

FISCAL EQUALISATION

*Why it makes sense and reflects Australia's
desire for a fair go all around*

Presented by Don Challen
Secretary
Department of Treasury and Finance

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Tasmania

This paper explores the concept of ‘a fair go’, and how this value is reflected in the way that governments make decisions in Australia. It particularly focuses on the ideal of ‘a fair go’ in the context of horizontal fiscal equalisation (HFE), the poorly understood, but crucially important, ‘glue that holds the Australian federation together’, to which it has been commonly referred. To tackle the question as to whether or not HFE is simply a by-product of federalism, the paper considers what might happen to equalisation if Australia were to adopt an alternative system of government.

‘A Fair Go’

Consider a scenario in which a random sample of a hundred people were taken off the street and asked what ‘equalisation’ meant to them. Like a Rorschach ink blot, this question would probably provoke a variety of interpretations and responses, and perhaps a few blank stares. If, however, the same people were asked about the meaning of the phrase ‘a fair go’, the response from each person would probably be remarkably similar to that of the others. And this apparently universal understanding reflects a deeply ingrained cultural and social identity unique to Australia.

Most social theorists agree that ‘a fair go’ can be traced back to Australia’s convict and settler origins. Being so remote from Europe, Australia was logically one of the last European colonies to be settled and, for the first waves of immigrants, it must have been an especially harsh environment in which to start a new life. Unlike the original occupants of the country, the new settlers were barely self-sufficient and were, therefore, highly dependent on their government for survival.

Perhaps it was this interdependence, shared in common by most new Australians, that helped rid them of the old class distinctions of their mother countries. Whatever the precursor, it was in these early days that Australian egalitarianism was born.

This spirit of egalitarianism has endured and has acted to attract waves of migrants from diverse origins, particularly since World War II, who have come to our country on the promise of the opportunity to make a fresh start in life; or in other words, to be given a fair go. In the main, this promise has been delivered and can be witnessed by the successful careers and businesses that many migrants and/or their descendants continue to have in Australia.

Despite its widespread use, academics argue about the exact definition of the phrase ‘a fair go’, including the degree to which it is based on either meritocratic or egalitarian principles. Summoning a dictionary definition may be difficult because the concept reflects more a subconscious value than one of ideology. But a common theme in the literature is that it is about *equality of opportunity* – providing everyone with the opportunity to make the most of their lives by removing the barriers that might be tolerated in other societies.

Some now argue that egalitarianism is dead, or dying, in Australia. While it could be argued that income inequality has been increasing in Australia for some time, the nation’s commitment to a fair go has been retained. As an example, consider something taken for granted in Australia, such as the Higher Education Loan Program (HELP, which was formerly HECS). The objective of HELP is to make higher

education available to everybody. A university degree still comes at a cost, but this cost can be deferred so that the *barrier* to higher learning – an up-front fee – is removed. This may seem perfectly unremarkable until one considers just how few countries actually provide anything similar. The fact that such programs are taken for granted is a sign that Australian egalitarian expectations are much higher than overseas.

Amidst this tradition of a fair go all around, it is no coincidence that Australia pioneered the modern principle and practice of horizontal fiscal equalisation.

Horizontal Fiscal Equalisation

It may be useful to clarify the meaning of horizontal fiscal equalisation (HFE).

The term ‘equalisation’ is usually associated with intergovernmental grants between levels of governments. And indeed, Australia’s system of HFE involves the transfer of Commonwealth raised funds – the pool of GST revenue – to the states and territories on an equalisation basis, shared on the basis of recommendations by the Commonwealth Grants Commission (CGC), an independent statutory body.

The fact that HFE involves grants from the Commonwealth to the states is, in effect, an accident of the way the Constitution has played out over the last century, producing the long-standing problem of vertical fiscal imbalance.

Vertical fiscal imbalance (VFI) refers to the fact that states are responsible for providing more services than the Commonwealth, despite the Commonwealth controlling the majority of the tax base. VFI has evolved and increased over time, largely due to a succession of High Court rulings and circumstantial happenings that have progressively shifted the legal power to raise many sources of revenue from the states to the Commonwealth, without a commensurate reduction in state expenditure responsibilities.

