

## COMMONWEALTH FISCAL POWER AND AUSTRALIAN FEDERALISM

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### I INTRODUCTION

Australian federalism is characterised by an unusually high degree of vertical fiscal imbalance ('VFI'). With just more than half of the service delivery responsibilities, the Commonwealth controls over 80 per cent of all tax revenue – well in excess of its requirements. Such disparity necessarily entails some system of fiscal transfer whereby the surplus funds of the Commonwealth are used to make up the corresponding shortfall in the States. The States, on average, are dependent on the Commonwealth for 45 per cent of their revenue.<sup>1</sup> A substantial share of those transfers is in the form of Specific Purpose Payments ('SPPs') or 'tied grants' which the Commonwealth uses to exert policy influence in areas of State jurisdiction. While tied grants are not the only means by which the Commonwealth exerts power over the States, they are a major one. The amount of money involved is considerable, as is the number and range of programs.<sup>2</sup>

There is an ambiguous quality to this state of affairs. On the one hand, the proliferation of SPPs can be seen as reflecting the adaptation of an old constitution to new circumstances. By means of tied grants, the Commonwealth can exercise a necessary national interest role in areas where, by an accident of history, it would otherwise be denied access. On the other hand, the resulting pattern of intervention and entanglement can be seen as one of the pathologies of federalism. The heavy reliance of the States on the Commonwealth and the resulting constraints and burdens this creates magnifies some of the problems and reduces the potential benefits of a system of divided jurisdiction. The current arrangements reflect both underlying socio-economic realities and more

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1 Commonwealth Treasury, *Architecture of Australia's Tax and Transfer System* (2008) 297.

2 In 2008–09, the Commonwealth budgeted \$45 billion in general purpose payments (the GST revenues) and \$33 billion in SPPs to the States. There were by official count 'more than 90' different SPPs – though the bulk of the funds (two-thirds) were focused on only two portfolio areas: health and education. See Commonwealth, *Budget Paper No 3: Australia's Federal Relations 2008–09*.

particular features of Australia's constitutional history. An extensive range of recent reports and studies have highlighted the adverse effects of these arrangements and the newly elected Rudd Labor Government announced a series of reforms in its first budget, the Budget of 2008–09. If there is a case for federalism in Australia, then there certainly is a case for such reforms – and more. Australian federalism would benefit from changes moderating the degree and effects of VFI and bringing the use of tied grants under control.

## II CONSTITUTIONAL STATUS

The architects of the *Australian Constitution* elected to follow the American single-list approach to creating a division of powers in preference to the Canadian multiple-list approach.<sup>3</sup> Article I(8) of the *United States Constitution* set out an exhaustive or limiting list of domains in which Congress was permitted to legislate – though where it was assigned powers Congress was granted 'supremacy'. The powers of the States, meanwhile, were left plenary and untouched unless expressly indicated to the contrary. While it would seem a necessary implication of such an approach to the division of powers that those areas in which the national government is not granted a head of power remain within the exclusive domain of the States, nowhere in either the *United States Constitution* or the *Australian Constitution* was that made explicit. The restrictive nature of the enumerated powers and the plenary nature of the powers of the States in the *United States Constitution* were given textual recognition with the adoption of amendment X in 1791.<sup>4</sup> Section 51 of the *Australian Constitution* is a reasonably close analogue to article I(8), if somewhat longer; section 107 is a looser approximation to amendment X.

From very early on it became clear that the United States ('US') Congress could extend its legislative reach beyond the apparent limits of its assigned jurisdiction by means of the spending power – and that this would severely test the division of powers that lay at the heart of American federalism. No formal sanction for such an extension was provided in the text of the *United States Constitution* and a great deal was seen to hinge on the interpretation of the highly ambiguous opening phrase of article I(8).<sup>5</sup> One way in which Congress came to extend its legislative reach was to offer 'grants-in-aid' to State governments for defined purposes, which in general the Supreme Court held to be valid since they

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3 See further Alan Fenna, 'The Division of Powers in Australian Federalism' (2007) 2 *Public Policy* 175.

4 *United States Constitution* amend X: 'The powers not delegated to the United States by the *Constitution*, nor prohibited by it to the states, are reserved to the states respectively, or to the people.' As has been often noted, this begs the question of what is encompassed by those powers.

5 *United States Constitution* art I(8): 'The Congress shall have power to lay and collect taxes ... to pay the debts and provide for the common defence and general welfare of the United States'. In the Hamiltonian view this granted a power to spend in whatever way Congress deemed conducive to the general welfare; in the Madisonian or Jeffersonian view it meant to spend on the general welfare within the boundaries of the enumerated powers.

constituted ‘inducement’ rather than compulsion or ‘coercion’.<sup>6</sup> In Canada, the Judicial Committee of the Privy Council (‘JCPC’) declared in the 1930s that Parliament could not introduce a spending program that ‘in pith and substance ... encroaches upon the provincial field’.<sup>7</sup> Assisting in the expansive interpretation of the spending power in the US was the absence of any enumerated State powers. However, even in Canada, where provincial powers have greater constitutional anchor, a permissive approach eventually prevailed. Ultimately this reflected popular demand. Indeed, it has been said that ‘English-speaking Canadians tend to view the federal spending power as the source of highly valued “national” social programs’.<sup>8</sup>

While in many regards following closely US federal design, the Founders of the *Australian Constitution* decidedly remedied the defect of having no explicit licence to spend in areas of State jurisdiction – if indeed a defect it was. Section 96, a section that has no equivalent in these other federal constitutions, was inserted at the last moment. According to Saunders, this was for reasons that are not entirely clear but which seem to have been connected with the desire of the financially weaker States to facilitate subsidies from the Commonwealth.<sup>9</sup> Section 96 gives the Commonwealth authority to make grants to the States ‘on such terms and conditions as the Parliament thinks fit’. This has two consequences. One is that unlike in the United States and Canada, no scope exists for judicial doubts about the constitutionality of national spending programs that impinge upon sub-national jurisdictions. This was the High Court’s message in its bemusingly terse judgement in *Victoria v Commonwealth*.<sup>10</sup> The other is that the spending power can be used as a much more punitive and coercive instrument to deny the States access to one of their core powers, as it was in the 1942 Uniform Tax legislation<sup>11</sup> – an action that likewise has no parallel overseas.<sup>12</sup> Following American trends, Latham CJ

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6 Conditionality was upheld by the US Supreme Court in *Steward Machine Co v Davis, Collector of Internal Revenue* (1937) 301 US 548, 580–90 on the grounds that ‘to hold that motive or temptation is equivalent to coercion is to plunge the law in endless difficulties. The outcome of such a doctrine is the acceptance of a philosophical determinism by which choice becomes impossible.’ Enforcement of conditionality was upheld in *South Dakota v Dole*, 483 US 203 (1987) with two dissenters arguing that stipulated conditions ‘must be reasonably related to the purpose of the expenditure’ – which in this matter they held were not to be.

