

R.C. Mills (1886-1952) and Australian Fiscal Federalism, with Special Reference to the Methodology of the Grants Commission

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Abstract: Provides some biographical background on the Australian economist, R.C. Mills. Outlines his position on federal financial relations between 1928 and 1935 and discusses his involvement with the Grants Commission, 1941-1945. Concludes that Mills's early vision of improved federal financial relations has proved to be an enduring one.

I am delighted to participate in this symposium on federalism on the occasion of marking the centenary of Australian federation at the 2001 HETSA Conference here in Hobart. The last factor imposes the constraint that in this discussion we need to take history of economic thought considerations seriously in our approach to this topic. I intend to do this by looking at R.C. Mills's role in Australia's fiscal federalism debate for several decades, with special reference to his contributions to the methodology of the Grants Commission. The last organisation, so crucial in the contemporary fiscal federalism decision-making process, is of course not yet a hundred years old. It celebrated its fiftieth anniversary as recently as 1983, being established in 1933, or one third of the way into the first one hundred years of Australia's federation. However, its establishment then can be described as a natural outcome of the federal movement. The financial arrangements made for the six original federating colonies as separate States within a new federal compact carried within them an ultimate requirement for a body such as the Grants Commission became when it was founded during the early 1930s.

1 Biographical Background to R.C. Mills

First some biographical background to R.C. Mills (drawn from Groenewegen 1986), the person at the centre of my story. He was an economist who over his lifetime exerted considerable influence over the path which the Australian federation was to take during a substantial part of its first century's existence, an influence which in many respects needs to be seen as a continuing one.

Richard Charles Mills was born in Mooroopna, Victoria, on 8 March 1886, the son of Victorian-born parents, hence a genuine Australian. His father, Samuel, was a school teacher. Mills received a good education at University High School, followed by Wesley College, and then studied Law, History and Political Economy at the University of Melbourne, gaining an LL B (1909) and an LL M (1910). Among his teachers was W. Harrison Moore, who presented his gifted student with a copy of the second edition of his annotated Constitution of the Commonwealth (a copy now in my own library. Unfortunately, it contains no annotations by the original owner on the financial clauses of the constitution, while my other piece of Mills memorabilia, a set of lecture notes taken by a student of his economic lectures at the University of Sydney during the early 1920s, indicates that Mills was not

lecturing on fiscal federalism topics at this time. This task was probably assigned to Mills's colleague in the Faculty of Economics, F.A. Bland.) But I digress. Mills finished his tertiary studies at the London School of Economics, where he won the Hutchinson Medal and graduated D.Sc. with a thesis on Wakefield's Scheme for the colonial settlement of Australia. The next years were spent on active military service in France, during which he was mentioned in despatches and was promoted to acting captain of his regiment. On his return to Australia in 1919, he tutored for a while in history at Melbourne, and served on his first government inquiry, the Victorian Royal Commission on Prices.

In 1920 he joined the small teaching staff of the then newly created Faculty of Economics at the University of Sydney, lecturing on economics and commerce. In 1922 he succeeded R.F. Irvine to the chair of economics and to Deanship of the Faculty, positions he held until 1945, when he moved to full-time work in the Commonwealth Public Service. In 1924 he assisted in the founding of the Economic Society of Australia, serving on the editorial board of its journal, *The Economic Record*, for several decades. During the 1920s he published various textbooks on monetary and international finance topics, which went through many editions. This literary output probably led to his appointment to the 1936 Royal Commission on Money and Banking, though his experience in such work was by then already extensive. It had started with his participation in the Victorian Royal Commission on Prices previously mentioned and was followed by membership of a 1924 official Inquiry into the Queensland Basic Wage and the 1932 Wallace Bruce Committee on Depression Problems. While a member of the Royal Commission on Money and Banking, he became good friends with Ben Chifley, a friendship which undoubtedly assisted his subsequent appointment to a number of positions of great significance to Australia's fiscal federalism system at the time when Chifley was federal Treasurer before becoming Prime Minister of Australia in 1945 as successor to Curtin.

