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A NOTE ON POLITICAL FACTORS IN FEDERAL FISCAL ARRANGEMENTS IN AUSTRALIA

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The Commonwealth Grants Commission represents a sophisticated institutional method of dealing with the problem of horizontal fiscal imbalances in Australia, which has managed to combine equity and efficiency considerations without untoward political bias. By contrast, the problem of vertical imbalance has been addressed by specific purpose payments, which are much more amenable to party political calculation, and can thus be employed to maximise electoral support. This note briefly reviews public finance and public choice models of intergovernmental grant determination and shows that a public choice perspective can shed at least some light on how party political factors may influence grants like specific purpose payments.

Introduction

In common with all federal systems of government, the Australian Commonwealth is characterised by fiscal imbalance. In the context of a federation, it is possible to identify two kinds of fiscal imbalances. Firstly, vertical fiscal imbalances arise because different levels of government have differing capacities to raise revenues to finance expenditure. And secondly, horizontal fiscal imbalances occur since the various states which comprise a federation experience divergent costs in the provision of public goods and do not have equivalent revenue-raising capacities. Various institutional responses have been developed to deal with the problems posed by fiscal imbalances, involving either tax-sharing arrangements or fiscal equalisation schemes. Whilst most federal countries have pursued formal or informal tax-sharing arrangements between different levels of government, Australia has established a policy of horizontal fiscal equalisation. Indeed, it has been cogently argued that "Australia has developed the most comprehensive, effective and equitable system of fiscal equalisation in the world" (Matthews 1994, p. 16).

Fiscal equalisation is carried out by the Commonwealth Grants Commission (CGC) and various state-local grants commissions in accordance with the so-called principle of fiscal equalisation. This principle holds that (CGC 1990, p. 5):

> ...each State is entitled to receive a level of general revenue funding from the Commonwealth which would enable it to provide, without having to impose taxes and charges at levels appreciably higher than the levels imposed by the other states, government services at standards which are not appreciably different from the standards provided by the other states.

The implementation of this principle involves a per capita comparison of summated "standardised expenditure" (or weighted averages of all the categories of recurrent services provided by subnational governments) less any specific purpose payments (SPPs) which may have been paid with aggregated "standardised revenues" (or the revenue raising capacities of the subnational governments). The formula below summarises the nature of the calculation:

$$\frac{\sum(\text{standardised expenditures - SPPs}) - \sum(\text{standardised revenues})}{\text{population}}$$

The outcome of this process, referred to as the "standardised budget deficit", provides an assessment of the relative needs of different states for Commonwealth financial assistance. Table 1 below shows the results of this process for the fiscal year 1991/92:

TABLE 1. CGC RELATIVITY CALCULATIONS AND GENERAL REVENUE GRANTS 1991/92

State	Relativity factor	Population (m)	Grant per capita ($)	Grant per state ($m)
NSW	1.016	5.864	839	4912.5
VIC	1.000	4.406	826	3637.6
QLD	1.336	2.939	1113	3272.5
WA	1.409	1.650	1173	1935.1
SA	1.527	1.448	1261	1826.2
TAS	1.732	0.458	1429	654.4
NT	5.980	0.158	4963	784.2

Source: Walsh and Thomson 1993, p. 53.

Given this formulaic method of calculating the size of intergovernmental grants, it is often argued that the Australian method of dealing with the problem of horizontal fiscal equalisation is not only sophisticated but also free from party political bias. Thus Mathews (1994 p. 7) emphasises that since "...the assessment of State expenditure and revenue needs and hence of general revenue grants relativities is undertaken by the independent Commonwealth Grants Commission", the whole process of evaluating disabilities and determining relative grant sizes in Australia takes place in "[an] open, flexible and accountable system...free from political and bureaucratic bias" (Mathews 1994, p. 16).

Attempts to deal with the problem of vertical fiscal imbalance have been less successful than the CGC at excluding party political bias. Vertical fiscal imbalance arises in Australia largely due to the fact that revenue-raising powers are concentrated at the level of the Commonwealth government relative to state and local governments. In the Australian federation SPPs have been employed as a method of reducing the degree of vertical fiscal imbalance. Mathews (1994, p. 2/3) has described this procedure as follows:

> A second kind of equalisation is fiscal performance equalisation, which is intended to equalise service provision through specific purpose grants from the federal government to state governments. Because these grants must be spent in the manner designated by the federal government, fiscal performance equalisation is an instrument of federal government control over state policies.

