

# FIXING AUSTRALIAN FEDERALISM

For federalism to work, the states need clear roles and their own revenue, argues **Robert Carling**

One of Kevin Rudd's first acts as prime minister of Australia was to convene a conference with the state premiers and territory chief ministers. The Council of Australian Governments (COAG) meeting in December 2007 aimed to 'to end the blame game and buck passing, and to take major steps forward for the Australian community.' Confering with the states has never before been high on a new federal government's to-do list. That Prime Minister Rudd did so quickly adds credence to his claim that fixing federalism will be a high priority for the Labor government.

The Rudd government's apparent determination to reform federalism has been well-received. For a variety of reasons, it is an almost universal view that federalism as it has evolved in this country is not serving us well, and has not done so for a long time. The new government has made much of the 'cooperative' nature of its approach, but it is not clear exactly what this amounts to apart from federal and state governments being reasonable with one another and not engaging in 'blame-shifting' and 'buck-passing.'

It is difficult to know whether the government has a larger agenda, because reforming federalism means different things to different people. The underlying objective is open to disagreement, with some favouring a more decentralised system and greater state autonomy, others greater centralisation and 'consistency.' Nevertheless, the various

reform ideas that course through the Australian debate on federalism can be grouped under six broad headings:<sup>1</sup>

1. Defining the roles and responsibilities of the Commonwealth and state (and possibly local) governments
2. Reform of specific purpose payments (SPPs) from the Commonwealth to state governments, which tie state governments to implementing federal policy
3. Commonwealth–state collaboration in national economic reform
4. Changing the way general purpose grants (now GST revenue) are allocated across the states (horizontal fiscal equalisation)
5. Addressing vertical fiscal imbalance (VFI): the mismatch between revenue-raising powers and expenditure responsibilities
6. Reforming state taxation

Whatever 'cooperative federalism' means, the Rudd government's reform of federalism will be judged according to what it does in these six

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areas. That is not to claim that the six are of equal importance, or that their importance is accepted by all participants in the debate, but the six areas define the material from which any reform action plan will be constructed.

### 1. Defining Roles and Responsibilities

A federal system needs to be firmly anchored to a rational allocation of roles and responsibilities for the different levels of government. This is essential for accountability, efficiency, and effectiveness in the delivery of public services. Australian federalism, if it ever had such an anchor, has broken free of it and drifted far in the direction of centralism. The public, encouraged by the behaviour of governments, has fallen into the habit of thinking that if there is a problem in any sphere of state service delivery, federal intervention must be part of the solution.

Recent events—such as the Howard government's intervention in Tasmania's Mersey hospital—have brought this issue into sharper focus, but the drift towards centralism has been occurring over many years. The process has gone so far that the Howard government, in its last year in office, was promoting a version of federalism in which a structured assignment of responsibilities was of no importance, and where the end (delivery of the service) justified the means (delivery by any or all governments).

The long-term drift to centralism has been based partly on the Commonwealth's stronger revenue position. But the Commonwealth's dominance of national taxation does not in itself provide a rationale for centralising expenditure responsibility. It is not clear why the mismatch between revenue-raising power and expenditure responsibility should be remedied by centralising expenditure responsibility rather than by decentralising revenue-raising power.

Behind increasing centralism is an implicit assumption that the Commonwealth is more efficient at service delivery than the states. This requires a huge leap of faith in the efficiency of Commonwealth administration, for which there is precious little evidence. The Commonwealth has no track record in running schools, hospitals, public transport, and the like. In its own bread-and-butter responsibilities, such as defence procurement and visa administration, it has hardly excelled.

There is no denying that the states are not delivering services to the satisfaction of all users, but it is a mistake to assume that devolved power is the cause. The reasons are more likely to be found in a failure to apply suitable financial, operations, and workforce-management practices, and the opportunity that the tangle of Commonwealth–state overlaps and duplications gives the states to avoid their responsibilities. The solution is not to emasculate the states, but to reform their policies and operations and to hold them to account through the democratic process.

A review of roles and responsibilities is the logical starting point in any attempt to reform Australian federalism. Such a review would start from first principles, and define the respective functional

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roles of the Commonwealth and the states in areas such as health services, education, law enforcement, and transport. A principles-based approach does not mean turning the clock back to 1901. Nor does it necessarily rule out shared responsibilities for some functions, but the involvement of the Commonwealth should always be within carefully defined parameters, and limited to cases where the national interest is genuinely at stake.

