

MAY THE BEST-RUN STATE WIN

State income tax makes good sense but only if embedded in the fiscal rules of competitive federalism, argues **Wolfgang Kasper**

In late March and early April this year, a brief promise of economic rationalism flared up suddenly when Prime Minister Malcolm Turnbull floated a plan to hand some income-taxing powers back to the States, making them fully responsible for funding State schools and allowing them more freedom in shaping their education and healthcare services. Alas, two days of frenetic lobbying by *GetUp!* and the thumbs-down from most State Premiers, bar Western Australia's Colin Barnett, extinguished the idea. The centralised tax cartel was reaffirmed. More's the pity. International experience shows that a properly designed system, in which each jurisdiction has responsibility for funding its own assigned and chosen tasks, goes along with lower tax and regulatory burdens, citizen-friendly public services and more freedom.

The quick demise of Turnbull's proposal was not surprising. Such a major reform idea cannot be sensibly discussed before an election. Fundamental reforms require the dispassionate, comprehensive re-assessment of constitutional ground rules and political tenacity. Yet after more than 100 years of unprincipled *ad hocery*, a thorough reform of Federal-State financial relations now seems overdue. Australia's complicated and unstable system of vertical and horizontal transfers is a leftover from the bygone era of protectionism, massive redistribution by government and welfarist irresponsibility. In the present-day era of openness and globalisation, voters expect governments to do more to help them face the pressures of international competition. Making the States fiscally more responsible is one way of achieving this. Moreover, the health of public finances, indeed the long-term legitimacy of

democratic governance in the eyes of the electorate, could be greatly enhanced by balancing the State governments' expenditure plans with political responsibility for raising the required funds.

Competing governments advance freedom and prosperity

It is no coincidence that properly-run federations—such as Switzerland and the United States—are among the world's most prosperous nations and have safeguarded individual rights most effectively. The division of powers to legislate and administer between a central and a number of sub-national entities (let's call them States) is a powerful instrument to ensure civil liberties. Moreover, State governments that are responsible for weighing their spending against their taxing capacity face realistic disciplines. When they have to cultivate the tax base by fostering economic development in their jurisdictions, State governments will confront the many anti-



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development lobbies that now habitually oppose economic growth and job creation. Voters then become fully aware that they are not only the beneficiaries of political largesse, but also producers and taxpayers. When State governments compete with each other by offering the most citizen- and producer-friendly revenue-expenditure mix, they become a source of international competitiveness and domestic job creation. They then act as support organisations for internationally and nationally competing producers, providing expedient rules, which enhance the nation's institutional capital and productivity.

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Alas, Australia's gradual fiscal centralisation, which has run counter to devolution in many other nations, has subverted this crucial role of government. Centralised 'cooperative federalism' was tenable under the collectivist-protectionist post-Federation 'Australian Settlement'. But changing circumstances have long made it necessary to jettison that cosy political arrangement—only largely centralised taxation and transfer hand-outs to the States survive from that bygone era. The States are able to shun most of the onus of taxing and hence behave like welfare claimants. Most State Premiers seem infantilised. State bureaucracies are able to avoid innovative administrative solutions when new problems evolve. Into the bargain, we have ended up with an undignified, cantankerous culture of blame and bluff at each Council of Australian Governments (COAG) meeting.

It now seems urgent to rethink this last, anti-competitive holdout from the 'Australian Settlement'. With the end of the mining boom, Australians have to compete more than ever in a dynamic world economy. The deadweight of the lopsided fiscal system is becoming less and less affordable. To reiterate: Australia's fiscal cartel has enabled State governments to inflict high compliance and transaction costs on producers and job creators. In other words, the Federal-State redistribution regime weakens the States' incentives to promote

growth and at the same time enables them to adopt a politically opportunist style of governance. Yet our future prosperity will depend on whether producer-friendly, expedient regulations and lean governments support workers and businesses that have to face competitors here and overseas.