While the influence of party political factors on the distribution of general revenue from the Commonwealth to the states has been severely constrained by the institutional mechanism of the

CGC, the same cannot be said of SPPs. These transfers from the Commonwealth to the states, whilst acknowledged by the CGC, are generally made outside the scope of fiscal equalisation, and thus may well be subject to political manipulation. Indeed, the CGC itself admits that "SPPs are distributed on all sorts of criteria - but very few on equalisation as the Commission understands its" (CGC 1993, Vol. 1, p. 16). Moreover, the Commission has also advocated "...that any trade-offs between fiscal equalisation and other policy objectives should be open and transparent" - indicative of possible conflicts in its position of statutory independence (CGC 1993, Vol. 1, p. 16). It would thus seem that such grants distributed to any state "on such terms and conditions as the Commonwealth sees fit permits a far more likely avenue for intergovernmental political bargaining and trading" (Bungey, Grossman and Kenyon 1991, p. 663). Given the discretionary nature of SPPs, a public choice perspective can shed light on their distribution.

The limited purpose of the present short note is to argue that both of the two genre of economic explanations for intergovernmental grants are relevant to the actual grants process in Australia. To this end, we review the relevant literature on intergovernmental grants and distinguish two conceptual models which have been used to evaluate real world grant processes; namely, the traditional public finance or "equity/efficiency" model and the more recent public choice theory. It is argued that whilst the operation of the CGC can be adequately explained by means of standard equity and efficiency criteria of conventional public finance, SPPs require in addition public choice analysis.

Conceptual Explanations of the Grants Process

Intergovernmental grants have been historically justified on the basis of what may be referred to as traditional "equity/efficiency" type criteria (Bungey, Grossman and Kenyon 1991; Grossman 1994). This model generally regards intergovernmental grants as the necessary transfer of funds in a federation, either from a central government or from another constituent state, to a fiscal jurisdiction in order to satisfy some concept of economic efficiency and/or equity (Oates 1972). Various reasons for this have been advanced, including the presence of spillover or external effects (Oates 1972; Gramlich 1977); considerations involving the distribution of income (Gramlich 1977); issues of economic stabilisation (Gramlich 1977); the uniform provision of public services (Bungey, Grossman and Kenyon 1991); and viewing lower-level governments "as agents, or contractors, for the central government" in carrying out selected tasks, usually classified as an institutional justification (Gramlich 1977, p. 222). All of these rationale are commensurate with "a government committed to maximising a nationwide social welfare function" (Grossman 1994, p. 295).

An alternative public choice perspective to the traditional Pigouvian model of "benevolent government" (Bungey, Grossman and Kenyon 1991, p. 659) holds that political agents use the grants process to further their own electoral interests. As Grossman (1994, p. 296) has observed "...it is widely accepted that federal politicians allocate own-purpose expenditures for the purpose of enhancing their reelection chances...it seems consistent to assume that grants are allocated to the same end". Accordingly, the public choice designation of grants as being motivated by "political expediency" (Grossman 1994, p. 296) rather than simply on equity and efficiency grounds has strong intuitive support.

Despite the instinctive appeal of intergovernmental grants being used to purchase political capital for donor politicians, a number of conceptual problems remain. Firstly, "...intergovernmental grants increase the level of activities provided by recipient governments. As a result...individuals are willing, *ceteris paribus*, to provide a greater level of political support" (Leyden 1992, p. 325). However, it would appear that the increment in political support is directed to recipient government politicians, rather than those of the donor government. Secondly, the process of funding grants "involves either increases in own-source taxation, reductions in own-purpose outlays, or both. Such actions involve direct costs to the federal grant-giver in the form of lost votes" (Grossman 1994, p. 295). Bearing this in mind, it seems that a positive net political benefit might accrue to the recipient politician, with a negative net benefit falling on the donor politician. Since it would appear that these grants "...are extraordinarily valuable to the donee government [but] seem to have little political payoff to the donor government" (Hartle 1976: 96), the problem now becomes one of reconciling the Downsian donor politician, the provision of grants, and indirect or obscure political benefits.

Various efforts have been directed towards resolving this problem, including Breton and Scott (1980), Grossman (1988; 1994) and Leyden (1992). Breton and Scott (1980, p. 11) argue that the grants system is characterised by an active market in functions - referred to as "...the power, responsibility, and authority that the government of a jurisdiction possesses to make decisions, to pursue policies, and to undertake activities in a particular area". The principal "traders" in these functions are generally regarded as federal governments (buyers) - given surplus taxation receipts - and state governments (sellers) - with deficit taxation receipts. This would appear to be consistent with federations characterised by vertical fiscal imbalances. A "trade" is signalled when donor politicians have a greater desire for centralisation, due to either their own preferences for centralisation or for political purposes, and the function is exchanged for "lump-sums, debt transfers or block grants" (Breton and Scott 1980, p. 151). The real objective for both sellers and buyers of functions is the acquisition of "...degrees of freedom (their probabilities of reelection)" (Breton and Scott 1980, p. 152) - an outcome dependent on "relative financial strengths...the historical features of the function, together with the political fortunes, political views and current political vulnerability of each transacting government" (Bungey, Grossman and Kenyon 1991, p. 661).