The nature and extent of reforms to the federal system in areas such as SPPs and VFI depend on the outcome of this review of roles and responsibilities. The review may lead to proposals for constitutional change, but will not necessarily do so.<sup>2</sup> The constitutional assignment of responsibilities has in practice been overridden by the section 96 power, which enables the Commonwealth to make grants to the states on such terms and conditions as it sees fit. Altering the Commonwealth government's involvement in state services through SPPs could effect much change.

So far, there is no indication that Rudd is advocating a review of roles and responsibilities, but he has not ruled it out. The Business Council of Australia has proposed that a federal convention

be held ‘with a wide range of participants to develop a framework for reassessing the respective roles of the Commonwealth and states.’<sup>3</sup> This seems to be a good starting point. COAG should consider the recommendations of the federal convention, and the outcome should be embodied in an intergovernmental agreement.

**2. Reform of specific purpose payments**

SPPs—known generically in federal systems as tied grants—are key instruments of central government influence on state service provision. As conditional payments to the states, they enable the Commonwealth to pursue national objectives through services that are the constitutional responsibility of the states. Tied grants are a feature of all federal systems and are not inherently good or bad; that judgement depends on how they are used.

Total SPPs to the states in 2007–08 are \$22 billion, equivalent to 2% of gross domestic product.<sup>4</sup> Their importance to state budgets can be seen in the fact that they account for about one in six dollars of total state revenue. SPPs have grown strongly in recent years, and in the long term have trended upwards as a proportion of total Commonwealth payments to the states, from about 20% in the 1960s to 40% now. There

are currently about seventy separate ongoing SPPs and a significant number of one-off SPPs, bringing the total close to one hundred. Each one is subject to its own governing agreement between the Commonwealth and the states, and to its own monitoring and administrative apparatus. Table 1 shows the functional composition of the 2007–08 aggregate of SPPs to the states. Within each functional category, there are a number of separate SPPs.

Changes to the number and size of SPPs is one aspect of reform. Reducing the number would allow some lessening of administrative and transaction costs. However, if the reduction is made merely by grouping some SPPs, it will not result in a withdrawal of unwarranted federal intervention in state affairs; to achieve that, some SPPs would need to be cancelled. The dollar aggregate cost of SPPs is a separate issue, which needs to be considered in the overall context of how the states are funded.

Some SPPs will always exist, and the second aspect of reforming them is ensuring they are designed optimally. This has long been a sore point with the states, but their push for reform made little headway under the Howard government. The states’ position, shared by many independent observers of the process, is that the conditions attaching to SPPs often go beyond specifying how SPP funds are to be used, restricting the states’ freedom in spending their own revenues by requiring maintenance of state funding or dollar-for-dollar matching. The conditions have tended to become more onerous over time, and apply even where the Commonwealth may only make a minority contribution to the total program. This enables the Commonwealth to override state policy choices to a degree that exceeds what is needed to reflect the national interest, and ignores the fact that states are often better placed to determine spending priorities. SPP agreements also need to be refocused on outcomes rather than inputs.

An agreement to redesign SPPs and reduce their number would be welcome, but in itself could not prevent the old habits from creeping back over time. One way of limiting that prospect would be to codify principles for the design and operation of SPPs into a COAG intergovernmental agreement. A permanent federal commission could then be

**Table 1:** Functional classification of 2007–08 SPPs

Function	\$ billion	% of state outlays
Health	10.6	28
Education	4.4	11
Transport and communication	2.5	16
Social security and welfare	2.2	23
Housing	1.1	15
Agriculture, forestry, and fishing	0.6	23
Fuel and energy	0.1	7
Public order and safety	0.1	1
Recreation and culture	0.1	3
Other	0.9	n.a.

Source: Australian Government, ABS<sup>5</sup>

created, which would, among other things, be required to certify that any new or renewed SPP complies with the intergovernmental agreement as well as the COAG-endorsed assignment of roles and responsibilities discussed above.