Elements of competitive federalism

The Prime Minister's idea therefore makes good sense, but only if it is embedded in a comprehensive, mutually reinforcing system of Federal-State fiscal rules. These are:

- (a) *Rule of origin*: What is legally produced and sold in one State can automatically be produced and sold throughout the federation without regulatory impediments. This prohibits discrimination. This maxim was advanced by the Keating government's 1993 National Competition initiative. It is also enshrined in the Constitution, though not always obeyed.
- (b) *Exclusive assignment of government tasks*: The various tasks of governance need to be exclusively assigned to one specific level of government, avoiding duplication, overlap and potential for blame shifting. The assignment of tasks should be governed by the principle of subsidiarity—that is, the principle that the lowest level of government that can effectively provide particular goods and services should be given the task. National security, foreign affairs, the general protection of life, limb and property, as well as matters that affect citizens across all jurisdictions, seem prime candidates for assignment to Canberra. The States should be made exclusively responsible for education (at least at primary and secondary levels), healthcare and the provision of those infrastructures that cannot be built and run more efficiently by private enterprise. Where private infrastructures are preferable, the States must ensure access and supervise safe operation. It is a waste of taxpayers' money by the Commonwealth to run costly, meddling central bureaucracies

for health, education, urban development or housing, as the Commonwealth does not produce these services.

- (c) *Fiscal equivalence*: Each government should have independent revenue-raising powers to fund its assigned and chosen tasks in ways that it sees fit. This must be coupled with a ban on—or at least very strict limitations of—vertical and horizontal fiscal transfers. Each government must also be held responsible for its debts. In this context, constitutional rules that constrain public borrowing promise to be useful. Fiscal equivalence would do away with unending ‘social welfare’ for notoriously mendicant States and create incentives for all jurisdictions to cultivate

their own tax base by promoting job and wealth creation. Fiscal equivalence need not mean that tax administration has to be duplicated. It would be feasible to present citizens with one income-tax bill, based on a federal income tax rate and State-specific rates that may differ from one State to the next, and then remit the shares of the tax take to the various governments.

- (d) *Prohibition of ‘subsidy wars’*: A ‘most-favoured State clause’ (analogous to the World Trade Organisation’s most-favoured nation clause) needs to ensure that State governments, which offer tax concessions or subsidies to one producer, must then make the same offer to other interested producers.

Important Insights from Switzerland

A seasoned observer of Swiss fiscal policy, Professor Christoph A. Schaltegger of the University of Lucerne, summarised the most important conclusions from a lifetime of research on the Swiss experience, warning against centralisation and burden-shifting in an article in the daily *Neue Zürcher Zeitung* (21 January 2015).¹ His conclusions seem highly relevant for Australians concerned about our fiscal arrangements. He wrote among other things: ‘If one tries to summarise the results of forty years of research on financial federalism . . . five hypotheses stand out . . . :

- Federalism based largely on self-responsible Cantons [that is, Switzerland’s sub-central jurisdictions] still offers numerous advantages for the nation. This depends crucially on ever-present incentives to enhance governance through innovative political experiments. The evolutionary process of trial and error generates knowledge about the functional effectiveness of social rules—knowledge that a rationally designed and centrally-planned government system could never generate.
- To ensure that the advantages of federalism come to bear, the principle of fiscal equivalence must be strictly adhered to. Government tasks have to be assigned or distributed to one specific level of government as appropriate. At the same time, each jurisdiction has to tap its own requisite sources of revenue. Both must be subjected to . . . democratic decision-making. Liability, control and risk have to coincide in the same hands under a clear separation of responsibilities, be it at the Cantonal or the Federal level.
- Fiscal equalisation [can] . . . reduce gross disparities where fiscal equivalence begins to falter, for example where benefits of public spending impact outside the borders of individual Cantons. Such equalisation must prevent free-riding at the expense of third parties.
- Many problems with federalism arise when fiscal equivalence is disregarded. Joint Federal-Cantonal projects, mixed financial arrangements, deficit transfers and—above all—the slide to centralisation come with risks. Political decision makers then consider the medium-term budget balance all too readily as something flexible, and fiscal discipline suffers. Rule-bound fiscal policy can help to resist the centralising dynamics inherent in federalism. Federalism is strengthened by formal limits on public debt and by keeping fiscal equalisation free of politicking. Instead, it must be based on established rules, effective credit markets and transparent insolvency laws.
- Vigorous federalism requires a strong federal government and strong Cantons. The Federation must be strong enough to withstand Cantonal demands for subsidies and transfers. It must also ensure that market disciplines constrain Cantonal deficit finance and that relief of Cantonal debts is strictly ruled out. And the Cantons have to be sufficiently strong to ensure that the Federal government cannot slowly assume central control over the fulfillment of the tasks assigned to them.’

