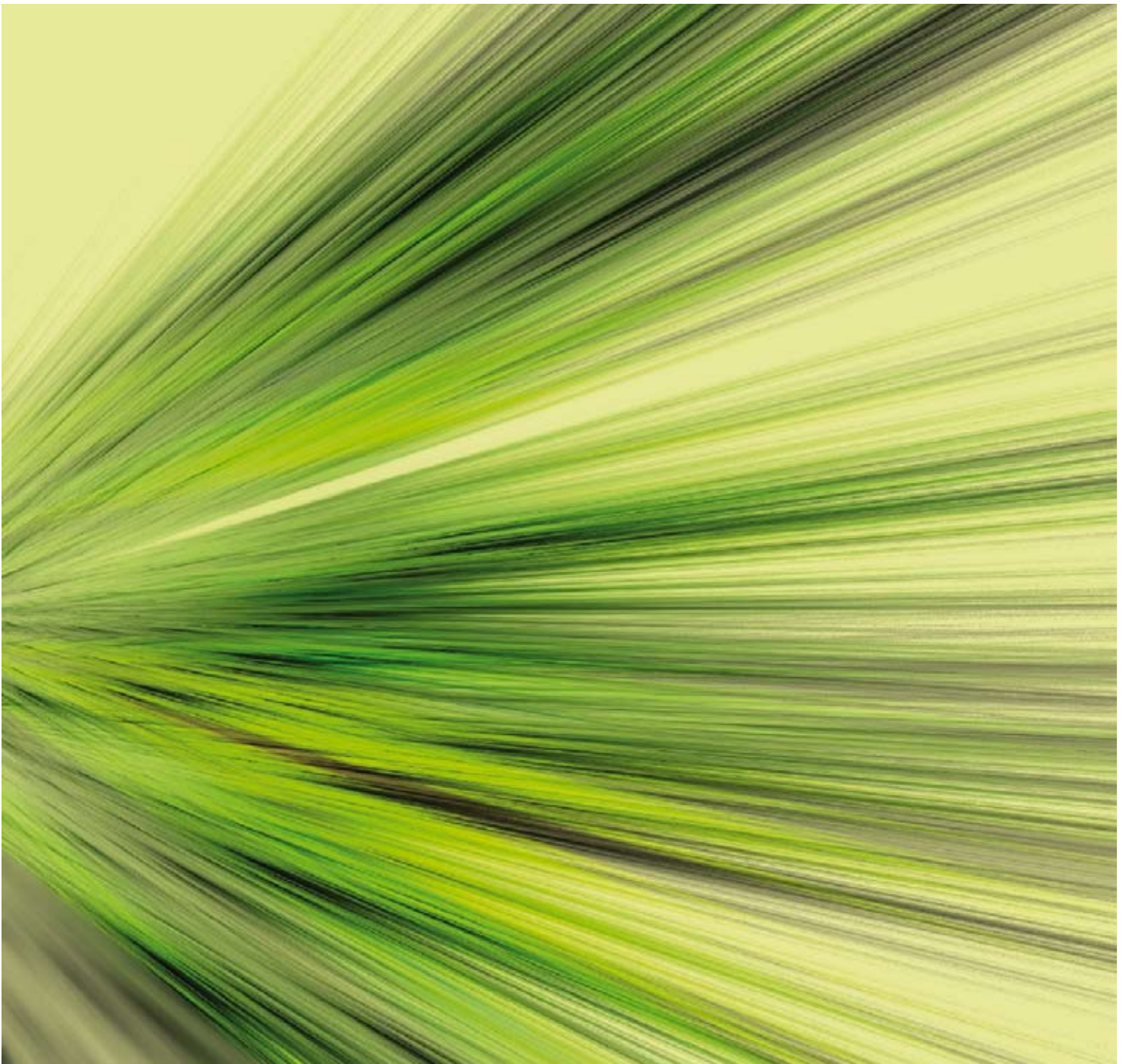


# FEDERALIST PAPER I AUSTRALIA'S FEDERAL FUTURE

A REPORT FOR THE COUNCIL FOR THE AUSTRALIAN FEDERATION  
PREPARED BY **ANNE TWOMEY & GLENN WITHERS**

APRIL 2007





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PREPARED BY **ANNE TWOMEY & GLENN WITHERS**

APRIL 2007

**Anne Twomey**

Associate Professor in Law  
University of Sydney

**Glenn Withers**

Professor of Public Policy  
Australian National University and  
Australia and New Zealand School of Government

This report presents the views of its authors. It does not necessarily represent the views of the Council for the Australian Federation or its members.

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THE HON STEVE BRACKS MP  
PREMIER OF VICTORIA

Dear Premier,

## AUSTRALIA'S FEDERAL FUTURE

On behalf of the Council for the Australian Federation, you asked us to prepare a report on what federalism has to offer Australia today. We are delighted to present our report entitled *Australia's Federal Future*.

It became apparent to us in writing this report that Australian attitudes towards federalism are out of step with those in the rest of the world. In Australia, it is often asserted that federalism is an old-fashioned, cumbersome and inefficient system. Yet internationally, federalism is regarded as a modern, flexible and efficient structure that is ideal for meeting the needs of local communities while responding to the pressures of globalisation. The difference between these two views is stark.

In this report we have used political, legal and economic analysis and international comparisons to highlight that, far from being a burden, Australia's federal system provides us with many economic and social benefits. For example, federalism:

- divides and limits power; protecting the individual;
- gives Australians a wider range of choices and allows policies and services to be tailored to meet the needs of communities; and
- spurs all Australian governments to be more innovative and responsive.

Compared to centralised, unitary governments, federal nations such as Australia have:

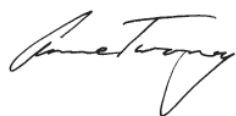
- more efficient governments; and
- higher rates of economic growth and higher per capita GDP.

These benefits deliver significant economic and social advantages to all Australians. However, increasing centralisation in Australia threatens these benefits.

Where there are problems, they are often with the way our federal system operates, rather than with federalism itself. Rather than criticising our federal system, we should be working to make better use of its advantages in order to improve our prosperity. In particular, the reform of the allocation of powers and responsibilities between the Commonwealth and the States, and reform of fiscal federalism, are desperately needed.

Together, the Commonwealth and the States and Territories have achieved a great deal, such as national competition policy and economic reform. This has laid the economic foundations for our current prosperity. It is important that we maintain the health of our federal system and inter-governmental relations in order to support the next wave of reform, the National Reform Agenda, and beyond.

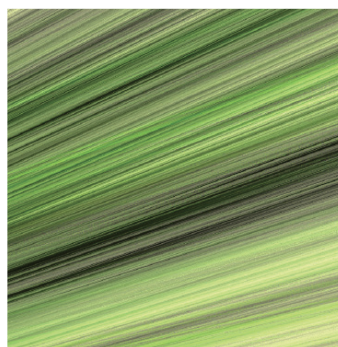
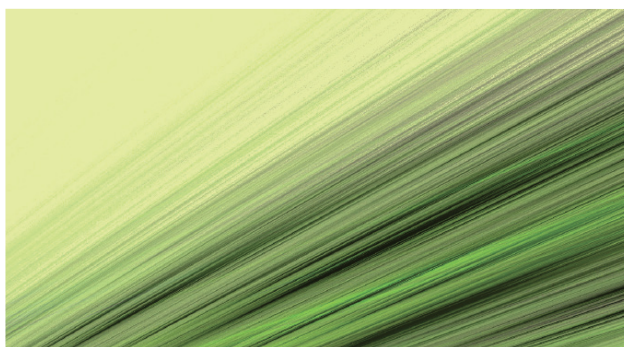
It is our hope that this report sparks a more sophisticated and informed public debate in Australia about federalism. Federalism is a significant part of Australia's identity and an important source of our prosperity. We have much to gain, as a nation, from reforming our federal system to increase the advantages it offers us. The time for that reform is now.



**Anne Twomey**  
Associate Professor in Law  
University of Sydney



**Glenn Withers**  
Professor of Public Policy  
Australian National University and  
Australia and New Zealand School of Government



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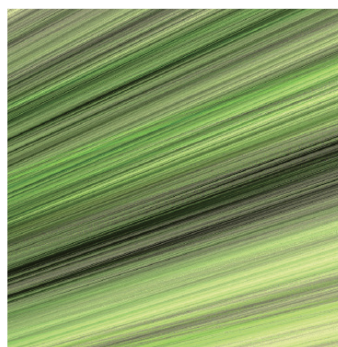
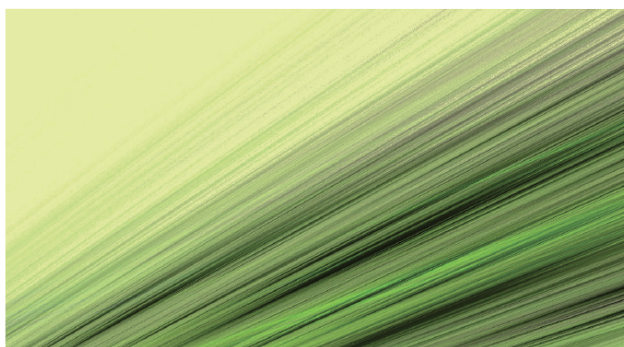
## EXECUTIVE SUMMARY

Within Australia, federalism has been under attack. The Commonwealth has been using its financial powers and increased legislative power to intervene in areas of State responsibility. Centralism appears to be the order of the day.

