

## **Commonwealth–State Financial Relations: The Case for Competitive Federalism\***

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### **Introduction**

In a publication for the Committee for Economic Development of Australia,<sup>1</sup> I have argued that Australian federalism is in rough good health. It could be improved, and there are serious threats to its fruitful operation. But by and large, the Australian federal system of government has worked well. Along the way, it has achieved a reasonable balance between centralisation of government functions and decentralisation of them and a reasonable balance between cooperation and competition between governments. It is concern about the maintenance of that balance that motivates me today.

The distinctive characteristic of federation is that it introduces a new form of intergovernmental competition, and not a new form of cooperation. We do not need political federation in order to achieve intergovernmental cooperation. For example, an intergovernmental agreement enables a letter with an Australian stamp to be delivered in any country in the world, by that country's postal workers. NATO involves cooperation between sovereign nations, not all of them members of a single political federation. So today I will focus on the competitive angle of Australian federalism, because I believe that there is a danger that this could be lost, if there is an insufficient appreciation of its value.

All governments are subject to competition. Some forms of intergovernmental competition, like war, are horrid; but some are conducive to good social and economic outcomes. The best arrangement is to have a formal constitution and informal political traditions that encourage good competition.

'Vertical competition' is the top level of competition within a federation, and is unique to federations. In Australia, it is competition between the Commonwealth Government, on the one hand, and the governments of the states and territories on the other. It is an intergovernmental competition for the affiliation and support of citizens and voters, and it is manifest in the competitive offerings promised and fulfilled. It is unique because the two levels of sovereign government simultaneously rule over the same pieces of geography. That's what a federated nation is.

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\* This paper was presented as a lecture in the Senate Occasional Lecture Series at Parliament House, Canberra, on 14 August 2009.

<sup>1</sup> Jonathan Pincus, '6 myths about federal–state financial relations', *Australian Chief Executive*, February 2008, pp. 36–47, <[http://ceda.com.au/email/noindex/docs/pincus\\_2008.pdf](http://ceda.com.au/email/noindex/docs/pincus_2008.pdf)>.

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Today I will argue that Australians should welcome and approve competition between governments in a range of matters. However, many politicians and political commentators want to limit intergovernmental competition within Australia, and especially to eliminate vertical competition between the states and the Commonwealth. The goal is to reduce or eliminate what Mr Rudd calls ‘the blame game’ that can occur when more than one government is responsible for a role or function. The ‘blame game’ will only end when the Commonwealth does everything. Australians would then face a monopoly form of government, and citizens would have fewer avenues through which to encourage government to perform well.

A final introductory remark: neither today nor elsewhere, do I call upon ‘states’ rights’. Lawyers tell me that states have rights, and I believe them. But I prefer to regard governments as means to ends, and not as ends in themselves. Any rights that states may have should derive from the rights and responsibilities of citizens concerned.

### **Competition or monopoly**

Government is a means of getting done collectively some important things that otherwise would get done badly, like external defence and domestic law and order, or maybe otherwise wouldn’t get done at all.

What level of government should be given the task of, say, running public hospitals, or running TAFEs—should it be the Australian Government, the state or territory governments, or local governments? I can make a strong argument that only one level of government, the Commonwealth, should be providing our national defence: for the money, seven state navies will be much less effective than one national navy. But what is it about public hospitals, or TAFE colleges, that make them a case suitable for control by a single government? When should one level of government have a monopoly?

The opposite of monopoly is competition. It took six or seven decades for the idea to be accepted by Australian opinion leaders and politicians, that vigorous competition among businesses and regulated competition in the professions, by and large, are forces for the social good.

The Secretary of Treasury, Ken Henry, has called attention to ‘a community sensitivity to market-determined prices, and also quantities; that is, a sensitivity to market-determined patterns of resource allocation’. This sensitivity, Secretary Henry

said, was a ‘barrier to the development of efficient markets [that] is at least as old as government’.<sup>2</sup>

So, although the Australian opinion leaders and politicians mostly now accept that regulated market competition is a force for the social good, there is still some scepticism among the general public. And even more scepticism that intergovernmental competition can deliver net social benefits. I have a tough assignment today.