The Commonwealth has generally attempted to address this imbalance through the provision of tied grants and general purpose payments. Since the 1930s, most general purpose payments have been distributed on an equalisation basis, though the working definition and implementation of HFE has continued to evolve during that time.

The principle and practice of HFE seems to be poorly understood in Australia. A common misperception is that HFE is intended to equalise the economic wealth of each state, or to equalise the standard of living of individuals throughout the country. However such an approach would effectively reward, and even encourage, incompetent and lazy governments, since any state economic failure would be compensated for under such an arrangement. There would, moreover, be little or no incentive to promote economic growth and development. If states were equalised on such a basis, it would not be long before Australia became an economically stagnant and politically dysfunctional federation.

Rather, equalisation in Australia refers to the practice of providing state and territory governments with relative equal *fiscal capacities*, the measure of relative size being, of course, based on population counts. This is succinctly and eloquently captured in the CGC's current definition of HFE:

State governments should receive funding from the pool of Goods and Services Tax revenue and Health Care Grants such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.

'Capacity' is the crucial word here. It could just as easily be swapped for the word 'opportunity'. Equalisation is about providing each state with the same opportunity to provide services to its residents, based on the concept of an Australia-wide or common standard. Central to this practice is the principle of state sovereignty, whereby each jurisdiction decides how this capacity is actually used.

But does this mean that HFE as a policy tool was created specifically to deal with the existence of VFI?

Through addressing VFI, the concept on which HFE is based tends to be publicly highlighted, but the two are otherwise quite independent. Equalisation is embedded not in our Constitution, but in our social and cultural fabric – the idea of a fair go for everyone.

This is perhaps best illustrated by considering what would actually change – and what would not change – if Australia were to abolish its federal system, as has been suggested on a number of occasions.

Alternative Models

What are the alternatives to federalism for Australia? Broadly speaking, two major alternative models can be considered, both at opposite ends of the spectrum.

One possibility is a unitary system, whereby a single Australian government (regardless of whether local government is also abolished) holds ultimate governing responsibility over the nation, and any regional autonomy is granted at the sufferance of this central government.

Another possibility, which may sound more foreign, involves the reverse arrangement – the dissolution of the Australian states and territories into individual nation-states. Most people would consider such a suggestion ridiculous today, which may seem to be paradoxical given the reluctance with which some states joined the Commonwealth in the first place. It is easy to forget that the feat of unifying the states in 1901 overcame considerable odds at the time, and was only achieved following several compromising amendments in the drafting of the Constitution.

Despite this, the idea of splitting Australia into several nation-states would be unworkable today, due to the diseconomies of small scale that each state would face, the unavoidable trade disadvantages, and, most crucially, the issue of who provides for national defence and makes appropriate economic, environmental and other like policies relevant to Australia as a continent. This is to say nothing of the

implausibility that the majority of Australians would willingly tear up and discard our national identity in the name of efficiency and global competitiveness.

In order to deal with the logistical dilemmas alone, it is likely that the states would eventually form a very tight co-operative union or *de facto* federation, with a single currency, unrestricted interstate trade, and perhaps a constitution granting to a central body powers similar to those in the current Constitution. In other words, there would be a great deal of effort for not much real change and it is unlikely that there would be much popular support for such a move in any case, as attractive as this may seem to the uninformed.

A unitary system of government seems, on the surface, to be a more plausible alternative; but many of the unitary systems existing today face their own unique difficulties, especially when it comes to adequately addressing regional diversity. Internationally, most highly centralised governments, especially in the last few decades, have been pressured into handing back ever-increasing amounts of power to their regions. Those who have resisted such decentralisation, as for example has the United Kingdom traditionally, have often faced the threat of secession, civil strife, or both.

Nevertheless, it is interesting to consider hypothetically how a unitary system of government might operate in Australia, and especially how this might impact financially on the regions. Would the economically poorer regions such as Tasmania, lacking a system of equalising intergovernmental grants, collapse into poverty? Or would we instead see interstate inequality disappear as a result of a single, borderless, uniform economy and national standards of service delivery?

It is impossible to predict exactly how our newly empowered centralist leaders would act, but it is still possible to make some educated guesses by looking at the way that governments in general already make taxation and expenditure decisions in Australia, and by reflecting on the behaviour of various systems of government overseas.