7 *Attorney-General for Canada v Attorney-General for Ontario* (1937) AC 355.

8 Hamish Telford, ‘The Federal Spending Power in Canada: Nation-Building or Nation-Destroying?’ (2003) 33 *Publius: The Journal of Federalism* 23, 23.

9 Cheryl Saunders, ‘The Hardest Nut to Crack: The Financial Settlement in the Commonwealth Constitution’ in Greg Craven (ed), *The Convention Debates 1891–98: Commentaries, Indices and Guide* (1986) 149, 171.

10 (1926) 38 CLR 399 (‘*Roads Case*’). In this case the constitutionality of the *Federal Aid Roads Act 1926* (Cth) was challenged.

11 The suite of legislation comprised: *States Grants (Income Tax Reimbursement) Act 1942* (Cth); *Income Tax (War-time Arrangements) Act 1942* (Cth); *Income Tax Assessment Act 1942* (Cth); *Income Tax Act 1942* (Cth).

12 The legislation was upheld by the High Court in *South Australia v Commonwealth* (1942) 65 CLR 373 (‘*First Uniform Tax Case*’). The key piece of legislation in this ‘scheme’ was the *States Grants (Income Tax Reimbursement) Act 1942* (Cth).

declared that tied grants should be seen as merely instruments of inducement rather than coercion. Moreover, he declared, inducement can as legitimately be directed at expelling the States from a jurisdiction as it can be at eliciting action: 'The Commonwealth may properly induce a State to exercise its powers ... by offering a money grant. So also the Commonwealth may properly induce a State by the same means to abstain from exercising its powers.'<sup>13</sup>

In all three of the Anglo federations, then, the idea of a division of powers with each level enjoying its own autonomous domain in addition to areas of concurrent jurisdiction gave way to a reality in which the national government continued to enjoy its exclusive jurisdiction and the States largely had to relinquish theirs. This suggests that Fullagar J was making an important point when, in *Victoria v Commonwealth*,<sup>14</sup> he declared that section 96 might well constitute a redundant surety for the Commonwealth: 'Even if the reference to terms and conditions had been omitted, it would not, I think, have been easy to maintain that the Commonwealth could not impose conditions on the making of a grant to a State.'<sup>15</sup> However, the fact that conditional grants have not been used in the US or Canada for a purpose so inimical to federalism as excluding the States from their most important tax base suggests that section 96 does enhance the Commonwealth's powers in this respect. This is what Fullagar J might be read as implying when he went on to say, '[b]ut it is expressly provided that conditions may be imposed, and I can see no real reason for limiting in any way the nature of the conditions which may be imposed'.<sup>16</sup> Without the High Court reversing the interpretive doctrine of legalism that has prevailed since *Amalgamated Society of Engineers v Adelaide Steamship Co Ltd*<sup>17</sup> and embarking on a radically revisionist interpretation of the *Constitution* along federalist lines, it is difficult to see any constitutional limits to the spending power in Australia.

In taking the path of inducement – even if such inducements amount to the proverbial offer one cannot refuse – the Commonwealth is operating in at least a formal sense within the boundaries of federalism. However, as the High Court confirmed in *Victoria v Commonwealth and Hayden*,<sup>18</sup> it does not need to do even this: grants can be paid directly to recipient organisations operating in areas of State jurisdiction, bypassing the State governments altogether. There is, in addition, a middle ground: a subset of tied grants that do not pretend to be inducements, grants that go 'through' the States to designated beneficiaries. The Commonwealth directs grants to local governments and to private schools through the State governments. It likewise moved in the early 1990s from providing grants to the States for universities to funding them directly and describing that funding as grants through the States.

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13 *First Uniform Tax Case* (1942) 65 CLR 373, 417.

14 (1957) 99 CLR 575 ('*Second Uniform Tax Case*').

15 *Ibid* 656.

16 *Ibid*.

17 (1920) 28 CLR 129 ('*Engineers' Case*').

18 (1975) 134 CLR 338 ('*AAP Case*').

### III THE REASON FOR TIED GRANTS

If the foregoing discussion of constitutionality answers the question ‘*how* do tied grants exist?’ the next question has to be ‘*why* do they exist?’. The answer lies in the nature of the classic or ‘first generation’ federations<sup>19</sup> and the adaptations they have made to modern industrial society.<sup>20</sup> The question really has two parts, though. The first one is why does VFI exist – why does the Commonwealth have such revenue excess and the States such a revenue deficit? The second is why central governments in general, and the Commonwealth government in particular, make use of their surplus in the way they do?

#### A Fiscal Imbalance and Modern Federalism

VFI, it must first be acknowledged, is an endemic tendency in federal systems of the Australian type and in that sense Australia is an instance of a wider phenomenon. But it is not a typical instance. As numerous commentators have noted,<sup>21</sup> VFI is more extreme in Australia than in other federations – and in this sense Australia is, if not *sui generis*, certainly distinctive. This needs explaining. In accordance with the approach Australia followed to the division of powers – the approach of ‘legislative federalism’<sup>22</sup> – the two levels of government were assigned parallel taxing capacities. This contrasts with the German approach of requiring that the revenue from the main tax bases shall be shared between the levels of government in stipulated proportions.<sup>23</sup> Taking the approach of legislative federalism created an inbuilt tendency to conflict over resources. Given that one of the main reasons for otherwise autonomous political entities to federate was to maximise strategic clout,<sup>24</sup> central governments in such systems have typically been assigned a broad, indeed perhaps plenary, power to tax – as the Commonwealth was in section 51(ii) of the *Constitution*. In the words of one delegate to the Constitutional Conventions, in a time of dire threat it may be necessary ‘to spend our last shilling or to sacrifice our last man in our own defence ... It is utterly impossible in a federal form of government to attempt to

19 In chronological order, the United States, Switzerland, Canada and Australia, which were formed prior to the 20<sup>th</sup> century transformation in the role of government: Thomas Fleiner-Gerster, ‘Federalism in Australia and in Other Nations’ in Greg Craven (ed), *Australian Federalism: Towards the Second Century* (1992) 14.

20 See Alan Fenna, ‘The Malaise of Federalism: Comparative Reflections on Commonwealth–State Relations’ (2007) 66 *Australian Journal of Public Administration* 298.

21 Most recently, Neil Warren in his comprehensive examination of Australian fiscal federalism, *Benchmarking Australia’s Intergovernmental Fiscal Arrangements – Final Report* (2006) 82 <[www.treasury.nsw.gov.au/\\_data/assets/pdf\\_file/0006/5793/fin-bench-rep.pdf](http://www.treasury.nsw.gov.au/_data/assets/pdf_file/0006/5793/fin-bench-rep.pdf)> at 10 August 2008.

22 See Thomas O Hueglin and Alan Fenna, *Comparative Federalism: a Systematic Inquiry* (2006) 146, *passim*.

23 See *Fundamental Law for the Federal Republic of Germany* [trans of: *Grundgesetz für die Bundesrepublik Deutschland*], art 106(3) (inserted by amendment in 1958).