There are hopes for SPP reform under the Rudd government. The December COAG meeting gave it high priority and delegated the details to the treasurers, who met in January and will meet again in March to progress the reforms. Indications are that consolidation rather than cancellation will reduce the number of SPPs. If so, there will be some administrative savings, but meaningful rebalancing of Commonwealth and state powers is unlikely. However, the details remain to be seen.

### 3. Commonwealth–state collaboration in national economic reform

Economic reforms have been formulated and implemented by the Commonwealth and the states together at times in the past. Most notable are the National Competition Policy (NCP) adopted in 1995 and A New Tax System (ANTS) in 2000. A new round of coordinated policy reform—the National Reform Agenda—was discussed by COAG in 2006 but appears to have made little progress to date.

As part of its approach to federalism, the Rudd government intends to revive this agenda, which includes business deregulation, infrastructure, energy markets, water policy, and transport pricing, as well as health, early childhood development, and education and training, which are to be brought under the umbrella of economic reform for the first time. There is talk of Commonwealth incentive payments being made to the states for implementing reforms and achieving specified target outcomes.

There is a case for a degree of coordination to optimise the working of a federal system. The states control many of the policy instruments involved in microeconomic reform. National markets and corporations with national operations are much more prominent in economic life now than they were in 1901. The Commonwealth is best placed to sketch the economic ‘big picture’ and to identify the most effective state contributions to national policy reform. From a pragmatic perspective, state governments reluctant to tackle politically difficult

reforms can be induced to act by peer pressure and by the political cover provided by the force of Commonwealth intervention.

Yet the case for policy coordination can be taken too far. The essence of the federal model is that the public interest is best served by each state pursuing its own policies within its areas of constitutional responsibility. The arguments for a national approach to reform do not provide a blanket justification for ironing out all interstate policy differences. The test for policy coordination should not be whether interstate policy variation should not be whether interstate policy variation inconveniences people and businesses, but whether coordination is necessary to achieve a legitimate national objective. Interstate differences must be expected to remain in many policy areas if federalism is to deliver such benefits as interstate competition, policy experimentation, and responsiveness to local preferences.

The states bear many of the fiscal costs of reform, but reap comparatively few of the fiscal benefits, due to their limited access to broad revenue bases.

The need for Commonwealth incentive payments to the states for undertaking coordinated reforms is open to question. At first sight, it seems odd that governments should need financial incentives to adopt policies that are in the public interest, as if they were revenue-maximising entities rather than servants of the public interest. The only justification for financial incentives exists in the fiscal structure of Australian federalism, in which the states bear many of the fiscal costs of reform but reap comparatively few of the fiscal benefits, due to their limited access to broad revenue bases. Thus, states may be reluctant to undertake reforms because the distribution of the fiscal costs and benefits adversely affects their budgets even though it advances the broad public interest. This was the basis for the Commonwealth payments to the states under NCP.<sup>6</sup>

While this argument for incentive payments has some validity, it has been weakened by the ANTS reform that delivered to the states the full

GST—a broad-based growth tax, the revenue from which will reflect the benefits of national economic reform. In fact, the rationale for incentive payments points to the correction of vertical fiscal imbalance—that between the states' expenditure responsibilities and their own revenue sources—as the fundamental solution.

The states raise much less from their own revenue sources than they spend on their own functions.

The Rudd government clearly includes joint Commonwealth–state action on policy reform in its vision of cooperative federalism. However, only the fine print will reveal whether it is justified by bona fide national objectives, or is merely a further intrusion of Commonwealth influence on state responsibilities that will be another nail in the coffin for Australian federalism.

#### 4. How GST revenue is distributed

Squabbles among the states about the interstate distribution of Commonwealth general purpose grants (now GST revenue) are almost as old as the federation itself. This is a zero-sum game in which the 'donor' states receive less than their population shares in grants and the 'mendicant' states receive more.<sup>7</sup> Deviations from population shares are based on Commonwealth Grants Commission (CGC) assessments of each state's relative revenue-raising capacities and unit costs of service provision. New South Wales and Victoria have always been 'donors,' but have now been joined (not necessarily permanently) by Queensland and Western Australia.

The New South Wales and Victorian governments lead the constituency for reform of this 'horizontal equalisation' system. Their long-running advocacy of a reduction in cross-subsidy from donor to recipient states is often seen as bleating by the losers in a zero-sum game and as defiance of the independent umpire, the CGC. Yet it would be a mistake to see it as nothing more. Independent economists have also advocated far-reaching reform of the system.<sup>8</sup> Successive

Commonwealth governments have professed to be open to reform ideas, but have been loath to take the lead without broad state government support, which, given the zero-sum nature of the issue, has never been forthcoming.