The Natural Tendency to Equalise

Regardless of any inequalities in personal wealth that may exist in Australia today, the community's expectation of a fair go for all remains clearly omnipresent when it comes to government responsibility. With some qualification, Australians expect certain basic services to be readily available within reason to themselves and to others, regardless of where they live.

Therefore, if any level of government wishes to either stay in or win office, a key driver of most of its expenditure decisions will be based on where its constituents live, and hence where demand for the bulk of services exists.

This is not necessarily where income, or the bulk of tax revenue, is actually generated.

Any level of government rationally aims (or should aim) to raise revenue in the most economically efficient manner possible. Each level of government in Australia is restricted in the tax base that it can exclusively access, but the same universal principles usually apply (or should apply) to taxation policy – that is, a government should favour taxes that are broad-based, stable, transparent, efficient and equitable.

Some of the highest income generating areas can actually receive very little expenditure attention. For example, resource rich areas are so by virtue of their geography or geology and often happen to be remote from population centres. Despite the wealth they may generate, mining towns for example tend to be small because mining is now typically capital, rather than labour, intensive. Furthermore, government services are likely to be below the national average in the more remote mining towns despite their greater than average contribution to government revenue.

Likewise, few people (particularly those with a background in economics) would seriously argue that fuel taxes should be used exclusively to fund roads, or that health care and schooling should be completely ‘user-pays’ funded.

However, because it can make a particular tax more palatable to the community, governments sometimes do hypothecate certain taxation revenues. But this practice is not widespread in Australia. The Commonwealth’s Medicare Levy is sometimes mentioned as an example of a hypothecated tax, but even this doesn’t really qualify given that some of the funds raised from the Levy are appropriated as consolidated revenue.

The reality is that any level of government in Australia makes specific revenue-raising decisions independently of its expenditure choices. In fact, the premise of all government activity is based on the notion of *general revenue* and *portfolio expenditure*. The only real relationship between them is that ideally budget totals should match.

Since services tend to ‘chase’ people, the distribution of the population effectively dictates regional fiscal equalisation. This is not to say that residents of Alice Springs expect the same level of government services as those to be found in Hobart, or that Hobart residents expect the full range of services that would be found in Sydney. Instead, Hobart residents expect services comparable to those of similar sized towns, such as Ballarat. On the other hand, residents of Alice Springs expect that living in a smaller and more isolated community will not preclude them from accessing basic government services, even if providing such services is ‘uneconomic’. This in itself would probably be enough to drive an efficiency purist mad, but apparently not the majority of voters.

Australia as a Unitary State

Now consider, in very broad terms, what might change in Australia under a unitary system of government, particularly in regard to:

- Revenue raising;
- Expenditure equalisation; and
- Regional administration.

Revenue Raising

In a unitary state, the Australian Government would be able to raise revenue more efficiently than can any level of government currently. This is particularly so given that it would have access to the entire Australian tax base and could select the most efficient taxes available. It would not be forced, as states have frequently been, to levy a number of the more narrowly based and less efficient taxes such as the transaction taxes.

The tax regime would be – could only be – uniformly applied throughout Australia. All taxpayers would be treated equally, subject to the same taxes, at the same rates. It would not be possible to make more ‘tax effort’ in one region than another, so that revenue equalisation would by default become automatic.

This is not to say that each region would yield the same amount of tax revenue per capita. It is already clear, through an examination of the CGC’s assessments, that each state’s capacity to raise revenue varies substantially on a per capita basis. There is no reason to expect that this would be any different under a unitary system, given the underlying structural differences in state revenue bases. Tasmania as a region would still have below average land values, and therefore a lower land tax base. Western Australia would still be resource rich and offer higher royalty revenues. And most large companies and multinationals would still locate their head offices in Victoria and New South Wales, meaning that these regions would still potentially contribute the greatest per capita payroll tax revenues.

Applying the uniform tax regime to all of these regions, with their varying tax bases, would result in different per capita tax yields from each. But, as was established earlier, governments tend to pretty much make their decisions on revenue raising independently of those on expenditure. So the fact that one region contributes per capita revenue higher or lower than the average does not in itself affect the provision of services in that region.

The unitary tax regime would therefore be theoretically more efficient than the current one, but would it look radically different?

