

THE CENTRE FOR
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Sovereignty, Blame Games and Tony Abbott's New Federalism

**Nick Greiner
Robert Carling
Anne Twomey
Jeremy Sammut**

**Sovereignty,
Blame Games and
Tony Abbott's
New Federalism**

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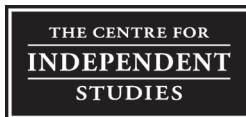
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Sovereignty, Blame Games and Tony Abbott's New Federalism

The Hon. Nick Greiner AC
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CIS Policy Forum 27



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Preface

On 14 July 2014, The Centre for Independent Studies (CIS) held a public forum in Sydney on reform of the Australian federation. The forum, titled ‘Sovereignty, Blame Games and Tony Abbott’s New Federalism,’ continued the CIS involvement in issues related to Australian federalism over many years. It was held at this time in response to Prime Minister Abbott’s announcement of a review leading to a White Paper on Reform of the Federation to be released by the end of 2015. The review process will generate renewed public interest and discussion of federalism, to which this publication aims to contribute. The forum brought together an audience of approximately 100 interested members of the CIS and the general public to hear the views of four prominent practitioners and scholars in the field of federalism:

The Hon. Nick Greiner AC was the Premier of New South Wales from 1988 to 1992.

Robert Carling is a Senior Fellow at The Centre for Independent Studies.

Anne Twomey is Professor of Constitutional Law and Director, Constitutional Reform Unit at the University of Sydney.

Dr Jeremy Sammut is a Research Fellow at The Centre for Independent Studies.

Their presentations form the four chapters of this volume.

Reforming the Federation: Perspectives of a Practitioner

The Hon. Nick Greiner AC

I am going to talk about my perspective of where, hopefully, the Abbott government's review of federalism might come out and what political obstacles there are in the way of anything productive happening. I was part of a previous new federalism project which was a creature of Bob Hawke's, and I guess I was the leading state participant, almost a quarter of a century ago.

Starting points for the white paper review

My starting point is that the Abbott new federalism runs a danger of becoming a captive of the bureaucracy. I noticed when I came back from overseas a few days ago that there is a steering group, which is made up of the directors-general of each state premier's department. And you would guess my reaction was that that wasn't necessarily the most certain way of getting the most risk-taking and productive approach to what is a fraught subject.

But my overarching point is that this is political. I don't mean political in the Liberal/Labor sense, although it will no doubt end up that way. What I mean is that the review of the Federation needs to be seen as overwhelmingly part of the Australian body politic, of how we govern ourselves, and how we'll govern ourselves going forward. There has been no serious review of the Federation in the 115 years since Australia was created. There was none at the Centenary of Federation, which is the sort of time when politicians might think to have a look at it. I think it is fair to say that with the exception of Prime Minister Hawke, there has been very little interest in this subject by either side of politics, state or federal, throughout the 115 years of Australia's political history as a Federation.

I do think that one of the starting points in terms of making real progress is that this is so complex, so difficult, so readily captured by vested interests of one sort or another that unless one can build a significant amount of bipartisan support—by which I mean both sides of politics and equally federal and state levels—the chances of success are very small indeed.

Another starting point is that there needs to be an agreed statement of principles. Unfortunately, they tend to be words like ‘sovereignty’ and ‘subsidiarity’ and things like that which aren’t exactly going to catch the front page of the *Daily Telegraph*. But unless we get an agreed set of principles as to how the Federation might improve—and they are things like ensuring some clarity, some sovereignty for different levels of government, and getting things done at the level that is most appropriate, and so on—and the process devolves automatically to the detail, it becomes very hard to achieve anything.

You really do need to try to get some momentum behind the idea that the Federation as it now exists is dysfunctional, or in simpler language, broken. Without that, if you start trying to talk, as Jeremy will, about health or different areas you wouldn’t want to bet the family jewels on getting an agreement. That is especially the case given that no federal government is going to want constitutional referenda to try to implement anything, and therefore, there need to be other forms of structuring and enforcing this—and they’re not altogether easy to find.

So who should own it? I think one of the sad things is that Tony Abbott has started this as a Commonwealth project, and almost a Commonwealth bureaucracy white paper. I think the chances would be a lot better if it was owned by the Federation—by the seven governments rather than the federal government—because this is ultimately the most mutual thing that these governments do. I would have thought the appropriate ownership is in fact the Council of Australian Governments (COAG). Call it what you like, structure it as you like, but if you want it to succeed, you are better off having some commonality of ownership.

I’m afraid that what is going to happen is that there are some intelligent, well-meaning people in the prime minister’s department

who will beaver away on the various papers they have announced in the past few weeks, and the directors-general of various premiers' departments in the states will ride roughshod and make sure no one says anything terribly radical. I would have thought that the reverse is much better. Try to have it owned by everyone because at the end of the day, it's got to be owned by everyone. It's not capable of meaningful implementation if it's contested in a serious way—as between the Commonwealth and the states.

The need for bold strokes

My next general point is that you need bold strokes rather than little incremental changes. No doubt there are some useful incremental changes you can make, but this is about a new federalism. It is seriously about changing what has been a one-way slide towards dysfunctionality for the last 75 years, in the sense that we have lousy accountability. We have no match between who raises money and who spends it and all the other faults that we're all aware of. So I do think you're looking for big bold strokes and big bold decisions to start with, which goes with my notion that you need a set of principles as to what you are trying to achieve rather than how to better fund education or whether should they get rid of 700 school-focused public servants in Canberra. They probably should but that's not exactly the point of trying to reform the Federation.

Incidentally, I think if people read Tony Shepherd's National Commission of Audit report, they will appreciate it when I say that my friend Joe Hockey could have timed the release differently. It got lost in the budget and has been lost ever since. I think it should have been released earlier and stood on its own feet, and a longer period of debate or narrative would have helped. But what they say about federalism is entirely sensible. It's a dispassionate group of people from outside government, and they say intelligent things both about reducing the number of federal/state agreements and the associated specific purpose payments, and more importantly, the serious long-term work of allocating responsibilities: what I call the 'who does what to whom and why.'

Who does what to whom and why

I do think that should be the first question. It's easy and understandable to get diverted into vertical fiscal imbalance and how do we pay for it, but the basic question is who does what to whom and why or who should do what to whom and why. And you have to be prepared to have a sensible discussion about that. I don't think you need to spend too much time arguing that you ought to have clarity and you shouldn't have duplication and triplication in almost every area. If that's not self-evident, then you really do have Buckley's chance of making serious progress. So the first issue is to get a clear statement of who does what to whom and why.

At the risk of being slightly radical, I'm not sure that the actual answers always matter. What matters is the clarity. What matters, as my old cabinet secretary Gary Sturgess put it—no doubt borrowing the words from someone else—is that good fences make good neighbours. That's what this is about. You need good fences and whether TAFE becomes all Commonwealth or not is something you can have profound discussions about, but it's a low-level problem. The high-level problem is that everyone's got their finger in every pie, and that's the basis for the sort of dysfunction we have at the moment. So to repeat, that's in my view where it should start: who does what to whom and why.