The first of these appointments was chairmanship in 1942 of the Commonwealth Committee on a uniform federal income tax, the findings of which had an enormous impact on Australia's post-World War II system of federal financial relations. In 1945 he was appointed to the full-time chairmanship of the Universities Commission and as foundation Director of the newly-created Commonwealth Office of Education. In 1949 Mills also chaired the interim Council of the Australian National University in Canberra following its establishment by Act of Parliament in 1946. Also in 1949, Mills successfully persuaded Chifley of the importance of continuing financial assistance to university students beyond the existing repatriation arrangements for returned servicemen, thereby inaugurating the Commonwealth Scholarship Scheme. (I might digress here to indicate that without the existence of this scheme, I would not have been able to benefit from full-time university education as an undergraduate in the University of Sydney from 1957 to 1960.) Under Menzies, who had succeeded Chifley as Prime Minister in 1949, Mills chaired a special committee on financing universities beyond their existing requirements, enabling them greatly to expand their activities in teaching and research, and to lift their general standards. Mills therefore greatly assisted the enormous expansion in university funding which followed during the Menzies era and after.

Mills's involvement in the uniform income taxation arrangements (incidentally a cause he had already strongly supported as an academic in the 1920s and 1930s) ensured Commonwealth fiscal hegemony over the States, not only for

the duration of the second world war and the half century which followed but indeed for the foreseeable future as well. It brought in its wake a structure of Commonwealth general revenue assistance for the States (and territories) which developed from the 1942 Income Tax Reimbursement Grants, compensating the States for the second time in the history of federation for giving up their major revenue source. (The first such transfer had taken place on the federal compact itself, when the Commonwealth gained exclusive powers over customs and excise. At the time of federation, this revenue source was seen as more than sufficient for financing the very few services the Commonwealth was then expected to provide, so that its surplus revenue was to be regularly transferred to the States.) Expanded revenue powers also enabled significant expansion of the Commonwealth system of grants to the States by means of Specific Purpose Payments, a device by which the federal government gradually extended responsibility to what, in 1901, were seen as exclusive State responsibilities. The Commonwealth incursions into university financing initiated by the Chifley government and continued under Menzies were a striking example of this approach, and one in which Mills had been heavily involved in the beginning.

In 1941 Mills also became Chairman of the Commonwealth Grants Commission, a position he relinquished in 1945, together with his posts at the University of Sydney. He had been a consultant to the Commission in 1934 and 1935, within a year of its inception in 1933. He also reviewed its early Reports in the *Economic Record* in 1935 in a special issue devoted to examining recovery measures initiated by governments in Australia and New Zealand during the 1930s depression. Mills's active involvement as a member of the Grants Commission was therefore longer than the four years he served as its chairman. Moreover, it coincided with a period in which Australian inter-governmental financial relations were drastically altered by the uniform income tax legislation enacted in 1942 as a 'temporary' war measure. Mills's subsequent period of Commonwealth public service administered Commonwealth entry into the State field of university education as part of post-war reconstruction and development, an initiative which provided the Commission with a great deal of new business over subsequent decades.

2 R.C. Mills's Position on Federal Financial Relations (1928-1935)

R.C. Mills published three articles in the *Economic Record* dealing with economic aspects of Australia's federal system, with special emphasis on matters associated with the evolving system of inter-governmental revenue transfers under federation. The first of these appeared in May 1928 (that is, in the sixth issue of the *Record*). It may be described as a survey article on Australian inter-governmental revenue transfers up until the late 1920s, when the Commonwealth government decided to end the *per capita* payments to the States which, in 1910, had replaced the constitutionally obligatory transfer of surplus Commonwealth tax revenue during the first ten years of federation. This was quite a momentous change, since it inaugurated a very brief period when no grants for general revenue purposes were paid by the Commonwealth to the States (see Mathews and Jay 1972, pp. 118-23), though special revenue assistance grants had been paid to Western Australia and to Tasmania from 1910-11 and 1912-13 respectively, while Road Grants, the first of what became a multitude of matching Specific Purpose Grants, were paid to every State from the early 1920s onwards. In addition, the Financial Agreement Act

which implemented the abolition of the *per capita* grants provided for a National Debt Sinking Fund strategy, in which the States were to make agreed contributions to debt interest and to a formally created sinking fund. Moreover, the prolonged bickering at Premiers' Conferences over the continuation of *per capita* grants had also found room to debate the desirability of changing the original tax power division agreed to on federation by conceding exclusive rights to certain taxes (land tax, inheritance tax, entertainment tax) to the States and reducing the burden of Commonwealth income taxes to the potential advantage of income tax collections for the States.