### **Vertical competition**

As recently as 2008, Treasury Secretary Henry wondered at what he called ‘a startlingly new concept of vertical competitive federalism—that is, competition between the Commonwealth on the one hand and the States and Territories on the other’.<sup>3</sup>

Actually, the concept is hardly new; and the practice has been going on since Federation. Let me give one recent example.

The Rudd Labor government has moved to implement its electoral promises, including a reduction in the waiting lists for elective surgery. The states had not succeeded in delivering waiting lists that are acceptable to many voters, and so Mr Rudd made an election promise to do better. This is a clear example of vertical competition between the Commonwealth and the states and territories. It is competition for the support of voters, in an area of service delivery traditionally regarded as the responsibility of the states—the states own and run public hospitals.

Vertical competition leads to blurring of responsibilities. Who will be responsible for the public hospital waiting lists or for public hospitals generally: the state or the feds? Who is responsible for the supply of supermarket groceries, Coles or Woolies?

Very few people would argue that Australia would be better served by a monopoly grocery chain, than by competition. However, many believe that Australia would be better served by a clear and unassailable assignment of governmental responsibilities within the federation. Such a clear assignment means the end of vertical competitive federalism, an end to the blurring of responsibilities, and an end to overlap of their domains, with its duplication.

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<sup>2</sup> Ken Henry, ‘Time to “get real” on national productivity reform’, *Productive Reform in a Federal System: Roundtable Proceedings*, Canberra, 27–28 October 2005, <<http://www.pc.gov.au/research/confproc/productivereform>>, p. 344.

<sup>3</sup> Ken Henry, ‘Realising the vision’, *Ian Little Memorial Lecture*, Melbourne, 4 March 2008, <[http://www.treasury.gov.au/documents/1351/PDF/Ian\\_Little\\_Speech.pdf](http://www.treasury.gov.au/documents/1351/PDF/Ian_Little_Speech.pdf)>, p. 4.

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Just as competition among private companies and firms safeguards consumers against high prices and shoddy goods and services, so competition among governments can safeguard citizens against bad government and encourage good government.

Democratic government exists to serve its people, with their common as well as their diverse interests and perspectives. In democracies, competition is required to ensure high quality of service by government.

Intergovernmental competition requires governments with capacity for uncooperative and independent action. The formal abolition of the states is unlikely to occur any time soon. However, what started many decades ago is an effective sidelining of the states. If this continues to gather pace, the states will end up no more independent of the Commonwealth, than are local governments independent of their own state and territory governments.

However, if the states and territories become mere service agencies of the Commonwealth, this will not put an end to the blame game. The blame game will end only when the Commonwealth does everything. Otherwise, when things go wrong, the states will say ‘Don’t blame us, blame the Commonwealth. The Commonwealth refuses to pay us enough to do the job properly. And besides, the Commonwealth hamstring us by regulating the working conditions in hospitals, or schools, or universities, or whatever’.

### **National goals**

Federal government forays into areas of policy or services that were formerly occupied solely or largely by the states, are often described in terms of ‘national’ priorities and ‘national’ goals. However, I cannot believe that the hospital waiting lists in Western Australia, or the shopping hours in Western Australia, for that matter, are of great moment to residents of Queensland or New South Wales.

And, although the processes of the Council of Australian Governments (COAG) seem to me to be superior to those of the Premiers’ Conferences and the Loan Council, which COAG has replaced, there is still a hint of strong-arm tactics from the Commonwealth: ‘Agree to what we say are national priorities and goals, or else’. Anne Twomey and Glenn Withers call this ‘coercive federalism’.<sup>4</sup>

Earlier I said that Mr Rudd’s election promise to reduce hospital waiting lists is an example of vertical competition. But this kind of competition, if used more widely, is very unlikely to produce systematically good outcomes. In regulated markets, this

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<sup>4</sup> Anne Twomey and Glenn Withers, *Australia’s Federal Future*, Federalist Paper no. 1, Council for the Australian Federation, Melbourne, April 2007.

kind of competition is called ‘cherry picking’, which occurs when a supplier enters into a regulated market very selectively, supplying only those things with high payoffs and low costs. The task of supplying everything else that the regulations require to be supplied is left to the established suppliers. It is a kind of behaviour that public schools complain about: namely, that a private school can find ways not to accept students who are costly to teach, knowing that the public schools must take them.