I do think there is an argument about the total amount of government, and I'm not sure if this differs from the CIS view. What do people expect from governments, not specifically state or federal but in the totality? What should they expect from governments and where does the accountability lie? That discussion is worth having because if you simply assume the answer, that either the existing government is the right size, too big or too small, you're not going to carry the public with you in a meaningful kind of way.

Horizontal fiscal equalisation

Finally, I spent a year and a half of my life on the study of horizontal fiscal equalisation and I'm persuaded it's a low-level issue. I wouldn't get carried away with that again. The views of our committee and the views of the Commission of Audit are the same.

In the long term, the distribution probably ought to be equal per capita. The two states and two territories that do need some long-term support—and I'm not sure South Australia will be there forever, but Tasmania and the territories probably, for different reasons, do require support, cross subsidisation, whatever—can get it directly from the Commonwealth. But for what it's worth, I think diverting one's energies into a politically barren debate about horizontal fiscal equalisation is a waste of time.

I point out in passing that WA Premier Colin Barnett, who started the debate that led to me and two others wasting a year of our lives, was doing very badly out of the GST distribution at the time because Western Australia's revenues from mining were doing very well. Now that WA revenues from iron ore are not doing so well, he is suddenly doing better out of the GST and you'll notice that he's not quite as excited about horizontal equalisation. That's all reasonable politics, but my point is that this discussion is so hard that you have to focus on the more fundamental question of who does what to whom and why. Once you have resolved that, you need to look at vertical fiscal imbalance and the range of issues around that.

What to do about the GST

Inevitably, the debate about vertical fiscal imbalance will go down one of two paths. One is where the Commission of Audit went and where Malcolm Fraser went in the mid-1970s with input from me and others, which is some form of income tax space creation or income tax sharing between the Commonwealth and the states. Alternatively, it will go the way that is more fashionable now, which is to change the GST. I suppose the CIS would say that the third way is just to spend less money in government and you mightn't have to address this question. I accept that's a plausible third option.

But for what it's worth, I do think on balance the GST ought to go up regardless of where you fall on the previous question about the overall size of government. Whether you think government is the right size, or like the CIS, you think it's too big, I still think you need more consumption tax. Any enquiry—it doesn't

matter whether they're from Washington, Paris, Bourke or Gulargambone—anyone who has half a brain will tell you that the composition of our tax structure doesn't rely heavily enough on GST. So I would increase the GST, and how much you spend compensating the poorer part of the community, how much you spend getting rid of totally dysfunctional state taxes (of which there are many), and how much you might spend in some sort of hypothecated way on health and the new disability scheme are matters to be determined.

If we're not honest with ourselves about health and the National Disability Insurance Scheme (NDIS), we're going to have this debate for 30 or 40 years because the truth is that everyone wants better health and they certainly want a national disability insurance scheme. Neither of them was funded under the last government, neither of them is funded under this government, and I think it's high time for some honesty about that.

So how you spend the GST is a good question and it no doubt gets a lot of time, but the important thing to recognise is that wherever you come out on the question of the overall size of government, you should rely more heavily on consumption tax and less on all these transaction taxes and such things that are around.

Don't throw the baby out with the bathwater

I am absolutely a fan of making federalism work. It does involve some giving back of effective power to the states. However, I don't think you should throw the baby out with the bathwater. There has been some progress in terms of national reporting, national information flows, and so on. We are a nation of 22 million people. It doesn't mean that we have to run our schools or hospitals the same way, but it does mean that one should acknowledge that there are in many ways national markets for these products and services. I'd be reluctant to see all of the somewhat reasonable progress in creating national approaches—not approaches in terms of mandating a way to do it but approaches in terms of information flows and accountability—thrown out in this federalism discussion.

If I could finish where I started, I do think for better or for worse this is highly political. You only need to go back to the debates in the 1890s to see this is about how we govern ourselves and people got immensely wound up about it. They will get wound up about it again if the review is serious. If it's not serious we're wasting our time. So my only point is we should all do what we can to try to build a consensus for a serious non-partisan approach to federalism.

Reshaping the Federation for Stronger Accountability and Responsibility

Robert Carling

The title of tonight's forum refers to Tony Abbott's new federalism, but Abbott is by no means the first prime minister to call for a 'new federalism.' Just about every prime minister going back to Gough Whitlam has aimed to fix what they perceived to be wrong with the Federation.

Whether because of such initiatives or in spite of them, the system has continued to evolve largely unchecked on a path towards a stronger role for the central government and a diminished one for the states. Whitlam was the prime minister who got most of what he wanted in the way of a new federalism, and that was a vast expansion of Commonwealth influence on states' constitutional responsibilities through a huge increase in conditional grants. This process was really started by the Menzies government, but Whitlam took it to a new level and it has continued ever since with few interruptions.

The current prime minister appears minded to steer the federal system onto a different path. Abbott speaks of making the states sovereign in their own sphere. However, he has also stated a very centralist position in his 2009 book, *Battlelines*. Either he has had a major conversion since then, or we are misinterpreting what he is saying now. We shall see.

So it remains to be seen whether this review is any more likely than other initiatives in the past to bring about a fundamental change of direction. The forces arrayed against such a change are formidable, but the white paper project and its stated objectives deserve to be taken seriously. This is the first time there has been a white paper process devoted to the topic in its own right.

Where the federation has gone off the rails

The CIS has long been an advocate of federalism, but it is one thing to champion federalism as an ideal and another for federalism in practice to live up to that ideal. For that to happen, the structure and incentives of the system have to be right. Australia's federal system falls short of its potential because its structure has drifted away from the principles of federalism.

The drift has occurred in a number of ways. One is Commonwealth regulatory adventurism under various constitutional heads of power such as the corporations power. Another is Commonwealth expenditure directly into functions outside its section 51 constitutional powers—something that has been highlighted recently by the High Court's decision in the *Williams* case concerning the schools chaplaincy program. These are important matters deserving attention in a complete review of federalism, but the subject of focus for me is the breakdown of the link between spending and revenue responsibilities at each level of government.

