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Fiscal Equalisation and Natural Resources in Federal Systems

Alan Fenna*
Curtin University

Redistribution from wealthier to less-wealthy jurisdictions is a common if not virtually universal practice in federal systems and accords with some of the key principles of federalism. However, it easily becomes controversial or contested – particularly when resource revenues are at stake. This paper looks at the particular challenge posed by regionally-concentrated resource wealth in boom times and considers equity and efficiency arguments for a dilution or abolition of Australia's comprehensive system of horizontal fiscal equalisation put forward by 'donor' States and others.

Federations face a number of challenges inherent in the operation of a system of divided jurisdiction. From their inception they have faced the challenge of maintaining the balance between the central government and the constituent units. In that vertical dimension the constituent units are, in principle, on the same side – with a common interest in preserving their jurisdictional autonomy. There is another challenge federations face, though, one where they have much less of a common interest. This is the challenge of balancing fiscal autonomy and fiscal equality across the federation as is widely attempted in systems of horizontal fiscal equalisation (HFE). This pits jurisdiction against jurisdiction in a zero-sum conflict. Unsurprisingly, less wealthy regions are convinced that sharing the wealth is the good and right thing to do (e.g., Challen 2006), while wealthy regions argue that it is unjustified and counterproductive (e.g., Garnaut and FitzGerald 2002a; Porter 2011).[1] Perceived self-interest rules. What is right for federalism, or most consistent with the federal idea, is rather less clear in these instances than it is in the vertical conflicts that, in principle, pit the central government against the constituent units collectively.

Leading equalisation economist Robin Boadway (2006a:376) describes HFE as the "life-blood of federations". That being said, we know that federations differ substantially in the degree to which they equalise and that changing circumstances can pose new challenges for equalisation systems. Recognising the tensions created in Australia's system by the resources boom, the Commonwealth commissioned a public review on 30 March 2011.[2] This paper reflects on those challenges and on the criticism of current arrangements made by the Government of Western Australia (Porter 2011).

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* Professor of Politics, The John Curtin Institute of Public Policy, Curtin University. This article is based on a paper delivered at the conference *Power and Politics – new dimensions of federalism in Australia*, Australian Association of Constitutional Law and the Constitutional Centre of Western Australia, West Perth, 2–3 July 2011.

1 See also the various State submissions to the GST Distribution Review.

2 The GST Distribution Review made up of one ex-NSW premier, one ex-Victorian premier and a representative from a business consulting firm. The Prime Minister's announcement flagged two other issues: possible disincentives to service delivery reform and the degree of complexity and opacity in the operation of the current system.

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The Comparative Experience

Almost all federations – even the Swiss – have mechanisms in place to equalise between jurisdictions (Dafflon and Vaillancourt 2003). The notable exception is the United States (Kenyon and Kincaid 1996). Australia and Germany stand out for the comprehensiveness of their equalisation (re the latter, see Buettner 2008). In Germany this is grounded in a constitutional requirement while in Australia it is not. The Australian system is established under Commonwealth legislation and is facilitated by the high degree of vertical fiscal imbalance (Fenna 2008). As established in the *Intergovernmental Agreement on Commonwealth-State Financial Relations* of 1999, total net revenues from the Commonwealth government's Goods and Services Tax (GST) are distributed to the States.[3] By Commonwealth decision, that distribution is effected via an equalisation formula developed and applied by the Commonwealth Grants Commission.

Like Germany, Canada also has a constitutional requirement for equalisation,[4] but political realities there ensure that only a partial levelling is implemented. Under the Canadian scheme, those provinces with revenue raising capacity below a five-province average are funded to that average but no effort is made to bring provinces to a common standard or uniform level. Thus wealthier provinces continue to enjoy a superior fiscal position.[5]

Until recently, the high degree of equalisation was not particularly controversial in either Germany or Australia. The wealth gradient was not steep and the recipient jurisdictions were significantly less populous than the donor jurisdictions. Destabilising changes have occurred, however, in both countries. In Germany it was the accession of much poorer *Länder* from what had been the German Democratic Republic. In Australia, it was the onset of the resources boom. Even with that boom, though, only "around 8 per cent of the GST revenue pool has been redistributed away from an equal per capita outcome" (GST Distribution Review 2011: 2). Fiscal equalisation has always been more controversial in Canada, a generally more fractious federation, but the differences have likewise become heightened with the resources boom.[6] "The most stunning development affecting Canadian fiscal federalism in recent years has been the unprecedented oil and gas boom in Alberta and to a lesser extent its neighboring provinces" (Boadway 2006b: 1).

