

FIRST PRINCIPLES

Robert Carling provides an overview of how federalism in Australia works

‘P M offers billions for skills training,’ announced a recent newspaper headline, referring to the latest Commonwealth offer of money to the states (albeit with some strings attached). This is what the ordinary citizen sees as modern federalism at work: the central government raising tax dollars and using them to cajole state governments to implement Canberra’s policies. It would never occur to most citizens to ask whether the central government should be involved at all in functions such as ‘skills training.’

Complex forces have enabled the power of the federal government to grow continually since the Commonwealth came into being in 1901. The skills training and countless other examples highlight key issues raised by this well-established trend: does the expansion of Commonwealth power matter; is it something to welcome; why has it occurred; and how could it be stopped or reversed if the body politic were of a mind to do so?

Broad public opinion on federalism is pragmatic. It has no quarrel with the principle of an expansive federal government, and is more concerned with how well the functions of government are performed than with which level of government performs them. It is also fair to say that whatever view people take of particular governments of the day, there is wide disenchantment with the performance of state governments in general.¹ Federalism to the general public means arbitrary lines on the map, too many governments and elections, wasteful duplication, inconsistencies, and endless squabbling.

But before accepting these views as the natural order, and consigning federalism to the dustbin of history, we should allow for the possibility that public opinion has been conditioned by

the actual behaviour of federal governments as masters—and state governments as supplicants—over a very long period, and that Commonwealth/state interaction would be seen in a different light if the basic principles of federalism had been more closely adhered to in practice.

A world view of federalism and decentralisation

Only two dozen or so of the world’s 196 countries are federations, Australia among them. We are in the company of the United States, Canada, Mexico, Brazil, Germany, Switzerland, India and Malaysia, while other familiar names such as Japan, China, South Korea, the United Kingdom and France have adopted more centralised models of government. Each country’s governance structure is the result of accidents and exigencies of history, but deliberate choice has also played a part. The founding fathers of Australia’s federation, and ultimately, the populations of the six colonies, made a conscious decision to federate using the United States (modified to a Westminster platform) as a model. This has made us a member of a small group of countries. We possess something valuable, but do not value it.

Instead, Australia has become something of an oddity. While other federations have also drifted towards stronger central governments, we are exceptional in the *extent* to which this has occurred. Abolishing the states is sometimes the subject of serious contemplation here, but rarely or never in the United States or Canada. Meanwhile, in the large slabs of the world that

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are not federations, many countries—from the United Kingdom to Peru—have been making their governments more decentralised to a degree. Most countries, except the smallest, have concluded that running everything from the national capital doesn't work. There are powerful economic, political and administrative reasons to decentralise at least to some degree. Federalism is a form of decentralisation. If Australia did not possess decentralisation in the form of the federal structure, some other form of decentralised government would have evolved.

Federalism is not merely one form of decentralisation among many, but one that has the advantage of being constitutionally the most robust. Both the national government (in our case, the Commonwealth of Australia) and the sub-national governments (the states) are sovereign governments in their own right, entrenched by a Constitution that neither can change unilaterally. Anything else is 'decentralisation-lite.'

Although federalism is synonymous with decentralisation, the very act of forming a federation is a step towards centralisation when the starting point—as in the case of Australia—was a collection of separately governed colonies. The act of federating created a central government that was not present before. The colonies federated because they had enough in common and saw economic gain from combining under a single national government, but they also chose to retain a substantial degree of independence in their internal affairs.

The rationale for federal systems is that they are good at balancing centripetal and centrifugal forces. The former, such as common needs for external defence, are best met by a central government, while the latter, such as geographical divisions or the existence of regional consciousness, are best satisfied by sub-national governments.

Federalism has less ideological content than other 'isms,' but it does appeal to those who believe it is important to protect the individual from the concentration of power in the hands of a single government. The constitutional basis of federalism provides the strongest defence against such concentration of power. This thinking was certainly important in the

formation of the United States as a federation, which in turn strongly influenced the architects of Australia's federation a century later.

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Essential features of federalism

The constitutional division of sovereignty between the Commonwealth and state governments is an essential feature of federation. Nonetheless, the balance between national and sub-national governments must be expected and allowed to change over time as underlying conditions change. The constitution must by its very nature be difficult to change, and it has certainly proven to be the case with the Australian Constitution. However, formal constitutional amendment is not the only way the federation can change.