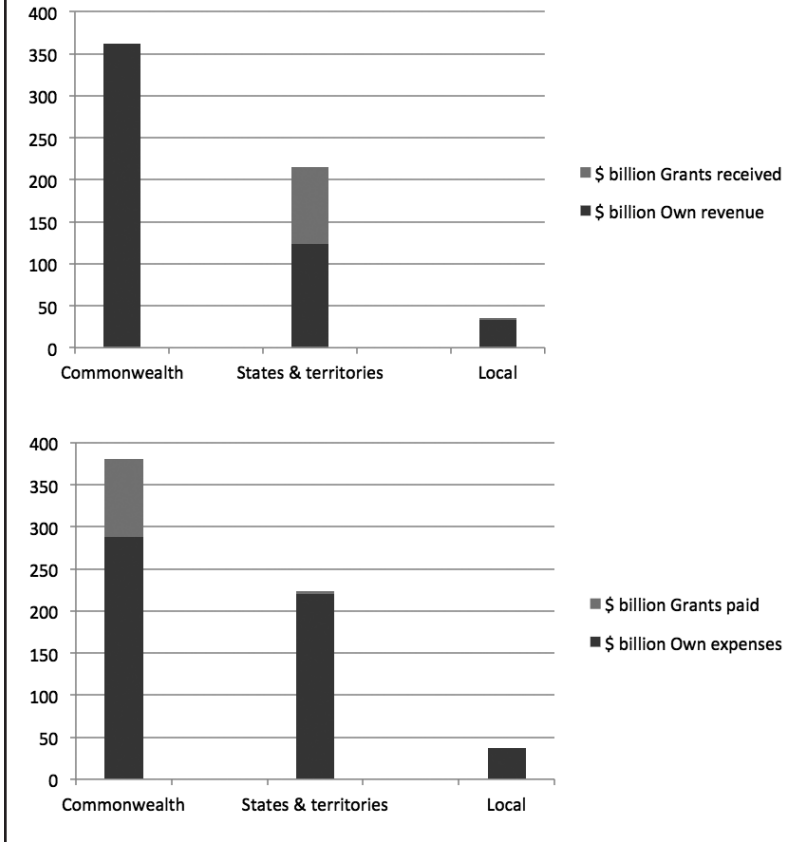
My premise is that the system cannot function as it should if accountability of the various tiers of government is lacking and functional responsibilities are not aligned with the power and capacity to raise the requisite revenue.

Vertical fiscal imbalance and accountability

This inevitably leads us to the concept of vertical fiscal imbalance, which is at the heart of the accountability problem. It is best illustrated graphically using the latest available data, for 2012–13 (Figure 1). The Commonwealth takes in much more revenue than it needs for its own purposes, the states spend much more on their own functions than they raise from their own sources, while for local government spending and revenue raising are more balanced.

The imbalance between the Commonwealth and the states is resolved by the Commonwealth making both unconditional and

**Figure 1:
Vertical Fiscal Imbalance, 2012 - 13**

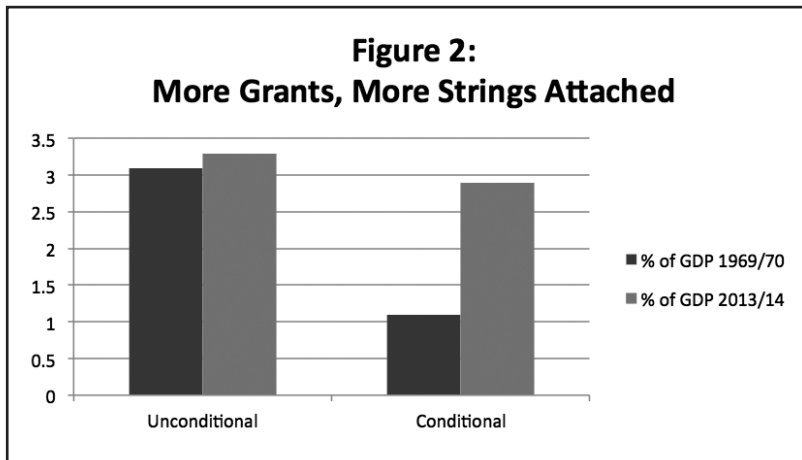


conditional grants to the states.[‡] Conditional grants have to be spent on specific purposes and are subject to all kinds of checking and monitoring by the Commonwealth to make sure the states are complying with the conditions. In the current fiscal year

[‡] Unconditional and conditional grants are also referred to as 'general purpose' and 'specific purpose,' or 'untied' and 'tied,' respectively.

unconditional grants will total \$55 billion, almost all of this being the pass-on of GST revenue to the states, while the conditional grants will total \$46 billion.

A degree of vertical imbalance was built into the Federation from day one, and it exists in all federations, so we should not expect it ever to disappear. But the imbalance has become very pronounced in Australia, and its origins are well enough known: The Commonwealth took over income tax from the states during World War II and never gave it back. This led to the states becoming increasingly dependent on Commonwealth grants. What is not so well recognised is that the growth of grants has occurred much more in the conditional type than in the unconditional or 'general purpose' type (Figure 2).

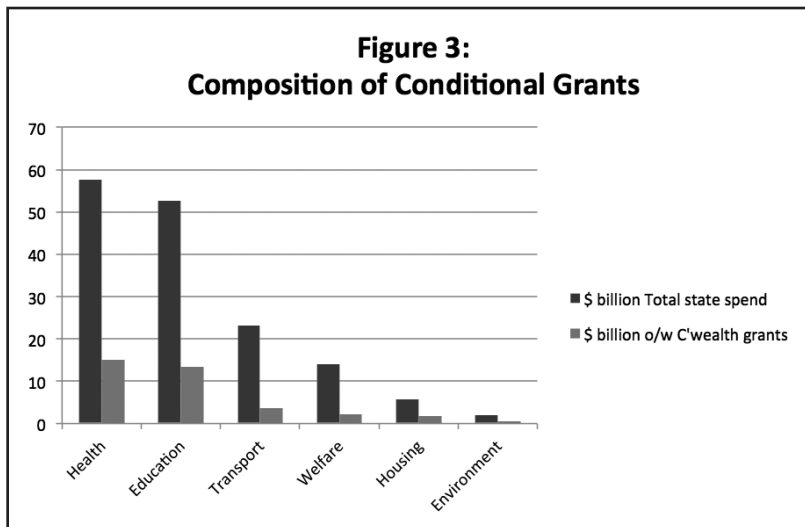


Conditional grants

Before the 1970s conditional grants were a minor feature of the system, but that was before the Commonwealth became heavily involved in funding public hospitals and government schools, among other things. The growth of conditional grants plays a central role in the story of how Australian federalism has evolved. Conditional grants have been the Trojan horse of Commonwealth influence on the provision of public services.

This is not to suggest that conditional grants are the only source of dysfunction in our federal system. States' reliance on unconditional grants also encourages a mendicant culture on the part of state governments and a command culture on the part of the Commonwealth. I believe, however, that conditional grants do the most damage to federalism because of their sheer magnitude and their potential to distort state policies, as well as to create problems of duplication and overlap.

One measure of the Commonwealth's policy influence on state functional responsibilities is the size of conditional grants relative to total state spending in key functional areas. Conditional grants are widely spread, but as Figure 3 illustrates, they are concentrated in six areas: health; education (schools and TAFEs); public housing; transport (mainly roads); welfare services (home and community care, and increasingly in the future National Disability Care Scheme (NDIS)); and environmental protection.



The case against conditional grants is not absolute. In Australia, however, conditional grants have blossomed way beyond any reasonable justification for them.

A reform proposal

The fundamental goal of reform should be to strengthen the link between spending and revenue responsibilities so as to make governments at each tier more accountable and responsive, and remove or at least reduce the scope of duplication and overlap.

To that end, my proposal is to replace most conditional grants with revenue that the states themselves control by shifting tax power down from the Commonwealth to the states. The choice of the words ‘tax *power*,’ rather than ‘tax *revenue*,’ is deliberate. The Howard government assigned all GST revenue to the states, but that shifted revenue downwards, not tax power.