It is the comprehensiveness of Australia's system that often gives rise to complaint or criticism: equalising to an all-jurisdiction standard that attempts to provide each State or Territory with the same service provision capacity regardless of their revenue-raising potentials.[7] Other

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3 That Agreement is only a political, not a legal, instrument. For the latter, see the Commonwealth's *A New Tax System (Goods and Services Tax) Act 1999*. Under the *Intergovernmental Agreement on Federal Financial Relations* of 2009, Australia's governments have agreed to "the equalisation of fiscal capacities between States and Territories". However, again this is merely a political, not a legal, instrument. The relevant legal instrument is the *States (Personal Income Tax Sharing) Amendment Act 1978* (Cth).

4 *Constitution Act, 1982*, s 36(2): "Parliament and the government of Canada are committed to the principle of making equalisation payments to ensure that the provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."

5 On the Canadian case see Dahlby (2008) and Boadway (2008).

6 For two recent official attempts to "reconcile the irreconcilable" in Canada, see Advisory Panel (2006) and Expert Panel (2006).

7 "State Governments should receive funding from the pool of goods and services tax revenue such that, after allowing for material factors affecting revenues and expenditures, each would have the fiscal capacity to provide services and the associated infrastructure at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency."

dimensions of national fiscal policies and spending programs may contribute to, or detract from, the formal equalisation effect depending on such factors as regional demographics. Analysis by WA Treasury suggests that in Australia HFE is accentuated by such factors, creating a "net fiscal subsidy"[8] of almost $11 billion from Western Australia to the recipient jurisdictions in 2008–09, equivalent to 6 per cent of Gross State Product (Petchey 2011:210; though cf. Treasury 2011).

Reasons and Rationales

There are two closely related questions here. One is about fiscal equalisation in general; the other is about equalisation of resource revenues in particular. I shall discuss the latter presently; for now the issue is about equalisation in general.

Federations are by definition composed of subnational jurisdictions and premised on the idea that those jurisdictions are political communities entitled to an important degree of autonomy in their policy choices and, simultaneously, responsible to important degree for their own welfare. However, federations are also nation-states where a sense of common citizenship is central to national identity and shared values. That citizenship comprises a set of norms about public benefits, and different jurisdictions need to be in the position to provide services corresponding to those norms. Equalisation ensures that fundamental benefits of citizenship can be enjoyed by Australians regardless of where on this continent they happen to live. It must be remembered that even the most comprehensive of equalisation systems does not equalise employment opportunities, incomes or life chances; it merely enables governments in each jurisdiction to provide a similar quality of public service in such core areas as education, health or economic infrastructure.

Interestingly enough, free-market economists – who are not usually prone to favour redistribution – tend to support HFE as a general principle. The reason for this, as James Buchanan (1950: 589) presented it, is that in determining their locational choices, production factors should "respond to market-determined economic reward" rather than have their decisions "distorted" by a fiscal structure that is not locationally neutral. Buchanan (1950: 599) also pointed out that if fiscal capacity is not maintained across the federation, the result will be a greater drift to the centre since only policy action from the central government will ensure the quality of service desired by citizens across the country. States thus have a collective interest in sharing the wealth amongst themselves.

Federations are also an insurance club, where we make prudential investment in the common pool in defence against that day, whenever it might come, that we are in need. For instance, Western Australia was for many years a 'claimant' State, benefitting from Commonwealth largesse. Now the tables have turned, with the State's massive resource revenues leading the Grants Commission to reduce WA's share of the GST transfers commensurately. In principle this may be a sound argument. In practice, though, it cannot help but struggle to gain traction: the swings and roundabouts simply come too infrequently and unevenly. New South Wales and Victoria have never been anything but donor States – a condition made tenable by their economic size. Meanwhile, the Western Australian voters who are being told their hard-earned wealth is being siphoned off to mendicant regions are not the

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8 Being the variation between all taxes collected by the Commonwealth from a State and all expenditures within or transfers to that State.

same Western Australian voters who benefited from decades of Commonwealth support. The connexion between past, present and future generations is a tenuous one; it is all too easy to transition from being indignant that one is disadvantaged to being indignant that one is being made to help the disadvantaged.