24 Indeed, the only real reason according Riker: William H Riker, ‘Federalism’ in Fred I Greenstein and Nelson W Polsby (eds), *Handbook of Political Science: volume 5, Government Institutions and Processes* (1975) 93, 116.

limit the power of taxation in any way whatever'.<sup>25</sup> This was, of course, hardly correct since limitations could easily be subject to a constitutional override clause such as defence or emergency powers; however, it was a normal perception.

Unfettered tax power has certainly helped the cause of centralisation, but it would not have brought about centralisation on its own. This has resulted from political and economic realities. Among those has been the natural upward migration of taxing responsibility, as explained by the theory of fiscal federalism. Public finance economics emphasises the problems facing sub-national jurisdictions in levying taxes on mobile factors of production. Sub-national jurisdictions are constrained in their ability to levy either corporate income taxes or progressive personal income taxes by the ready availability of an exit option for businesses and higher income individuals.<sup>26</sup> In the US, where many of the States do levy their own income taxes, those are generally flat rather than progressive in structure, consistent with such predictions.<sup>27</sup> Similarly, there are reasons to think that in Australia the States fail to exploit one of the better taxes they control, payroll tax, as fully as they could or should. This systemic pressure to under-tax at the sub-national level is compounded by the interest that economically less-advantaged regions have in drawing upon the common pool rather than on their own meagre resources. There has thus been a centralising dynamic on the revenue side, tied to centralising forces on the expenditure side with demand for redistributive social programs financed from progressive taxation.

The public finance literature is replete with reasons why central governments have ended up with a disproportionate share of tax revenues. Contributors to that tradition have also been broadly in agreement that beyond a certain point the resulting state of affairs is undesirable. The prevailing view has been that if governments rely extensively on revenue they are not responsible for raising, then they will not be in a position to 'tailor the supply of public goods to local citizens' preferences and willingness to pay'.<sup>28</sup> Economists have often expressed concern that a 'fiscal illusion' created by spending someone else's money may foster profligacy and encourage an overdevelopment of the States' social service provision. Other, more practical, objections have been noted. One is that mendicant status leads sub-national governments to fossick for own-source revenues in economically inefficient or socially undesirable ways. One suggestion has been that in the 1980s the State governments were led, because of chronic revenue shortfalls, to drain revenue from their public utilities that should

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25 Richard Baker (1891) quoted by James Crawford, 'The Legislative Power of the Commonwealth' in Craven (ed), above n 9, 113, 120.

26 Wallace E Oates, *Fiscal Federalism* (1972). See also Richard A Musgrave, 'Devolution, Grants and Fiscal Competition' (1997) 11 *Journal of Economic Perspectives* 65, 67.

27 Martin Feldstein and Marian Vaillant Wrobel, 'Can State Taxes Redistribute Income?' (1998) 68 *Journal of Public Economics* 369.

28 Isabelle Jourard and Per Mathis Kongsrud, *Fiscal Relations across Government Levels* (2003) 161. See also Russell Mathews, *Revenue Sharing in Federal Systems* (1980) 16.

have been re-invested in their capital stock.<sup>29</sup> Likewise, State governments may be more favourably disposed to the gambling industry than they might otherwise have been.<sup>30</sup> Another of the practical objections to VFI is that it leaves State budgets heavily dependent on payments that may be unilaterally reduced at any time to meet the evolving fiscal priorities of the national government. This vulnerability seemed to be very much in evidence in the 1980s, when payments to the States were ‘drastically’ reduced to fund the Commonwealth’s deficit elimination program in the Hawke–Keating years, with lasting damage arguably done to provision of social and physical infrastructure across the country.<sup>31</sup>

## B Fiscal Imbalance and Australian Federalism

The general tendency towards VFI does not, of course, mean that national experiences or outcomes will be the same. In Australia, the State and local governments together control only 18 per cent of total tax revenue and the Commonwealth controls the remaining 82 per cent.<sup>32</sup> In Canada, by contrast, the central government commands only 45 per cent of the total tax revenue. The difference is substantial. One does not have to look very hard to see what lies behind these differences: in both Canada and the US, sub-national jurisdictions can and typically do levy their own sales and incomes (corporate and personal) taxes while in Australia the three main tax bases are monopolised by the Commonwealth. This is not a consequence of fiscal necessity: tax specialists agree that sales taxes suffer little from inter-jurisdictional mobility pressures and are thus well-suited to sub-national control.<sup>33</sup> It is also the case that the income tax base can be shared through a piggy-backing arrangement in the Canadian vein – as was mooted briefly in Australia in the early 1990s.<sup>34</sup>

### 1 *The Sales Tax Prohibition and the GST*

Australia’s atypical degree of VFI is a consequence of constitutional and political history. The Founders were not entirely unaware of the problem they were creating. Establishing the single market meant transferring the colonies’

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29 Cliff Walsh, ‘Vertical Fiscal Imbalance: the issues’ in David John Collins (ed), *Vertical Fiscal Imbalance and the Allocation of Taxing Powers* (1993) 31.

30 John M Williams, “‘Come in Spinner’: Section 90 of the *Constitution* and the Future of State Government Finances’ (1999) 21 *Sydney Law Review* 627.

31 Russell Mathews and Bhajan Grewal, *The Public Sector in Jeopardy: Australian Fiscal Federalism from Whitlam to Keating* (1997) 529, 532:

The Commonwealth was in the fortunate position of being able to reduce government spending while leaving the States to incur the political blame for the consequential decline in services ... the fall in payments to the States ... not only permitted the Commonwealth to significantly reduce its total outlays as a proportion of GDP, but also funded substantially increased spending on the Commonwealth’s own constitutional responsibilities, notably benefit payments to individuals and families.

The same occurred in the mid-1990s in Canada.

32 Commonwealth Treasury, above n 1, 291.

33 See, eg, Jeffrey Petchey and Perry Shapiro, ‘An Economist’s View of Section 90’ in Neil Warren (ed), *Reshaping Fiscal Federalism in Australia* (1997) 41, 49.

34 Mathews and Grewal, above n 31, 555.

most important revenue source – customs tariffs – to the Commonwealth and, in the absence of an equivalent transfer of responsibilities, the Commonwealth would be left with a large surplus and the States an equivalent deficit. However, it would seem that the Founders were oblivious to quite how complete a financial discrepancy might ensue, notably by electing to insert a gratuitous requirement in section 90 that not only customs tariffs but also ‘excise’ would be exclusive to the Commonwealth. As Saunders has noted, delegates gave confused reasons for thinking that such an augmentation was necessary, desirable or advisable.<sup>35</sup> It was certainly not a formula operational in any other federal system. Admittedly, the Founders cannot be held responsible for the perversely expansive way in which the High Court has interpreted the concept of excise, rendering it synonymous with sales tax.<sup>36</sup> However, one might reasonably have expected some adherence to the precautionary principle when setting down justiciable rules in as important a document as a constitution.