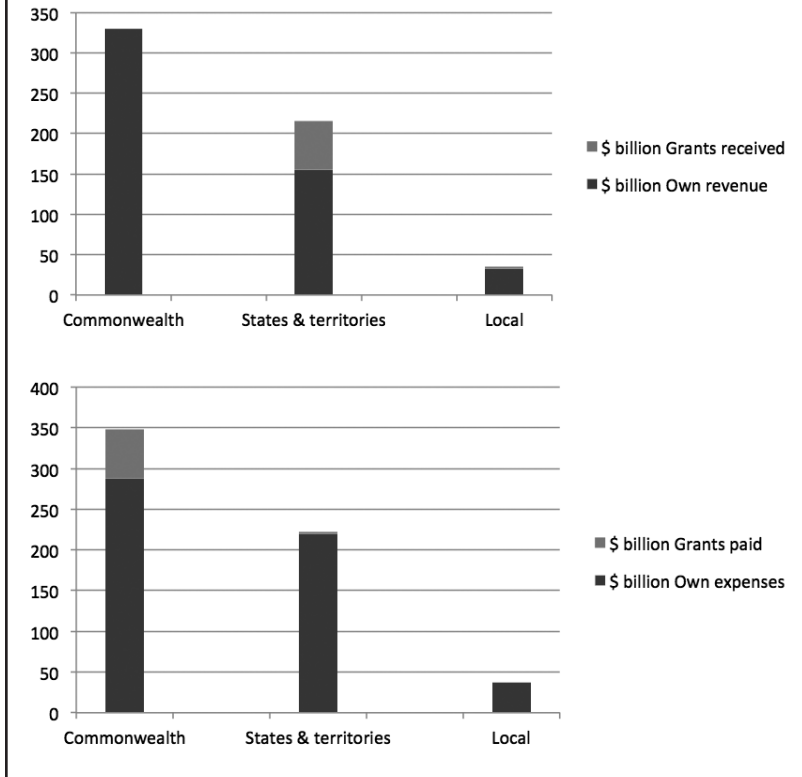
Constitutional experts believe that the states could not exercise legislative power over the GST or any other form of consumption tax. But there is no constitutional bar to the states imposing their own income tax, provided the Commonwealth cooperates. Such sharing of income tax power has been proposed and discussed many times in the past.

In the general community, the very idea of a state income tax is often met with shrieks of disapproval as a knee-jerk reaction, but many of the concerns can be overcome if only we could ever get beyond scare campaigns. The most important point is that any state income tax should be applied to personal, not corporate, income and should begin as a dollar-for-dollar substitute for the existing Commonwealth income tax, not as an additional tax. Then, over time, each state would have the flexibility to vary its personal income tax up or down, subject to the usual political and competitive constraints.

The realignment of expenditure and revenue responsibilities would enable Commonwealth grants to the states to be reduced, and as I have suggested, the first priority should be conditional grants. This could take the form of a reduction in all conditional grants, without abolishing any of them, but it would be more consistent with the aim of reducing duplication and overlap for the Commonwealth to withdraw completely from whole functions.

Public housing would be at the top of my list. Next would come funding of government schools and technical and further education.

**Figure 4:
Vertical Imbalance After Reform**



Health is trickier, because of Medicare, but there are opportunities to at least reduce Commonwealth conditional grants in this area, too. Jeremy Sammut will have more to say about that.

As the withdrawal of Commonwealth conditional grants for particular functions would be matched by increased general funding, the states would be no worse off financially, but they would have more discretion in the allocation of funds. Over time, as masters of their own destinies, the states would shape their budgets more according to their own priorities.

To provide a concrete illustration, if the states were assigned 20% of personal income tax, they would receive \$31 billion (in 2012–13 terms). This would allow almost three-quarters of the value of all conditional grants to be eliminated. Such a reform means, for example, that all the conditional grants excepting those for non-government schools and national roads could be eliminated. Figure 4 portrays the structure of Commonwealth and state finances after this change, as if it had happened in 2012/13. The vertical imbalance remains, but to a lesser degree, and grants to the states are overwhelmingly of the unconditional type.

The Abbott government's recent National Commission of Audit recommended something similar to the reform I have just described, but its version involves income tax revenue sharing rather than devolution of income tax power.

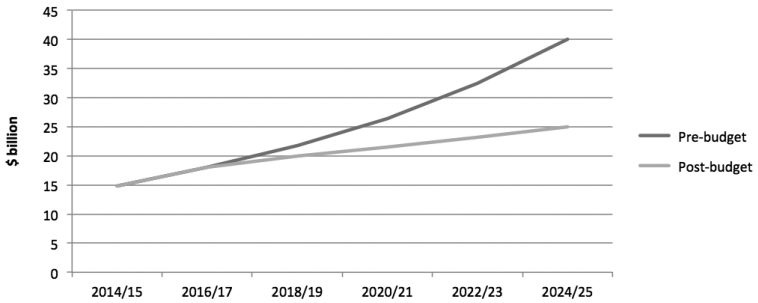
More taxation or a change in the mix?

The proposal I have outlined involves a change in the composition of taxation between the Commonwealth and the states but not in the overall level. However, there are also calls for an increase in the overall level of taxation on the grounds that the public sector needs more tax revenue to meet the rising costs of public services. The one kind of additional tax revenue most frequently nominated is the GST, with the money going to the states.

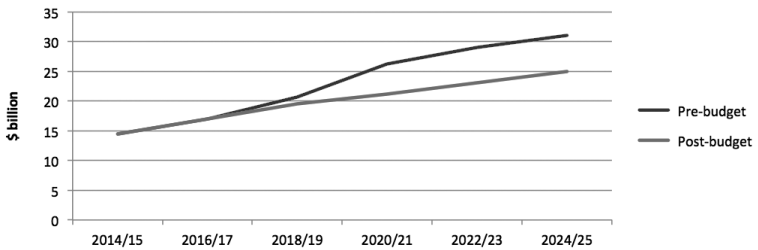
Before governments go off in that direction, however, they need to give a lot of thought to the nature of the problem being addressed: Is it really one of inadequate revenue or is it a case of excessive growth in spending? A strong case can be made that the issue is not one of inadequate revenue growth, but rather the composition of revenue (too much dependence on Commonwealth grants and sub-optimal state taxes) and the very rapid growth of state spending on health, which no 'growth' tax could possibly match.

The Commonwealth budget for 2014–15 sharpened the focus on these issues by lowering the growth path of payments to the states for hospitals and schools from 2017–18 onwards by changing the annual escalation factors. This is the basis for the complaint by state premiers and others that the Commonwealth is taking \$80 billion away from them. Figure 5 illustrates the point.

**Figure 5: The \$80 Billion 'Cut'
Hospitals Share**



Schools Share



One interpretation of this budget announcement is that the Abbott government needed to identify a large saving to meet the goal of a budget surplus of more than 1% of GDP, and the Expenditure Review Committee found it in these large and fast-growing expenditures.

It is not at all unusual in the history of Commonwealth-state financial relations for the Commonwealth, when under fiscal stress, to effectively shift some costs on to the states. But on this occasion the Commonwealth, with an eye to its review of federalism, had the additional objective of opening up in a tangible fashion the whole issue of which tiers of government should bear which costs.