The Awkward Case of Natural Resources

Equalisation issues are compounded when natural resource revenues become a major part of the mix. And part of the mix they indeed have become as Australia experiences an extraordinary revival in its terms-of-trade – "one of the largest such economic events in our history" (Stevens 2011: 67). "The tax base which causes most difficulties in revenue equalisation is natural resources" (Williams 2005:356). While Germany equalises as aggressively as we do in Australia, it has the good fortune of having limited natural resources. Natural resource wealth has some particular characteristics that make it challenging for equalisation systems, among these the fact that resource endowments tend to have a very uneven geographic distribution. No Australian State is without mineral or hydrocarbon resources, but the fact is that Queensland and Western Australia have the overwhelming share of those resources that are currently in the greatest demand.

As Porter (2011) correctly emphasises, these mineral and hydrocarbon exports are enormously significant to the Australian economy. The proposition (Gittins 2010) that although resources constitute 42 per cent of total exports, they are not that important because "mining accounts for only 7 per cent of the value of all the goods and services in the economy" and is dwarfed by the service sector cannot be taken seriously. To suggest that the contribution of the typical lawyer, doctor, hairdresser, panel beater, psychotherapist or journalist to the national accounts is of the same significance to the Australian economy as the work of those producing traded goods or services,[9] whether exporting or displacing imports, is either deliberately mischievous or economically naïve. When Australia was said to 'ride on the sheep's back' it was for good reason. It is not the significance of Australia's resource exports that is at issue, it is how the benefits are shared.

Stashing the Loot

What might a Western Australian paradise look like? To answer this, we can look overseas. The other particularly resource-divided federation is Canada, and its system of partial equalisation does not prevent the oil and gas-rich province of Alberta from amassing wealth in its "Heritage Savings Trust Fund". At times, Alberta has been a lender to needy provinces in the federation. By 2011, the Alberta Heritage Savings Trust Fund had $15 billion in it – not an enormous amount in itself given that the fund has been operational since the mid-1970s, but even taken on its own, scarcely trivial for a jurisdiction of only 3.7 million souls. But that is only part of the story. Alberta has also been able to spend on gold-plated public services while simultaneously maintaining its status as the lowest-taxing jurisdiction in Canada. And if that's not enough, the province has used oil and gas revenues to create a "Sustainability Fund" to finance budget deficits in lean years. As of March 2011, there was a further $11 billion in the Sustainability Fund and the province has been drawing on those monies to cover its GFC-induced budget deficits (Government of Alberta 2011: 25).

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9 Whether those be tertiary education, engineering services, manufactured goods, agricultural products or any of a range of such goods and services that sell to overseas buyers or compete against overseas producers.

In summary, resource wealth has enabled the Alberta government to spend "12.2 percent of Gross Provincial Product while only levying taxes equal to 8.0 percent of Gross Provincial Product" – and to do so while eliminating debt and accumulating $36 billion in net financial assets between 1993 and 2007 (Alberta Financial Investment and Planning Advisory Commission 2007). Alberta's personal income tax rate of 10 per cent contrasts with that of up to 24 per cent in less fortunate provinces (Berg-Dick et al. 2008: 181).[10]

Political Economy of Resource Regions

Provincial ownership of natural resources and control of resulting revenues is uniquely entrenched in the Canadian constitution.[11] But there is more to the story than this. After all, money is infinitely fungible and presumably an equalisation system could be designed that would achieve a *de facto* redistribution without technically touching those revenues (e.g., Boadway and Shah 2009: 235). Part of the answer is that Canada is a very different federation from Australia, with a far more federal society (Lecours and Béland 2010; Fenna 2007; Erk 2007). But part of the answer is also that the resources-and-HFE combination represents a particularly thorny issue. Why is this?

It would seem that tension is most likely in very particular situations: situations where a jurisdiction with a small population and limited base in the secondary and tertiary sectors that has endured a period of disadvantage as a consequence, comes into non-renewable natural resource wealth. This is accentuated when there is a strong awareness of how finite those resources are and how quickly the manna may cease falling. By contrast, for a large and economically-diversified jurisdiction to have a small surplus skimmed off an apparently permanent economic base to assist a relatively small population in a patently disadvantaged region is not particularly irksome. There was also a moral case for redistribution from such regions in a situation where manufacturing was subsidised by consumers in all regions of the country by the customs tariffs that sheltered metropolitan industry from international competition. Real or not, hinterland regions regularly perceive themselves as labouring under "disabilities" consequent upon dominance by the much more populous urban industrial heartlands (e.g., Western Australia 1934).