The section 90 prohibition has contributed not just to an under-resourcing of the States, but to an underdevelopment of consumption taxes in Australia in general. With the commencement of the federal Goods and Services Tax (‘GST’) on 1 July 2000, these deficiencies were partially addressed. The net revenue of the GST is hypothecated by statute to the States and Territories, superseding the annually budgeted Financial Assistance Grants (‘FAGs’).<sup>37</sup> This has represented a not inconsiderable improvement for the States in practical revenue terms, but could be said to have simultaneously made them even more dependent on the Commonwealth. As one critic has characterised the situation, the GST has enhanced their budgetary capacity while reducing their fiscal capability.<sup>38</sup> Even in straight capacity terms, though, the GST has been something of a disappointment for the States. By the time GST revenues were flowing in a healthy way, the Commonwealth was starting to enjoy the much greater windfall created by income tax gains related to the resources boom. Relative to those, the GST bonus seemed pedestrian. Those windfall revenues in turn have funded capital reserves – ‘future funds’ – available to be spent by the Commonwealth on yet more projects in areas of State jurisdiction. Critics also note that although the GST was legislated following a formal ‘deal’ with the States, first enshrined in the 1999 Intergovernmental Agreement on Commonwealth–State Financial Relations and then in the legislation implementing the GST,<sup>39</sup> it is Commonwealth legislation, amendable at any time by the federal Parliament.

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35 Saunders, above n 9, 158.

36 See Chris Caleo, ‘Section 90 and Excise Duties: a Crisis of Interpretation’ (1987) 16 *Melbourne University Law Review* 296.

37 *A New Tax System (Goods and Services Tax) Act 1999* (Cth) s 1.3; *A New Tax System (Commonwealth–State Financial Arrangements) Act 1999* (Cth).

38 As argued, for instance, by David Hamill, *The Impact of the New Tax System on Australian Federalism* (2006) 150.

39 *A New Tax System (Goods and Services Tax) Act 1999* (Cth) s 1.3; *A New Tax System (Commonwealth–State Financial Arrangements) Act 1999* (Cth).



## 2 *The 'Surplus Revenue' Delusion*

The Founders were also by all accounts oblivious to the leverage this revenue imbalance might provide for the Commonwealth in the federal system. The dominant assumption was that the surplus would be handed straight back and the vexed question was what formula would be used to allocate shares to the respective States. In Zines' words, '[t]he Commonwealth was thus seen by many [of the Founders] as a revenue collecting agent for the States'.<sup>40</sup> Taken together, sections 87 – the 'Braddon clause' – and 94 would seem to embody this intent; however, they do not succeed in doing so in a binding way. Section 87 – effectively now a spent clause – required the Commonwealth to return all but one quarter of its customs and excise revenue to the States for 10 years. Section 94 permits, or perhaps enjoins, the Commonwealth to limit itself to that share in perpetuity. This is a curiously redundant and insipid clause for a constitution to contain – whichever of those constructions one leans towards – since express constitutional licence for such a course of action is scarcely necessary and no express requirement is transmitted.<sup>41</sup>

## 3 *Money Without Power?*

Finally, and most extraordinarily of all, the Founders seem to have been oblivious to the naked power placed in the hands of the Commonwealth by section 96. Again, it is also the case that the High Court elected to interpret section 96 in a way sufficiently broad to encompass its coercive use to dictate which of their powers the States might or might not exercise and that this was not intended or indeed even envisaged by the Founders. Nonetheless, it was surely a conceivable outcome. In all these regards, the blithe disregard of the Founders seemed to have arisen out of the prevailing assumption that the Commonwealth's list of enumerated powers would function as a limiting list and thus the Commonwealth would have only that finite range of functions on which it could legitimately spend.<sup>42</sup>

## C Tied Grants and Modern Federalism

Of course the central government's surplus revenue could simply be returned to the sub-national jurisdictions – presumably on an equalising basis – with the national government acting as little more than a tax collection service, just as the Founders envisaged. Indeed, this is what for a good part of Australian history the Commonwealth has done with the bulk of its grants to the States. General purpose payments are those intergovernmental transfers that have no policy or

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40 Leslie Zines, 'The Federal Balance and the Position of the States' in Craven (ed), above n 9, 75, 78.

41 While acknowledging that s 94 speaks in what he called 'facultative rather than mandatory terms', Barwick CJ put forward a strong interpretation of the clause grounded in federalist norms in his dissenting opinion in the *AAP Case* (1975) 134 CLR 338, 359.

42 Saunders, above n 9, 165–6.

program conditions attached and simply supplement recipient general revenue.<sup>43</sup> For several years after the Commonwealth took over the income tax, these were styled ‘reimbursement grants’ – implicit acknowledgement that the funds at issue were State moneys – but that was eventually changed to FAGs, a term that carried an entirely different connotation. In addition, the Commonwealth surplus now provides the fiscal foundation for an extensive program of conditional transfers or Specific Purpose Payments. This was initiated with the *Main Roads Development Act 1923* (Cth) (*‘Main Roads Act’*)<sup>44</sup> and took on its current character under the Whitlam Government in the early 1970s.

The main reason for the extensive use of conditional grants in the first generation federations is that these federations were designed around a pre-industrial division of powers where most, if not all, social policy responsibilities, along with environmental and business regulation, were left to the sub-national jurisdictions. Such a division of powers corresponded to the social and economic circumstances of the time, but not to those of the 20<sup>th</sup> century. Considerable adjustment tensions occurred in the middle decades of the 20<sup>th</sup> century, leading in some cases to constitutional amendment, but also leading to the extensive use of transfers to instigate and fund new national policies and programs in areas of sub-national jurisdiction. In Australia this use of tied grants to build the modern welfare state accelerated later than elsewhere because of the retarding effect of Labor being kept out of national office until 1972. Under the Whitlam Government tied grants became a preferred mode of circumventing the constitutional obstacles to growth of the national regulatory and redistributive state that had long chafed for the Labor Party.

This endemic need for transfers of a directed kind has long been recognised in the fiscal federalism literature. When Mancur Olson outlined his principle of ‘fiscal equivalence’ in 1969 – the principle that each level of government should be responsible for the provision of those collective goods whose boundaries most closely approximated theirs – he concluded that the much criticised system of intergovernmental grants in the US was a ‘needed’ element in adjusting for the rarity of a perfect fit.<sup>45</sup> Contrary to a widespread assumption, the principle of fiscal equivalence does not entail, let alone require, that each level of government be self-financing;<sup>46</sup> indeed, it assumes some necessary degree of VFI. Directive grants serve a two-fold function in this view. They fund sub-national governments to deliver services those governments would otherwise undersupply because of externalities problems – too much of the resulting benefit would spill

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43 This is not to say that they do not have conditions at all, since under the *State Grants Act 1942* (Cth) even the general purpose payments were made conditional on the States refraining from levying their own income taxes.