If it is a national goal to have better hospitals generally, then this kind of selective intervention seems a poor way to achieve it. The states have arrangements, maybe good, maybe bad, for managing hospitals. As I look around, I see many public institutions with more than one government master: universities with state charters but within the Commonwealth’s Unified National System; schools that report to state departments of education, but also to the Commonwealth; local governments that are the creatures of their states, but are partly funded by the Commonwealth and therefore ‘responsible to’ the Commonwealth; indigenous organisations, similarly. These arrangements mean that the managers of these institutions do not have a single ‘line manager’. The deleterious consequences of overlap of government are magnified.

Possibly in response to that kind of thought, the Rudd Government has threatened to take over the public hospitals from the states, if the states do not shape up quickly enough. Say the federal government does take them over but, unfortunately, makes a hash of running the hospitals from Canberra? What then? Wouldn’t you expect voters to reward a state government that turns around and establishes better public hospitals than those run by the Commonwealth? That would be vertical competitive federalism in action.

Similarly, business has decried the performance of TAFE colleges in some states and territories. Vertical competition in a federation would see the Commonwealth establishing its own TAFE colleges, in competition with those of the states. Then let business and TAFE students choose between the public providers.

Vertical competition is not confined to government providers. It is in action when the Commonwealth directly funds independent schools, and lets parent decide between a public provider and a private provider. And it would be vertical competition if the Commonwealth followed Norway, and issued student vouchers to fund independent schools.

The main advantage that the Commonwealth has over the states, in running things like hospitals or colleges, is its dominant financial power.

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Otherwise, what is it about public hospitals that make it likely that the central government will do a better job than the states? Superior understanding of patient needs? Superior ability to change how hospitals are run? Superior capacity to change hospital workforce practices?

The Commonwealth has had unchallenged control of a number of matters, including defence. No doubt defence is one of the most complicated and difficult areas but, that granted, it can hardly be said that the administration of defence has always been a brilliant success.

My point is that we do not know, in advance, whether the Commonwealth is likely to turn out to be better than the states in running public hospitals. Why not experiment with vertical competitive federalism, and let the Commonwealth try its hand at public hospitals, before moving to take all of them over. Best if it was a fair competition, with all Commonwealth hospitals and all state hospitals funded through the same formula (for example, case-mix funding, begun in Victoria, and recently suggested by the National Health and Hospitals Reform Commission).

Even better: let the Commonwealth be the funder and not a provider, and adopt that Commission's suggested new scheme, dubbed Medicare Select, the 'next gen' Medicare—a voucher proposal that dare not speak its name—in which the patient has more choices about how to secure the medical and hospital services that they want, and could choose freely between private and public providers.

### **Competitive outcomes**

I will briefly discuss the nature of competition and competitive outcomes.

Some of you may have been exposed to undergraduate economic textbooks, which tend to emphasise what is called 'perfectly competitive markets', with each business producing exactly the same product as each other business. In these circumstances, competition enforces uniformity in prices, in qualities, and in conditions of sale.

But it is mighty unusual in consumer markets for competition to result in many firms producing identical products. Standard specifications are less rare in markets selling intermediate products, like screws. In contrast, the struggle for the consumer dollar induces businesses to differentiate their products, to try variations that appeal to different types of customers. That is, competitors tailor their products to what consumers want and are willing to pay for. The more readily consumers shift their custom in response to different offerings, the greater the rewards to businesses for getting it right—even if the rewards are temporary.

Putting the issue more generally, economists say that the relative uniformity or diversity of the products offered for sale in competitive markets is an *emergent* outcome: the actual outcome that emerges depends on the process that produces the outcome. Change the process: change the outcome. Competitive processes produce different outcomes from other processes. There is no way for a wise person to predict accurately and systematically what the outcomes of the competitive processes will be. A metaphorical way to put it is to say that the competitive process ‘discovers’ the outcome.

The point of this short excursion into economics of ordinary markets is that its lessons apply to any competitive process. When the various state governments compete with each other, the outcomes are a changing mix of uniformity and diversity. The more readily families and firms move across state lines in response to the social and economic environment offered by the various states, then the larger the rewards to the state that ‘get it right’.