Another essential feature of the federal model is a constitution that specifies the responsibilities, functions and powers of each level of government, backed by a judicial authority (in our case, the High Court) that interprets the constitution and rules on any disputes about the division of powers. The Australian Constitution, like the American one, specifies the powers of the Commonwealth in quite narrow terms and leaves everything else (the residual powers) to the states. This was designed to make the Commonwealth the weaker partner in the federation, or at least to circumscribe its powers.

The guiding principle for the allocation of powers in a federation is the 'subsidiarity' principle, according to which each function of government should be performed at the lowest tier at which it is practical for the function to be performed. Although the architects of the Constitution would not have known of the subsidiarity principle by that name, there are traces of it in the Australian Constitution. The powers specified for the Commonwealth encompass defence, foreign affairs, and trade and

commerce with other countries—and among the states, taxation, post and telecommunications, currency and banking, insurance, weights and measures, immigration, marriage and divorce, and invalid and old age pensions. There is nothing too surprising in this list; they are functions that sit logically with the national government, but a government fitting that job description bears little resemblance to the actual federal government of today. It is noteworthy, in light of the Commonwealth's present-day functions, that the Constitution does not give it powers in relation to higher education, school education, or health, which combined now absorb a quarter of the Commonwealth budget.

Forces for centralisation in Australia

How did the Commonwealth get from being the weaker to the dominant partner in the federation? The primary instrument has *not* been formal amendment of the Constitution to assign greater powers to the Commonwealth. Many more such amendments have been proposed than have been approved under the demanding tests specified in the Constitution. The only amendments that have been approved are those giving the Commonwealth powers over various social security and medical benefit payments, and to make laws in relation to Aborigines. Far more important has been the evolution of what David Solomon calls the 'working constitution,' which includes not only formal amendments but also effective changes brought about by the Commonwealth's inventive or opportunistic use of various powers originally granted to it; the High Court's interpretation of the constitutional powers; and changes in the general economic and political scene.²

The most significant changes driving increased centralisation have been:

1. The Commonwealth's broad use of its financial power under section 96 of the Constitution to make grants to the states 'on such terms and conditions as the Parliament thinks fit.' Grants to the states now comprise around one-quarter of the Commonwealth budget and almost one-half of total state revenue.
2. The Commonwealth's use of its taxation power to monopolise the income and

consumption tax bases. (Note that the Commonwealth's taxation power does not prevent the states from imposing taxes—with one important exception as discussed below—but it does give the Commonwealth priority.)

3. The Constitution bars the states from imposing customs duties and excises. The latter have been interpreted broadly by the High Court in relation to indirect taxes, and constitutional law experts believe states would also be barred from a broad-based consumption or sales tax such as the Goods and Services Tax (GST), although this has never been directly tested.
4. The Commonwealth's power to pass laws in relation to corporations, and the Commonwealth's subsequent broad use of this power (for example, in its coverage of industrial relations). Corporations were not the dominant form of business organisation in 1901.

Fiscal federalism

Four broad sets of indicators highlight the shift in the balance between the Commonwealth and the states in favour of the former: increased Commonwealth involvement in activities that the Constitution assigns to the states; financial relations between the Commonwealth and the states ('fiscal federalism'); increased Commonwealth regulatory activity; and the increased emphasis on 'cooperative' as opposed to 'competitive' federalism.

The Commonwealth is now heavily involved—via grants to the states—in education, health and housing services, which the Constitution leaves to the states. It is also involved in transport in ways that go beyond international and interstate transport, which logically rest with the central government. It makes grants to local government through the states.

Where the Commonwealth extends its influence by making grants, its main influence is through policies such as in education and health. It is not involved directly in the delivery of the services. But its formal constitutional powers over social security, welfare and medical benefits to individuals ensure it is directly

involved in these areas and has driven the long-term expansion of the welfare state.