In the rest of the world, the prevailing trend is towards decentralisation and federalism. Indeed, federalism is regarded as one of the best governmental systems for dealing with the twin pressures produced by globalisation – the upward pressure to deal with some matters at the supra-national level and the downwards pressure to bring government closer to the people. The latter pressure is reflected in the principle of subsidiarity, which states that matters should be dealt with by the lowest level of government practicable.

In Australia, by focusing too much on problems in the operation of our federal system we forget about the benefits of federalism, which include:

- **Checks on power** – Federalism divides and limits power, protecting the individual from an overly powerful government. It ensures that there is greater scrutiny of government action and helps to reduce the incidence of corruption.
- **Choice and diversity** – Federalism gives citizens a greater range of choices. People can vote for one party at the national level and another at the State level. They can move from one State to another if they prefer the latter's policies or they can seek to have another government's policies implemented by their home State. If one level of government lets them down, they can seek redress from the other.
- **Customisation of policies** – Federalism allows policies and services to be tailored to meet the needs of people and communities they directly affect. Differences in climate, geography, demography, culture, resources and industry across our nation mean that different approaches are needed to meet local needs. Federalism accommodates these differences and brings democracy closer to the people, allowing them to influence the decisions that affect them most.
- **Competition** – States and Territories are constantly compared with each other and must compete with each other. This gives States the incentive to improve their performance. It increases efficiency and prevents complacency. Comparisons show that federations have proportionately fewer public servants and lower public spending than unitary states.
- **Creativity** – States and Territories need to be innovative and to experiment in order to compete with other jurisdictions. The successful innovations of one State will often be picked up by other States and sometimes implemented nationally. At times, States and Territories lead the Commonwealth in proposing reform.
- **Co-operation** – The need to co-operate to achieve some types of reform means that proposals tend to be more measured and better scrutinised. The agreement of all jurisdictions to implement a difficult reform brings together all parts of the nation in a common endeavour and gives the reform greater insight, legitimacy and support.



Complaints are often made that federalism is an old-fashioned system that is not competitive in the modern world and involves too many tiers of government and too much duplication. International comparisons suggest that this is not the case. Of the G8 nations (the countries with the eight largest economies in the world), four are federations, seven have at least three tiers of government, and all still manage to compete powerfully on the world stage.

In the last 50 years, federations have consistently out-performed unitary states in economic terms. The more decentralised the federation, the better the performance. Research suggests that federalism may have increased Australia's prosperity by \$4,507 per head in 2006 and that this amount could be increased by another \$4,188 or even more if Australia's federal system were more financially decentralised.

While federalism does give rise to duplication, much of this could be avoided through a better allocation of responsibilities and financial resources between the Commonwealth and the States, with each managing and funding its own responsibilities. Much is made by the Commonwealth of the great financial 'windfall' to the States generated by the GST; however, the figures show that in 2006 Commonwealth funding to the States (as a proportion of GDP) was approximately the same as it was before the implementation of the GST in 1996, while the pressures on State expenditure continue to increase. In fact, it is the Commonwealth that has increased its share of tax revenue, gaining a \$20 billion annual 'windfall' of its own. The implementation of the GST has not changed the fact that the Commonwealth still controls the level of funding to the States. In some cases, as the GST increases, the Commonwealth has simply reduced the amount of specific purpose payments to the States.

Recent trends in Australian federalism show a shift from competitive and co-operative federalism to a system of 'opportunistic federalism', where the Commonwealth uses its array of financial and legislative powers to intervene selectively in areas of traditional State responsibility to make ideological or political points. In doing so, the Commonwealth undermines the benefits of federalism and exacerbates problems such as duplication and excessive administrative burdens.

Governments share a responsibility to make the federal system work better: Harnessing the advantages of federalism and taking action to reduce or eliminate the problems in its operation would deliver substantial economic and social benefits to the nation. There are three main areas in which reform is needed:

- 1 Reallocation of roles between the Commonwealth and State and Territory Governments to reduce duplication and clarify responsibilities.
- 2 Improvement in the mechanisms for inter-governmental co-operation.
- 3 Reform of federal-State financial relations, both in the operation of specific purpose payments and in the level of vertical fiscal imbalance.

Many of these reforms could be achieved through co-operation, and the referral of power where necessary. However, a constitutional convention may be a useful means of reaching consensus on these reforms and proposing any constitutional amendments that could enhance the future operation of the Australian federation.

Australia has much to gain from adopting best practice federalism, with the successful delivery of these reforms estimated to generate an annual 'bonus' to the nation of up to \$86 billion or more.



## FEDERALISM IN THE WORLD TODAY

In Australia, the prevailing trend has been away from federalism towards the centralisation of power. This centralisation has occurred across a range of areas, including industrial relations, water resources and education. This is in contrast to the strong international trend towards federalism and the decentralisation of power:<sup>1</sup>

Beyond Australia, federalism is growing in popularity.<sup>2</sup> Federal systems are recognised for cultivating unity through accommodating diversity, bringing government closer to the people, providing more flexible and responsive government, and promoting innovation and greater efficiency through competition. Federalism is also supported because it strengthens the democratic process by increasing access to and participation in the political system, and checks the potential abuse of power.

Governments around the world have responded to the pressures of globalisation by joining supra-national bodies, such as trading blocs, to obtain the economic advantages of globalisation, while at the same time decentralising power and conferring greater functions and responsibilities on sub-national states and regions.<sup>3</sup>

This is most evident in Europe, where the abiding principle of the European Union is subsidiarity – which states that responsibility for a particular function should, where practicable, reside with the *lowest* level of government.<sup>4</sup> Recent reforms in Europe have strengthened the powers and functions of sub-national jurisdictions in both federal and unitary countries.

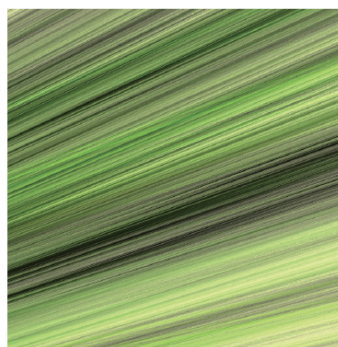
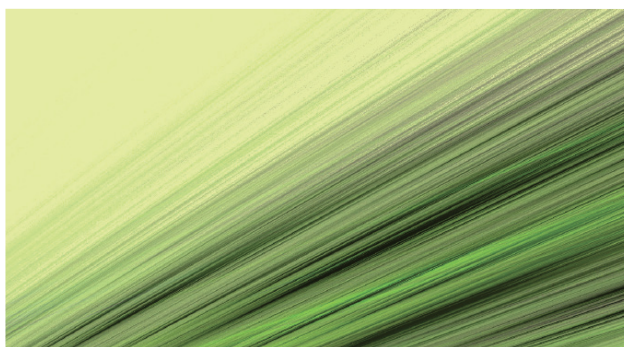
1 T Hueglin and A Fenna, *Comparative Federalism – A Systematic Inquiry* (Broadview Press, Canada, 2006), p 11.

2 R Watts, *Comparing Federal Systems in the 1990s* (Institute of Intergovernmental Relations, Queen's University, 1996), p 5.

3 G Arachi and A Zanardi, 'Designing Intergovernmental Fiscal Relations: Some Insights from the Recent Italian Reform' (2004) 25(3) *Fiscal Studies* 325.

4 J Pincus, 'Productive Reform in a Federal System', in Productivity Commission, *Productive Reform in a Federal System* (Roundtable Proceedings, Canberra, 2006), p 25, at p 27.