On cue, commentators rushed in with the suggestion that the GST must be expanded or increased. In an arithmetic sense, a GST increase could be designed to fill the state funding gap left by the Commonwealth, at least for a while, but in itself this would do little to reform the federation. It would replace a slab of future conditional grants with unconditional grants, which may be an improvement in a limited way, but it would not remove the Commonwealth from any state function or realign state revenue raising powers with expenditure responsibilities.

I should add that while the GST should not be increased to pay for bigger government, we should be open to the idea of tax reform involving a higher GST to substitute for other taxes, provided such a change is structured sensibly and is not hijacked by populist politics. But I emphasise that this should not be for the purpose of generating additional net revenue to pay for bigger government. The alternative to raising more overall tax revenue is to exercise tighter control over expenses. The Commonwealth budget can be interpreted as saying to the states that they run public hospitals and schools and need to bring their expenses under better control.

Federalism and the long-term fiscal gap

If we join all the dots together, the Commonwealth budget has drawn attention to the long-term budget pressures from galloping health care costs and population ageing. The Productivity Commission projects that after 50 years, this impact will push public sector health, pension and aged care costs up by a staggering 7% of GDP over and above present levels, offset only by about 1% of GDP less in other areas such as education where there will be relatively fewer young people.

The pension and aged care impacts will fall mainly on the Commonwealth, while the health impact will be shared between the Commonwealth and the states. The Commonwealth budget proposal would, if sustained, tilt the balance of the health cost impact towards the states.

Whichever way the impact is distributed, it really points to the need for fundamental changes in the health, age pension, and aged

care systems over the long term, of which the proposal to lift the pension eligibility age to 70 is but one example. Otherwise, there will certainly be pressure on the tax burden to rise at both the Commonwealth and state levels. But the long-term fiscal impact of health spending and ageing is also a key issue for federalism, reform of which would better position the public sector to deal with the problem.

In winding up, I should say while I have focused on the one aspect of federalism that I believe is most in need of reform, the reform process also needs to address other aspects such as the way in which GST revenue is distributed to the states through the Grants Commission process. Indeed, there is no point in giving the states more revenue raising power unless the horizontal equalisation system is changed at the same time.

Re-tuning and Renewing the Federal System

Anne Twomey*

We so often hear people complaining that the federal system is 'broken,' that we are over-governed and that it is a horse-and-buggy system no longer appropriate for the modern age that these messages of doom become self-fulfilling. Sometimes we need to remind ourselves that federalism is actually one of the best and most economically efficient systems of government and one that is absolutely essential in a geographically large country. It is not broken, but like all systems, it could do with some attention, adjustment and renewal on a regular basis. A well-tuned and efficient federal system would bring the next great wave of economic benefits to Australia.

Myth-busting federalism

Let's start with the myths. Are we over-governed with three levels of government? No. Most democratic countries have at least three levels of government and many have four. Why do we think three levels are excessive? This is because we commonly compare ourselves with New Zealand and the United Kingdom, which are perceived as having only two levels of government. In reality, New Zealand has two levels of local government, which operate at the regional and local levels, giving it three levels of government overall. Similarly, in the United Kingdom, not only did devolution give three levels of government to Scotland, Wales and Northern Ireland, but within England two levels of local government operate in most areas.

* The first two parts of this paper, including references made to statistics, are drawn from Anne Twomey and Glenn Withers, *Australia's Federal Future*, Federalist Paper No. 1 (Council for the Australian Federation, April 2007).

This is because even in non-federal countries, it is difficult to manage without three levels of government. People want their local car parks, roads, libraries and planning issues dealt with by the people in their own community, whom they know and who understand their concerns and needs. Hence, they want a local authority in each community to decide upon such matters. Education, health and policing, however, require greater economies of scale to be managed effectively, so these tend to be dealt with at the regional or state level. This still accommodates the different wishes and needs of different geographical locations, but allows the functions to be managed efficiently. Other functions such as defence, immigration and foreign affairs need to be dealt with at a national level. The principle that is generally used to allocate functions is known as subsidiarity—that functions should be allocated to the lowest level of government that can effectively perform them. The recent National Commission of Audit placed emphasis on the importance of the principles of subsidiarity and sovereignty.

Geography is another indicator of why Australia needs three levels of government. Every country with a landmass as big as Australia or larger is a federation with at least three levels of government, except for communist China, which is a quasi-federation. If one looks at the G8—the countries with the biggest economies—they are all either federations or countries that have engaged in significant devolution in recent years. Seven of the eight have at least three tiers of government, with the United Kingdom being a mixture of two or three tiers. If one looks at democratic countries with a similar population to Australia, they all have at least three levels of government. It is extraordinarily difficult, if not impossible, to find a democratic country with a similar geographical size or population that has fewer levels of government than Australia.

The next myth is that federalism is an economic drain on the country and less efficient than a unitary system of government. The evidence, however, is that the opposite is true. In the last 50 years, federal economies around the world have consistently outperformed non-federal economies, and the more decentralised countries become, the better their performance. Without internal competition,

governments tend to become inefficient, over-staffed and expensive to run.

If we compare Australia against the United States, Canada, the United Kingdom and New Zealand in terms of the cost of government as a share of GDP, it is the two unitary countries, the United Kingdom and New Zealand, that have the most costly governments, while the three federations, the United States, Australia and Canada are the cheapest. According to Organisation for Economic Co-operation and Development (OECD) figures, the proportion of public sector workers is greater in unitary states than in federations. Equally, public sector spending as a share of GDP is much higher in unitary states than in federations. In brutal terms, if Australia were a unitary state rather than a federation, we would most likely have *more* public servants, costing *more* taxpayers' money and working less efficiently.

The benefits of federalism

So what are the positive benefits of federalism?

Check on power: Federalism is one means of preventing governments from becoming all-powerful and behaving in oppressive and arbitrary ways. Human rights advocates, such as Michael Kirby, support federalism because it protects the individual from the excesses of an unrestricted government. Federalism results in greater public scrutiny of policy and lower levels of corruption.

Choice and diversity: Federalism provides greater choice for the people. If you think the school curriculum in your state is poor or that the support for your disabled child in public schools is insufficient, you can move to another state that better suits your needs. If you have a national curriculum and national school standards, to which you object, there is no choice other than to leave the country. Federalism also ensures there is diversity in our institutions—they are not all situated in Canberra. We have state capitals that all have major museums, libraries, art galleries and universities. In comparison, in a unitary state such as France, all major institutions are situated in Paris.

Customisation of policies: Federalism is important in a large country like Australia because it allows policies to be customised to meet the different needs of people in different parts of the country. Federalism accommodates differences and brings democratic decision-making closer to the people, allowing them greater influence on the decisions that affect them.

Competition: The comparison between the performance of states and territories means there is a constant process of improvement. If a state premier sees that another state is performing better in hospital efficiency or NAPLAN results, he or she will want to know why and will take action to improve.

Creativity and innovation: Federalism also encourages states to innovate to outperform other states. It allows for experimental change on a smaller scale, which can be taken up by other jurisdictions if it proves a success (e.g. compulsory seat-belts, hospital case-management and environmental protection) or rejected if it proves a failure (e.g. WA Inc), without bringing down the whole nation. It gives the country as a whole a chance to judge how successful an innovation might be (e.g. Victorian Charter of Rights) before deciding whether it should be adopted across other jurisdictions or nationally.