44 Superseded by the *Federal Aid Roads Act 1926* (Cth): Geoffrey Sawer, *Australian Federal Politics and Law 1901–1929* (1956) 266.

45 Mancur Olson, ‘The Principle of “Fiscal Equivalence”: The Division of Responsibilities among Different Levels of Government’ (1969) 59 *American Economic Review* 479. See also Wallace E Oates, ‘The Theory of Public Finance in a Federal System’ (1968) 1 *Canadian Journal of Economics* 37, 51.

46 See, eg, Productivity Commission, ‘Productive Reform in a Federal System’ in *Annual Report 2004–05* (2005) 1, 4.

over the jurisdictions' boundaries for any individual community to justify the full expense. And they fund sub-national jurisdictions to bring their services up to a 'national standard'.<sup>47</sup> That there is an economic rationale for VFI and directive grants does not mean, however, that the existing grant programs in the real world of federal systems can actually be justified on those grounds. Indeed, the broad conclusion seems to be that these grant programs of the real world go well beyond what the criteria would justify.<sup>48</sup>

#### IV THE BUSINESS OF TIED GRANTS

From the beginning, the purpose of tied grants was to 'induce', in Latham's words, a specific policy action from the recipients. Thus, the key condition was that the moneys be spent on provision of a specified good or service. The problem here for the granting government is the fungibility of money: one dollar is entirely substitutable for any other dollar. Thus, the primary challenge is to ensure that a particular grant does indeed have the net effect it was intended to have. This is not so difficult if it is being directed toward an activity that is currently receiving no funding from the recipient government. If, however, as is often the case, it represents an addition to existing expenditures or programs, there is always the potential for the recipient government to shift some of its existing expenditure away to another purpose and thus undermine the policy intent of the grant. For this reason, one of the most characteristic augmenting forms of conditionality is either 'maintenance of effort' or 'matched funds' – both mechanisms to ensure net effect. Australia's first SPP program, that legislated by the *Main Roads Act*, was of this nature: providing equal shares matched funding.<sup>49</sup> If, as the fiscal federalism literature suggests, grants are to boost local spending on services that would otherwise be undersupplied, then this is an essential condition.

In many cases the purposes of a particular grant are not so much to increase the level at which an activity takes place as to shape the way it occurs; it is about achieving policy design goals in areas of sub-national jurisdiction. At the extreme, tied grants provide the means for introducing large-scale policy innovations. Thus, in Canada tied grants were the means by which the Provinces were brought on board for the establishment of Medicare, the national universal health insurance scheme, in 1966 – one of the most important policy moments in Canadian history and still today a major focus of spending power politics. They remain the mechanism through which the integrity of the Canadian Medicare system is maintained.<sup>50</sup> In Australia, tied grants were instrumental in bringing the

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47 Wallace E Oates, 'An Essay on Fiscal Federalism' (1999) 37 *Journal of Economic Literature* 1120.

48 Oates, 'The Theory of Public Finance in a Federal System', above n 45; Joumard and Kongsrud, above n 28, 194.

49 Russell L Mathews and W R C Jay, *Federal Finance: Intergovernmental Financial Relations in Australia since Federation* (1972) 128. While equal shares are archetypal, various other ratios have been used and in the case of roads, the required State contribution was soon reduced below 50 per cent.

50 As required by the *Canada Health Act*, RSC 1985, c C-6.

States onboard for a national policy of free public hospital care with the *Hospital Benefits Act 1945* (Cth). Currently, the bilateral Australian Health Care Agreements 2003–08 between the Commonwealth and the individual States carry several conditions. Signatory States are required to provide free service ‘to the community’ at public hospitals; they are required to increase their own funding at a rate matching the increase in Commonwealth funding; they are required to meet performance targets and provide performance reporting; and they are required to provide stipulated patient entitlements.

Tied grants have become, since they were ratcheted up by the Whitlam Government in the early 1970s, a dominant feature of Australian federalism. There have been periods in recent times when they accounted for half of all intergovernmental transfers and a quarter of all State spending. Their proportion slipped back with the introduction of the GST, but they still made up over 40 per cent of the Commonwealth’s transfers in 2008–09. They are used in a large number of policy fields and collectively they impose a wide range of conditions. Because of this, and because Australia represents an extreme case of the VFI that underpins SPPs, it can appear that Australia is also an extreme case of centralisation through tied grants. However, here one needs to be cautious. In the US, VFI is indeed less acute and thus Congress has proportionally less fiscal capacity to employ for inducement purposes. However, it compensates for this by using its fiscal capacity much more energetically. If 40 per cent sounds high in Australia, it pales in comparison with the more than 80 per cent of transfers that are conditional (‘categorical’) in the US. Moreover, Congress imposes conditions that go well beyond those found in Australia. So-called ‘cross-cutting sanctions’ build requirements into one grant that may apply across the entire public sector of a recipient government while ‘cross-over sanctions’ use one grant to impose conditions on other grant programs. In addition, there is the controversial problem of ‘unfunded mandates’. These impose policy requirements on sub-national governments without providing accompanying financial assistance – tied grants without the grants, as it were.

## V THE PROBLEM WITH TIED GRANTS

Probably most emblematic of the lengths to which tied grants could go in recent times was the Howard Government’s school flagpole policy of 2004, which provided education funding to the States conditional upon each school having a ‘functioning flagpole and flying the Australian flag’.<sup>51</sup> Aside from authority to grant ‘benefits to students’ provided in the 1946 social services amendment,<sup>52</sup> education lies within exclusive State jurisdiction. This recent

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51 See the *Australian Government Programmes for Schools Quadrennial Administrative Guidelines 2005–2008* <[http://www.dest.gov.au/sectors/school\\_education/programmes\\_funding/forms\\_guidelines/quadguide/schools\\_quadrennial\\_administrative\\_guidelines\\_2005\\_to\\_2008.htm](http://www.dest.gov.au/sectors/school_education/programmes_funding/forms_guidelines/quadguide/schools_quadrennial_administrative_guidelines_2005_to_2008.htm)> at 10 August 2008.

52 That is, s 51(xxiiiA), which grants Parliament authority to legislate for:

example is of course an insignificant example of the extensive and growing way in which the Commonwealth uses its financial resources to exercise authority in the area of education. What it draws attention to, though, is the capacity the spending power gives Commonwealth governments for imposition of their particular values or policy priorities at the time. On a much more substantive level, tied grants were used as a vehicle for the Commonwealth to assume a key role in supporting non-government schools, for Commonwealth takeover of the university sector and, more recently, for establishing curriculum and evaluation standards in primary and secondary schools across the country.