The case for reform hinges on the extreme complexity and opaqueness of the current system and the economic efficiency costs of what is fundamentally a redistributive system. Moreover, while most other federations around the world practice some form of horizontal equalisation for their sub-national governments, the Australian version is widely recognised to be the most complex and far-reaching. Although the available evidence suggests that the static economic efficiency gains from a shift towards a simple population-based distribution would be modest, the dynamic gains could be much larger, as state policies would respond over time to the realignment of incentives.

The previous Commonwealth government, with the support of the states, initiated a review of the equalisation system aimed primarily at simplification. The Grants Commission is undertaking this review, and will report in 2010. It will not, however, open up the fundamentals of the system, and there is no indication that the Rudd government intends to push for a more fundamental review.

#### 5. Vertical fiscal imbalance

The states raise much less from their own revenue sources than they spend on their own functions. In Australia, this phenomenon is called *vertical fiscal imbalance*. Commonwealth general and specific purpose grants, which contribute more than 40% of total state revenue, make up the difference between state revenue sources and expenditure. Table 2 shows the structure of state revenue. Among the world's federations, the extent of VFI in Australia is comparatively extreme.<sup>9</sup>

A review and reallocation of roles and responsibilities as discussed above could, in principle, reduce the imbalance by assigning some state expenditure responsibilities to the Commonwealth. The existing imbalance is so large, though, that it is unrealistic to expect that it could be overcome in this way unless the states were to be completely marginalised. The VFI issue is fundamentally one concerning the allocation of revenue-raising powers

**Table 2:** Structure of state revenue 2007–08 (estimated)

Revenue source	\$ billion	% of total
<i>Commonwealth grants:</i>		
GST revenue	42	28
Specific purpose	22	15
Subtotal	64	43
<i>Own-source:</i>		
Tax	49	33
Other	35	24
Subtotal	84	57
Grand total	148	100

Source: ABS<sup>10</sup>

between the Commonwealth and the states, which is skewed in favour of the Commonwealth.

Granting the GST to the states as part of the ANTS reforms was in part promoted as a solution to VFI, but the efficacy of the move is doubtful because the states do not control the GST: it is not their own-source revenue, but grant revenue from the Commonwealth. Although the GST has given the states more revenue, the issue is not simply one of the amount of funds flowing to the states, but of dependency on the Commonwealth as opposed to autonomy from it.<sup>11</sup> Increasing state revenues by granting them the GST revenue without giving them individual control over GST policy has not enhanced their financial responsibility or strengthened Australian federalism. It is more likely to have strengthened the states' culture of dependency on the central government.

The high degree of VFI is central to the federalism debate. An effective federal system of government is one in which sub-national governments have substantive responsibilities and the autonomy to carry them out as they see fit.<sup>12</sup> Fiscal autonomy of sub-national governments is a sine qua non of an effective federal structure.<sup>13</sup> A high degree of financial dependency on central government stifles federalism. A culture of dependency is the antithesis of financial responsibility and accountability. State governments' revenue-raising responsibility needs to match their expenditure responsibility if we expect them to make sensible public choices. VFI breaks the link between expenditure and revenue-raising decisions. It results in a confusion

of accountability in the minds of voters, and a tendency for the central government's influence on sub-national expenditure choices to grow, resulting in overlapping responsibilities.

It is undoubtedly the case, as the rejoinder to these arguments goes, that the states still have significant revenue and expenditure flexibility at the margins, which they have failed to exploit. But this in no way alters the fact that there is a major task on the revenue side of the VFI, to restructure state revenue away from dependence on Commonwealth grants and towards revenue sources that the states can control. In broad terms, and assuming overall revenue neutrality, this requires a substantial reduction in Commonwealth grants to the states (with first priority given to reducing SPPs), offset by the transfer of some revenue-raising power from the Commonwealth to the states, the expansion of existing state taxes, and/or the creation of new taxes. For example, I have described elsewhere how a portion of the personal income tax could be transferred to the states, and Commonwealth grants reduced, as a way of reducing VFI.<sup>14</sup>