Commonwealth budget outlays, including grants to state and local governments, account for around 73% of all public sector (general government) outlays by the three tiers of government. The main features of Commonwealth/state financial relations are the Commonwealth's domination of taxation (around 80% of national taxation) and the high level of financial grants to the states, which comprise around 22% of Commonwealth budget outlays and 43% of total state revenue on average across the states. State expenditures are around 14% of gross domestic product (GDP), but revenue raised by the states themselves (as distinct from money received as grants from the Commonwealth) comprises only 8% of GDP.³ This disparity is called 'vertical fiscal imbalance,' and while such an imbalance is a feature of all federations, it is especially steep in Australia.⁴

Another feature of fiscal federalism is horizontal fiscal equalisation, better known in Australia as the way in which Commonwealth grants (mainly GST revenue now) are distributed to the states unevenly so as to correct for states' intrinsic advantages and disadvantages in raising revenue and providing services. While horizontal equalisation as a principle is widely accepted in federations, its application is highly controversial in Australia because we have institutionalised the pursuit of equalisation to a higher degree than most other federations. The recurrence of disputation over this issue in Australia—which many find tiresome—is not an inevitable feature of federalism.

The Commonwealth has successfully used various constitutional heads of power to extend its regulatory reach in areas such as industrial relations, the environment and business regulation. In some cases, this expansion has been facilitated by the voluntary referral of powers from the states to the Commonwealth.

The other measure of the centralisation is the growth of 'cooperative' federalism, as opposed to the 'competitive' variety. Cooperative federalism does not refer to an absence of rancour and disputation in the Commonwealth/state relationship, but to situations in which

the Commonwealth persuades states to adopt policies they would not adopt of their own volition, or in which the Commonwealth brokers agreements between states to adopt uniform policies or legislation in particular areas. Examples in recent times include the National Competition Policy (for which the states were rewarded with conditional Commonwealth payments), the harmonisation of occupational health and safety laws, and the adoption of a common school curriculum. Big business is a strong advocate of greater harmonisation of state regulation to achieve what it calls a 'seamless national economy.'

Cooperation is not necessarily the antithesis of federalism. A lot of it is necessary to the efficient functioning of a federal system. Without it, trains running between NSW and Victoria would still have to stop at the border to change to a different rail gauge. It is only when too much emphasis is placed on uniformity and harmonisation of policies and legislation at the expense of competition and diversity that cooperation undermines the foundations of federalism. At the extreme, if all state policies and legislation were 'harmonised,' there would be no point in having a federal system.

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Benefits of federalism

The Australian federation is alive, but is running on two cylinders. If there are benefits worth having from federalism, Australia is missing out to a significant degree. Do the greater costs of federalism warrant greater centralisation? So what are these benefits and costs?

The first benefit of federalism is that it divides government power and provides greater protection to the individual than does a unitary state. Decentralisation within a unitary state cannot guarantee this benefit, because ultimately, the central government makes all the rules. Second, federalism brings government closer to the people, allowing a better chance for policies and services to be tailored to local needs and

preferences. Third, it results in competition between state governments, for example, in taxation. Federations tend to have smaller total public sectors and lower overall tax burdens than unitary states. Fourth, federalism allows state governments to innovate and experiment with different policies, with the best results providing a demonstration effect to other states.

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The costs of federalism come mainly in the form of a higher administrative overhead in electing and running multiple parliaments and public services, and the costs faced by businesses with operations in more than one state in dealing with different tax policies and regulations. Duplication is often cited as another cost, but federation need not involve much duplication if central and state governments have clear and distinct responsibilities. There is a good deal of duplication and overlap in Australia, but this is because of the Commonwealth increasingly intervening in state responsibilities as discussed above.

Proponents of federalism believe that the benefits vastly outweigh the costs, provided the federal system adheres to the principles of federalism. One estimate of the net benefits suggests that Australia is reaping only half the potential benefits because the federal system has been allowed to drift so far from its original design.⁵

Where to from here?

