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# **Inter-Governmental Managerial Mechanisms in Australia**

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## Abstract

This paper looks at the intergovernmental mechanisms by which federalism operates in Australia, notably the Council of Australian Governments (COAG), Commonwealth Grants Commission (CGC), Australian Loan Council (ALC). These three main systems contribute to improve Australian intergovernmental relations, that is, establish managerial mechanism in Australia. Australia's intergovernmental system provides the foundation for new federalism operations. And these mechanisms are an opportunity to consider the intergovernmental relations as a whole. Reform of intergovernmental operations and federal financial arrangements would contribute to greater economic efficiency, improved equity outcomes, and greater accountability and transparency. Reform will deliver benefits to the national economy and improve both Commonwealth and state fiscal operation.

**Managerial mechanism:** This is defined to be administrative in its mode of operation, concerned with the effective and rational management of human and other resources, and rich in policy goals and objectives. The States play a creative and proactive part but are as service providers whose performance is subject to continuous scrutiny and oversight. The financially dominant Commonwealth Government plays the manager's role.<sup>1</sup>

**COAG:** The main role of vertical cooperation is COAG which established in 1992. In 2008 the new Intergovernmental Agreement on Federal Financial Relations placed financial issues firmly at the centre of the COAG stage. This development received added impetus from the Global Financial Crisis, with the announcement in February 2009, following a Special COAG meeting, of the Nation Building and Education Investment Fund to introduce education and Health and Hospitals Fund.<sup>2</sup>

**CGC:** The Commonwealth Grants Commission (CGC) was established in 1933 to provide independent advice on the needs of financially weaker states. The fiscal position of a state is heavily dependant on both the total amount of revenue transferred from the Commonwealth to the states and its distribution between the states. The transfers represent around 50 per cent of total state revenue. Around 50 per cent of the transfers are allocated in a manner designed to even out fiscal imbalances between the states as recommended by the Commonwealth Grants Commission. Federal-state financial relations

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<sup>1</sup> Griffith [2009].

<sup>2</sup> Griffith [2009].

have been altered by the abolition of financial assistance grants and revenue replacement grants and by the distribution of goods and services tax (GST) revenue amongst the states and territories.<sup>3</sup>

**ALC:** Australian Loan Council has been responsible for the design and implementation of external controls over subnational borrowings in Australia since 1927. A common objective of controls over subnational borrowing appears to be to control the growth of public debt at subnational level. No discussion of the Australian Loan Council can be complete without comment on the role of the Commonwealth government, which dominated and used the Council's decisions throughout this period for enforcing its macroeconomic policies on the States.<sup>4</sup>

These three organizations will support economic growth, improve inter-governmental fiscal efficiency and reduce the complexity of inter-governmental fiscal relations, increase the transparency and accountability of states expenditure, and provide a basis to provide better services for the community. Especially the reform of Specific Purpose Payments (SPPs) is important.

**KEYWORDS:** Australian Loan Council, Intergovernmental fiscal relations of Australia, the Commonwealth Grants Commission, Debts, Public Australia, the Council of Australian Governments.

**JEL code:** H71, H74, H77

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<sup>3</sup> Wilkinson [2000], pp.10-11.

<sup>4</sup> Grewal[1999], pp.2-3.

## **1. Introduction**

Australia has a two-tiered highly centralized federation of six states (New South Wales, Victoria, Queensland, Western Australia, Tasmania) and two federal territories. The Commonwealth has sole responsibility for defense, trade, immigration, external affairs, social security, and employment. State and territory governments are providers of main community services such as health care, education, child support, public housing and police service. Reform of the inter-governmental financial system needs to be considered in the context of providing states and territories with greater fiscal autonomy to provide greater security and sustainability of revenue to deliver of services. As to government revenue, the states had expected their financial independence to be preserved under the Constitution. However, legal constraints have led to centralization of revenue functions and an ever-increasing financial dependence of the states on the central government.