That this great expansion of the Commonwealth's policy-making reach through tied grants has occurred is not in doubt. What is open to question is whether it is a good thing or a bad thing. Tied grants have been regularly and extensively criticised, with that criticism falling into either of two categories. In one, tied grants are problematic for their very existence. They contravene federal norms by violating the division of powers and imposing centralised decisions in areas lying within the jurisdiction of the States; by doing that, so the argument goes, tied grants – like any other instrument of centralisation – compromise the ability of a federal system to deliver its potential advantages. In the other category, tied grants are problematic because of the governmental entanglement and inefficiency they create quite separately from the issue of whether the domain is properly a national or a local one.

### **A Tied Grants and the Erosion of Federalism**

Category one criticism raises fundamental questions about federalism as a mode of governmental organisation in a modern society. In the Australian context those questions are sharpened considerably by the unusually low degree of underlying sociological difference justifying and sustaining constitutional federalism. To object to tied grants because they violate the division of powers or usurp the role of the States is to beg the question whether the inherited division of powers is optimal or suitable and whether the States are in the best position to direct policy in those areas. One answer to that question is that while it is undeniably the case that an expanding Commonwealth role is addressing deficiencies in the inherited division of power in a number of areas, the unlimited capacity of the Commonwealth to intervene in areas of State jurisdiction means that it does so without establishing such a case. The spending power is an invitation to 'opportunistic federalism', where intervention occurs for electoral expediency or ideological desire and does not correspond to the sort of justifications articulated by the theory of fiscal federalism. Mathews and Jay argue that this was precisely the case with the very first of Australia's tied grants, the road funding programs of the 1920s. The theory of fiscal federalism would argue that there is a place of tied grants in such an area of sub-national

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The provision of maternity allowances, widows' pensions, child endowment, unemployment, pharmaceutical, sickness and hospital benefits, medical and dental services (but not so as to authorize any form of civil conscription), benefits to students and family allowances.

jurisdiction because externalities problems will otherwise lead to cross-jurisdictional transport networks being under-funded. The American interstate highway system would exemplify such reasoning. According to Mathews and Jay, though, that is not what happened in Australia, where Commonwealth road funding was directed in the opposite direction, to rural roads prioritised by the Country Party.<sup>53</sup>

Answers to the sort of questions being posed here depend to a considerable extent on one's disposition toward federalism and view of its intrinsic value and practical possibilities. If federalism is seen as being capable of delivering the kind of democratic and policy benefits its proponents laud it for,<sup>54</sup> there is every reason to prefer the inherited division of powers and look suspiciously on any centralising initiatives. Unless the States retain genuine policy autonomy the system cannot be expected to deliver those benefits.

## **B Governmental Deficiencies of Tied Grants**

Category two criticisms focus on the practical implications of tied grants. From this point of view, there are a number of costs that flow from an arrangement where one party, the principal, seeks to induce behaviour or sets of behaviour from a second party, the agent. It inevitably engenders some wastefulness, since the principal must invest resources in managing the agent. It means that the agent must invest resources in ensuring conformity and reporting on conformity to the principal. It means that the agent in turn must invest own-source resources in ways required by the principal or effort in evading the principal's requirements. It means that the agent might focus on executing the required actions (investing the required inputs, generating the required outputs) rather than on producing the most desired outcomes. It means that principal and agent can displace responsibility for failures onto the other. All these and more have been identified by a legion of critics<sup>55</sup> as bedevilling the practice of tied grants in Australia.

It must be acknowledged that not all the alleged deficiencies of intergovernmental policy entanglement in Australia can be sheeted home to tied grants. The single largest SPP program is the Commonwealth's subsidisation of the public hospital system and no discussion of SPPs is ever complete without highlighting the irrationalities of Australia's health system. Here, though, the reality is that the problem is not one intrinsic to SPPs – as prominent as they are in the area. Criticisms of Australia's health arrangements focus first and foremost on so-called 'cost shifting' and related irrationalities of health service provision that result from the fact that the two main divisions of the health care system are

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53 Mathews and Jay, above n 49, 227.

54 As, for instance, canvassed in Anne Twomey and Glenn Withers, *Federalist Paper 1 – Australia's Federal Future*, Report for the Council for the Australian Federation (2007).

55 See Joint Committee of Public Accounts, Parliament of Australia, *The Administration of Specific Purpose Payments: A Focus on Outcomes* (1995); Ross Garnaut and Vince Fitzgerald, *Review of Commonwealth–State Funding: Final Report* (2002); Allen Consulting Group, *Governments Working Together? Assessing Specific Purpose Payments* (2006).

operated separately by the two levels of government. Although in part funded by the Commonwealth, public hospitals are operated by the States. Meanwhile, under Medicare, physician services are funded by the Commonwealth, as increasingly is the provision of aged care. It is thus not the fact of tied grants that is the problem in this area; rather, it is the way that responsibility for health care is divided between the two levels of government.

## VI THE BENEFITS OF TIED GRANTS

Tied grants have their defenders. One defence is that they do serve important national purposes and are less coercive than at face value they might appear to be. In other words, they address constitutional deficiencies without negating federalism. The other is that they actually enhance federalism by offering citizens greater policy choice and political leverage: the very overlap and duplication they represent is actually a benefit.

### A Tied Grants as Benign Corrective

In the first view, tied grants create room for manoeuvre in the context of an otherwise quite confining, pre-industrial, constitution; they enable national policies in areas where such policies have popular support. Health care might be taken as an example. Although the social services amendment provides strong constitutional grounds for Commonwealth action in the field, and while physician services through Medicare are provided directly by the Commonwealth, the public hospital systems of the States operate as such under the umbrella of an SPP. Concerns that tied grants may nonetheless be too directive can also be assuaged by reassurances that achieving the intended conformity with national policy frameworks is more difficult than might be thought. One reason for this has already been noted: the fact that one dollar can be substituted for another often leaves recipient governments considerable ‘wiggle room’. As has been argued in the American context, ‘because money is fungible, the amount of relief provided is far more important than the specific subject matter of the intervention’.<sup>56</sup>

There is likewise a strong tradition in Australian political science of downplaying the practical directive capacity of tied grants. One of the few books devoted to the study of Australian federalism, for instance, argued that because ‘state public servants are not likely to be hampered in the design and implementation of programs by an lack of jurisdiction’ and it is they who ‘teach in schools, run hospitals, and administer the vast majority of civil, criminal and administrative law’, the reality is that ‘the conditional grant ... is a blunt

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56 David Super, ‘Rethinking Fiscal Federalism’ (2005) 118 *Harvard Law Review* 2544, 2561. However, in Australia this is complicated by the interaction between SPPs and the equalisation system: see Neil Warren, ‘Reform of the Commonwealth Grants Commission: It’s All in the Detail’ (2008) 31(2) *University of New South Wales Law Journal* 530.

weapon'.<sup>57</sup> State governments have the capacity to design and implement broad and ambitious policy programs which the Commonwealth can only influence at the margins. Similarly, research into the Commonwealth–State Housing Agreement, a prominent SPP program that has run through successive iterations for many years, concluded that room for manoeuvre at the State level has been substantial:

Rarely has the Commonwealth imposed unacceptable conditions on a reluctant state through housing grants. The grant conditions have tended to be so broad and flexible to permit wide variation in implementation and, arguably, even degrees of non-compliance.<sup>58</sup>

At this stage, insufficient research exists to assess how broadly such an interpretation might apply.