The notion that the outcomes emerge from competitive processes, gives a warning to those who, observing similar but slightly different policies or offerings in the various states, jump to the dangerous conclusion that there may as well be one national policy (or one national regulation, or one national service provider, or whatever) and that the one national policy will be at least as good as the average of the slightly diverse state policies. Without competition, the outcome may in fact be less than ‘fair average quality’.

Moreover, in competitive environments, when someone discovers a better way of doing things, or when the tastes of consumers change, or a new class of products hits the market, then the old offerings disappear, under the pressure of competition. Contrast the uniformity that can arise from deliberative processes of a single national government, or of a set of governments that have foresworn competition in favour of cooperation, or have retired in favour of the Commonwealth. This uniformity is often the result of experts scanning the horizon for ‘Best Practice’, which the government adopts, and then gets stuck with it. (Those of you familiar with ministerial councils will appreciate my point.)

I am not pretending that differences across states in public schooling arrangements, in tax rules, in occupational health and safety laws, and so on, do not impose considerable costs on families who move between states, and businesses that operate in more than one state. But I insist that they also bring considerable benefits, especially the important benefit of being able to move to where things are different.

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## Subsidiarity

Today my main target is the claim that vertical competition is strange and always undesirable and should be eliminated. However, I am not claiming that no areas of public action should be set aside exclusively for one level of government.

Here, I should explain why I do not invest much in the European Union's principle of federal subsidiarity. This principle is that a specific governmental role or function should be left with the lower level of government, unless the higher level of government can handle it more effectively.<sup>5</sup> For a devotee of federalism, the subsidiarity principle is something, but not much. The very idea of subsidiarity is at right angles to the idea of vertical competition. The subsidiarity principle carries with it the notion that all governmental roles and functions should be assigned unambiguously and exclusively to one level of government or the other. So let me state some conditions under which there should be an exclusive, unambiguous assignment of a governmental power, role or responsibility, and so vertical competition is undesirable.

The fundamental consideration, expressed in the language of economics, is that there should be substantial economies of scale and scope (or synergies) that cannot be secured through contract or agreement. National defence is archetypical. To repeat—for the money, seven state navies will be much less effective than one Australian navy. An allied condition is that the advantages of standardisation outweigh the disadvantages. Standardisation of weights and measures, for example, may be best achieved through government and, in a federation, by the central government with exclusive powers.

The second fundamental consideration is that intergovernmental competition can sometimes lead to a disastrous race to one extreme or the other: a race to the undesirable and miserable bottom, or a race to the undesirable and extravagant top. An example of the race to the top is the nuclear arms race. Tax illustrates the possibility of a race to the bottom. Under Premier Joh Bjelke-Petersen, Queensland sought to attract retired folk by abolishing its death duties. Other states followed suit, and now Australia has no death duties. Death is unpopular, and so are death duties. However, most tax economists think that death duties are a relatively efficient form of taxation, and should be in the tax mix.

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<sup>5</sup> 'The principle of subsidiarity is defined in Article 5 of the Treaty establishing the European Community. It is intended to ensure that decisions are taken as closely as possible to the citizen and that constant checks are made as to whether action at Community level is justified in the light of the possibilities available at national, regional or local level. Specifically, it is the principle whereby the European Union does not take action (except in the areas which fall within its exclusive competence) unless it is more effective than action taken at national, regional or local level' <[http://europa.eu/scadplus/glossary/subsidiarity\\_en.htm](http://europa.eu/scadplus/glossary/subsidiarity_en.htm)>.



On a less dramatic scale, state governments have competed to attract or retain specific businesses in their states, often by the granting of special exemptions or reductions of payroll or land taxes. The states are, as it were, fishing in the same pond, and whoever casts the most bait, gets the most fish. The tax revenues of state governments are, collectively, worsened by this kind of competition and the efficiency of the tax system, damaged. Possibly spurred by a strong criticism of this kind of competition from Gary Banks, the head of the Productivity Commission, all states except Queensland agreed to limit or cease this kind of interstate ‘bidding wars’.<sup>6</sup>

Concern about the tax race toward the bottom leads me to lend some support to the arrangement under which the Commonwealth collects more tax revenues than it spends, and the states, vice versa. (The argument is detailed in my CEDA piece.) In particular, the Commonwealth has control of taxation of personal and company income and the GST, and has the main responsibility for social security payments; but the states retain their own significant tax sources and spending responsibilities.