## **2. A Problem of eroding state revenue bases**

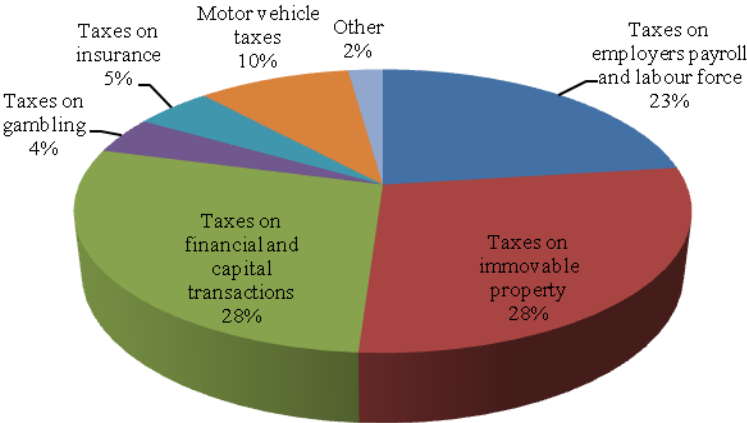
The revenue bases of the states and territories (the states) have narrowed due to interpretations of the High Court. Especially under the income taxation legislation passed by the Commonwealth Parliament in 1942, the Commonwealth government assumed exclusive power to impose taxes on income for the period of World War II. At a 1946, Prime Minister Chifley indicated that the Commonwealth government intended to continue with the income tax system indefinitely. The legislation survived various subsequent High Court challenges and remains in place to the present day. Government responsiveness to community needs requires a robust funding base. Ideally, governments would have autonomy over a secure, stable and independent revenue base to fund expenditure.

As Chart 1 shows that the state tax base is limited to consumption tax, for example employer payrolls, land and a small range of goods and services. This leaves states in difficult position from which to plan expenditure on infrastructure and services. As a result, the thorny issue of vertical fiscal imbalance remains in Australia.<sup>5</sup>

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<sup>5</sup> Wilkinson [2000], pp.10-11.

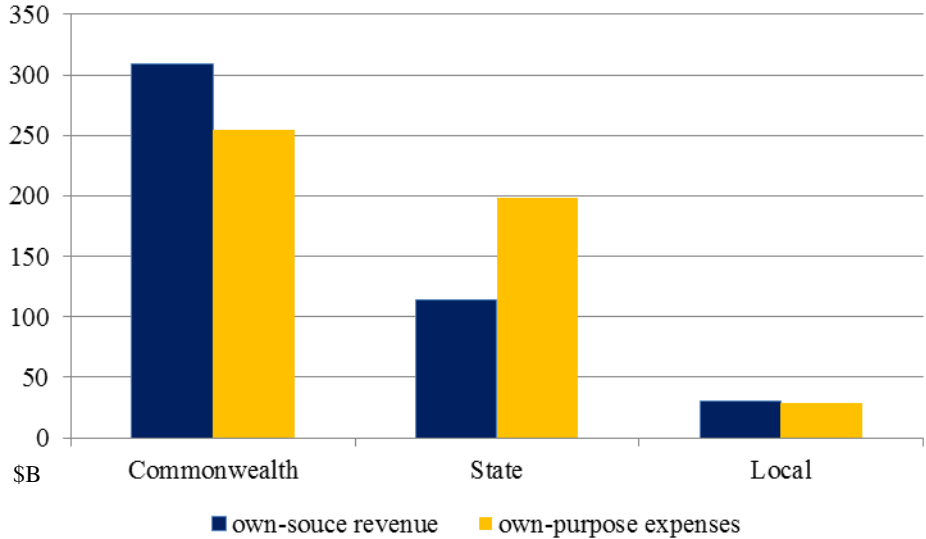
**Chart1. The states' tax base**



Source: ABS 5506.0 2010-11

A vertical fiscal imbalance is undesirable because it can weaken government accountability to the public by breaking the nexus between a government’s decisions on the level of service provision and the revenue raised to fund it. Commonwealth revenues exceed their own-purpose expenses and state own-source revenues are inadequate to fund their expenses, as shown in Chart 2.