### Decentralisation in Europe

- In France, a unitary state, functions in the fields of higher education, industrial policy and regional infrastructure were transferred to the regions in 2003. This was accompanied by the assignment of new taxing powers to sub-national governments.<sup>5</sup>
- In Germany, a federation, major constitutional reforms, described by the Bavarian Premier as the 'mother of all reforms', took effect on 1 September 2006. The Bundesrat (the upper house of the federal parliament), which is comprised of representatives of the States (Länder), has had its veto over legislation reduced in exchange for sole responsibility for certain matters, such as education, being transferred to the Länder.<sup>6</sup>
- In Italy, a unitary state, fiscal reforms in the last two decades have given the Italian regions greater power to impose taxes and access a fixed share of national taxes. These reforms also ended the use of tied grants and gave the regions incentives for greater efficiency.<sup>7</sup> In 2001, a new division of legislative powers between the regions and the central government was approved in a referendum.<sup>8</sup> However, in June 2006, further federal reform granting greater responsibilities to the regions was rejected in a referendum that also would have granted the Prime Minister greater powers.<sup>9</sup>
- In Spain, a de facto federation, health care and social services spending has been devolved upon Autonomous Communities, along with increased tax powers. Negotiations continue around giving greater powers to the Autonomous Communities.<sup>10</sup>
- In Switzerland, a federation, the distribution of powers was clarified by constitutional amendment in 2000 and further reforms were ratified by the Swiss people and Cantons in a referendum in November 2004. These reforms included the reallocation of some powers (such as responsibility for people with disabilities being transferred to the Cantons) and a new formula of fiscal equalisation between the Cantons.<sup>11</sup>
- In the United Kingdom, significant powers were devolved upon Scotland and Wales in 1999, including the establishment of associated legislatures in Edinburgh and Cardiff, and consideration has been given to establishing further elected regional assemblies.<sup>12</sup>

- 5 G Arachi and A Zanardi, 'Designing Intergovernmental Fiscal Relations: Some Insights from the Recent Italian Reform' (2004) 25(3) *Fiscal Studies* 325, at 328.
- 6 M Heckel, 'German compromise ends standoff on federalism' (2006) 5(3) *Federations* 3, at 4.
- 7 G Arachi and A Zanardi, 'Designing Intergovernmental Fiscal Relations: Some Insights from the Recent Italian Reform' (2004) 25(3) *Fiscal Studies* 325, at 328–30 and 360–1.
- 8 B Caravita, 'Italy: toward a federal state?' (2002) *Federations* 25.
- 9 C Pinelli, 'The 1948 Italian Constitution and the 2006 Referendum: Food for Thought' (2006) 2 *European Constitutional Law Review* 329.
- 10 N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements* (Final Report, May 2006), p 11; and G Anderson, 'Catalonia votes for more autonomy within Spain' (2006) 5(3) *Federations* 15.
- 11 C Braun, 'The importance of horizontal and vertical collaboration within the Swiss federal State from the perspective of the Cantons' (2006) 5(2) *Federations* 23; and T Milic, 'Switzerland' (2005) 44(7–8) *European Journal of Political Research* 1213.
- 12 B Hadfield, 'Devolution in the United Kingdom and the English and Welsh Questions' in J Jowell and D Oliver, *The Changing Constitution* (OUP, 5th ed, 2004), p 237; and J Tomoney, 'Reshaping the English Regions' in A Trench (ed), *The State of the Nations 2001* (Imprint Academic, 2001), p 107.
- 13 J Roskam, 'Panel Discussion', in Productivity Commission, *Productive Reform in a Federal System* (Roundtable Proceedings, Canberra, 2006), p 325.

The international experience should give us pause to think. Why does Australia treat federalism so dismissively when the rest of the world sees the many advantages of federalism and the decentralisation of power? Is it a case of familiarity breeding contempt?<sup>13</sup> In Australia, federalism battles against cynicism, neglect and the illusory attractions of centralism. Too often, the public debate about federalism focuses on the perceived disadvantages of the system without taking into account the far more significant benefits Australians have derived from our federal system.

# THE BENEFITS OF FEDERALISM FOR AUSTRALIA

Federalism offers Australia significant benefits:

- Protection for the individual by checking the concentration of power
- Choice and diversity
- The customisation of policies to meet local needs
- Incentives to reform and improve, in order to compete with other jurisdictions
- Incentives to innovate and experiment
- Greater scrutiny of policies as a result of the need to achieve co-operation.

## 2.1 CHECKING CONCENTRATED POWER

Federalism is a system that divides power, ensures scrutiny of the exercise of power and protects the individual. While those who hold power usually have an aversion to sharing it, federalism requires that they do so, making it the 'least undemocratic' of all forms of government.<sup>14</sup> Without the federal limitations in the Constitution, the Commonwealth would have plenary legislative power over all matters.

In Australia, federalism is the 'major mechanism' for the formal dispersal of power.<sup>15</sup> The continuing importance of federalism as a check on power is reinforced by the gradual decline in the informal checks and balances on concentrated power, which some have seen as producing a 'democracy deficit'.<sup>16</sup>

Sir Robert Menzies made the point in 1966 that, as a federalist, he believed:

**that in the division of power, in the demarcation of powers between a Central Government and the State Governments, there resides one of the true protections of individual freedom.<sup>17</sup>**

Forty years later, his remarks were echoed by Justice Kirby, who saw federalism as liberty-enhancing<sup>18</sup> and went on to state:

**This Court and the Australian Commonwealth need to rediscover the federal character of the Constitution. It is a feature that tends to protect liberty and to restrain the over-concentration of power which modern government, global forces, technology, and now the modern corporation, tend to encourage. In this sense, the federal balance has the potential to be an important restraint on the deployment of power...<sup>19</sup>**

Business groups have also regarded federalism as imposing checks and balances upon government power. The Business Council of Australia has argued that the exercise of power becomes more contestable when more than one government is involved. As a consequence, governments are under greater pressure to defend their decisions publicly, leading to more moderate and considered outcomes.<sup>20</sup>

There is also evidence that federations fare better in terms of governmental integrity than do unitary states. Transparency International survey data supports this view, with OECD federations having a 5.4 per cent higher integrity rating on average than OECD unitary states.<sup>21</sup> Under federalism, power is more dispersed and is more open to scrutiny and to comparison by other jurisdictions.

14 *NSW v Commonwealth* (2006) 81 ALJR 34, per Callinan J at [775] and [777].

15 This is particularly so in the absence of a Bill of Rights or a formal separation of powers between the legislature and the executive. See T Hueglin and A Fenna, *Comparative Federalism – A Systematic Inquiry* (Broadview Press, Canada, 2006), p 41; and also P Coleman, 'No wonder state Liberals are confused', *The Australian Financial Review*, 7 March 2007, p 63.

16 M Sawyer, *The Democratic Audit of Australia: Populism vs. Citizen Rights* (Democratic Audit of Australia Project, ANU, Audit Paper 6/2006); and H Evans, *Democracy: the Wrong Message*, (Democratic Audit of Australia Project, ANU, Audit Paper 8/2006).

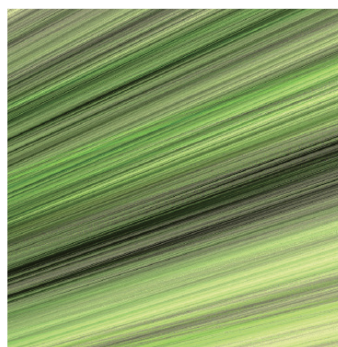
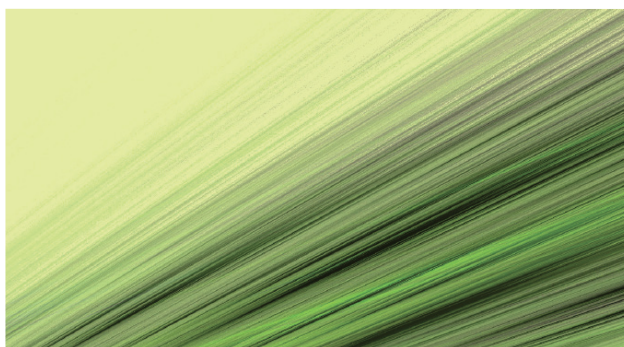
17 Sir Robert Menzies, *Central Power in the Australian Commonwealth* (Cassell, London, 1967), p 24.

18 *NSW v Commonwealth* (2006) 81 ALJR 34, per Kirby J (dissenting) at [558].

19 *NSW v Commonwealth* (2006) 81 ALJR 34, per Kirby J (dissenting) at [612].

20 Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal-State Relations* (2006), p 5.

21 Transparency International, *Corruption Perception Index* (Berlin, 2006).



## 2.2 CHOICE AND DIVERSITY

Federalism gives people greater choices. People can, and often do, choose to support a government of one political party at the State level and another at the Commonwealth level, because they prefer different approaches to different policy issues. For example, people might vote in favour of one party at the national level because of its policies regarding defence or the management of the national economy, and for another party at the State level because of its policies concerning the provision of services such as education and health, or its approach to law and order. If there is only one central government, all issues are 'bundled' into the one election and the choices of the electorate become limited.

Federalism also allows choice and diversity between jurisdictions. For example, if a country has only one education system, which sets inadequate standards or imposes ideological views, there is no escape from that system. However, when each State has its own education system, families can 'vote with their feet' and move to another jurisdiction if the system in their State is performing badly or failing to offer the opportunities or resources they desire or need.<sup>22</sup> Over the years, Australia has witnessed significant inter-state migration – due, in part, to the different policies pursued by governments.<sup>23</sup>

Similarly, businesses can set themselves up or adjust their activities to benefit from the jurisdiction with the best economic performance or which best accommodates their particular needs in relation to resources, regulations or qualified employees.