The first issue provided the basis for much of the thrust of Mills's 1928 article. It had been originally presented as his Presidential Address to the 1928 meeting of the Australasian Association for the Advancement of Science at Hobart, and commenced by quoting from remarks made by Giblin (Mills's predecessor in that capacity), who had declared 'the financial relations between the component States and the Federal Government [to be] the chief determinant of the character of the Federation' (quoted in Mills 1928, p. 1). After reference to the *de facto* dominant tax power of the Commonwealth under the Constitution and its s.96 power to make grants to the States, Mills indicated that these powers in combination were capable of yielding important equity and efficiency benefits from major tax reform. Mills then declared personal income tax to be preferable to customs and excise on both, but especially on redistributive, grounds, and proposed exclusive income tax powers for the Commonwealth combined with special grants for the economically weaker, because less populous, States, which had also gained least from the development benefits of trade protection. Mills also noted the existence under the current arrangements of excessive tax duplication (land tax, personal income tax, inheritance tax) and the resort by some States (the newspaper tax in New South Wales, petrol tax in South Australia) to illegal taxes, as further reasons for tax simplification and reform. Mills's specific proposal focussed on exclusive (hence uniform) Commonwealth income and inheritance taxation combined with compensatory revenue grants to be paid to the States. He described it as a proposal for 'cooperative federalism' (a term he attributed to Seligman), in which the national principle underlying the federal idea – 'we are all Australians now, and members of a State afterwards' – was firmly enshrined (Mills 1928, p. 14).

In this context, Mills stressed that the revenue-sharing principles underlying his proposal for enhanced Commonwealth tax powers implied special treatment as well for the less populous States. In his view, taxation ought to be raised on the principle of taxable capacity; it should be distributed on the basis of need as established by population. In this manner, 'the more wealthy States [would contribute] to the needs of the less wealthy' (Mills 1928, p. 4). Uniform national direct taxation was combined with grants incorporating fiscal redistributive principles in Mills's first published excursion into the important federal financial relations topic. Given such views, it is not surprising that he was invited to act as consultant to the Grants Commission in 1934 and 1935, thereby possibly assisting in the preparation of its first two reports.

Mills's second *Record* article on federal financial relations was written jointly with F.A. Bland, his faculty and professorial colleague in Public Administration at the University of Sydney. It was a review article of the 1931 Premiers' Plan, that cooperative federalism endeavour to tackle the social and economic problems created by the prolonged depression of the 1930s. The review

indicated that past fiscal profligacy on the part of the States made Keynes's policy of substantial public borrowing in order to finance a public works programme not a feasible remedy for the Australian States (Bland and Mills 1931, p. 162) and that, in addition, such excessive past borrowing imposed the urgent task of balancing budgets (eliminating deficits) on increased taxation and/or reduced expenditures (Bland and Mills 1931, p. 164). This deflationary strategy was in fact a major part of the Premiers' Plan's approach to restoring business confidence and reducing unemployment. Its other features included interest rate reductions on bank deposits, domestic government debt and mortgages. Bland and Mills strongly rejected the view that in combination these measures reflected genuine equality of sacrifice for all sections of the community. Interest rate cuts, for example, affected pensioners and small bond-holders far more adversely than the more substantial investors; likewise, proportional wage reductions as a cost-cutting depression remedy disadvantaged the lowly wage-earner to a far greater extent than the burden this measure imposed on high salary-earners (Bland and Mills 1931, pp. 166-7). Although State financial data were still too incomplete to make incontrovertible judgements, Bland and Mills (1931, p. 173) detected little success as yet in achieving the desired balanced budgets but noted, on the basis of what State budget information was available, that these tended to give highly optimistic revenue estimates while proposed reductions in expenditures tended to be over-estimated (Bland and Mills 1931, p. 174). In short, 'budgetary equilibrium' was not likely to be achieved and modification to the Plan was needed if budgets were to be balanced by the target date of June 1934 (Bland and Mills 1931, pp. 175-6). Although only indirectly concerned with fiscal federalism issues, the review reiterated Mills's emphasis on the need to seek 'equality of sacrifice' in formulating appropriate economic policy, even if in this case the relevant concerns were only loosely connected with matters of government finance. The investigation of State finances it contained, in particular of State budget outcomes, would have been very useful to him during his four-year chairmanship of the Grants Commission.