**Chart2. A fiscal imbalance in the Federation**

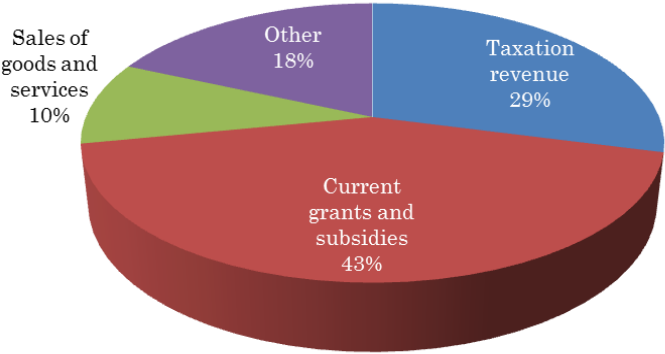


1. General Government sector only shown.
2. Own-source revenue defined as total revenue minus grant revenue; own-purpose expenses defined as total expenses minus grants to other levels of government.

Source: ABS 5512.0 2010-11

The narrowing of the state tax base has been filled by the Commonwealth through grants to the states, for example the general grants, Specific Purpose Payments (SPPs). Commonwealth grants occupy around 43% of state revenue as shown in Chart 3.

**Chart3. States’ dependence on Commonwealth grants**



1. ‘Other’ includes interest income, royalties and dividends from public trading enterprises.

Source: ABS 5512.0 2010-11

**3. The role and history of each organizations**

**A. Council of Australian Governments (COAG)**

COAG has reaffirmed its commitment to cooperative working arrangements through an historic new Intergovernmental Agreement (IGA) that provides an overarching framework for the Commonwealth’s financial relations with States. In 2008, COAG agreed the Intergovernmental Agreement on Federal Financial Relations (IGAFFR). The IGAFFR contributed a new framework establishment for the Commonwealth’s financial relations with the States. The Commonwealth and States financial relations new framework came into effect on 1 January 2009. In new framework States was provided with flexibility to deliver quality services where they are most needed, while increasing State’ accountability to the public expenditure. The new federal financial framework brings greater clarity to the roles and responsibilities of the Commonwealth and the States. The new system is all about performance reporting by governments, a system founded on accountability and designed to achieve transparency. The IGAFFR aims to improve the quality and effectiveness of

government services by reducing Commonwealth control, aligning payments with the achievement of outcomes and/or outputs and giving States the flexibility to determine how to achieve those outcomes efficiently and effectively<sup>6</sup>.

The current formulation of COAG's role reads as follows:

- to increase cooperation among governments in the national interest;
- to facilitate cooperation among governments on reforms to achieve an integrated, efficient national economy and single national market;
- to continue structural reform of government and review of relationships among governments consistent with the national interest;
- to oversee the work of the National Counter-Terrorism Committee, which reports to COAG on the level of national counter-terrorism preparedness and capability; and
- to consult on major issues by agreement such as:
  - major whole-of-government issues arising from Ministerial Council deliberations,
  - major initiatives of one government which impact on other governments.<sup>7</sup>

Through COAG activity, the Commonwealth and the States are implementing an ambitious reform agenda, specially focusing on the areas of health and ageing, education, skills and workforce development, housing, disability services, climate change and water, infrastructure, business regulation and competition, and Indigenous reform.<sup>8</sup>

## **B. Commonwealth Grants Commission (CGC)**

The Commonwealth Grants Commission was born 79 years ago in 1933 and given the job of providing advice on Commonwealth grants to the States. This Commission's main function is to inquire into the relative fiscal capacities of the States and to recommendation on the

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<sup>6</sup> COAG website Accessed 14 August 2012, Available at <http://www.coag.gov.au/>.

<sup>7</sup> Griffith [2009], pp.7-9.

<sup>8</sup> Griffith [2009], pp.7-9.



distribution all GST<sup>9</sup> revenue among States. The Commonwealth distributes all GST revenues to the States under the Commonwealth Grants Commission's recommendations. The Commission is a statutory body tasked under successive terms of reference from Government with recommending a distribution of GST revenue which achieves the objective stated in the Intergovernmental Agreement (IGA) that GST revenue would be distributed among the States to achieve fiscal equalization. The GST is distributed according to horizontal fiscal equalization principles (HFE).

The most recent definition was:

State governments should receive funding from the goods and services tax revenue 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.