Having governments at both the State and Commonwealth level gives citizens more than one point of access to the system of government. If one level of government ignores them, they can raise their concerns with the other level of government. Even where a level of government is not directly responsible for redressing those concerns, federalism allows them to be raised and debated in the public domain. The existence of more than one Parliament in Australia is important to ensure that matters of public concern are not ignored and can be exposed and debated in a public and privileged forum. Further, where one level of government fails to address policy issues, there is an opportunity for the other level of government to address and remedy that failure.<sup>24</sup>

Federalism also ensures that there is diversity in our institutions, as they are not concentrated in a single capital city. Federalism requires the development of a number of capital cities, with all the institutions and services of a capital, such as State Parliaments, libraries, museums, archives and galleries.<sup>25</sup>

Hueglin and Fenna have compared France, a unitary state, and Germany, a federation. They pointed out that France 'has only one dominant cultural, economic and political centre: Paris'. A successful education and career in France almost inevitably requires relocation to Paris. In contrast, they argued that Germany has no dominant centre. Careers are 'not dependent upon whether they begin in Hamburg, Frankfurt, Munich, Bonn or Berlin'.<sup>26</sup> Similarly, in Australia, Canberra does not dominate the nation as the single city of importance. Federalism helps to ensure that State and Territory capitals continue to thrive and that these capitals, in turn, support and promote regions that might otherwise be neglected by a central government.

22 J Roskam, 'A single curriculum is not the answer', *The Age*, 11 October 2006.

23 G de Q Walker, *Ten Advantages of a Federal Constitution* (Centre for Independent Studies, Sydney, 2001), p 7; and M Bell, *Internal Migration in Australia 1986-1991: Overview Report* (AGPS, Canberra, 1995), p 57.

24 J Roskam, 'Federalism is a safer way', *The Australian Financial Review*, 17 November 2006; and R Watts, 'States, Provinces, Länder, and Cantons: International Variety among Subnational Constitutions' (2000) *Rutgers Law Journal* 94:1, at 944.

25 D Elazar, *Exploring Federalism* (University of Alabama Press, USA, 1987), pp 251–3.

26 T Hueglin and A Fenna, *Comparative Federalism – A Systematic Inquiry* (Broadview Press, Canada, 2006), p 52.

### 2.3 CUSTOMISATION OF POLICIES

Federalism is more responsive to the preferences of voters. McConnell has given this example:

[A]ssume that there are only two states, with equal populations of 100 each. Assume further that 70 per cent of State A and only 40 per cent of State B wish to outlaw smoking in public buildings. The others are opposed. If the decision is made on a national basis by a majority rule, 110 people will be pleased and 90 displeased. If a separate decision is made by majorities in each state, 130 will be pleased and only 70 displeased. The level of satisfaction will be still greater if some smokers in State A decide to move to State B, and some anti-smokers in State B decide to move to State A.<sup>27</sup>

Federalism brings democracy closer to people, allowing them to influence the decisions that affect them most. It also 'discourage[s] the alienation that people might feel from a more distant and seemingly less controllable central government'.<sup>28</sup>

Federalism accommodates the vast differences across Australia by allowing policies that affect local communities to be tailored to meet the needs of those communities, by people who live there and understand those needs. Different policies may be appropriate in different States or Territories because of differences in climate, geography, demographics, culture, resources and industry. For example, the educational and transport needs in Western Australia during a minerals boom are likely to be quite different to those of Tasmania.

While a unitary system may have the advantage of being able to apply consistent standards across the nation, consistency can lead to unfair results where it does not take account of relevant differences and preferences. With the best will in the world, those who administer government programs in Canberra are not fully equipped to understand how those programs operate in practice in distant parts of the country and how they could be better adapted to achieve common outcomes. Local knowledge and experience make all the difference.

#### Royal Darwin Hospital

- When construction commenced on the Royal Darwin Hospital in the 1970s, the Commonwealth Government chose to use the same plans as for Woden Hospital in Canberra. Accordingly, the Royal Darwin Hospital was built to deal with extreme cold, frost and even snow, with snow caps installed on the Darwin building and a moat for snow drainage. The plans were not adapted to a tropical climate.<sup>29</sup>
- The hospital was also culturally inappropriate in style for its Aboriginal users. The report of the Royal Commission into Aboriginal Deaths in Custody noted that the hospital's 'multi-storey structure limits patients' access to the outside and does not lend itself to the presence of family members; an aspect likely to be important for the morale and recovery of at least some Aboriginal patients. It is not surprising that such an alien environment contributes to the reluctance of some Aboriginal people to be admitted to, and stay in, hospital'.<sup>30</sup>
- Later extensions to Royal Darwin Hospital, planned by the Northern Territory Government, used a modern tropical design more suited to Darwin's climate.

Although Australia has a relatively homogenous society, there are still distinct differences in the wants or needs of communities. 'Some States or Territories may opt to spend more or less on education, or health, or to set particular taxes higher or lower. In a federal system, such diversity is possible'.<sup>31</sup> For example, the people of one State might prefer lower taxes at the expense of services, while those in another might place a higher priority on the quality of government services. Western Australians might have different views about poker machines and retail hours than people in New South Wales.<sup>32</sup>

27 M McConnell, 'Federalism: Evaluating the Founders' Design' (1987) 54 *University of Chicago Law Review* 1484, at 1494; as quoted in: G de Q Walker, *Ten Advantages of a Federal Constitution* (Centre for Independent Studies, Sydney, 2001), p 14.

28 M Filippov, P Ordeshook and O Shvetsova, *Designing Federalism* (CUR, 2004), p 2.

29 J Aagaard, Northern Territory, *Parliamentary Debates*, 13 August 2003, p 4670.

30 Royal Commission into Aboriginal Deaths in Custody, *National Report*, Volume 4, para 31-3-28.

31 Access Economics, 'The Cost of Federalism' in Business Council of Australia, *Reshaping Australia's Federation - A New Contract for Federal-State Relations* (2006), Appendix 2, para 1.4.

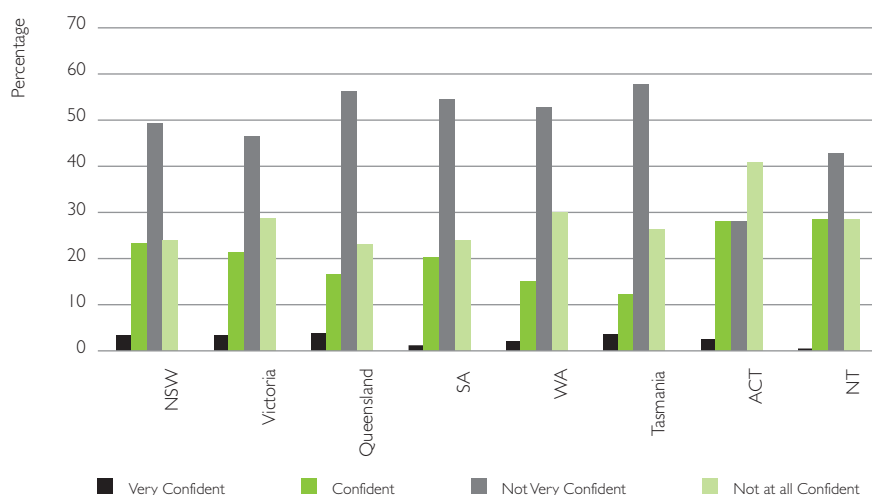
32 Western Australia, Department of Treasury and Finance, *Discussion Paper on Commonwealth-State Relations* (April 2006), p 10.

As Prime Minister John Howard put it after a recent Cabinet meeting in Perth:

It's great for Cabinets to move around the country and it's a wonderful opportunity to be reminded again as we constantly are that the centre of gravity of Australia is not the triangle constituted by Sydney, Melbourne and Canberra. And Western Australia has its own nuances and its own particular characteristics of which I have been both familiar and fond over a very long period of time.<sup>33</sup>

Certainly, there are wide discrepancies by region in the level of trust in the Commonwealth Government. In the 2001 Australian Election Study<sup>34</sup> the response to confidence in the Commonwealth Government (as indicated in Figure 1) varied significantly by jurisdiction.