Grossman (1988; 1994) accepts the basic argument that in the first instance the political benefits of intergovernmental grants are received by the recipient government. In this regard, "local governments gain the capability to provide increased own-purpose services with no attendant increase in own-source taxation with no reduction in own-purpose service levels" (Grossman 1988, p. 2). As we have seen this is more than likely to engender voter support for recipient government politicians rather than donor politicians. However, Grossman (1987, p. 7) also argues that grants buy "...the loyalty and political support of the local politician, since for each local politician, the grant[s] [are] seen as funded in large measure from taxes on other localities". In an attempt to "export their tax burden" recipient government politicians will gladly trade - as representatives of "...the special interest group comprised of a specific locality's voters" - "...his/[her] political endorsement and the votes of his/[her] local supporters" (Grossman 1988, p. 7). Moreover, the attempts by recipient government politicians to trade "political support" for "tax burdens" are not contingent upon either actual tax exporting, nor upon the perception of such activity. Grossman (1988, p. 7) postulates that it takes only a limited number of "...politicians in a few localities to attempt to export their tax burden for all to be forced, out of self-preservation motives, to act accordingly". Thus, the return to the donor politician from "...this political endorsement and its attending votes may more than offset the vote loss arising from increased taxation" (Grossman 1988, p. 7).

Leyden (1992) has attempted a synthesis of the equity/efficiency model of grant determination with that of political self-interest in the context of general and categorical grants. His model examines the relationships between spillover effects - when the activity levels of one recipient jurisdiction affect another, fiscal illusion - where there is the overestimation of grant benefits or the underestimation of donor government taxes, and political asymmetry - referring to an imbalance in federal/state political influence. Firstly, in the absence of spillover effects, there will be "...no political benefit to the dominant party in providing grants to nonmember districts" (Leyden 1992, p. 331). As a result, the grants process will be characterised by a public choice model of political self-interest. However, as the dominant party's strength increases, the administrative costs begin to outweigh the revenue gains of this policy, and the grant-based purchase of political capital will be discontinued. Secondly, in the presence of fiscal illusion there are benefits to the donor politician in providing grants, either because the tax costs are underestimated, or the benefits of the intergovernmental grant are overestimated. In particular, it is in the donor government's interest to direct grants at activities where the illusionary influence is the greatest. Finally, where political asymmetry exists at the recipient level, the group that "dominates the recipient government's decision-making process will be different to that which provides support to the donor government representative" (Leyden 1992, p. 333). Accordingly, the grants process will be dominated by categorical grants aimed at rewarding political patronage. In Leyden's (1992) approach categorical grants, which are more common in models of political patronage, are evident where spillover effects, fiscal illusion and political asymmetry predominate. Furthermore, the ability to use grants to "purchase" political capital is contingent upon the ruling coalitions strength relative to both alternative state coalitions and other jurisdictional levels. However, "...as the size of the dominant party's coalition increases, the likelihood this condition will hold decreases" (Leyden 1992, p. 331).

It is apparent from this work (Breton and Scott 1980; Grossman 1987, 1994; Leyden 1992) that the public choice argument of politically determined grants may thus have some substance, notwithstanding the conceptual difficulties outlined above. Despite some differences, all three approaches have the initial concept of trading or acquiring the political patronage of recipient government politicians, rather than appealing directly to voters themselves - though Leyden (1992) does examine this possibility in regard to fiscal illusion. To some extent, the ability to trade and/or purchase support is a function of relative political power, bargaining opportunities, ideological similarity and rational, vote-maximising behaviour on the behalf of recipient and donor government politicians alike.

Conclusion

In our earlier synopsis of the process of fiscal equalisation in Australia we argued that because horizontal fiscal equalisation took place through the institutional auspices of the CGC, which employs the principle of fiscal equalisation to calculate the relative needs of different states in terms of a standardised budget deficit, party political factors had little influence, and traditional public finance "equity/efficiency" arguments are sufficient for the analysis of the process. After all, it would seem that the principle of fiscal equalisation, and the existence of an independent statutory authority in the form of the Commonwealth Grants Commission, has produced a system almost wholly based upon the "equity/efficiency" (Oates 1972; Gramlich 1977; Bungey, Grossman and Kenyon 1991) model of grant determination. Moreover, Bungey, Grossman and Kenyon (1991, p. 663) have observed that "...by and large, general purpose grants have been arrived at through the application of formulae, and institutional arrangements that have kept political factors at least at arm's length remove from the process". Similarly, "the capacity for political factors, particularly those stressed in the public choice approach to intergovernmental grants, to determine the size and direction of general purpose grants [in Australia] is somewhat attenuated" (Bungey, Grossman and Kenyon 1991, p. 663). However, whilst the influence of party political factors on the distribution of general revenue, or financial assistance grants, appears limited, this does not appear to be the case for SPPs. Although we do not deny the significance of equity and efficiency considerations underlying SPPs, the discretionary nature of these payments seems to imply that party political elements may be significant. This means that traditional public finance explanations need to be augmented with more modern public choice arguments in order to explain the pattern of SPPs. Despite some remaining conceptual difficulties, public choice models of intergovernmental grants appear capable of shedding at least some light on these transfers.

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