## B Tied Grants as Enhancement

The other argument in favour of tied grants, as for other modes of centralisation, is that they facilitate a certain variant of competitive federalism. There is a school of economic thought that holds one of federalism's main virtues to be the jurisdictional rivalry it creates as sub-national governments compete against each other to please their residents and attract and retain investment.<sup>59</sup> This competition occurs 'horizontally' – that is, within the one sub-national level of government – and ultimately requires mobility of capital and labour between jurisdictions.<sup>60</sup> It is a dynamic, however, that privileges certain already privileged sectors of society – capital and high income earners – since they are more mobile and more in demand. An alternative version of this concept emphasises rivalry *between the levels of government*. In this notion of 'vertical' competition, national and sub-national governments compete against each other for the affections of their citizens; 'overlap and concurrency widen the opportunities for citizen-consumers to signal their preferences about their preferred mix of goods and services'.<sup>61</sup> Mobility is not required, merely voting power, and thus the main criticism of horizontal competition is neutralised. Such a contest can only take place if an extensive degree of jurisdictional overlap exists and tied grants are a

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57 Jean Holmes and Campbell Sharman, *The Australian Federal System* (1977) 125.

58 Andrew Parkin, 'Housing Policy' in Brian Galligan (ed), *Comparative State Policies* (1988) 249, 249.

59 Going back to Friedrich Hayek, 'The Economic Conditions of Interstate Federalism' in *Individualism and Economic Order* (1949).

60 Though in a milder form much of this competition can be seen as being of the 'yardstick' or 'benchmarking' type which does not require mobility and thus presumably does not privilege particular interests. See Pierre Salmon, 'Decentralization as an Incentive Scheme' (1987) 3 *Oxford Review of Economic Policy* 24; Pierre Salmon, 'Horizontal competition among governments' in Ehtisham Ahmad and Giorgio Brosio (eds), *Handbook of Fiscal Federalism* (2006) 61.

61 M H Sproule-Jones, *Public Choice and Federalism in Australia and Canada* (1975) 29. See further Albert Breton, *Competitive Governments: An Economic Theory of Politics and Public Finance* (1998) and 'Federalism and Decentralization: Ownership Rights and the Superiority of Federalism' (2000) 30 *Publius: The Journal of Federalism* 1. For Australian endorsement, see Jonathon Pincus, 'Productive Reform in a Federal System' and Cliff Walsh, 'Competitive Federalism: Wasteful or Welfare Enhancing?' in Productivity Commission, *Productive Reform in a Federal System: Roundtable Proceedings* (2006).



major vehicle for such overlap. Education provides a good example of this logic at work: where State governments might be failing their citizens in the provision of quality education – perhaps because their proximity makes them beholden to vested provider interests – the Commonwealth can intervene. The chief exponent of this view, Albert Breton, urges us to regard as mistaken the frequent refrain that modern federalism is encumbered with redundancy:

Vertical competition is ... usually accompanied by what, looking at it from the outside, appears to be duplication and overlap of responsibilities, though in reality, as in the marketplace, the competition is over near-substitutes, so that the duplication and the overlap are more apparent than real. What looks like duplication and overlap are, however, manifestations of actual vertical competition.<sup>62</sup>

There is something pleasantly reassuring about the view that one of modern federalism's most widely deplored failings is actually its strength. Suspicion naturally arises, though, that there is something Panglossian about such a happy interpretation. One problem with the argument is the idea that we are mistaking duplication for 'competition over near-substitutes', an argument that would seem to be falling into the common trap of seeing reliable analogies between market processes and governmental ones. In the private sector, whether firms offer exact substitutes or near substitutes for each other's products is immaterial: the 'duplication and overlap' is beneficial since it increases the competition that is the *sine qua non* of the market; it involves no entanglement between the provider entities; and, if competition is adequate, it cannot displace costs onto the consumer. Not so in the public sector, where two levels of government 'competing' in the same policy field with different programs ('near substitutes') are typically entangled (unavoidably so if it is through the mechanism of tied grants) and increase the cost to the taxpayer in proportion to the degree of duplication and overlap. Another problem is that there is no level playing field in this policy market: VFI means that the sub-national governments – which carry the burden of public expectations since they exercise *de jure* responsibility – may be failing to provide their residents with the desired level, quality, or type of service for reasons largely outside their control while the national government has the luxury with its superior financial resources and no formal responsibility of benevolently intervening in ad hoc fashion when and where it wants. This is compounded by the exit-over-voice problem identified by Hirschman. Freedom to defect to the external supplier (exit) may undermine processes of democratic political expression within their own jurisdiction (voice).<sup>63</sup> Finally, there is the problem that the greater the degree to which a federal system functions in terms of vertical competition, the more likely its ability to function in a federal manner will be compromised and other benefits of federalism minimised. Logically, we must expect the scope for horizontal and vertical competition to be inversely related since meaningful horizontal competition is predicated on substantial sub-

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62 Breton, 'Federalism and Decentralization', above n 61, 8.

63 Albert O Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations and States* (1970) 43.

national policy autonomy, with State governments fully responsible for policy failures and success.

## VII REFORMING TIED GRANTS

What is to be done? One possibility is to tackle the underlying problem of VFI. In a sense, this is the more structural solution and one implicit in the many criticisms of the gross fiscal disparity between the two levels of government in Australia. It is also implicit in the criticisms of the 1999 Intergovernmental Agreement on the Reform of Commonwealth–State Financial Relations which gave the States the GST but did nothing to restore some taxing power of their own. While understandable, this option confronts the stubborn reality that ‘arguments for decentralization apply more strongly on the expenditure side than on the tax side’.<sup>64</sup> Nonetheless, movement toward a Canadian-style set of taxation arrangements would reduce VFI noticeably. It is too late in the piece for State sales taxes to be practical; however, a share of the personal and perhaps corporate income tax is readily conceivable. What this suggests, though, is that the GST solution – where the Commonwealth serves as tax collector for the States, as originally envisaged by the Founders – is probably the satisficing solution. Criticisms of the GST as remedy for what ails Australian federalism miss the mark in that respect. Indeed, the suggestion that there is a double benefit to lifting the GST rate – reducing Australia’s over-reliance on income taxation and its excessive VFI in one stroke – deserves more of a hearing than it has received.<sup>65</sup>

It must be remembered that extensive use of tied grants does not require anything like the degree of VFI that currently exists; attacking that aspect of the issue, therefore, is unlikely in itself to be the answer. Less than half of the current transfers come in the form of SPPs, so there is ample room to reduce general purpose payments without touching tied grants. As the American case demonstrates, the same or greater effect can be achieved with a considerably lower degree of VFI. This points to reform of the tied grant practice itself. Overseas the solution has been the replacement of individual tied grants with more generic ‘block grants’. In the US, cycles of federal reform revolve around the conversion of highly specific and prescriptive categorical grants into block grants; north of the border most federal grants were rolled into the ‘Canada

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64 Robin Boadway, ‘Tax Assignment in the Canadian Federal System’ in Warren (ed), above n 33, 61, 85.