**FIGURE 1 > CONFIDENCE IN THE FEDERAL GOVERNMENT, BY STATE/TERRITORY, 2001**



Central governments are usually constrained by political, and sometimes legal, imperatives to tax equally and provide common levels of services. The Commonwealth Constitution expressly provides that the Commonwealth cannot discriminate between States or parts of States when imposing tax and may not give preference to one State or any part of a State through any law or regulation of trade, commerce or revenue. However, the application of uniform policies where different preferences and circumstances exist can lead to the 'underprovision of services in some areas compared with what those communities would prefer; and overprovision in others'.<sup>35</sup>

There is a role for the Commonwealth Government in ensuring that all Australian citizens have access to minimum levels of basic services. Beyond that, there should be room for choice.<sup>36</sup>

33 J Howard, Prime Minister's Press Conference, Perth, 21 February 2007.

34 I McAllister et al., *Australian Election Study 2001*, Canberra: Social Science Data Archives, ANU, 2001, Question G9P1.

35 N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements* (Final Report, May 2006), p xxvi.

36 Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal-State Relations* (2006), p 4.

## 2.4 COMPETITION

Another benefit of federalism is that it leads to competition. The mobility of people across State and Territory borders means that the States and Territories compete with each other to attract business and residents. This competition is largely productive.

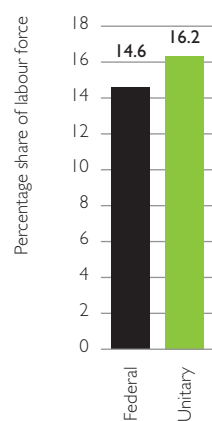
As the Productivity Commission has pointed out:

[I]f some States charge excessive prices for essential services, or allow the reliability of their electricity and transport networks to deteriorate, or levy excessive payroll taxes or allow access to important health and community services to worsen, then better performing jurisdictions are likely to find some firms and households migrating their way. This in turn provides an incentive for governments to improve their performance – to attain a better balance between the burden of taxation and the benefits of public spending; and similarly for regulation. Hence, competition between States on the ‘economic fundamentals’ is an important benefit of a federal system.<sup>37</sup>

State and Territory policies are constantly compared against each other.<sup>38</sup> These comparisons are more meaningful than those between different countries, because they are made from a common base.<sup>39</sup> The States and Territories are periodically placed under real political pressure to improve their performance, through innovation or through learning from the successes and failures of other jurisdictions.

Without this interaction, comparison and competition, there would be little incentive for a centralised government to reform or take the risk of implementing new ideas, especially when the consequences of failure are more widespread for national reforms. The likely result would be a bloated, complacent and sedentary central bureaucracy.

**FIGURE 2 > PUBLIC EMPLOYMENT LABOUR FORCE SHARE: FEDERAL AND UNITARY COUNTRIES, 1999–2001**



On average, federations are much more economical than unitary states because of the benefits of competition over monopoly. Monopolies such as the Australian Wheat Board remind us that the centralisation of power can come at a considerable price. Without internal competition, government is more likely to become inefficient, over-staffed and expensive to run. Figure 2 shows that if federal and unitary states are compared, the average share of public employment in the total workforce increases by almost 11 per cent for unitary states.<sup>40</sup> These figures suggest that if Australia abandoned federalism and became a unitary state – and these averages applied to Australia – the number of public servants might rise by as much as 181,800 persons.

37 J Pincus, 'Productive Reform in a Federal System', in Productivity Commission, *Productive Reform in a Federal System* (Roundtable Proceedings, Canberra, 2006), p 25, at 35. See also: G Banks, 'Inter-State bidding wars: calling a truce', Speech to CEDA, Brisbane, 6 November 2002, pp 3–4.

38 C Shiel (ed.), *The State of the States 2006* (Evatt Foundation, Sydney, 2006); Productivity Commission, *Report on Government Services 2007* (Productivity Commission, Canberra, January 2007).

39 J Pincus, 'Productive Reform in a Federal System', in Productivity Commission, *Productive Reform in a Federal System* (Roundtable Proceedings, Canberra, 2006), p 25, at p 36.

40 OECD, *Public Management Service*, 2002.

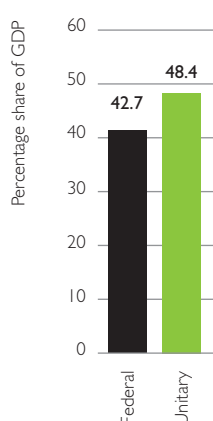
**FIGURE 3 > GENERAL GOVERNMENT SPENDING SHARE: FEDERAL AND UNITARY COUNTRIES, 1988–2000**

Figure 3 shows how the relative size of public expenditures also varies with the form of government, with public spending as a share of GDP 13 per cent higher on average in unitary states.<sup>41</sup> Based on these figures, if Australia were a unitary state, our 2006 public spending may have been \$44 billion greater (in 2006 terms).

Competition can also be destructive: for example, where States and Territories bid against each other in giving special concessions to attract companies to set up their headquarters in particular locations or to win sporting events. In such cases, the bidding may reach a point where no benefit is achieved. This problem can be avoided through better policy and co-operation. Most Australian jurisdictions have entered into an agreement to restrict the use of selective assistance to attract investment.<sup>42</sup>

Federal systems need to strike the right balance between co-operation and competition to harness the benefits of both.

## 2.5 CREATIVITY AND INNOVATION

Another important advantage of federalism is the opportunity, and often the pressure, to be innovative and to experiment in order to compete with other jurisdictions. Federalism provides a laboratory in which ideas can be tested on a smaller scale before being implemented across the country.

Prior to the recent centralisation of industrial relations laws, innovation in the field of industrial relations was generated not just by ideology, but by the need to compete with other jurisdictions. As the Business Council of Australia has pointed out, 'industrial relations reforms were begun by States such as Western Australia, Queensland and New South Wales, ahead of national initiatives'.<sup>43</sup>

Justice Kirby has argued that s 51 (xxxv) of the Constitution – the industrial relations power – was intended to protect diversity in the legal regulation of industrial relations. He observed that this resulted in:

**occasional diversity of approach, inventiveness in standards and entitlements, and appropriate innovation. Such innovation, by which industrial standards determined in one jurisdiction of Australia are tested and sometimes copied in another, constitutes a good illustration of an important advantage of the federal form of government enshrined in the Constitution.**<sup>44</sup>

Where there is only one central industrial relations law, the entire country is subject to that law and the particular ideology it reflects. There are no competing regimes against which comparisons can be made and no opportunities for successful innovations in other regimes to be picked up and implemented. The pressure to improve and meet the outcomes achieved by other jurisdictions is removed and there is no opportunity to test new ideas on a small scale before introducing them nationally.

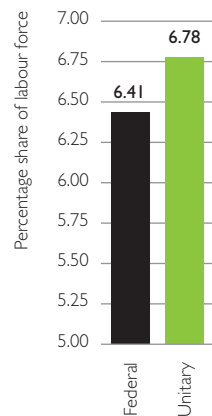
41 OECD, *Economic Outlook*, Volume 2006/1, Number 79, June 2006, Annex Table 25.

42 Interstate Investment Co-operation Agreement, 2003. See also: G Banks, 'Inter-State bidding wars: calling a truce', Speech to CEDA, Brisbane, 6 November 2002.

43 Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal-State Relations* (2006), Exhibit 1, p 5.

44 *NSW v Commonwealth* (2006) 81 ALJR 34, per Kirby J (dissenting) at 534.

**FIGURE 4 > STANDARDISED UNEMPLOYMENT RATES: FEDERAL AND UNITARY COUNTRIES, 2004**



In the labour market area, industrialised countries that are federations have a better performance record than unitary states. As seen in Figure 4, using standardised OECD unemployment rates and using the most recent year for which such data are available, unemployment in unitary states is on average 5.8 per cent higher than in federal states.<sup>45</sup>

In Australia, the States have been the main innovating forces in reforming political processes, such as changes to electoral laws. Past examples include the secret ballot, votes for women, compulsory voting, proportional voting and lowering the voting age to 18. More recent innovations include four-year terms, fixed terms and measures to avoid the manipulation of 'above the line' voting in upper houses. Such measures were only adopted by other Australian jurisdictions after they had an opportunity to see how these measures operated in practice.

One current area of State and Territory innovation is the development of Bills of Rights. The Australian Capital Territory commenced the process with the enactment of its *Human Rights Act 2004*. This has been followed by the Victorian *Charter of Human Rights and Responsibilities Act 2006*. Again, other Australian jurisdictions will have the chance to see from the experience of Victoria and the Australian Capital Territory whether the experiment is successful and to improve upon any weaknesses in the way those Acts operate if they choose to implement their own Bills of Rights.

Where experiments fail, federalism 'cushions the nation as a whole from the full impact of government blunders'.<sup>46</sup> Bryce compared a federation with a ship that has watertight compartments: 'When a leak is sprung in one compartment, the cargo stowed there may be damaged, but the other compartments remain dry and keep the ship afloat.'<sup>47</sup> In other words, policy mistakes made in one State do not spread throughout the entire country and can be corrected by adopting successful policies from other States.