However, to signal what is coming, the benefits of assigning the income taxes to the Commonwealth come with significant costs. Thus there is a third consideration: that exclusive assignment in one area does not cause too severe damage in other areas of governance.

### **Other forms of competition**

I say that Australians should think carefully before abolishing vertical competition from the federation. But don’t governments feel considerable competitive pressures of other kinds? I will argue that these are not enough and, in addition, the very same people who are sceptical about vertical competition in our federation are at least as sceptical of other forms of intergovernmental competition. In fact, more effort has been made to reduce or eliminate horizontal competition between the states, than has been made to prevent vertical competition between the states and the central government. If both vertical and horizontal forms of intergovernmental competition are eliminated, then that leaves electoral competition alone to do the job (supported, of course, by a free press).

Whenever there is government, there will be *competition to become the government*. This is true for all kinds of government, including tyranny, hereditary monarchy, and rule by theocrats, or by philosopher kings. As any reader of history knows, all of these involve competition, often bloody, to be tyrant or king, or to represent truth or the word of god on earth.

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<sup>6</sup> Gary Banks, ‘Inter-state bidding wars: calling a truce’, speech to the Committee for Economic Development of Australia, Brisbane, 6 November 2002, <<http://www.pc.gov.au/speeches/cs20021106>>.

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Undoubtedly, fair electoral competition is the foundation upon which decent democratic government is based. And because Australia has no tradition of ‘winner takes all’ after a change of government, this nation has an enviable record of peaceful transfers of power. Federalism is a way to commit not to have ‘winner takes all’. Combined with short electoral cycles and party stability, this is one reason Australians have such confidence in government.<sup>7</sup>

Associated with these occasions for transfer of democratic power, is party-political competition, with which we are all familiar. There is competition to be preselected for your party, and then there is the competition to be elected as one of the temporary rulers. But there are many other forms of competition, even when there is only one government involved. For instance, there is competition to influence party platforms, competition to influence voter attitudes, competition to influence government decisions, and so on and on.

But is this all the competition that we need: electoral competition to gain temporary control of the one-and-only government? Imagine a periodic election for the right to be the monopoly supplier of groceries to all Australians. One year, Woolies wins. Next time around, Coles wins, maybe in alliance with IGA. And so on, through a series of temporarily monopolistic suppliers of groceries. Most Australians would be uncomfortable with this arrangement, fearing, correctly, that periodical competition to become the temporary grocery monopoly is not enough to ensure good outcomes, is not enough to discipline the supplier, is not enough to prevent price gouging and poor service.

If you agree about groceries, then surely the argument applies more strongly to competition among governments? Surely the services of government are at least as important to Australians, as are the services of grocery stores. Why be content with monopoly control of public hospitals, or school curricula, or tax rates, or industrial relations, or business regulation and so on? Why work to make the states completely subservient to the Commonwealth, or abolish them altogether, and thereby abolish intergovernmental competition within Australia?

Australia is a federation, comprising sovereign states and a sovereign central government. An Australian is simultaneously a citizen of a state or territory, and a citizen of Australia. Only in a federation can a citizen look to two sovereign governments, each operating over the same piece of geography. If one level of government fails in some way, then the Australian citizen can stay at home and push the other level of government to provide what he or she wants.

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<sup>7</sup> See the international comparisons of perceived state legitimacy, in chapter 4 of D. Denmark et al. (eds), *Australian Social Attitudes 2: Citizenship, Work and Aspirations*. Sydney, UNSW Press, 2007.

### **Voting with the feet**

Or, there is another option. If one Australian state offers what a person or family or business wants, and wants it badly enough, then they can move interstate. For people, examples are education, and laws relating to personal choices—drugs, abortion, and euthanasia. For businesses, examples tend to be financial, like taxes and charges, or the quality of infrastructure, or the nature of business regulation.

This is the basis for horizontal competition. Until there is only one government in the world, horizontal competition between governments will occur. All Australian governments are competing with governments in other countries for population. Similarly, Woolies and Coles and IGA are competing for customers.

I would rather live in a country into which many people wish to immigrate, like Australia, than to live in a country from which many people want to leave, like Zimbabwe and the former East Germany. Bad government is the major problem for a long list of countries. Good government is one of the major sources of the attraction of Australia.