Both Alberta and Western Australia fit this pattern, and both have suffered significant periods in their history without significant resources being discovered or developed – periods where they were disadvantaged by comparison with the metropolitan jurisdictions. This was, of course, the period in which, under pressure from Western Australia, the Commonwealth created the Grants Commission and launched the equalisation system. Both Western Canada and Western Australia have experienced a somewhat fraught relationship with their respective federations from the beginning (Fenna 2009).

Invidious Development

Contributing to the contentious nature of the question is another set of empirical realities. In Australia at least, the resource economy's gain is in substantial and undeniable ways, everyone else's loss. This is because of the so-called 'Gregory effect': a surge in export income from resources flows through to an appreciation of the currency, the effect of which is to make the country's non-resource products less competitive in both export and domestic

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[10] These are in addition to the standard personal income tax levied by the Government of Canada.

[11] Notably in the original *British North America Act's* s109 and the revamped *Constitution Act 1867's* s 92A.

markets (Gregory 1976; Corden and Neary 1982). Australia's terms of trade are now "at their highest level since at least Federation – by a good margin" (Stevens 2011: 69). The stimulus this provides to Western Australia was made clear when, at 16.4% in the year to September 2011, growth in WA reached the highest level ever recorded by an Australian State (ABS 2011). The cost of success in the mining boom is borne by firms and workers in the manufacturing States; "those parts of the Australian traded sector not linked in some way to the resources boom are currently facing severe and sustained competitive pressure from foreign competitors" (Gruen 2011: 133). They are declining as a consequence, and not always just in relative terms.

This would be much less of a problem if it were not for the highly *entrepôt* nature of much resource extraction, which is poorly linked to the domestic economy. Ownership is estimated to be 80 per cent foreign, so much of the enormous earnings leave the country (Connolly and Orsmond 2011). More importantly, neither upstream nor downstream linkages are plentiful, with manufactured inputs being sourced overseas and processing either occurring at destination or not in fact required.[12]

Assessing the Arguments

It is very irksome to have one's windfall revenues redistributed so relentlessly away. According to economist Jeff Petchey (2011:213), the minerals wealth is stretching Australia's equalisation system and "raising the spectre of instability in Commonwealth–state financial relations". But is there a real argument against it? There are both equity and efficiency criteria to consider.

The Right to Resources

Equity considerations are implicit or explicit in any discussion of HFE and the stance of Western Australian critics has an unmistakeably righteous tone. As discussed above, there may well be understandable reasons for this. In principle, though, the equity argument for selfishness garners few disinterested supporters."Failure to include mining revenue in the tax base will violate both the efficiency and equity principles", argues Williams (2005:356), for instance. One could even go further and argue that the case for excluding resources is *even weaker* than it is for excluding other revenue streams. Neither the iron ore, nor the China-driven resources boom, have landed in Western Australia's lap through any effort, initiative, insight or intelligence on the part of Western Australians. The availability of the resource is, as Brosio (2006: 446) puts it, "pure geological hazard". That being the case, it raises an obvious question: "Why should residents of resource-rich jurisdictions have these advantages, created by unequal access to the national patrimony?" (McLure 1993:248). It is hard to avoid the conclusion that the design of an equalisation system is most appropriately carried out behind Harsanyi's (1953) "position of ignorance": judging without knowing where one will be positioned in respect to likely gains or losses.