45 OECD, *OECD Factbook 2006* (Paris 2006).

46 G de Q Walker, *Ten Advantages of a Federal Constitution* (Centre for Independent Studies, Sydney, 2001), p 33.

47 J Bryce, *The American Commonwealth*, (Macmillan and Co, London, 3rd ed., 1893), p 353.

48 J Conybeare, 'Evaluation of Automobile Safety Regulations: The Case of Compulsory Seat Belt Legislation in Australia', *Policy Sciences*, 12, 1980, pp 27–39.

49 A Unglik, 'Between a rock and a hard place: the story of the development of the EPA' (EPA, Melbourne, 1996).



### State and Territory innovations

States and Territories have led reform in Australia at both the State and national level by implementing or campaigning for reform in the following areas:

- road safety campaigns and the compulsory use of seat-belts;<sup>48</sup>
- the establishment of the first Environmental Protection Authority in Australia and the second in the world after California;<sup>49</sup>
- the enactment of various kinds of anti-discrimination laws;<sup>50</sup>
- the use of commercialisation and corporatisation to improve the performance of government business enterprises;<sup>51</sup>
- the development of trade relations with Indonesia;<sup>52</sup>
- the creation of mechanisms for the review of business regulations;<sup>53</sup>
- the use of casemix funding of public hospitals;<sup>54</sup>
- the establishment of health care call centres;<sup>55</sup>
- the development of private financing initiatives;<sup>56</sup>
- the development of the mutual recognition scheme;<sup>57</sup>
- the reform of financial regulation;<sup>58</sup>
- the development of the National Reform Agenda to enhance human capital;<sup>59</sup>
- the development of regional migration schemes;<sup>60</sup>
- the development of markets for the trading of salinity credits and biodiversity credits;<sup>61</sup>
- the creation of carbon rights and the development of a national carbon emissions trading scheme;<sup>62</sup> and
- the development of population policies.<sup>63</sup>

## 2.6 CO-OPERATION

Federal systems provide a mix of competition and co-operation. Where competition is not appropriate because too great an overlap exists between functions, co-operation may be needed to achieve outcomes of national significance.

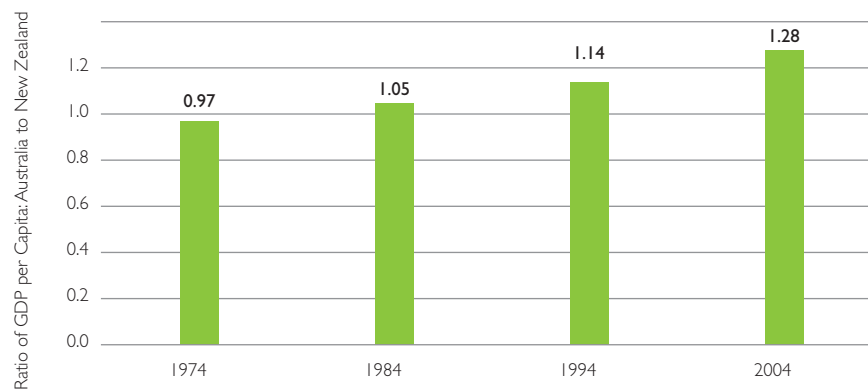
The involvement of more than one government means that that a proposal will receive a great deal more scrutiny than if it were the work of one government alone. Problems with implementing the proposal in different parts of the country are more likely to be identified. Where there is conflict between governments on the nature and detail of the proposal, there is more likely to be a public debate, as different governments are forced to put their positions and justify them in the public domain. While this has the disadvantage of sometimes slowing down reform, the need for co-operation has the corresponding advantage of ensuring that reform, when implemented, is better considered and more moderate in its nature.

- 50 See, for example, the *Prohibition of Discrimination Act 1966* (SA).
- 51 M Mead and G Withers (eds), *Privatisation: A Review of the Australian Experience* (CEDA, Melbourne, 2002).
- 52 See, for example, the Memorandum of Understanding with Indonesia on Economic Development Co-Operation, 1992.
- 53 See, for example, the *Subordinate Legislation Act 1994* (Vic.).
- 54 S Duckett, 'Casemix Funding for Acute Hospital Inpatient Services in Australia', *Medical Journal of Australia* (161) 1998, S17–S21.
- 55 Western Australia, Department of Treasury and Finance, *Discussion Paper on Commonwealth–State Relations* (April 2006), pp 9–10.
- 56 Economic Planning Advisory Commission, *Private Infrastructure Taskforce: Final Report*, (Canberra: AGPS, 1995).
- 57 COAG, *Users' Guide to the Mutual Recognition Agreement and Trans-Tasman Mutual Recognition Arrangement* (2006).
- 58 M Keating and J Wanna, 'Remaking federalism?' in M Keating, J Wanna and P Weller (eds), *Institutions on the Edge?* (Allen & Unwin, 2000), p 135.
- 59 *A Third Wave of National Reform – A New National Reform Initiative for COAG*, (Department of Premier and Cabinet, Victoria, August 2005).
- 60 Victorian Government, *Victoria's Skilled Migration Strategy, 2004–2007* (Melbourne, November 2004).
- 61 S Salvin, 'Developing a market in biodiversity credits', *Community Biodiversity Network Newsletter* (2000).
- 62 National Emissions Trading Taskforce, *Possible Design for a National Greenhouse Gas Emissions Trading Scheme* (August 2006).
- 63 South Australian Government, *Prosperity Through People* (Adelaide, March 2004).

In contrast, New Zealand, with its highly centralist system of government, finds it much easier to implement major reforms quickly without dispute or delay. The consequence is that economic reforms in New Zealand have tended to be more extreme and implemented much faster than reforms in Australia, where greater co-operation – and hence consideration – has been required. Both the Muldoon era of ‘Think Big’ industry support policies and the subsequent ‘Rogernomics’ era of liberalisation of the New Zealand economy are illustrations of reform in a centralist system. Each of these eras in New Zealand was more exaggerated, one in the direction of intervention and the other in deregulation, than corresponding Australian policies. This is one of the reasons why the Australian economy, with its more measured and considered reform, has significantly out-performed the New Zealand economy.<sup>64</sup>

Figure 5 divides Australian per capita GDP by New Zealand per capita GDP to show the relative position of the two (as a ratio).<sup>65</sup> Where the ratio exceeds 1, Australia is ahead of New Zealand (with both being measured in \$US purchasing power parity). Over the thirty years since 1974, Australia moved ahead of New Zealand by almost one-third in average incomes, after starting from behind.

**FIGURE 5 > RATIO OF REAL GDP PER CAPITA, AUSTRALIA AND NEW ZEALAND, 1974–2004**



Co-operative schemes also have advantages over Commonwealth Government stand-alone actions because they bring together all parts of the nation in a common endeavour, rather than leaving parts of the nation disgruntled and alienated by reforms imposed by Canberra. A powerful political message is sent to the community by the mere fact that all governments in Australia recognise that a problem exists and agree how to tackle it.

64 P Dalziel and R Lattimore, *The New Zealand Macro-economy: A Briefing on the Reforms and Their Legacy* (Oxford University Press, 1999).

65 OECD, *OECD Factbook* (Paris, 2006).

### **Terrorism laws – a case of co-operation and scrutiny**

In 2002 the Commonwealth Government sought to enact extensive anti-terrorism laws. As it was not clear whether the Commonwealth had sufficient legislative powers to support its proposed laws, it requested referrals from the States under s 51 (xxxvii) of the Constitution. The States agreed to refer to the Commonwealth the matters of the power to enact its proposed law and the power to amend it in the future. This referral was subject to a condition in an inter-governmental agreement and in the text of the law the Commonwealth was empowered to enact: that any amendment to the law be approved by a majority of the States and Territories, including at least four States.

In 2005 the Commonwealth proposed to enact more controversial anti-terrorism laws that included provisions concerning control orders and preventative detention. It could not simply guillotine these laws through the Parliament because it was obliged (politically, and perhaps legally) to seek the agreement of a majority of the States and Territories. This led to significant public debate about the merits of the proposals.

The matter was addressed at the Council of Australian Governments (COAG) in September 2005, where in-principle agreement was reached. Later, substantive amendments were made to the Bill, inserting new safeguards at the request of the States and Territories. Ultimately, five States and one Territory agreed to its enactment.

This case study shows that:

- agreement with States and Territories can be reached quickly on important matters of national interest;
- public debate and scrutiny were enhanced because the Commonwealth was forced to make its case in the public domain to achieve the agreement of States and Territories;
- the need for inter-governmental agreement proved a moderating force on the legislation concerned; and
- the resulting laws gained greater legitimacy in the public domain because they were supported by different jurisdictions with governments of different political persuasions.