Economists say that people and business who emigrate in search of better lives are ‘voting with their feet’. There are many reasons for such migrations, but sometimes an element of attraction is a better fiscal deal: better government services or lower taxes; or the consequences of a long series of government policies have made that state more attractive to some people and businesses. It undoubtedly helps put competitive pressure on states to perform better.

Competition has its own costs, and I am not arguing that competition always delivers the best of all possible worlds. But I am arguing against the opposite extreme position, that interstate competition is always detrimental to good government.

On this question, I will again quote Secretary of Treasury Ken Henry:

Competitive federalism asserts that there is a national interest in fostering sub-national decision making in respect of things that are of national importance. The proposition is that while competition among sub-national governments will initially produce a number of different policy models, that same competition will eventually produce convergence on a model better than what any national government would likely be able to design and/or implement.

So, is competitive federalism the reason why nationally operated trains have to be equipped with eight different radios? Does competitive

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federalism explain why we have such a plethora of inconsistent state-based regulatory requirements for occupational licensing, occupational health and safety, road transport, water trading, and so on? Possibly. But there is a more likely explanation: a stubborn parochial interest in putting the welfare of the State or Territory ahead of that of the nation.

Parochialism is understandable. But a proper accounting of its national economic consequences would be weighted heavily in the negative.<sup>8</sup>

There may be something in the claim state politicians and bureaucrats are too parochial, too captured by state and local interests; whereas federal politicians and bureaucrats have a broader, national point of view. But to me, there is a rather anti-democratic tone here: the feds can more easily run roughshod over various inconvenient interests, be they local or regional, or industrial, or occupational, or passionate supporters of a particular parrot, possum or wombat.

And in fact the states have not always stubbornly put the parochial ahead of national interests. In the 1980s, far-ranging reforms of competition policy offered prospects of significant nationwide advantages from coordinated action. The states pushed for cooperative reform and then came to the party, in the form of the intergovernmental agreements on National Competition Policy. More recently, the initial impetus for the New Reform Agenda, of coordinated efforts to improve the long-term economic and social prospects of Australians by reforms in health and education, came from Victoria.

### **Tax powers and competition**

Competition works for the best when there is a close relationship between the costs and rewards of action; and competition is unlikely to further the social good when the relationship between costs and rewards is vague or broken. In ordinary markets, prices should reflect full social costs and benefits. For example, businesses should pay for environmental damage they cause, and should pass those costs onto their customers.

Similarly, for intergovernmental competition to be most beneficial, there should be a close relationship between the costs and the rewards of the government action. In particular, it improves electoral accountability if, when a state wants to increase its spending, the state Treasury can go to only one source of funding, namely, the states' own taxes and charges. Conversely, every time a state reduces its taxes and charges, then it should reduce its spending; every time it reduces its spending, then it can give tax relief.

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<sup>8</sup> Henry, 2005, *op. cit.*, p. 343.

This does not happen in Australia; and I am not sure that it can happen, unless the Commonwealth distributes all revenue grants to the states by a general formula, like that used to distribute the GST monies. The states raise taxes and charges to cover about half of their spending, and receive the other half from the Commonwealth Government. But these payments by the Commonwealth are not independent of the actions of each state. Instead, the Commonwealth enters into arrangements with individual states that blur state incentives and accountability. Recently, these arrangements have been partly codified into a system of National Partnership Payments. But this codification does not make it clear to the electors as to who is paying for what, and weakens fiscal discipline on the states. The evidence is that state governments are by and large content with the situation in which the Commonwealth collects much more tax revenue than it spends, and sends the surplus to the states.

However, all this presents a bit of a puzzle: what is the political payoff for the Commonwealth, from taxing too much? If the Commonwealth were only interested in the national interest, then maybe it should be content with the realisation that the assignment of taxes types is roughly in accord with good economic design—namely, assign to the states those taxes that are costly to escape by moving interstate and assign the other kinds to the Commonwealth.

Rather, it is in the political interests of the Commonwealth to claim credit for services or facilities that it has funded. This has deleterious effects, the chief of which are that voters are confused as to who is funding what; and that states have many ways to seek extra Commonwealth funding. And it has more subtle effects, mentioned earlier: that too many public institutions and agencies have more than one government master, which makes for confused lines of accounting and responsibility.