The total pool of funds allocated to the states is allocated on an equal per capita basis adjusted for States specific expense and revenue needs. CGC Reports were completed in 1988, 1993, 1999, 2004 and 2010. With the introduction of the GST and the abolition of a number of state taxes, state governments are now dependent on CGC recommendations for 25 per cent of their revenue. The formulae included elements of horizontal fiscal equalization. The history of the CGC must be set in the wider context of overall federal-state fiscal relations.<sup>10</sup>

### **C. Australian Loan Council (ALC)**

#### **C-1. From establishment of the Australian Loan Council to 1940's**

The Australian Loan Council was established in 1923. The Constitution did not provide for coordination of public borrowing, and until 1922 the Commonwealth and the States borrowed individually. In 1927, these arrangements were formalized when the

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<sup>9</sup> The GST came into operation on at the beginning of the fiscal year 2000/01.

<sup>10</sup> Williams[2011], pp.2-3.

Commonwealth and the States signed the Financial Agreement. The necessary legislation was passed by each of the Parliaments in 1928. This was ratified by all States and the Commonwealth in 1928. The relevant Commonwealth Legislation is the *Financial Agreement Act 1928*. The Loan Council consists of the Prime Minister and the Premiers of the six States or their representatives. The Prime Minister is usually represented by the Treasurer.

The Loan Council was established to co-ordinate State and Commonwealth borrowing. The principal functions of the Loan Council include the determination of the total amount that may be borrowed in a particular year, the allocation of this total among the States, the determination of the terms and conditions, and the timing of the approved loan raisings. Each State has one vote at the Loan Council while the Commonwealth has two votes and a casting vote.

In addition financial strength of the Commonwealth, especially after having gained the income tax base in the 1940s, has enabled it to dominate Loan Council decisions since the early 1950s. The fiscal advantage of Commonwealth have not only allowed it to dominate the decision of Loan Council but also to calculate the level of general revenue grants to the States and to extend its power into areas of State responsibility through the use of specific purpose grants. This has been characteristic of Australian fiscal relation in long time.

Since 1927, the Australian Loan Council has been responsible for determining the overall level of public borrowing in Australia, and state government borrowings could not be undertaken without the approval of the Loan Council. Under the 1927 Agreement, the Loan Council is only authorized to approve borrowings by governments. Borrowings of local and semi-government authorities were initially outside the scope of the Loan Council. When it became clear, this exception might become a loophole for avoiding the Loan Council's discipline. As a result the exception was removed in 1936 with the passage of the so-called Gentlemen's Agreement. This Gentlemen's Agreement brought the exempted borrowings under the purview of the Loan Council. This Agreement was abolished in 1984-85 when the Global Borrowing Arrangements were instituted.

## **C-2. States' dependence on Commonwealth Lending(1950's-1970's)**

The Loan Council arrangements worked reasonably well until after the Second World War. The role of the Loan Council began to change since 1950's. From the 1950s, it began to be regarded by the Commonwealth even more than ever as an instrument of macro-economic policy. The post-war boom in investment in Australia was reflected in private gross fixed capital expenditure increasing by 30 per cent in 1949-50 over the previous year, 43 per cent in 1950-51 and 22 per cent in 1951-52. <sup>11</sup>

In the early 1950s, Commonwealth faced with significant inflationary problems, the Federal Treasurer grappled with reductions in the proposed Loan Council borrowing programs. With Commonwealth control over financial policy, capital funding to the States was only maintained by the Commonwealth subscribing its own financial resources by contributing to what were commonly called as 'Special Loans'. Although the Loan Council approved a borrowing program of \$454 million, only \$148 million could be raised through the public loan. <sup>12</sup>The Commonwealth provided the remaining \$306 million in the form of a special loan to the States. Special loans became a major source of Commonwealth control over State borrowings during the 1950s and 1960s. This situation encouraged the increasing of states' dependence on Commonwealth. In result, the Commonwealth controlled directly over the volume of State borrowings. This might show that there was attempt to centralise Commonwealth fiscal power. However in response to the shared prospect of a resources boom in Australia in the late 1970s, the Commonwealth accepted the States' pleas for higher public sector borrowings for financing large infrastructure projects in energy and mining sectors. <sup>13</sup>

## **C-3. The new Global Limit Approach (1980's)**

During the late 1970s, the Loan Council's control over the borrowings of semi-government authorities was relaxed until the Gentlemen's Agreement. It was clear by 1983-84 that this Gentlemen's Agreement was no longer an effective instrument for imposing Loan Council

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<sup>11</sup> Grewal [1999b],p.9.