## MYTHS ABOUT FEDERALISM

The current debate about the Australian federal system tends to focus upon arguments against federalism, which include the following:

- Federalism was imposed upon us because of our history, but we would not choose it now.
- Federalism is a nineteenth-century system of government that is incompatible with globalisation and international competition.
- Federalism results in too many tiers of government.
- Federalism is a costly system of government because of the duplication involved.
- A unitary government would be more efficient and better managed.
- Federalism gives rise to conflict and buck-passing rather than achievement.
- Federalism is a failure because even with the GST windfall the States still cannot fulfil their responsibilities.

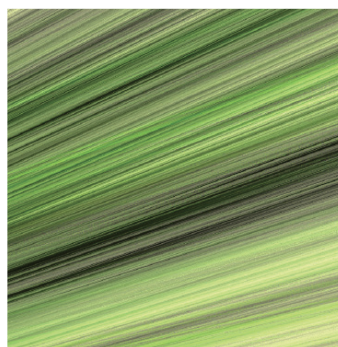
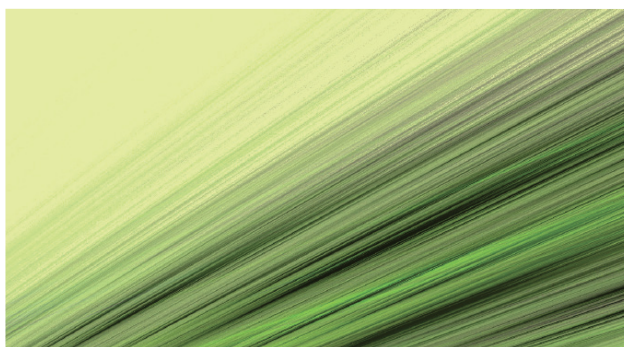
These arguments are addressed below. In some cases, the arguments are misconceived or based upon assumptions that are not borne out in practice. In other cases, the arguments identify genuine problems with federalism in Australia. However, these problems generally could be eliminated or reduced by reforming the way the federal system operates.

Every system of government has its failings. A fair assessment balances these failings against the advantages of that system of government, rather than focusing solely on the disadvantages.

### 3.1 FEDERALISM – WHY WE WOULD CHOOSE IT NOW

It is true that our federal system is the product of Australia's colonial history. The Constitution was drafted in the 1890s by political leaders of the different Australian colonies who established a Commonwealth Government of limited powers, with most powers remaining in the hands of the States. But it was not simply parochialism or political convenience that caused these leaders to choose a federation. They were well aware of the reasons why six different colonies were established in Australia.

When Australia was first settled, the single colony of New South Wales covered two-thirds of the continent. However, it proved impossible to govern people scattered across such vast distances from Sydney. Moreover, people objected to being governed by others who lived so far away from them and knew little if anything of their needs. The people of the Port Phillip District of New South Wales made this point in 1848 by electing (without his knowledge or consent) Earl Grey, the British Secretary of State for the Colonies, as their representative in the New South Wales Legislative Council. Their view was that Earl Grey, living in London, probably knew as much about their circumstances as a Sydney-sider.<sup>66</sup> Earl Grey took the point and Victoria was separated from New South Wales in 1851 and given its own legislature.



For these same reasons, if we were starting afresh, it is likely that Australians would choose a federal system. As international experience shows, it is still extremely difficult to govern a geographically large country through a unitary system of government. Almost every geographically large country is a federation, including Russia, Canada, the United States, Brazil, Australia, India, Argentina, Mexico, South Africa and Venezuela. China is the only country larger than Australia that is not a federation.<sup>67</sup> However, even China is now described as a 'quasi-federation' or 'nascent federation', with its provinces and autonomous regions being given substantial economic and political authority.

Improvements in transport and communications, while diminishing the tyranny of distance, do not alter the fact that people who are dispersed across large geographical areas live in different circumstances, with different climates, resources, industries, levels of wealth and access to services. Australians still want and need a system of government that accommodates these differences. Federalism fulfils this need. It permits difference while maintaining national unity by preventing the alienation caused by central control. For this reason, federalism has been described as the 'escape valve' of the Constitution.<sup>68</sup>

While Australia's history gives a good indication of why federalism was originally chosen as a system of government for Australia, its geography suggests that such a system would still be chosen by Australians today.

### 3.2 GLOBALISATION, COMPETITION AND FEDERALISM

Federalism is not an old-fashioned system of government anchored in the past. It is increasingly used across the world and is regarded as one of the best means of dealing with the pressures of globalisation. Indeed, the 'federal idea is now more popular internationally than at any time in history'.<sup>69</sup>

At least twenty-five countries have federal systems. Forty per cent of the world's population is governed by federal systems, generating 50 per cent of global gross domestic product.<sup>70</sup> The number of federal countries is increasing, not diminishing. Belgium, Ethiopia and South Africa adopted federal systems in the 1990s. Attempts are being made to achieve peace and stability in countries such as the Sudan, the Democratic Republic of Congo, Afghanistan and Iraq through the implementation of forms of federalism.

The centralist trend so evident in Australia is contrary to the worldwide trend towards decentralisation and federalism.<sup>71</sup> As Daniel Elazar has noted, 'federalism has emerged as a major means of accommodating the spreading desire of people to preserve or revive the advantages of small societies with the growing necessity for larger combinations' arising from globalisation.<sup>72</sup>

The process of globalisation is not itself new. At the time of Australia's federation, unprecedented developments in transport and communications had opened up relations between countries and increased international trade and flows in capital and people. While two World Wars and a depression turned nations inward, globalisation is again on the rise.

67 M Filippov, P Ordeshook and O Shvetsova, *Designing Federalism* (CUP, 2004), p 16.

68 M Keating and J Wanna, 'Remaking federalism?' in M Keating, J Wanna and P Weller (eds), *Institutions on the Edge?* (Allen & Unwin, 2000), p 152.

69 R Watts, *Comparing Federal Systems in the 1990s* (Institute of Intergovernmental Relations, Queen's University, 1996), p 5.

70 J Pincus, 'Productive Reform in a Federal System', in Productivity Commission, *Productive Reform in a Federal System* (Roundtable Proceedings, Canberra, 2006), p 25.

71 R Watts, *Comparing Federal Systems in the 1990s* (Institute of Intergovernmental Relations, Queen's University, 1996), p 4; T Hueglin and A Fenna, *Comparative Federalism – A Systematic Inquiry* (Broadview Press, Canada, 2006), p 11; B Galligan, 'The future of Australian Federalism' in S Prasser and G Starr, *Policy & Change – The Howard Mandate* (Hale & Iremonger, 1997) 85, at 86; and N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements* (Final Report, May 2006), p 5.

72 D Elazar, *Exploring Federalism* (University of Alabama Press, USA, 1987), p 6.

Globalisation imposes pressures of integration and fragmentation.<sup>73</sup> It has given rise to the development of 'supranational federalism', such as the European Union,<sup>74</sup> while at the same time being the catalyst for the devolution of power and functions from national governments to sub-national governments.<sup>75</sup> Larger political units and groupings are required to harmonise the liberalisation policies needed to improve the economic performance of countries competing in global markets, while smaller political units are needed to provide customised policies for localised centres of progress, such as Silicon Valley or Bangalore.<sup>76</sup> Federalism provides the best means of accommodating globalisation, local activity and local citizen preferences. It is 'an obvious institutional response to this transformation'.<sup>77</sup>

Countries with federal systems are not impeded from competing internationally. Many of the largest and most efficient economies belong to federations. Of the G8 nations (the eight largest economies in the world), half are federations (the United States, Canada, Germany and Russia) and the other four (France, Italy, the United Kingdom and Japan) have either proposed or implemented plans to strengthen the powers and increase the functions of their sub-national units in the last decade.

Federalism does not appear to have overly burdened the efficiency or productivity of the United States, and devolution has not impaired the economic position of the United Kingdom. On the contrary, there is evidence that federal countries tend to be more efficient and prosperous than those with unitary systems. Over the last 50 years, federal economies have consistently out-performed non-federal economies – and the more decentralised the federal country, the better its performance.<sup>78</sup>

### 3.3 FEDERALISM AND THE NUMBER OF TIERS OF GOVERNMENT

Australians tend to regard their three-tiered system of government as providing an unusually high level of governance.<sup>79</sup> However, in comparison with other countries, it is not unusual or excessive. Many nations have three or four-tiered systems, regardless of whether they are unitary or federal states. Apart from the United Kingdom (most of which has three tiers of government, but some of which has only two tiers), all members of the G8 have at least three tiers of government (see Table 1).