65 The suggestion is implicit in Twomey and Withers, above n 54, 49. Under the heading of ‘Reforming Federal–State Relations’, they write:

Serious tax reform would recognise that Australia overtaxes incomes and undertaxes spending compared to other OECD economies. Our overall tax take is at the lower end of industrial economies as a share of GDP but is strongly biased toward income tax sourcing. Both personal income taxes and corporate income taxes represent higher shares of public revenue in Australia than in most comparable countries.

Australia’s relatively light dependence on consumption taxes is also noted in Commonwealth Treasury, above n 1, 205.

Health and Social Transfer' in the mid-1990s.<sup>66</sup> This trend in the US has been interpreted as reflecting 'the transformation of states as a whole into policy and fiscal leaders'.<sup>67</sup> Block grants have many of the advantages of general purpose grants as far as devolving policy autonomy back to the sub-national jurisdictions is concerned.

Given the number of SPPs in Australia, the range of matters on which they focus, and the variety of conditions they impose, switching to block grants – 'broadbanding' – is the most obvious reform that could be achieved. Block funding minimises the input, the output and the outcomes' conditionality while leaving scope for broad national design standards, and leaves the States to be accountable to their own residents for their performance. Such an approach was recommended in the Garnaut–Fitzgerald report on Commonwealth–State funding commissioned by the governments of Western Australia, Victoria and New South Wales in 2001.<sup>68</sup> Although the message of that report was diluted considerably by its preoccupation with horizontal fiscal equalisation, the authors did identify many of the deficiencies of tied grants and proposed a major overhaul via broadbanding. The authors suggested that most of the 120 existing SPPs should be rolled into three 'national programs': health and aged care; education and training; and Indigenous community development. The Commonwealth would assume full responsibility for Indigenous policy while the States would have full responsibility for the other two. The idea would be to restore the sense that one level of government carries global responsibility for defined policy domains, something that was integral to Australian federalism as originally conceived:

The level of government with executive responsibility for administering and delivering a particular program would have the freedom to manage a single integrated program without interference from the other level of government and without input controls.<sup>69</sup>

Rationalisation of SPPs had also been sought by State and Commonwealth Treasuries, but it was not until a report commissioned by the Labor Party in 2007 arrived at the same conclusion that it began to look like this proposal to breathe life back into federalism might be more than wishful thinking.<sup>70</sup> Building its argument on the impeccably federal principle of subsidiarity, the ALP report advocated the elimination or broadbanding of SPPs that did not meet a 'national interest' test. With the election of the Rudd Labor Government in November 2007, these ideas became integral – surprisingly perhaps – to a concerted program of federal reform. The 2008–09 Commonwealth Budget announced plans to 'rationalise' the more than 90 existing SPPs into five new ones: health; early childhood education and schools; vocational education and training;

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66 Though the general approach was initiated in 1977 with the Established Program Financing arrangements and some disaggregation occurred from 2003.

67 Paul L Posner and Margaret Wrightson, 'Block Grants: a Perennial, but Unstable, Tool of Government' (1996) 26 *Publius: The Journal of Federalism* 87, 95.

68 Garnaut and Fitzgerald, above n 55.

69 Ibid 192.

70 Michael Keating et al, *A Framework to Guide the Future Development of Specific Purpose Payments* (2007).

disabilities; and housing.<sup>71</sup> Consistent with the rationale of broadbanding, the much resented ‘input’ controls are scheduled to disappear, leaving the States with the kind of autonomy to tailor and experiment with their own programs in a way traditionally associated with federalism. Of further benefit to the States as political systems is the commitment to replace agency-to-agency funding with global Treasury-to-Treasury agreements and correct the problem State politics face that the line departments are easily beguiled by their Canberra counterparts.<sup>72</sup>

There is, of course, a hitch – well, at least three of them actually. One is the ‘rigorous focus on the achievement of outcomes’, with the States being required to sign up to ‘a mutually-agreed Statement of Objectives and Outcomes’ for each of the new broadbanded SPPs and cooperate in a corresponding system of ‘performance reporting’. In a relatively benign version, this would be a form of centrally facilitated yardstick competition. In a less benign form, the Commonwealth would assume responsibility for rewarding and punishing States for their performances. The second hitch is that the old SPPs do not disappear; rather, they are reduced to an estimated 30 per cent of the total tied grant funding and are re-styled ‘National Performance Payments’. The third is that even if fully implemented, the reforms impose little constraint on the future use of the Commonwealth’s spending power. Tied grants may be pruned back, but there is little to stop them sprouting up afresh and little to arrest a return to the old ways. The American experience suggests that block grants offer no guarantees and are ‘vulnerable to recentralization, recategorization, and retrenchment’,<sup>73</sup> and there are strong centralising elements in the current federal reform agenda.<sup>74</sup>

## VIII CONCLUSION

Concerns have been expressed that Australian federalism as it currently operates is increasingly dysfunctional.<sup>75</sup> A major source of concern in such criticism is the pervasive policy entanglement that has resulted from the Commonwealth’s ability to engage or bypass the States using its substantial spending power. Neither VFI nor tied grants are peculiar to Australian federalism. From a theoretical point of view VFI is almost inevitable in modern federalism and tied grants have a justifiable role to play, particularly given the greatly changed realities that the classic federal systems now operate under.

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71 Commonwealth, *Budget Paper No 3: Australia’s Federal Relations 2008–09*.

72 Which, with some exaggeration, is what occurs according to Rolf Gerritsen, ‘Taxing Solutions: Continuing Conundrums in Australian Federalism’ in Ann Nevile (ed), *Policy Choices in a Globalized World* (2002) 71.

73 Posner and Wrightson, above n 67, 59.

74 See Geoff Anderson, ‘The Council of Australian Governments: A New Institution of Governance for Australia’s Conditional Federalism’ (2008) 31(2) *University of New South Wales Law Journal* 493.

75 Business Council of Australia, *Reshaping Australia’s Federation: a New Contract for Federal–State Relations* (2006) iv.

However, that does not mean that current practices are optimal. A case can certainly be made that if the disabilities of federalism are to be minimised and the benefits maximised, then both VFI and tied grants need to be kept to moderate levels – much more moderate than they are in Australia. Australian federalism is characterised by very high levels of VFI and extensive use of tied grants. The current reforms promise to correct that situation by broadbanding a good number of the existing programs. Effective reform would also include measures to reduce underlying VFI, lock in block grants, rationalise roles and responsibilities, and institutionalise restraints on the recrudescence of SPPs.