It is doubtful that most of the major taxes levied today – personal income taxes, company income taxes, sales taxes, fuel excises, customs duties and so on – would necessarily disappear. The unitary government would probably also adopt a number of the current state taxes, payroll tax and land tax being the obvious candidates.

One of the positive developments that arose from the 1999 *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* (IGA), which provided for the introduction of the GST, was that by partially addressing the problem of VFI the Commonwealth gave the states the flexibility to remove their most narrowly based and inefficient taxes. However, it is also the case that because states did not receive control over the GST, they also surrendered even more of their tax powers under the IGA. In a perverse way, the IGA has worsened the degree of VFI.

Nevertheless, Australia's taxation system today is an improvement over that of ten or twenty years ago, and it probably has more in common with the system that would be in operation under a unitary system of government.

Expenditure Equalisation

Expenditure patterns would often differ between regions in a unitary state – even in the absence of regional governments – either because the demand for services is greater or lesser in certain regions, or it costs more to provide services there.

The cost of providing services varies geographically for a number of reasons. It is not surprising that small states, or less populous regions within a state, suffer diseconomies of small scale in delivering many services.

But the socio-economic and demographic composition of the population is also a significant factor. Census data show that certain areas of Australia, and certain areas within states, tend to have higher proportions of elderly people; people from non-English speaking backgrounds; low-income earners; indigenous people; children of school age, and so on.

Some groups tend to use certain services more frequently than others. Older Australians, for example, are obviously greater users of most health services, while children are greater consumers of school education. Therefore, higher concentrations of these groups will translate into above-average demand for services in a region.

Even adjusting for increased use, providing services to some groups is more costly because of the nature of or level of demand for the services they consume, or the location in which they need to be provided. So not only are the elderly more likely to require hospital treatment than the wider population, but they are also likely to be admitted with more serious ailments and require longer stays.

The size and geographical variation of the Australian continent causes its own problems, creating a highly dispersed population distribution and greatly complicating service provision in some regions.

Furthermore, higher costs also arise from Australia's varying physical and economic environments; differing input costs between regions; differing infrastructure needs; variable road use, and so on.

It would take some time to list the many factors that contribute to inter-regional cost differences. The important point is that these are the very factors that are measured by the CGC when it assesses each state's relative fiscal capacity.

Based on its considerable expertise and experience, the CGC attempts to quantify every state's material relative disadvantages (termed *disabilities*), such as those mentioned above. On this basis it can then recommend to the Commonwealth a set of relativities required to equalise state capacity to provide services.

A unitary Australian government would not explicitly use the methods and services of a body like the CGC. But none of the regional disabilities would disappear because, by definition, the CGC only assesses them if they are clearly inherent and not as a

result of state government policy choice. Those disabilities would simply be reflected in the costs of regional service provision by agencies of the unitary government.

Thus, if the unitary government were to continue to meet service demand, it would, in effect, continue to indirectly equalise to address these disabilities.

This practice can be observed in action wherever there is some uniformity in service delivery, but regional variation in the unit cost of providing the service. Consider the provision of police services within regions of a state. A police presence is likely to be more visible in a city or large urban area. Nevertheless, residents of more sparsely populated regions still expect and are provided with access to police services. Interestingly, even though a police presence is less visible in smaller towns, the ratio of police to residents is perhaps greater than it is in a large city, or at least the cost of providing police services is likely to be greater per head. In this sense, the larger towns are 'subsidising', indirectly, the statewide provision of police services. Despite this, residents of the east coast of Tasmania for example do not enjoy the same response time to emergencies as someone in Hobart. Importantly for policy-makers, though, these residents still expect a minimum level of service; that their local police station will never be too far away.

Fiscal equalisation is not, therefore, a necessary evil arising from a federal system but an obvious and effective policy management tool for any government to employ. It just so happens that it is less visible when it doesn't require intergovernmental grants. The issue is not then one of whether a unitary government would equalise, but whether it would do so more or less precisely than under the current federal system.

Incidentally, this inherent policy tendency to equalise is not restricted to Australia, or federations generally, but can be found internationally in most unitary systems of government. In France, the UK, Spain and Italy for example, expenditure is largely driven by where residents live, rather than where revenue is raised. The fact that regional disparity is greater in all of these countries reflects the local social attitudes and preferences of their voters.