Cooperation: The need for different jurisdictions to cooperate to achieve a national outcome leads to reforms that are more measured and better scrutinised. If all governments join together to make a major reform, such as competition policy, it gives it greater legitimacy and public support than if it is simply imposed by one level of government.

Reform of the federation

Australia is therefore fortunate in having a federal system, but the problem is that it has been degraded over time. The Commonwealth's financial dominance has led it to interfere significantly in all areas of policy, including those not within its jurisdiction, resulting in unnecessary duplication, conflicting policy development and excessive administrative burdens. What we need to do now is maximise the benefits of federalism that derive from decentralisation, competition, innovation and diversity.

It is more than obvious that our system of government could be significantly improved by clarifying which level of government is responsible for which particular functions, ensuring that each level of government had access to the sources of revenue needed to fund its responsibilities, and removing as much as possible the involvement of two or more levels of government dealing with the same policy issues. This is not always possible. Often different responsibilities will be entwined. The Commonwealth, for example, has the power to provide pharmaceutical, sickness and hospital benefits, as well as medical services, while states are responsible for providing and running hospitals. But there are clearly some areas that the Commonwealth could appropriately move out of completely and return to the states, along with accompanying funding. The National Commission of Audit mentioned a number of them, including housing, vocational education and training, disaster relief and community investment programs.

Most new prime ministers have some kind of 'new federalism' policy in their pocket intended to revolutionise the system of government. Kevin Rudd, for example, swept to power in 2007 with a promise to end the blame game, remove most of the conditions on grants and consolidate them into a small number of broad grants that focused on outcomes rather than inputs and processes. Once Rudd was elected, many meetings were held, the midnight oil was burnt and much paper was churned to achieve these promises. But conditional grants, like zombies, seem unable to be killed. Renamed as 'national partnerships,' they arose from the grave and continued the walk of the living dead, dripping in prescriptive conditions, oozing with administrative burdens and sucking the life force from the federal system.

The promise in 2007 was that the 196 existing grant programs would be reduced to six. This has since grown back to more than 140 agreements. As the National Commission of Audit has noted:

The growth in the number of agreements has contributed to a significant growth in reporting and administrative expenses ... [A]n additional bureaucracy is required to develop, report on, review and assess the agreements,

which takes resources away from service delivery and gives rise to second guessing and duplication.[†]

Why, one may ask, do these reforms so often fail? One reason is that federal politicians and bureaucrats seem to think they know better than anyone else and can resolve all problems, regardless of their lack of experience in dealing with an issue. The other critical factor is power. From the bureaucracy's side, it is about building empires of departments and agencies, even when they have little, if any, relationship to the powers allocated to the Commonwealth by the Constitution. From the political side, it is all about spending money in a way that is most likely to result in the party in government being re-elected to office. There is no head of power in section 51 of the Constitution to fund surf clubs, aquatic centres and football grounds, nor from the point of view of the principle of subsidiarity is there any justification whatsoever for the Commonwealth doing so. Yet plenty of money on such projects seems to be splashed around by the Commonwealth in marginal seats prior to elections.

The biggest change, therefore, that needs to be made is the hardest type of change—cultural change. It needs to be accepted by all that the reform of the federal system is the next great economic change that Australia must make to ensure its prosperity. Like the competition policy reforms decades ago, this is the change that we have to have. While clarifying roles and responsibilities is important, the biggest change needs to take place in the field of federal-state finances. We need to assess, regularly, the cost of the various functions of government, as a proportion of our GDP, and we need to make sure that each level of government has access to the same proportion of public revenue to match its spending responsibilities.

Ideally, that would be done by significantly reducing Commonwealth taxes and giving the states the capacity and economic room to raise the taxes necessary to support their functions, while keeping the overall tax burden on the people at the same level, or

[†] National Commission of Audit Report, Vol. 1 (2014), 77–78.

a lower level to take into account the efficiencies achieved. This will ensure that states are more accountable, because they have to take responsibility for the burden of taxing, and therefore, have a greater incentive to keep taxes down and use the money raised as efficiently as possible. However, it has to be recognised that for constitutional or economic efficiency reasons, some taxes need to be imposed centrally. In those cases, consideration needs to be given to how to achieve tax sharing in a way that does not permit the Commonwealth to impose conditions on the states or interfere with state policies or starve the states of necessary funding. Equally, it needs to be done in a way that ensures the states share in the political responsibility for taxing.

If we could rebalance the federal-state financial system, so that each level of government was largely capable of funding itself and fulfilling its own responsibilities, this would significantly reduce the ability of the Commonwealth to use conditional grants to involve itself in policy areas beyond its constitutionally allocated powers. Section 96 of the Constitution could return to its original function as an emergency power to be used only when a state was suffering from an unexpected financial crisis and needed temporary extra assistance. The provision was never intended to be used as a means of imposing Commonwealth policy on the states and, if our federal system is to operate effectively in the future, it should cease to be used in that way.

Constitutional issues

There are some constitutional constraints upon what can be achieved. The Constitution prohibits the states from imposing excises. Hence, the GST could not be transferred to the states. Nor could the states impose sales taxes or any other taxes on goods. It is unrealistic to expect that a referendum to allow the states to tax goods would pass. Just as turkeys don't tend to vote for Christmas, one can be pretty confident that the Australian people would not vote for the states to be able to impose more taxes upon them. There is no constitutional impediment, however, to the states imposing

income taxes, although for economic reasons it would continue to make sense for the tax to be imposed and administered centrally.

In terms of responsibilities, the states can legislate to refer matters to the Commonwealth. While there is not an equivalent provision that allows the Commonwealth to refer matters to the states, this can for the most part be achieved by the Commonwealth simply dropping out of involvement in particular functions and leaving them to the states. We have started seeing that in the Commonwealth's recent withdrawal from some funding areas. But this ought not simply be a cost-shifting effort by the Commonwealth. As functions move, the source of funding should move with them.

Conclusion

The National Commission of Audit has already made recommendations on how to improve the federal system, including giving the states access to a share of income tax revenue, reducing the number of tied grants and the administrative burdens attached to them and rationalising the roles and responsibilities of the different levels of government.

In addition, the Commonwealth's White Paper on the Federation is being conducted concurrently with one on the taxation system. The two issues are intimately linked. Functions cannot be filled without funding. Those who are responsible for exercising functions should also be responsible for funding them. Such double responsibility results in greater accountability and economic efficiency. The Commonwealth's role in supporting that accountability should be through collecting and comparing the data that show how well states are performing in comparison to each other, so that the benefits of competition are harnessed and the states are encouraged to innovate and improve to maximise their performance.

Restoring our federal system to full operational efficiency does not involve rocket science, but it will involve cultural change and leadership at the Commonwealth level. It will require the courage to give up some of the influence and power that comes from controlling vast swathes of public revenue. But the payback for making that sacrifice will be immense in terms of the economic prosperity of Australia in the future.

