Oxford Economic Papers*, 27(2): 201-214.

Finance Commission (1994), *Report of the Tenth Finance Commission (for 1995-2000)*, Finance Commission, Government of India, New Delhi.

Government of Victoria (1988), Submission to the Commonwealth Grants Commission's Review of State Per Capita Relativities, Melbourne.

Grewal, B. (1975), *Centre - State Financial Relations in India*, Punjabi University Press, Patiala.

Grewal, B., G. Brennan and R. Mathews (eds) (1980), *The Economics of Federalism*, ANU Press, Canberra.

Harris, P. and D. Harris (1994), 'Interstate Disparities in Real GDP at Factor Cost and Real Disposable Income 1977-78 to 1991-92', Department of Economics, James Cook University of North Queensland, Townsville.

Heads of Treasury (1994), *Horizontal Fiscal Equalisation*, Canberra.

Industry Commission (1993), *Taxation and Financial Policy Impacts on Urban Settlement: Report on Impediments to Regional Industry Adjustment*, Canberra.

Mathews, R. L. (1977), 'Mechanisms for Fiscal Equalisation' in *Report of the Study Group on the Role of Public Finance in European Integration*, Vol. 2, Commission of the European Communities, Brussels.

______(1994). *Fiscal Equalisation: Political, Social and Economic Linchpin of Federation*. Canberra: Federalism Research Centre, ANU.

Mathews, R. L. and W.R. Jay (1972), *Federal Finance*, Nelson, Melbourne.

Mathews, R. and B. Grewal (1995), 'Fiscal Federalism in Australia: From Whitlam to Keating', CSES Working Paper No. 1, Centre for Strategic Economic Studies Victoria University, Melbourne.

May, R. J. (1971), *Financing the Small States in Australian Federalism*, Oxford University Press, Melbourne.

National Commission of Audit (1996), *Report of the National Commission of Audit*, AGPS, Canberra.

Rao, M. G. and R.J. Chelliah (1996), *Fiscal Federalism in India*, Indian Council of Social Science Research, New Delhi.

Swan, P. L. and G.T. Garvey (1996), *The Equity and Efficiency Implications of Fiscal Equalisation*, Swan Consultants Pty Ltd, Sydney.