Mills (1935) returned to these issues in his overview of development in grants to the States as recovery measures during the 1930s depression, in which he raised the issue in particular of whether such grants could be made on the basis of definite, and sound, economic principles. Although public finance economists had a well-established tradition in laying down such principles in the past (among others, he cited the views of Dalton, Adam Smith, Cannan, Bastable, Sax, Edgeworth, Pigou and Seligman on the need for equity and/or economy in taxation), Mills argued that such 'norms' were invariably outside the bounds of 'scientific economics' (Mills 1935, pp. 15-21). Turning to Australian policy thinking, Mills (1935, p. 21) then indicated that 'the best known "principle" in Australian federal finance is the principle of financial responsibility', though in all federations with whose practice he was familiar this principle was invariably breached in the practice. Revenues were raised by one level of government to be spent by another, with or without controls imposed by the taxing authority (Mills 1935, pp. 21-2). A fine Australian example was the Commonwealth payment of s.96 grants to Western Australia, Tasmania and South Australia, on 'principles' embodied in the four conditions to be met if special financial assistance was to be granted to a State. Following Giblin (as cited by Mills 1935, pp. 24-25), these conditions were: '(1) [The State] should be taxing its people with considerably greater severity than the Australian average. (2) It should not be attempting social provision on a more generous scale than the average. (3) Its costs of administration should be below the

average. (4) It should for some years at least have shown moderation and caution in loan expenditure’.

Mills then discussed in considerable detail the manner in which the Grants Commission had applied its principles to determine the grant entitlements of the three claimant States in its first years of operation. In this discussion, he noted that the principle of ‘compensation’ for financial disability from federation, which had justified the initial special grants paid to Western Australia, had been supplemented by that of ‘need’, partly arising from the severity of the depression’s impact on the State finances of Tasmania, of South Australia and, to a lesser extent, of Western Australia (Mills 1935, pp. 26-7). The Commission’s supplementary questions about problems of practical application of such principles in its procedures for estimating the appropriate grant, suggested to Mills that the Commission was also moving to the view that the Commonwealth government could not afford to let any State, ‘whether by reason of inferior natural resources or otherwise to fall significantly behind general Australian standards in delivering social and economic services’ (Mills 1935, p. 28). This justified the emphasis he placed on comparing State budgetary positions while preparing recommendations for special financial assistance to States. In this process, Mills also declared, there was considerable scope for the use of economic analysis in assessing taxable capacity and severity of taxation together with the real impact of State outlays on economic and social services.

Mills was in the unusual position for an academic economist of having the opportunity to act more directly on some of the Australian public finance reform measures which he had foreshadowed in the three *Economic Record* articles, whose contents have just been summarised. In the first place, his chairmanship of the Committee on Uniform Taxation in 1942 enabled him to recommend exclusive Commonwealth income tax for the duration of World War II and for one year thereafter, with appropriate fiscal compensation to be paid to the States. This proposal in the end was more than adopted. From 1942 onwards, income taxation has continued to be a federal government tax, with compensation paid to the States in the form of general revenue grants. Even the recent introduction of the GST, the revenue of which is passed to the States, has done little to alter this financing solution for State activities required by uniform income taxation. It only replaced one form of general revenue assistance with another one, because the States have no real rights to make alterations to the source from which this revenue is collected, either by changing the rate or details of the base from which the GST is collected.

In addition, and as part of implementing the uniform income tax scheme, Mills was able to exercise considerable influence over the financial reimbursement procedures for the States in his capacity as the (third) chairman of the Commonwealth Grants Commission. He had been appointed to this position in November 1941, holding it until 7 November 1945 when he resigned to join the Commonwealth Office of Education as its first head (as mentioned previously in section 1 of this paper). Mills’s work as chairman of the Commonwealth Grants Commission is explored in the third section of this paper, with special reference to the changes in its methods which occurred during his chairmanship.