Federalism at a Tangent: Public Hospital Reform

Jeremy Sammut

Federalism is an important part of the story in relation to health policy and the problems in state public hospital systems. However, while federalism is part of the problem—and can be part of the solution by changing incentives—the way public hospitals are run or should be run is more important than the revenue and functional allocation questions that dominate the federalism debate.

This is to say that the perpetual blame game between the states and the Commonwealth over health funding is a distraction from what should be the main game: the implementation of a micro-economic public hospital reform agenda by state governments that will address the system's major structural problems, help control its cost, and improve its productivity.

This solution has been set out in full in the work on public hospitals published by me and others as part of the CIS Health program. The argument advanced here is that there is no reason why state governments—outside of longstanding lack of political will—cannot implement this agenda regardless of the shape of the Federation. However, reshaping the Federation by realigning tax and functional powers would give the state governments greater incentive to undertake reform.

'Fixing the blame game'

It is almost seven years since Kevin Rudd promised to 'fix public hospitals' and 'end the blame game' during the 2007 federal election. But the blame game has come back with a vengeance this year following the so-called health funding cuts announced in the Abbott government's first budget in May.

The changes to federal funding for state health services backtracked on the funding deal that developed out of the Rudd government's national health reform process, and was eventually negotiated by the Gillard government in 2011. The bottom line—which attracted much media attention and complaints from state premiers and health ministers—is that in 10 years' time, annual federal hospital funding will be \$15 billion lower than it otherwise would have been under the original Gillard deal.

The federal share of hospital funding was set to rise by 185%—from \$14 billion in 2013–14 to \$40 billion in 2024–25. This would have meant that at the end of this period, federal funding alone would have totaled more than the combined federal and state expenditure on public hospitals today.

The reality is that funding for hospitals has not been cut. Under the revised arrangements, federal funding will still grow to \$25 billion in 2024–25.

Moreover, lack of funding is neither the problem, nor is 'more funding' the solution, regarding the performance of public hospitals.

In the decade between 2002 and 2012, total federal, state and territory government spending on public hospitals grew in real terms by 60%. Annual growth in government spending on public hospitals averaged around 5% in real terms, well above average growth in GDP.

This illustrates the long-term challenge facing the health system in general. Public hospitals, like Medicare as a whole, face a sustainability crisis. The pressures created by increased demand associated with an ageing and growing population, combined with the increased costs associated with ever-more technologically sophisticated hospital care, are compounded by public hospitals' seemingly endless capacity to absorb public funding 'inputs' without delivering a proportional increase in 'output.'

Productivity gaps

Productivity gaps were illustrated by the findings of the 2013 Queensland Commission of Audit headed by Peter Costello. The commission found that while expenditure on public hospitals in

Queensland had increased 43% in the five years since 2007, activity increased by less than half—only 17%.

The 2014 Council of Australian Governments (COAG) reform council report on public hospital performance found that despite large investments in enhancing emergency department services, national emergency waiting times had only marginally improved since 2007. Moreover, waiting times for elective surgery have lengthened nationally. The lack of improvement tallies with a 2013 report by the NSW auditor-general which found that thousands more patients could be operated on if public hospital theatres were managed more effectively and efficiently.

That inefficiency and poor productivity is a problem in all states and territories was tacitly conceded during the negotiation of the Gillard funding deal. Under the terms of the funding agreement, the Commonwealth agreed to increase funding on condition that the states and territories agreed to a national system of ‘activity-based funding.’

This new system has been characterised as ensuring that public hospitals are only funded for the services they deliver and are only paid at the ‘efficient price’ of delivering these services. However, this terminology is a misnomer.

Activity-based funding is designed to pay hospitals for the services they deliver based on the average cost of each type of service across the public hospital system nationally. In theory, this will require hospital managers in the least efficient services to improve operational and financial performance to the level of more efficient services.

However, the so-called efficient price, calculated by averaging the cost across all services, means the new funding arrangement will implicitly underwrite existing inefficiencies embedded in the public hospital system. These include, most importantly, the state-wide industrial agreements negotiated between state governments and health unions, which set the terms and conditions of employment for doctors, nurses and allied health professionals. These highly centralised and inflexible arrangements are a major barrier to productivity, as they entrench high cost and inefficient work practices. This includes strict nurse to patient ratios, antiquated

demarcation of roles, and the ability of doctors under the terms of their contract to control their own schedules and work practices, including the right to admit private patients to public hospitals.

These workplace rigidities deny frontline managers the ability to manage their services in innovative ways that can deliver services more cost-effectively. This is the first major structural problem plaguing the system—lack of proper managerial prerogatives.

Medicare's first victims

It is important to point out that the states do have legitimate grievances over federal-state financial relations regarding health, up to a point.

Obviously, there is the mismatch between revenue and responsibilities within the Federation. This is exacerbated in health by the fact that the Commonwealth sets the overall policy framework of Medicare, which obliges the states to provide 'free' public hospital services in return for federal health funding.

The states, in fact, deserve to be known as Medicare's first victims. In the mid-1970s, the Whitlam government got the states to sign up to Medibank (as Medicare was then called) by committing the Commonwealth to pay for 50% of the *real* cost of delivering public hospital services—that is, the cost of all services demanded and delivered each year without rationing, queues and waiting lists. The prospect of having their mouths stuffed with so much gold was an offer the states could not refuse; it was also too good to be true and proved fool's gold.

Under the Fraser government, 50% of real costs became 50% of 'approved costs'—this was the start of the fixed funding arrangements that became the Medicare agreements under the Hawke government after 1984. Needless to say that no federal government—under Hawke, Keating, Howard, Rudd or Gillard—has gone close to meeting the original Whitlam promise, with the federal share of hospital funding traditionally hovering around 40% of the total cost of (rationed) public hospital services.

There is no doubt Medicare left the states in an invidious situation. Medicare increased demand for 'free' public hospital

services as private health coverage declined. Moreover, the states were left to try to meet this demand as the real value of Commonwealth funding progressively dwindled. The only option to contain ever-growing and potentially unlimited health expenditure was to cap spending by rationing free care. Rationing care required altering the administrative arrangements for public hospitals.

Traditionally, each public hospital had been managed by its own board of governors. Prior to Medicare, public hospitals had also been a major public administration headache for state governments, since hospital boards frequently overran their budgets and left state treasuries to foot the bill. To exert stricter financial control, boards were abolished and public hospitals were placed under the control of regional bureaucracies (aka area health services).

The new administrative structure created a range of new problems, including large amounts of bureaucracy and red tape, and disempowered frontline managers. In effect, since the 1980s public hospitals have been run under a command-and-control regime, and more or less as branch offices of state health departments that have high levels of involvement in all operational matters. Moreover, the area health system perpetuated the same core defect that existed under hospital boards—financial risk, or rather financial responsibility for hospital budgets, ultimately remained the responsibility of the state. This is the second major structural problem plaguing the system—lack of proper financial accountability and incentives for good management to deliver services cost-effectively.

Unsustainability

These structural problems—lack of proper managerial responsibility and financial accountability—are the real issue in relation to sustainability. In all jurisdictions, health consumes around one-third of the state budget and public hospitals account for around two-thirds of total health spending. The NSW auditor-general has famously found that if spending on health continues to grow at current rates, health will consume the entire state budget in 20 years' time.