The reform most cited in any discussion of the future of federalism is abolishing state and local government in their current form, and replacing them with as many as 50 regional governments.⁶ Despite having a degree of policy and revenue autonomy from Canberra, these governments would for the most part be service

delivery agents of the central government. This would be the ultimate death-knell for federalism. Whether desirable or not, it is safe to say that it will never happen. As Twomey and Withers say, it would face an even higher constitutional hurdle than ordinary constitutional reform (which is difficult enough). It may even go as far as requiring a 'constitutional revolution' as distinct from formal amendment, because it would involve the dissolution of the 'one indissoluble Federal Commonwealth,' which is the very purpose of the Constitution itself.⁷

It is safe to say that replacement of the states will remain a centralist's pipedream and the three-tier system is here to stay, with sovereignty of the states preserved by the constitution. The question is whether this system in operation (the 'working constitution') continues to drift towards greater centralisation of policy and finance, or steps are taken to halt and reverse this process—such as the Commonwealth withdrawing from certain functions and handing some taxation powers back to the states. For the latter to happen, the strong centralising forces that have been at work for more than a century would have to be overcome, and there is little prospect of this happening.

It is one thing to describe *how* increased centralisation has occurred, but quite another to explain *why* it has occurred. Remarkably, the electorate has rejected most proposals for formal constitutional amendment extending Commonwealth powers, but has accepted the de facto growth of such power through other means as described above. Some of the main reasons for this could be the following:

1. There are few political champions for federalism. When states resist Commonwealth encroachment on their functions, more often than not, it is because they are holding out for a better deal rather than taking a stand on principle. (State politicians in Western Australia are the main exception.) No politician is extolling the benefits of federalism to the public.
2. Money is the key to power, and the Commonwealth is more financially

- dominant than ever. The assignment of GST revenue to the states has not changed this; in fact, it has increased the states' dependence on revenue raised by the Commonwealth. In general, state politicians are happier to receive and spend money raised by the Commonwealth than suffer the political opprobrium of raising more of their own tax revenue.
3. The public, notwithstanding inconsistent attitudes to taxation and spending, are happy to see more tax dollars poured into health, education and what is broadly termed 'infrastructure,' and are pragmatic about where the money comes from. People know the Commonwealth is in the stronger position and their experience of state taxation makes them wary of wanting more.
 4. The Commonwealth largely collects money and disburses it to individuals, rather than running services that bring it into contact with the public. These functions involve less reputational risk of inefficiency compared to traditional state government activities such as running public hospitals and schools, controlling crime and public disorder, and providing public transport and roads. The public may conflate inefficiencies in service delivery by particular state governments with a breakdown in the federal system in general.
 5. The concept of national economic management was hardly known in 1901, but came into its own after the Great Depression and particularly after World War II. This is not the place to argue the rights and wrongs of Keynesian fiscal policies, but the same policies gave the Commonwealth's fiscal role a major boost. More recently, the concept of national economic management has come to encompass goals such as productivity and labour force participation, which have given the Commonwealth another reason to broaden and deepen its economic policy interventions.
 6. The evolution and growth of the modern welfare state and the heightened emphasis on equity as a goal of government—whether or not desirable—have favoured the central government, as uniform national standards of equity are generally seen as being appropriate as distinct from different standards in each state. This trend has favoured the Commonwealth, with its powers in relation to pensions and social security payments, and encouraged its involvement in areas such as health which has become part of the welfare state.
- It is impossible to foretell the circumstances that could reverse this centralising trend. One possibility is that federal and (some) state leaders with a strong commitment to the principle of competitive federalism are elected to office at the same time. If something like this does not happen, Australia will continue to bear the largely hidden costs of an overly centralised system.

Endnotes

- 1 For example, a 2010 survey by Griffith University showed that only 17% of respondents perceived states as the most effective level of government, compared with 44% for the federal level and 27% for the local level. 'Australian attitudes to federalism reinforce need for reform,' Griffith University media release (10 April 2010).
- 2 David Solomon, *Australia's Government and Parliament* (Nelson, 1973), 118–119.
- 3 All data sourced from ABS (Australian Bureau of Statistics), *Government Finance Statistics, Australia, 2010–11*, Cat. No. 5512.0.
- 4 Neil Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements*, Final Report (May 2006).
- 5 Anne Twomey and Glenn Withers, *Federalist Paper I, Australia's Federal Future: Delivering Growth and Prosperity*, a report for the Council for the Australian Federation (April 2007), 40–42.
- 6 This idea had the support of about 40% of respondents to the Griffith University survey referred to above, which is a high percentage to favour such a radical change.
- 7 Anne Twomey and Glenn Withers, as above, 44–45.