Reward for Effort: the economic argument

Having acknowledged the inappropriateness in principle of excluding resources from equalisation, Williams inserts a significant caveat: "including revenue from mining activities has the potential to discourage exploitation of resources, at least if it is based on output rather than a pure resource rent tax". This is the main economic argument against equalising

[12] Of the 13 per cent addition to nominal GDP represented by resource exports, the Reserve Bank estimates that about half actually "accrues to Australians one way or the other" (Stevens 2011: 69).

resource revenues and it is simply a variation of the main economic argument against equalisation in general. It is a key part of the WA case and it was a concern of the recent Senate Select Committee on the Reform of the Australian Federation (SSCRAF 2011), whose recommendation no. 10 was that the GST Review "give particular attention to the issue of incentives and disincentives to states and territories to maximise their revenue". In turn, it is simply a variation of the efficiency argument against progressive taxation of private income: if individuals or jurisdictions are forced to give up their earnings, they will diminish the effort they put into generating those earnings. As Garnaut and FitzGerald (2002b:295) put it:

> The dominance of transfers from the Commonwealth in a framework of horizontal fiscal equalisation could be expected to have *a significant effect on the political economy of policy and development strategy affecting growth*, in both recipient and donor States [emphasis in original].

This is a plausible argument for HFE in general, particularly if one accepts Garnaut and FitzGerald's (2002b:295) claim that "growth often requires substantial State capital expenditure on economic and social infrastructure, that is not considered in the CGC's assessment of expenditure disabilities". To be more than merely plausible, however, this proposition would require some supporting evidence, and that is entirely wanting. As a practical argument, it is a matter best settled empirically: do jurisdictions indeed go slow on economic development in general or resource development in particular when they are shorn of the fiscal proceeds? And here the evidence, at least for resources, is overwhelming: they do nothing of the sort. Jurisdictions remain shameless in their pursuit of resource development. The reason for that is quite simple and obvious but less frequently acknowledged: local jurisdictions get many more benefits from resource development or economic growth than simply royalty or tax revenues. They get growth and development; they get opportunities for entrepreneurs and business investors; they get high-wage jobs; and they get flow-on effects to other sectors of the local economy. Regardless of the fiscal payoff, the electoral payoff from all that economic dynamism is potentially substantial. Challen (2006: 11) is speaking, of course, with the self-interest of his Tasmanian electors in mind when he rebuts the disincentive argument, but his reasoning stands on its merits.

> 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.

Devil in the Detail?

Discussion of equalisation in theory or in broad terms must be distinguished from discussion of any given equalisation regime as it exists in practice. Criticisms of the Australian system and the work of the Commonwealth Grants Commission from donor States such as Western Australia tend to be a mixture of the two. It may well be the case, as Porter (2011) argues, that the current regime inadequately accounts for the unusual public costs involved in resource development. This is presumably correctable within the existing framework, whose various putative deficiencies have been canvassed in a number of analyses (e.g., Warren 2008). The focus in this paper has been on equalisation in broad terms, which is not to deny that there may well be perverse or undesirable elements to the specific methods applied by the Grants Commission.

One technical matter raised by Porter (2011) does warrant mention here because it touches on broader issues in the political economy of resource development in federal systems. The CGC's work is problematic, it is suggested, because "a State only 'keeps' 100 per cent of any royalty revenue that are attributable to it levying above standard royalty rates so that the immediate economic incentive the system produces is to over tax because a State only keeps that part of royalties generated by the rate being above average". This is a puzzling objection. Logic and experience tell us that the desire to attract footloose capital creates an endemic tendency for subnational jurisdictions in federal systems to *under*-tax. This is precisely the reason in most federations that central governments assume a dominant role in such taxation. Any arrangement that provides a counterweight, or corrective incentive, to that tendency is surely to be welcomed by State governments.

Conclusion

Fiscal equalisation mirrors the essential tension in federal systems between unity and diversity, between a common citizenship and the existence of subnational political communities. Ultimately, the mode and degree of equalisation is a matter of political judgement reflecting the prevailing norms and realities in each federation. For both inherent and historical reasons, equalisation issues are inflamed in such federations as Australia and Canada by the resources boom. The situation is particularly acute in Australia, where Western Australia is experiencing a rapid change from being only moderately affected by equalisation to having its share of transfers dramatically reduced. It is understandable that Western Australia would like to keep a greater share of what for the time being and for the foreseeable future are quite substantial fiscal benefits and it is quite possible that the Australian system 'over equalises' by at least some margin. And it is indeed the case that Australia equalises more comprehensively than almost any other federal system. However, the main efficiency argument against resource revenue equalisation (and equalisation more generally) is theoretically weak and empirically unsupported. There is scant reason to predict that jurisdictions will go particularly slow on economic development just because they will not enjoy much of the fiscal benefits and no evidence of such behaviour has been identified to date.

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