<sup>12</sup> Grewal [1999b],p.9.

<sup>13</sup> Grewal [1999b],p.9.

discipline on subnational borrowings. In 1984-85, the Commonwealth decided to strengthen Loan Council control by implementing the Global Borrowing Arrangements. At its 1984 meeting, the Loan Council suspended the Gentlemen's Agreement and adopted a new Global Limit Approach for recovering the authority of the Loan Council. In result, new global limit approach was adopted and the Gentlemen's Agreement was terminated. The distinction between borrowings of the State governments and their semi-government authorities was removed under the new Global Limit Approach.

Global Limit Approach was changed in 1993-94. These have been replaced by a system of Loan Council Allocations. This system was operated under Financial Agreement Act 1994. One of the reasons behind this, in the mid-1980s, concerns over Australia's current account deficit and foreign debt led the Commonwealth into enforcing a strategy of severe fiscal contraction, which culminated in the recession of 1990-91. After 1990's there were a few significant changes to the program.

Firstly, in 1990, it was decided that the distribution would be adjusted over a five year period, beginning in 1990-91, to an equal per capita basis. It was agreed that the administration of the limits would continue to be flexible, with temporary additions being approved for any State which could demonstrate a need for supplementary borrowings.

Secondly, since 1984-85, State authority overseas borrowing had been set at the ceiling of 22 per cent of new money borrowing plus the refinancing of maturing overseas debt. Commencing in 1991-92, this ceiling was abolished. The Commonwealth was of the opinion that the States had gained sufficient expertise in handling overseas debt and hedging transactions to warrant this freedom. There was a need to allow the States more flexibility in the structuring and financing of that debt.<sup>14</sup>

#### **C-4. Current Loan Council**

The global borrowing limits were replaced by the new Loan Council Allocations (LCAs) in July 1993. The new LCA approach signaled a change in the philosophy of the Loan Council from a rigid regime of compliance to a framework that is both credible and transparent. New arrangements for Loan Council monitoring and reporting were also put in place. Under the

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<sup>14</sup> James [1993],p.11.

new arrangement, each jurisdiction is required to nominate a Loan Council allocation, which is anchored in its own estimated budget balance for the forthcoming year and its strategy to achieve a balance, if the budget is in deficit. If the sum total of the nominated LCAs is inconsistent with the Commonwealth government's macroeconomic policy objectives, appropriate adjustments are negotiated with the States. Each jurisdiction is obliged to report to the Loan Council on an annual and quarterly basis about its budgetary situation.<sup>15</sup>

It is clear from the above discussion that the Commonwealth government's domination of Australia's public finances is important in understanding the Loan Council's role in the coordination of subnational borrowings. But the Loan Council's discipline was never fully effective and the Council was often a step behind in closing the loopholes exploited by one State or another for avoiding accountability. It is clear that the role of Loan Council and the intervention to the States of the Commonwealth is gradually decreasing.

#### **4. Reform of Inter-Governmental relation system**

The Australian new framework for federal financial relations introduced on 2009. This framework is going to provide a strong foundation for COAG to pursue economic and social reforms to underpin growth, prosperity and wellbeing into the future. Australia's federal relations are characterized by three broad features:

- the financial arrangements are influenced by the large expenditure responsibilities of the States relative to their revenue capacities, so that they rely on transfers from
- the Commonwealth to finance their activities — referred to as vertical fiscal imbalance;
- the States have different capacities to raise revenue and deliver services — referred to as horizontal fiscal imbalance; and
- overlapping roles and responsibilities in areas of government activity which can lead to sectors where regulation or services remain fragmented, with duplication of activities, lack of coordination and blurred accountabilities.<sup>16</sup>

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<sup>15</sup> Grewal [1999b],p.15.