3 R.C. Mills and the Grants Commission (1941-1945)

Mills’s involvement with the work of the Grants Commission began when, in the first half of 1934, he was consulted by way of a questionnaire, together with seven

other Australian academics, on a difference of opinion between two of the foundation Commissioners. These questions addressed the nature of the grounds in which special financial assistance to States was justified in a federation. It especially referred to the compensation for federal policy view (specifically associated with the effects of the Commonwealth tariff on formerly free-trade States) as against the fiscal disabilities position. The text of the questionnaire was included in Mills (1935, p. 28) which also summarised some of the answers (Mills 1935, pp. 29-30). The four sets of answers which are extant (those by Brigden, Fisher, Melville and Mills) were 'strikingly similar' in that they 'agreed that grants were justified if a State, which was taxing its residents with an average or greater than average severity, was unable to provide services at a reasonable standard' (Commonwealth of Australia 1983, p. 28). In addition, though the four respondents agreed that the incidence of federal policy, including tariff policy, was unequal, they argued that either this could not be measured or that it was irrelevant to special financial assistance. They therefore sided with Giblin and against Eggleston on the matter, though in practice the issue was resolved in the Commission through a compromise. Fiscal disabilities, as shown by actual budget results, were to constitute the major criterion in assessing special grants, though States such as New South Wales and Queensland were to be prevented from becoming claimant States by pointing to the benefits they had received through protection, as estimated by the 1929 Tariff Enquiry (Brigden et al. 1929, Appendix W, especially pp. 230-1). Mills's concurrence with this position is evident in his 1935 *Record* article, and even more so in the Reports of the Grants Commission issued during his chairmanship of the Commission.

Mills's appointment to the Grants Commission in 1941 was undoubtedly related to his important role in securing uniform income taxation for the duration of the second world war, as chairman of the Committee on Uniform Taxation. Butlin (1955, p. 385) quotes Mills's argument that, following the implementation of uniform income taxation, 'the Commonwealth Grants Commission could then consider applications from any State for grants on account of special disability caused by this'. The direct association between the two events is strongly suggested by May (1971, pp. 44-5). The fiscal federalism implications of national uniform income taxation can be seen as a major explanation of the small but significant shifts in method visible in the Grant Commission's recommendations during the four war years when Mills was its chairman.

By the time Mills commenced his task as chairman of the Grants Commission, the basic principles on which it operated had been effectively settled. Broadly speaking, these principles embodied financial need of the claimant State(s) assessed on the basis of comparing the most recently audited budget results of both the claimant and the 'standard' States (for the war years comprising Western Australia, Tasmania and South Australia in the first; New South Wales, Victoria and Queensland in the second category) and making the necessary allowance for economy in expenditures and effort in the raising of tax revenue. Mills (1935) had himself subscribed to such principles in a general way; his chairmanship of the Commission and the four reports it issued between 1942 and 1945 reflect his continued adherence to their essentials. Innovations in method under his chairmanship arose largely from the adjustments required to take account of the impact of the second world war on State budgets.

The first such major change was induced by the impact of the war on the budget results of the States. By 1940-41, buoyant economic conditions caused a

number of States to report budget surpluses, a matter which a year later became the actual budget outcome for every State. In its tenth report, the Commission explicitly indicated its need to rethink its standards in the light of these changed economic circumstances brought about by war for a Commission which had started its work in a period of depression and the gradual recovery therefrom during the final years of the 1930s (tenth report, chapter 1). The emergence of a *de facto* surplus standard led the Commission initially to a balanced budget standard for 1940-41 (tenth report, p. 56) as adjusted for 'normal' expenditure levels and standard tax severity. This turned out to be a war-time adjustment only; the budgetary difficulties of the States returned in full measure by the end of the war (Prest 1964, p. 250).