What this really means is that no government, federal or state, has enough money to sustain the projected cost of public hospital

services. This implies that potential solutions related to federalism that sought to clarify blurred health responsibilities—spanning everything from a full federal takeover to a full devolution of health responsibilities and appropriate income taxing powers to the states—are not really a solution. Under any scenario, the same unaffordability problem and reform challenges would remain.

What this also implies is that regardless of whatever tax and functional realignments occur, this is no substitute, and there is no substitute, for tackling the reform and productivity challenges in public hospitals. There is no alternative to figuring out how to bend the projected cost curve down and increase the amount of services delivered for the funding available, and reduce the quantity of public resources consumed by public hospitals.

Altering federal relations along sound federalist lines could encourage all jurisdictions to take necessary action, since realigning tax and functional powers would give the state governments greater incentive to undertake reform.

A first step worth exploring is ending all specific purpose payments and giving the states one pot of money, which might convince state governments to make more rational decisions about how to best use scarce public resources amid competing priorities, and this might extend to the operation of public hospitals.

Conditional grants are basically a make-work program for state and Commonwealth public servants. Not only would abolishing conditional grants immediately cut down on the bureaucratic costs associated with accountabilities to Canberra, but minimising the states' ability to point directly to the inadequacies of federal health grants might (and I stress might) diminish the power of the 'lack of funding' excuse, which the states have perpetually hid behind while failing to address public hospital reform.

Technically, this arrangement would leave the future of Medicare—as far as 'free' public hospital care is concerned—as a matter to be determined by each state according to the will of the electorate. Political reality, however, might dictate caution and calculation. Reaffirming the national commitment to Medicare might also be the political price that has to be paid to achieve any change to the federalism status quo.

Micro-economic reform agenda

However, regardless of any changes to federalism, the prospect of bankruptcy ought to be sufficient incentive for state governments to undertake reform.

The major structural problems plaguing public hospitals reflect the fact that the system is run as a rigid public service monopoly model—and like all public monopolies, the system is inherently inefficient.

These structural problems can be addressed via a three-stage micro-economic reform process involving:

1. Creating a purchaser-provider split
2. Corporatising public hospitals under truly independent and accountable boards
3. Introducing competition and contestability via privatisation of public hospital facilities.

State health departments are both the funder and provider of hospital services. Reorienting the system towards more market-based arrangements requires transforming the traditional role of health departments into purchasers of hospital services.

The first stage of micro-economic reform—creating a purchaser-provider split—depends on the second stage—the corporatisation of public hospitals.

This requires devolving managerial and financial responsibility, including financial risk for each public hospital to their own board of management, with full control over all operational matters and full responsibility for the hospital's entire budget.

This could be achieved by emulating the Foundation Trust hospital governance model introduced in the United Kingdom. Foundation Trust boards have the power to borrow and are responsible for debt incurred, and can accumulate reserves as a reward for efficiency. Their solvency is monitored by an independent regulator.

Importantly, managerial autonomy and financial accountability under a corporatised system of hospital governance would mean giving hospital boards and their managers full control over the employment terms and conditions of their workforces.

Workplace flexibility is essential if independent management and financial accountability are to be meaningful; this is essential to permit innovation and allow competition to drive efficiency and productivity improvements.

Competition through privatisation is the third element of micro-economic reform.

Selective privatisation, via Public Private Partnerships, for new or redevelopment hospital projects would inject competitive pressures into the mix. This would create a contestable market for public hospital services, and give state health departments the ability to act as informed purchasers. The ability to purchase services from better performing private operators would encourage public facilities that remain in state hands to lift their game and emulate the more efficient and businesslike practices of private competitors.

Some steps—uneven steps—in some of these directions are being taken in various jurisdictions.

Welcome developments include the Public Private Partnership entered into by the NSW government for the construction and operation of the new public hospital at Frenchs Forest—as recommended by me and CIS Senior Fellow David Gadiel in our 2012 report on how the NSW Coalition government should govern health.

However, the legacy of the Rudd national reform process is not as promising. As part of that process, the states agreed to set up new administrative organisations under the name of Local Hospital Districts (LHD), replete with their own boards. This was presented as a devolution of management to the local level and an end to command and control bureaucracy.

What it actually has proven to be is another reinvention of the area health system. To take NSW as the example, there have now been five administrative restructures in the last 30 years, involving the creation and recreation of area health districts of varying size and location. But under all these configurations, including the latest, the same structural problems have remained.

The NSW Health Department has remained the overall system manager with high levels of involvement in operational matters,

and the LHD boards and managers have lacked real managerial independence and financial responsibility because financial risk continues to be carried by the state. This means LHDs continue to lack both the authority and incentive to manage their facilities commercially and exert proper control over hospital finances.

Most importantly, control over the health workforce remains a departmental responsibility. Rigid, state-wide employment agreements and restrictive work practices remain in place, limiting opportunities for innovation, productivity improvements, and enhanced cost-effectiveness.

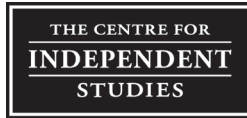
Conclusion

This all means that the political quarantine that has protected the public health sector from the kind of structural reforms that have been commonplace in other government instrumentalities remain in place.

There remains a lack of political will to take on the vested interests of public sector health workers, who have long benefited from government employment in public hospitals on the terms that suit them.

Public hospitals therefore remain the major public administration challenge facing state governments.

And there remains no policy substitute for political leadership at the state level that will set vested interests aside and pursue the public interest in containing health expenditure and maximising the state's return on spending on public hospitals.



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PO Box 92, St Leonards,
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Sovereignty, Blame Games and Tony Abbott's New Federalism

In July 2014, the Centre for Independent Studies (CIS) held a public forum on reform of the Australian federation, which continued the CIS's involvement in issues related to Australian federalism over many years. It was held at this time in response to Prime Minister Tony Abbott's announcement of a review leading to a White Paper on Reform of the Federation to be released in 2015. The review process will generate renewed public interest and discussion of federalism, to which this publication aims to contribute. The forum brought together an audience of interested members of the CIS and the general public to hear the views of four prominent practitioners and scholars in the field of federalism: former NSW Premier Nick Greiner; constitutional lawyer and expert on federalism Professor Anne Twomey; CIS Senior Fellow and former Commonwealth and state Treasury official Robert Carling; and CIS Research Fellow and health system expert Dr Jeremy Sammut. Their presentations, which form the four chapters of this volume, comment on issues such as the benefits of federalism; the need for clearer lines of responsibility between the Commonwealth and the states; how fiscal federalism should be reformed to strengthen accountability of each level of government in the federation; and the centrality of public hospital funding to the strains on federalism.

The Hon. Nick Greiner AC was the Premier of New South Wales from 1988 to 1992.

Robert Carling is a Senior Fellow at The Centre for Independent Studies.

Anne Twomey is Professor of Constitutional Law and Director, Constitutional Reform Unit at the University of Sydney.

Dr Jeremy Sammut is a Research Fellow at The Centre for Independent Studies.

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