### **Final remarks**

Today I have argued that intergovernmental competition, vertical and horizontal, brings benefits as well as costs. Critics easily see the costs, but tend to ignore or dismiss the benefits.

I have stressed, maybe stretched, the analogy between competition among businesses in ordinary markets, and intergovernmental competition in the ‘political market’. In that context, I suggested that some forms of vertical competition, especially selective intervention, are unlikely to be socially beneficial. More beneficial is competing using structurally different ways of doing things, with the institutions or instrumentalities fully controlled by and responsible to one government.

There is a case for limiting tax competition, by assigning personal or company income tax exclusively to the Commonwealth, in order to improve the efficiency of the tax

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system. But the methods by which surplus Commonwealth funds are distributed to the states reduce the independence, autonomy, responsibility and capacity of the states. Partly or mainly in consequence, the states have not performed well, and this has opened up scope for the Commonwealth. What one must fear is that the nature and form of Commonwealth interventions will cause the states to become less competent and accountable, and less able to provide effective and productive intergovernmental competition.



**Question** — A couple of centuries ago a textbook came across my bows which suggested that politics purges the system. It was an American textbook on federalism and it also made the observation that politics went well beyond the art of a possible to frankly who gets what, when and how. Can you give us your definition of politics please?

**Jonathan Pincus** — When I went to the University of Queensland, I was told that politics would be the authoritative distribution of goodies among people—exactly who gets what, when and how. I probably can't give you a useful definition of politics; I can give you a useful definition of economics if that will do. Economics is a social science which studies the exchange of things in all its various manifestations. And I suppose in that sense I don't see a sharp distinction between studying politics and studying economics because although politics has behind it the notion of authoritarianism, that is, the state is allegedly in control of the ultimate force and can go out and arrest you and have you put in jail or even in some places shot, my reading of politics is that a lot of economics seems to apply to it too. That is, there is a lot of bargaining in exchange going on. So yes, it may be the case as you say that it's about who gets what and where which is an authoritative kind of way of distributing things rather than the exchange way, a way of bargaining, which is the way that economics prefers. I think that a lot of politics still has tremendous amounts of bargaining. Mention the national competition policy which was very beneficial on average to Australians. There is a lot of bargaining that went on there. The Commonwealth didn't sit down and say, for the national good you will do this, so my answer is no. But there are some people who know who are in the audience who could give you a good answer.

**Question** — I don't want to hog the floor but didn't Menzies talk unceremoniously about economists: God bless them we need them, if only for the variety of their opinions?

**Jonathan Pincus** — Which is exactly right, economics is not a religion or an insight into truth, economics is a way of arguing and if all economists came to the same answer I think something would be mad.

**Question** — I think I could understand your argument on horizontal competition between the states. After all, different states could establish different priorities: some could give more emphasis to health, others to education, different levels of taxation and so on and voters can decide which they prefer. I have difficulty in understanding your concept of vertical competition and in particular your analogy with a market. After all, where the central government is largely responsible for funding the state governments, how can you see this as a market with competition between the two?

**Jonathan Pincus** — It's a very good question. Let me just go over a little bit again the example I gave of vertical competition where the states might compete with the federals. I don't know what the federal government is going to do about public hospitals and if I read in the newspaper this morning what Tony Abbott said, he was health minister for seven years so I suppose he must have thought about it, he says that when Mr Howard talked about how bad the state hospitals were, then said, 'but people, you wouldn't want all the hospitals run from Canberra', to which Mr Abbott says, unfortunately Mr Howard neglected to observe that Canberra bureaucrats would no more try to run public hospitals than they run nursing homes, which are Commonwealth funded, completely funded by the Commonwealth, and regulated by the Commonwealth but are privately run. I suppose this must be Mr Abbott's latest hospital plan, privately run public hospitals.