A further war adjustment arose from the implementation of uniform income taxation. Apart from the fact that this reintroduced general revenue grants for all the States in the form of income tax reimbursement grants, it meant that State income data based on income tax statistics supplemented by wage data for low income earners, were no longer available to act as a general measure of State taxable capacity. Under Mills, the Commission adopted a standard based on the tax revenue raising of the States on aggregate, treating *per capita* tax collections for each State tax relative to the standard as the appropriate measure of tax severity and tax effort. The standard used was the average of the tax rates ruling in the three non-claimant States (eleventh report, pp. 170, 171 and Appendix 1). The commission acknowledged that this approach had shortcomings, not least from the incomparability of the precise manner in which many of these State taxes were levied. Moreover, this approach at best was a very poor substitute for income as a taxable capacity index.

A third change came in the penalties imposed while assessing claimant State expenditures on social services relative to the standard level of expenditures in order to ensure the Giblin principle that claimant States should not be attempting social expenditures on a more generous scale than the average (as cited previously, above, p. xx). Such a proviso likewise secured that a claimant State could not, by excessive relative spending on such social services, affect its budget results with potential advantages for its special grant assessment. Giblin had initially put the desirable penalty at ten per cent, but this had been effectively lowered to six per cent during the first two years (1935, 1936) of the Commission's operations. From 1937 to 1942 it had been applied at ten per cent in line with Giblin's original intentions. However, the Commission explicitly lowered it to eight per cent in 1943, to an effective one per cent in 1944 and actually suspended it completely in 1945. Implicitly an austerity measure for effective expenditure restraint, this part of the original Commission's armoury was quietly abandoned after the war, a major effective change in its original design and purpose (see Maxwell 1967, pp. 28-30).

The last Report issued by the Commission with Mills as chairman commented explicitly on the evolving methodology of the Commission specifically to take account of changing economic circumstances as they affected State budget outcomes (twelfth report 1945, pp. 11, 50). It also firmly reiterated financial need as the major criterion in the assessment of special assistance, eliminating any vestiges of compensation for adverse effects of federation on specific States. Fiscal disabilities, related to population and geographical size (ninth report 1942, pp. 50-58) became more prominent in estimating these financial needs, which remained enshrined in comparisons of actual budget outcomes for claimant States as against the standards set by non-claimant States. Flexibility, and pragmatism, were also

ensured by the lagged system of paying the Grants, which allowed grants as assessed to be corrected for estimating errors when better data became available and thereby provided some resolution of fiscal uncertainty for claimant States arising from fiscal deterioration in their budgetary situation after payment of the first stage of the grant (twelfth report 1945, pp. 55-6). The fiscal equalisation in social service expenditures which the ninth report (1942, p. 35) had very explicitly rejected as a principle on which to base grants, remained outside the Commission's ambit at this stage; under Mills's chairmanship it continued to be wedded to the fiscal need principle combined with emphasis on comparable relative standards in spending and taxing. Mills's emphasis on the pragmatic use of economic analysis was vindicated by the flexibility in approach adopted by the Commission under his chairmanship, so appropriate when the changed circumstances imposed by the war economy had to be satisfactorily resolved to meet new patterns of fiscal disability as they emerged. Two minor, but nevertheless significant, examples of this are the abandonment of adjustments for economy of administration costs (substantially affected by war) and the removal of local government taxes in assessing the severity of State taxation.

4 Some Conclusions

Mills's late 1920s vision of improved federal financial relations has endured in many important respects. In line with these views, the two major national tax sources (on income and on consumption) have become national, with revenue shared with the States on the basis of Grants Commission recommendations. Grants for specific purposes have also greatly expanded partly through his initiatives (and supported by federal governments with different political colours) by launching Commonwealth involvement in education expenditure and in the financing of other 'social services'. When we commence a new century of federation in Australia of which, at best, I will only witness the first third, I trust that the inevitable changes in inter-governmental relations will be guided by similarly pragmatic policy responses to new or changing circumstances in the manner in which it was done by Mills. However, as this paper has also demonstrated, and as indicated in the opening sentence of this paragraph, suitable change is not only generated by reacting to altered circumstances; it can be substantially effected through clear elucidation of the principles – economic, social and political – which point to the need for such change. In this way, the historical exercise of surveying the role of R.C. Mills in altering Australia's inter-governmental financial relations (and hence of the basic character of the Australian federation) contains a moral for the future as well.

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