Such a system forces politicians and administrators to compete with each other by searching for solutions to problems. Inter-jurisdictional competition would shape an order analogous to Hayek's understanding of competition as a discovery procedure: decentralised experimentation, testing of new knowledge, and selection and imitation of what works well. The Swiss, whose fiscal system comes close to the design of competitive federalism, have long prospered under this regime and understand its merits. Australian reformers could certainly learn much from the time-tested and successful Swiss example (see the box on the previous page).

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The Swiss experience shows that competitive federalism lowers tax burdens, though not—as adherents of centralised tax cartels allege—to the lowest common denominator of public services. The Swiss enjoy moderate tax burdens, yet are well provided with civil services. Cantonal governments have experimented with more transparent rules of taxation, have simplified tax declaration forms and have offered advisory services that genuinely help taxpayers. Australians may be surprised to learn that a Swiss business journal publishes annual ratings of Cantonal tax offices for criteria such as speed of decision making, responsiveness to complaints from taxpayers, tax rates and methods of assessment. This contributes to political life in Switzerland being fairly harmonious and predictable. Political debates are mature. Politicians and administrators are respected, though of course not uncritically.

Australians may wish to reflect on this recent, most instructive political episode: The leadership of the low-tax Canton of Schwyz, which has lately suffered financially somewhat stretched conditions, has proposed the introduction of a flat tax on all private and corporate incomes with a rate of 5.1% p.a. The proposal, which has raised considerable controversy among the citizens, will be put to a

referendum later in the (northern) summer of 2016. If accepted, Schwyz would become the third Swiss Canton to adopt a flat income tax. Can we imagine that Australian States would get such leeway to cover the expenditures for which they are responsible? Can we imagine what effects on tax burdens and fiscal policy such sovereignty would have?

Globalisation demands innovative government

Over the past 30 years, most Australians have learnt to cope with the risks, structural adjustments and exposure to living with globalisation, assisted by our fortunate geographic location and bountiful geology. However, as the mining boom peters out, the burdens of government—tax and freedom-sapping regulations—are obstacles to future prosperity in our wide-open economy. This point becomes blatantly obvious when one looks at international comparisons of economic freedom and discovers that government and regulation—together with government-sponsored labour market rigidities—are Australia's biggest obstacles to growth and job creation.²

These handicaps have a lot to do with the fact that political and bureaucratic elites—and those organised interests that vie for political favours—are holding out against adjusting to the new global competitive order. Our increasingly mistrusted political-bureaucratic elites and the lobby industry will of course never voluntarily concede that they, too, must abandon the traditional mindset of the 'Australian Settlement'. We, the people, must demand that Federal and State governments become leaner and ready to compete amongst themselves and with their counterparts overseas. Our future prosperity and security depend on it.

Endnotes

- 1 The German original can be found at <http://www.nzz.ch/wirtschaft/fuer-effizienten-staat--gegen-allmende-problem-1.18465391>. Translation of excerpts by Wolfgang Kasper.
- 2 See the respected annual reports on economic freedom prepared by the Fraser Institute in Canada and the Cato Institute in the United States, www.freetheworld.com/reports.html Other surveys, using differing methodologies, regularly come to the same conclusions about Australia.