It is likely that, even under a unitary system, there would still be far greater equality in services in Australia than in other nations. Take another sample of a hundred people on the street and ask whether they would accept that for reasons of economy a child in Hobart should make do with an inferior education to a child in Ballarat; or that the elderly in Rockhampton should necessarily have a worse level of health care than those in Port Macquarie. They will no doubt answer with a resounding 'no'. It is difficult to comprehend that this would suddenly change because we abolished state governments.

It is perfectly plausible that equalisation would actually be more exact under a unitary state. In order to achieve equalisation in a unitary state, a government would simply meet demand for services. To achieve equalisation in any federal system though, all disabilities must be measured and quantified. This is what the CGC currently attempts to do, but in reality this can only at best be a form of rough justice. Data to measure many disabilities sometimes don't exist. This means that either the CGC does not recognise them, or if it does, that it must assess them using judgement that tends to be conservative, which may result in under-equalisation. Many other disabilities are not measured because they are considered to be immaterial, but again

even these could be addressed in a unitary state trying to respond to the community's preferences.

Regional Administration

When discussing a hypothetical unitary state, one begins to question just how central the government could really be. The problem of regional diversity arises because, like the concept of fairness, different regional preferences do not automatically disappear with the abolition of states.

It is noteworthy that some of the world's most highly centralised nations have created, or are in the process of creating, some form of autonomous regional government.

The French government, for example, has provided its regional councils with some legislative power. In the UK, Scotland has been granted some self-determination powers and now has its own parliament. Italy and Spain have devolved power to such an extent that they now operate much like federations. Belgium has taken it a step further and reformed its constitution to the point where it is now officially a federation. This decentralising trend has usually occurred in response to considerable pressure arising from regional discontent, and sometimes the threat of secession.

Such regional autonomy is usually granted at the sufferance of the central government, and can thus be revoked at any time; but it is interesting to note just how alike some unitary and federal nations actually operate.

There is no doubt that even as a unitary state Australia would have some sort of regional administration. In order to best deal with regional needs, the jurisdictions governed by these 'branch offices' probably wouldn't look that different to the current states – except that there may perhaps be a few more.

The real difference though is that those running these administrations would be unelected bureaucrats, ultimately unaccountable directly to their regional constituents.

The central government could always choose to simply ignore regional diversity and rule in a highly uniform manner across the nation, negating the need for large regional administrations. This would initially provide some cost savings compared to the current federal model. However, the only problem with this approach is that with the needs of regions no longer being met in a comprehensive way, some or all regions would almost certainly experience community rumblings for secession.

Imposing a unitary system on people can, therefore, be a very effective way of driving them apart.

Again, this might sound implausible until one looks to the experience of highly centralised nations overseas.

Criticisms of HFE

Now to return to the specifics of HFE as it is practised in Australia.

One of the most common criticisms of HFE is that it discourages states from pursuing economic growth and development and generates high efficiency costs. This

argument is based on the claim that any economic gains made by a state will be 'equalised away' through decreased grant shares.

This argument overlooks the fact that there are countless incentives for state governments to improve their economic wealth, the most significant being the desire to improve the welfare of their communities. No government would expect to be returned to office, and no opposition would expect to win government, if it did not actively propose and implement policies designed to increase economic development, especially if it tried to justify such lethargic behaviour on 'equalisation cost' grounds. Tellingly and despite an abundance of conjecture, no critic of HFE has ever been able to produce a specific example of a government avoiding economic reform on the basis of the equalisation impact.

An examination of the CGC's methodologies demonstrates that the 'equalising away' argument is also factually incorrect. As noted earlier, a state's share of the GST pool is intended to provide it with equal capacity to both raise revenue and provide services at the national average. If a state is able to deliver a service at a cost below the national average, or if it taxes at a rate above the average, its funding from the Commonwealth is only affected by the minimal impact it would have on the recalculated national average. The state would enjoy the benefit of the difference between the national average and what it actually spent or raised.

So even if one assumes that states do consider the implications of equalisation when making decisions, consideration within a cost-benefit framework will lead to states promoting efficiency and economic progress over avoiding it, because any gains will be greater than the subsequent loss in a state's grant share.