<sup>16</sup> Commonwealth of Australia[2009],pp.3-4.

This paper especially treats the third problem. As stated above, the Intergovernmental Agreement on Federal Financial Relations (IGAFFR) supported a new framework for Commonwealth-State financial relations:

A key feature of the new framework is the centralized payment arrangements which will simplify payments to the States, aid transparency and improve the States' budget processes. Previously, payments to the States were provided by Commonwealth portfolio departments to the relevant state agencies, and each payment has its own payment and administrative arrangements. Under the new arrangements all payments are centrally processed by the Commonwealth Treasury and paid direct to each state treasury. State treasuries will be responsible for distributing the funding within their jurisdiction. For the first time in decades the complexity of the Commonwealth's financial relations with the States will come under the umbrella of just one piece of legislation, the Federal Financial Relations Act 2009.<sup>17</sup>

On the same theme, the Commonwealth Government's 2009-10 Budget Paper No 3 commented that a 'new federal financial framework' was in place, one that would provide a 'robust foundation for collaboration between the Commonwealth and the States'. It went on to say:

The framework commenced on 1 January 2009 and involves a significant rationalization of the number of payments made to the States, while increasing the overall quantum of payments. The framework provides clearer specification of the roles and responsibilities of each level of government, so that the appropriate government is accountable to the community<sup>18</sup>

The objective of the federal financial relations framework is to improve the quality and effectiveness of government services. It seeks to do so by providing clarity about who is responsible for the delivery of those services, flexibility in the delivery of services and increased accountability to the public.

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<sup>17</sup> Commonwealth of Australia[2009],pp.3-4.

<sup>18</sup>Commonwealth of Australia[2009],pp.3-4.

**A. Key features of the framework**

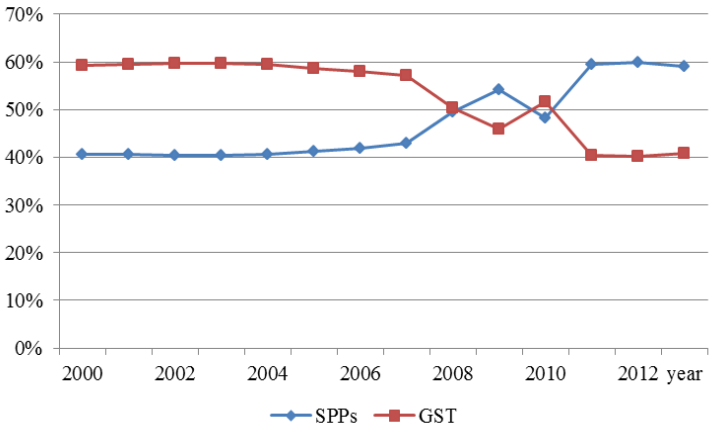
**Funding**

The Commonwealth currently provides financial support for the States' service delivery efforts through:

- National Specific Purpose Payments (National SPPs) to be spent in key service delivery sectors;
- three types of National Partnership payments - project payments, facilitation payments and reward payments; and
- GST general revenue assistance payments to be used by the States for any purpose, and other general revenue assistance.<sup>19</sup>

The framework rationalized a number of payments made to the States, centralized payment arrangements and provides greater funding certainty and flexibility to the States.

**Chart4. SPPs and GST payments from Commonwealth to the States**



Source: Commonwealth of Australia [2009], Australia's Federal Relations, Budget Paper No. 3 p.20.

Recently the ratio of GST and SPPs is replaced among subsidies paid to a state. SPPs are on the increase from 2008.

<sup>19</sup> Commonwealth of Australia[2009],p.8.

## **Greater flexibility for States' service delivery**

The federal financial relations framework gives the States greater flexibility. In the Intergovernmental Agreement, the Commonwealth has committed to move away from prescriptions on service delivery in the form of financial or other input controls, which inhibit state service delivery and priority. Rather than dictating of Commonwealth how things should be done, the framework focuses on the achievement of mutually agreed outcomes, providing the States with increased flexibility in the way they deliver services to the Australian people.<sup>20</sup>

For example, the States are required to spend the National Schools SPP in the healthcare sector. Although this National Schools SPP is tied, they have budget flexibility to allocate funds within that sector in a way that ensures they achieve the mutually agreed objectives for that sector.