My point is that just because the Commonwealth funds something, it doesn't mean it has to run it. Just because the Commonwealth funds the states to a substantial extent, doesn't mean it has to run them. You can have a capacity for independent action even if you're funded by somebody else. If the Commonwealth (let's hope it doesn't) takes over all the public hospitals and runs them all from Canberra, which I don't think it will do, but if it did, then my argument is that vertical competitive federalism would be that voters may say to the states, 'why don't you try some different system, why don't you try the system that used to be run, which was local public hospital boards with broad guidelines from the state running reasonably independently'. They're not private institutions but they are semi-autonomous institutions. The fact that the Commonwealth funds the states I think does have deleterious effects but the deleterious effects are on both sides. That is, that the Commonwealth feels free to interfere selectively, as I called it 'cherry picking', into what the states are responsible; and the states, instead of saying, where in effect we have to go to our voters and ask them for more money, run off to Canberra and say, 'oh, you have this program why don't you give us this money and we will report to you rather than to our voters'.

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Vertical competition is certainly harder to arrive at in a situation where the Commonwealth has the big stick, but let's take the GST. Up until now, I'm not saying now, but up until now, GST has been distributed to the states and they can do what they like with it. Now some time ago in putting in a submission to the Senate about how GST money should be redistributed, I suggested that the Commonwealth should hive off that portion of the GST moneys that the Commonwealth Grants Commission allocates differentially at this stage on account of remote Indigenous Aboriginal population and just deal with that. I'm not a lawyer but I suspect under the 1967 constitutional amendment the Commonwealth could deal with that money itself, but it has been the case that the huge amount of money goes to the states and up until now by and large the states have had capacity to make a decision about how they deal with that. You may say they have done it badly, you may say they have done it well, but it is possible to have central funding and to still have untied money, as we call it in economics, not tied to specific performance. It's not easy, but it's possible.

**Question** — Your market analogy, which I think you have difficulty in persuading people.

**Jonathan Pincus** — Sure, the market there is the customer. Customer markets are the thing that I am interested in. The customers are the people who want a public hospital and instead of having a single supplier of public hospitals, whether they do it by providing it themselves or whether they do it by funding it all and setting a single regulation of a single form of public hospitals, that's a monopoly form. The market analogy is, there other suppliers of public hospital regulations, public hospital arrangements, the states—we do have those. Most private hospitals are not-for-profit type hospitals, at least most hospital patients in non-government hospitals I think are in those. There are other ways of doing it, it's just avoid if you can, unless you have a really good reason for having a single supplier of something; and vertical competition is to enable the state to do something the Commonwealth is doing, but maybe not catering to a certain range of population, just like a business will carve out a niche in the market by saying, 'there's a group over there who aren't really being well looked after, we will look after them'.

**Question** — Kerry Packer broke up a monopoly, a world monopoly: cricket. Using Kerry Packer's attack on a monopoly, how could we use his example to get out of the mess we are in?

**Jonathan Pincus** — I regard that as a friendly question. In this house it would be called a Dorothy Dixier, but I didn't set it up. Let me say one thing first, which is that competition sometimes leads to awful results. Results that any sensible person wouldn't want to have. I'm not saying that always competition is a terrific idea. Sometimes it's a terrible idea. It does depend on the conditions under which



competition takes place, and all good forms of competition are regulated competition and Australia by and large has done a pretty good job in that respect. I'm really doing myself an easy job; I'm trying to avoid either extreme. The extreme which says that competition between governments is always bad, competition that Kerry Packer introduced may or may not be good, I'm sorry, I haven't studied the matter well enough to know whether there are more people annoyed by the fact that the ABC doesn't show it, thank goodness for SBS, maybe more people annoyed by what Packer did than you are, you seem to like it. I don't know what the outcome of competition is going to be. It may sometimes be terrible, but the notion that it's always terrible, and therefore it should always be gotten rid of, that is what I am attacking. I'm trying to avoid both extremes, so I am happy to take the analogy of Mr Packer. He is dead, so we couldn't get him to do anything for us any longer, but he broke up a cosy set of arrangements. Monopolies in markets are of two kinds. There is a temporary monopoly which results from a competitive process where somebody is so much better than everybody else that they dominate the market, and it may be that what I mentioned in the talk, that economies of scale can do mass things so cheaply that nobody else can get in. We call those natural monopolies. They're real. Most monopolies in private business are artificial monopolies. They're monopolies that have been generated by various means, sometimes illicit private action, sometimes licit government action. My plea is, think about the conditions under which monopolies tend to be good. Monopolies tend to be good when they become monopolies because a single supplier can do it much better than anybody else and has proven that in competition, not proven it by mere assertion to say, we can do it better.