While the CGC's methods are efficiency neutral, it could be argued that fiscal equalisation has other efficiency impacts. For example, it could be argued that, by compensating states for disabilities such as scale and dispersion, equalisation encourages a distorted and uneconomic population distribution and provides a barrier to the rationalisation of service provision. This is where there is a fundamental trade-off between the notions of equity and efficiency. But unless larger states are willing to compensate Tasmanians, South Australians, and Northern Territorians for moving to Sydney and Melbourne, it is doubtful that diminishing HFE would actually result in a supposedly more efficient redistribution of the population.

In any case, it is likely that the supposed efficiency costs of equalisation are actually very small. Attempts to model these costs have been of limited value and objectivity. However, even if they are accurate the estimates of the efficiency costs as a proportion of GDP are always small, if not negligible.

Currently, it is fashionable to benchmark many of Australia's economic and financial practices internationally. This seems a reasonable means of evaluating tax competitiveness, productivity, or fuel prices. However, to benchmark Australia's system of equalisation with those of other federations, as New South Wales recently commissioned Dr Neil Warren to do, is like benchmarking its culinary tastes. There is no international 'best practice' when it comes to voter preferences and as has been argued above, equalisation is clearly a matter of voter preference.

In his final report, Dr Warren found that Australia's system of HFE is perhaps the most comprehensive in the world and on this basis was critical of it. While Australia's system of HFE is almost certainly the most comprehensive internationally, this does not mean that the nation lags the world in any sense. To the contrary, this comprehensiveness results from a high degree of sophistication and rigour in the CGC's methods and reflects the fact that Australia stands out and actually leads the world in its implementation of HFE. The principle and practice of equalisation in Australia has evolved over the past seventy years, being continually reviewed and refined, and has actually become the envy of many international observers. It also seemingly meets with the policy preferences of the Federal Government, for the obvious reason that it has not been replaced by another policy to govern the distribution of general revenue transfers.

Conclusion

The Commonwealth of Australia at over a hundred years old possesses one of the more mature federal systems in existence today. But maturity is typical of the world's 'model' federations – Canada as a federation was established in 1867, the US in 1789, and Switzerland, while only formally becoming a constitutional federation in 1874, actually has a history of federal association dating back to the Middle Ages. Together these four nations have been used as model for many other younger constitutions.

Judging by the wealth and stability of these pioneering nations, the model of a federal system has admirably withstood the test of time. And the trend towards federalism doesn't appear to have subsided, with several unitary nations edging closer to a federal system but few, if any, moving toward greater centralisation.

It is therefore ironic in this environment of unprecedented international interest in federalism, that we are hearing renewed calls from within our own 'model nation' to fundamentally change our system of government transfers.

In saying that, few would argue that our federal system is perfect, and there is certainly room for some constructive reform. Despite some of the gains made from the *Intergovernmental Agreement*, VFI and the overuse of Commonwealth specific purpose payments remains a significant problem for state governments. Our current set of intergovernmental arrangements also has adverse impacts on the community, not least because it clouds the relationship between revenue raising and expenditure to the extent that it is hard to clearly assign accountability. This is not good for transparency, let alone for democracy.

However, coming back to the central theme of equalisation, all governments do equalise in practice, whether it be deliberately or inadvertently. How equalisation is achieved is a matter for each nation or sub-national government to decide through the preferences of its community. What is clear is that if equalisation does not reflect the preferences of the nation's community, the viability of that nation in its current form comes under threat. This is the case whether it be a unitary system of government, where the central government does not adequately equalise for the differences that exist between various regions within its borders, or for federal systems where sub-national governments no longer believe that equalisation provides a net benefit to remaining part of the federation.

While there is much debate and criticism about how HFE is delivered in Australia the fundamental fact is that there is no crisis in Australia's federation driven by the current system of equalisation.

The residents of Western Australia, New South Wales and Victoria are *not* about to renounce their Australian identity because they recognise the economic and social benefits that are derived from being part of the Australian federation, in which *all* states contribute, even the smaller, towards the capacity of the less well-off. While virtually impossible to measure, it would be difficult to refute the notion that the benefits in total of federation far outweigh what individual states could collectively achieve if acting as separate and completely unrelated and dis-connected jurisdictions.

The egalitarian principle is very much alive in Australia and is what Australians want to see reflected in the way governments in Australia equalise. This is why fiscal equalisation makes sense and reflects Australia's desire for a 'fair go' all around.

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