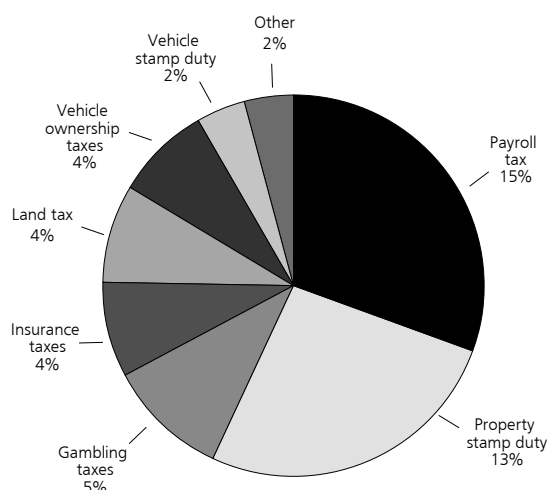
VFI and the policy options for correcting or at least reducing it have been discussed many times in the past, but at this point there is no indication that the Rudd government regards it as important or includes it in its plans for reforming federalism.

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## 6. State taxation

State taxation raises only one third of the money that states spend, and is closely linked to VFI. But it is also an important issue in its own right, because the existing array of state taxes leaves much to be desired. No tax expert, starting from scratch, would come up with the existing state tax system. This is a tax policy issue, but also a federalism issue, because a poorly designed state tax system undermines the states' viability as autonomous entities within the federation.

**Table 3:** Composition of state tax revenue 2007–08 (estimated)



**Source:** ABS and projections based on state budget papers<sup>15</sup>

The ANTS reforms replaced a swag of narrowly based, inefficient state taxes with a broadly based and more efficient Commonwealth GST. The state taxes to be scrapped included, most notably, financial institutions duty, debits tax, marketable securities duty, mortgage duty, stamp duty on business conveyances, lease duty, and hiring duty. Most of these have now been abolished or are scheduled to be abolished over the next few years. Although they were not taxes of everyday importance to taxpayers, they raised the not inconsiderable sum of about \$5 billion in annual revenue, and were among the most distorting and inefficient taxes in the Australian tax system.

The state taxes that remain raise almost \$50 billion in annual revenue. Table 3 shows its broad composition.

The main issues with the remaining state taxes are:

- The narrowness of the bases for payroll tax and land tax, and associated high rates of tax
- Continued heavy reliance on narrowly based and economically distorting stamp duties on transactions in property, insurance, and motor vehicles
- Dependency on gambling taxes, which raises social policy issues
- The imposition of a large number of highly selective nuisance taxes that raise relatively little revenue

- Pointless interstate differences in the way particular taxes are designed and administered, which do nothing for the cause of federalism but impose unnecessary compliance costs on taxpayers

Some of these problems could be addressed at little or no net cost in revenue, but solutions to others would be either enormously costly—and therefore could not be financed out of existing state revenue sources—or would involve highly contentious trade-offs such as a sizeable cut in the tax-free threshold for payroll tax. The GST has not advanced the states’ overall revenue position to anything like the degree popularly imagined, and could not be called upon to cover the substantial costs of further state tax reforms unless the rate of GST were increased. Another approach would be to transfer some Commonwealth taxing power to the states, which would also help to address VFI. These issues need to be addressed as part of comprehensive reform.

Further state tax reform beyond the ANTS package only seems likely to occur in response to pressure from the business sector, which is most sensitive to the issue because the lion’s share of the legal incidence of state taxation falls on business.<sup>16</sup> The Rudd government has shown no interest in these issues to date, and would seem likely to do so only as part of any broader review of business taxation or federal–state financial relations that might occur.

### Assessing the government’s plans

It is early days yet, but from what is publicly known about the new government’s plans for federalism, it appears mainly interested in the second and third approaches to reform in the classification used here: SPPs and Commonwealth–state collaboration in national economic reform. These have been the focus of the flurry of activity in COAG and other meetings.

A review of the roles and responsibilities of the different levels of government could be implicit in the other activities, but there is no indication that the government will launch one. Meanwhile, the government has shown no interest in addressing horizontal equalisation, VFI, or state tax reform. The benefits of a broad approach to reform, encompassing all of these areas, would be substantial.