## **B. Reform of Special Purpose Payments (SPPs) system**

The Intergovernmental Agreement on Federal Financial Relations provides the overarching framework for the Commonwealth's financial relations with the States on 2008. This agreement establishes a foundation for governments, especially States, to collaborate on policy development and service delivery. All policy and financial relations between the Commonwealth and the States are reigned over under the provisions of the IGA. There are three features of this new financial arrangements.

- National Specific Purpose Payments (SPPs) supported by new National Agreements.
- National Partnership payments associated with National Partnership Agreements.
- a performance and assessment framework to support public reporting and accountability.

Under the new framework for federal financial relations, the previous more than 90 different various payments from the Commonwealth to the States for specific purposes have

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<sup>20</sup> Commonwealth of Australia[2009],pp.3-4.



been combined into following new five national SPPs

- National Healthcare SPP;
- National Schools SPP;
- National Skills and Workforce Development SPP;
- National Disability Services SPP; and
- National Affordable Housing SPP.

National SPPs are ongoing financial contributions from the Commonwealth to the States to be spent in sectors of schools, skills and workforce development, health care, affordable housing, and disability services. The States are required to spend each National SPP in the service sector relevant to the SPP. They have full budget flexibility to allocate funds within that sector as they see fit to achieve the agreed objectives for that sector<sup>21</sup>.

National SPPs are associated with National Agreement between the Commonwealth and State. National Agreements establish the policy objectives in the service sectors of education, skills and workforce development, health care, affordable housing, and disability services

National Agreements set out the objectives, outcomes, outputs and performance indicators for each sector, which are agreed between the Commonwealth and State. The agreements also clarify the roles and responsibilities of the Commonwealth and States in the delivery of services and the achievement of outcomes. They do not include financial or other input controls imposed on service delivery by the States<sup>22</sup>. The National SPPs operate in conjunction with COAG's reform agenda for key social policy sectors, as set out in six National Agreements:

- National Healthcare Agreement;
- National Education Agreement;
- National Agreement for Skills and Workforce Development;
- National Disability Agreement; the National Affordable Housing Agreement;
- National Indigenous Reform Agreement.

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<sup>21</sup> Commonwealth of Australia[2011],pp.21-25.

<sup>22</sup>Griffith [2009],pp.21-23.

But note that not all National SPPs are associated with a National Agreement. For example, there is no National SPP associated with the National Indigenous Reform Agreement. They contain agreed objectives, outcomes, outputs and performance indicators, and clarify the roles and responsibilities that guide the Commonwealth and the States in the delivery of services across the relevant policy areas.<sup>23</sup>

## 5. Conclusion

The subject area covered in this paper is complex and multi-faceted. With the financially dominant Commonwealth taking the managing role, responsibilities and works are shifted to the States on the condition that they account for progress made in the achievement of outcomes agreed to through the COAG process.

While the States accomplish to policy development, Commonwealth seem to operate somewhat as managers in the delivery of services. In fact, the greater flexibility permitted to the States under the new National SPP payments are designed to increase the accountability of the States for expenditure decisions.

- to improve the quality of government services by reducing Commonwealth control;
- to achieve specific outcomes or the performance benchmarks under National Agreements;
- The role of Loan Council and the intervention to the States of the Commonwealth are gradually decreasing;
- While SPPs amount is increase, general revenue assistance(GST assistance) amount is gradually decreasing

In result, The Commonwealth currently manages financial support for the States' service delivery through COAG.

Finally, I refer to some problems about this framework. The impact on states of this framework is exacerbated by the composition of Commonwealth grants, many of which are

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<sup>23</sup> Griffith[2009], p.22.

tied to specific purposes. Specific Purpose Payments arrangements under the new IGA negotiated by COAG have relaxed some of the inflexibilities imposed by SPPs, by changing the focus of agreements from input controls to the achievement of outputs and outcomes. However, the structure of SPP financial arrangements will continue to act as a constraint on the capacity of states and territories to plan expenditure in infrastructure and services. The reform of Commonwealth grants must consider the possibility that States can tax a broader revenue bases.

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