The government's limited vision of federalism reform could deliver benefits by tidying up the SPP mess and launching a fresh round of coordinated economic reforms in the mould of NCP. However, the devil will be in the detail. 'Cooperative federalism' could also turn out to be nothing more than a further extension of centralism, delivering greater uniformity and more Commonwealth intervention in state policies. The only change would be that the path of centralisation would be lined with smiles and handshakes.

## Endnotes

- <sup>1</sup> There could be a seventh, involving changes to the constitutional structure of government, such as abolition of the states and their replacement by 'regional' governments. Whatever one thinks of the merits of such schemes, they are unrealistic and amount not so much to the reform of federalism as to its dismantling.
- <sup>2</sup> In opposition, federal Labor said that it would seek a constitutional amendment to give the Commonwealth control over public hospitals if its proposals to work with the states to improve the functioning of hospitals did not succeed.
- <sup>3</sup> Business Council of Australia (BCA), *Reshaping Australia's Federation: A New Contract for Federal-State Relations* (Melbourne: BCA, 2006).
- <sup>4</sup> Aggregate SPPs by the Commonwealth are \$30.8 billion, but this includes \$2.3 billion to local government and \$6.1 billion in payments through the states, mainly to private schools—hence the distinction between SPPs 'to' the states and those 'through' the states.
- <sup>5</sup> Australian Government, *Budget Paper No. 3: Federal Financial Relations 2007–08* (Canberra: Commonwealth of Australia, 2007). State outlays by function are estimated based on Australian Bureau of Statistics (ABS), *Government Finance Statistics, Australia, 2005–06*, ABS Cat. No. 5512.0 (Canberra: ABS, 2007).
- <sup>6</sup> These payments built up annually to a peak of about \$1 billion by 2005–06, but were then terminated by the Commonwealth against the objections of the states, which argued that they should be permanent. The payments were conditional on satisfactory state implementation of NCP measures, as assessed by the National Competition Council.
- <sup>7</sup> Population shares are used as the neutral benchmark. However, even a distribution in line with population shares contains an element of horizontal equalisation. There are alternative benchmarks, such as the origins of the revenue being distributed. The New South Wales government advocates the use of GST origin as the benchmark.
- <sup>8</sup> For example, see Ross Garnaut and Vincent Fitzgerald, *Review of Commonwealth–State Funding—Final Report: A Review of the Allocation of Commonwealth Grants to the States and Territories* (Melbourne: Review of Commonwealth–State Funding, 2002), <http://web.archive.org/web/20050123064928/http://www.reviewcommstatefunding.com.au/library/finalrep.pdf>.
- <sup>9</sup> For example, see Neil Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements: Final Report* (Sydney: New South Wales Government, 2006), chapter 5.
- <sup>10</sup> ABS, *Government Financial Estimates 2007–08*, ABS Cat. No. 5501.0.55.001 (Canberra: ABS, 2007).
- <sup>11</sup> The boost to state revenue is not the gross amount of GST revenue because the ANTS package involves a number of offsetting reductions in other state revenues. The net gain is estimated at \$2 billion for 2007–08.
- <sup>12</sup> For a full discussion of this issue, see for example Geoffrey de Q. Walker, *Ten Advantages of a Federal Constitution*, CIS Policy Monograph 49 (Sydney: The Centre for Independent Studies, 2001), and Wolfgang Kasper, *Competitive Federalism: Promoting Freedom and Prosperity*, IPA Issues Paper 3 (Melbourne: IPA, 1995).
- <sup>13</sup> This is what Kasper (as above) calls the 'fiscal equivalence' principle: that 'governments must finance their assigned and chosen tasks with the funds that they raise themselves through taxes, fees and borrowings for which they are responsible.'
- <sup>14</sup> Robert Carling, *State Taxation and Fiscal Federalism: A Blueprint for Further Reform*, CIS Policy Monograph 73 (Sydney: The Centre for Independent Studies, 2006).
- <sup>15</sup> ABS, *Taxation Revenue, Australia, 2005–06*, ABS Cat. No. 5506.0 (Canberra: ABS, 2007).
- <sup>16</sup> About two-thirds of the legal incidence falls on business, primarily through payroll tax, which is the largest state revenue-earner. Economic incidence is another matter, because most business taxes are passed on in prices or wages.