TABLE 1 > TIERS OF GOVERNMENT

| COUNTRY               | NATIONAL | STATE                       | REGIONAL       | LOCAL  |
|-----------------------|----------|-----------------------------|----------------|--------|
| Australia             | 1        | 6 States, 2 Territories     |                | 673    |
| Canada                | 1        | 10 Provinces, 2 Territories |                | 3160   |
| France (metropolitan) | 1        | 22 regions                  | 96 departments | 36,679 |
| Germany               | 1        | 16 Länder                   | 439 districts  | 12,320 |
| Italy                 | 1        | 20 regions                  | 110 provinces  | 8101   |
| Japan                 | 1        | 47 Prefectures              |                | 3100   |
| Russia                | 1        | 89 regions                  |                | 12,215 |
| South Africa          | 1        | 9 regions                   |                | 284    |
| Switzerland           | 1        | 26 Cantons                  |                | 2867   |
| United States         | 1        | 50 States                   |                | 87,849 |
| United Kingdom        | 1        | 3 devolved governments      |                | 367    |

73 T Hueglin and A Fenna, *Comparative Federalism – A Systematic Inquiry* (Broadview Press, Canada, 2006), p 17.

74 The Hon R G Atkinson, 'Federalism in a Post-Modern World' (2004) 16 *Bond Law Review* 5, at 25.

75 G Arachi and A Zanardi, 'Designing Intergovernmental Fiscal Relations: Some Insights from the Recent Italian Reform' (2004) 25(3) *Fiscal Studies* 325.

76 R Florida, *The Rise of the Creative Class*, (Pluto Press, Sydney, 2003); National Economics, *State of the Regions Report 2002: Learning Region*, (NIEIR, Melbourne, 2002); National Economics, *State of the Regions Report 2003: Regional Economic Governance* (NIEIR, Melbourne, 2003).

77 T Hueglin and A Fenna, *Comparative Federalism – A Systematic Inquiry* (Broadview Press, Canada, 2006), p 31.

78 See the more detailed discussion of this point in chapter below and Appendix 1.

79 See, for example, R Hall, *Abolish the States!* (Pan Macmillan Australia, Sydney, 1998), p 22.

Having three tiers of government can be efficient and effective. It allows decisions to be made at the closest practical level to the people affected to ensure that services best meet their needs. Abolishing local government would take decisions about local matters, such as the local park, library and car parking, out of the hands of local people. Similarly, abolishing the States would place control of public transport, schools and hospitals with the Canberra bureaucracy, away from the people who use these services.

The level of efficiency of the system depends upon how inter-governmental relations between these tiers of government are conducted and how powers and functions are allocated between the tiers. Ways of improving on these aspects of federalism are discussed in chapter 6.

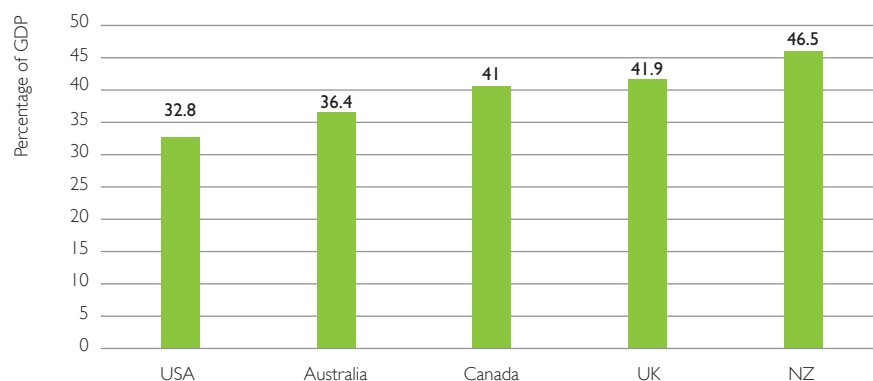
### 3.4 FEDERALISM AND DUPLICATION

From time to time, assertions are made that federalism costs Australia billions of dollars in wasted taxes. Mark Drummond has made various estimates of the amount that the abolition of the States would save Australia.<sup>80</sup> Access Economics has also attempted such an estimate.<sup>81</sup>

The Access Economics estimates can be challenged because of the extensive arbitrary assumptions made in relation to percentage savings in the various areas of government activity. Drummond's figures have been criticised as being 'implausible even in static terms – by an order of magnitude or more'.<sup>82</sup> A further problem with such calculations of the cost of federalism is that they usually do not balance costs against benefits or take into account the additional costs involved in establishing and maintaining a system of government to replace the States.

One way to address this concern objectively is to compare Australia's experience with other federations and with unitary states. Countries in the Anglo-American tradition have much in common with Australia, making a comparison with their systems more relevant. In making these comparisons, the cost of government is represented by the general government revenue share of GDP, as this reflects the tax-price imposed by government on citizens for the services of government. For the OECD as a whole, Australia's tax revenue as a percentage of GDP<sup>83</sup> is quite economical and less than that in most countries with unitary systems of government.<sup>84</sup> As Figure 6 shows, for the Anglo-American countries with which Australia often compares itself, the largest costs of government apply to the two unitary systems – not the federations.

**FIGURE 6 > GENERAL GOVERNMENT REVENUE: ANGLO-AMERICAN COUNTRIES, 2005**



80 R Hall, *Abolish the States!* (Pan Macmillan Australia, Sydney, 1998), p 24 and Appendix 1, estimating \$30 billion; M Drummond, 'Costing Constitutional Change: Estimating the Costs of Five Variations on Australia's Federal System' (2002) 61 (4) *Australian Journal of Public Administration* 44, at 53, estimating \$20 billion; and M Davis, 'Federal system wastes \$2.4bn', *Australian Financial Review*, 14 March 2005, p 5, estimating \$13.5 billion per year.

81 Access Economics, 'The Cost of Federalism' in Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal-State Relations* (2006), Appendix 2, para 3.4, estimating \$9 billion.

82 Allen Consulting Group, *Governments Working Together? Assessing Specific Purpose Payment Arrangements*, Report to the Government of Victoria (June 2006), p 57. See Appendix 1 for further review of these studies.

83 OECD, *OECD Economic Outlook*, 2006/1 June (Paris, 2006) Annex Table 26.

84 R Wilkins, 'A New Era in Commonwealth-State Relations?' (April 2006) *Public Administration Today* 8 at 9; and K Rudd, 'The Case for Cooperative Federalism', Address to the Don Dunstan Foundation, Queensland Chapter, 15 July 2005, p 22.

It is certainly the case that federalism gives rise to duplication and this can be costly. However, if a federal system is well structured and well managed, the amount of duplication may be minimised. Much of the duplication in Australia arises because the Commonwealth funds and attempts to micro-manage State programs through specific purpose payments. This means that the Commonwealth creates its own bodies to set conditions and monitor their implementation, duplicating State bodies. It also means that the States are required to undertake unnecessary administration in justifying the use of Commonwealth funds. The duplication and waste involved here is not inherent to federalism. It could be avoided if there were a better allocation of responsibilities and financial resources between the Commonwealth and the States, with each managing and funding its own responsibilities (see chapter 6).

In cases where responsibility needs to be shared, the Commonwealth could make better use of existing State bodies, rather than replicating them. The amount of administration could be reduced if programs were judged upon outcomes rather than processes and inputs.

Where duplication is the consequence of competition, the value of that competition could, in principle, offset the costs of the duplication and drive better outcomes for voters.<sup>85</sup> Duplication may be beneficial when it results in diversity and greater choice, a rationale sometimes adopted by the Commonwealth within areas of its own responsibility such as telecommunications, including cable roll-out.

However, great care is needed in pursuing such 'vertical competition' between central and State authorities as costs of duplication are necessarily incurred, and benefits would only apply for shared functions where neither the advantages of localism nor the advantages of national scale dominate and co-operative mechanisms have transparently failed. These qualifications to gaining benefit from vertical competition, contrast strongly with the clearer benefits accruing from 'horizontal' competition operating in a federation across geographical borders.

### 3.5 UNITARY SYSTEMS – SIMPLICITY AND EFFICIENCY

The simplicity of a central solution to all problems appears a very attractive alternative to the conflict that arises in competitive federalism or the effort required to achieve co-operative federalism. However, once the competition, comparison and scrutiny inherent in a federal system are removed, one is left with an all-powerful and potentially complacent bureaucracy, which is likely to be less responsive to local issues and needs.

International trends are moving away from centralised governments. As Watts has put it, 'centralized unitary government has increasingly ceased to be the norm as nation-builders have come to recognize that overcentralisation can lead to anaemia at the extremities and apoplexy at the centre'.<sup>86</sup>

In Australia, Roskam has pointed to Commonwealth policies and laws on income tax, industrial relations and superannuation as examples of the doubtful track record of the Commonwealth Government in relation to 'simplicity'.<sup>87</sup> To this list could be added Commonwealth native title laws, which have been criticised as being unnecessarily complex and imposing excessive burdens on all parties concerned. The 'simplification' of Commonwealth industrial relations legislation amounted to 762 pages of complex detail and the consolidated *Workplace Relations Act 1996* is over 1200 pages long.

The Business Council of Australia has documented the growth of Commonwealth legislation in terms of pages in primary legislation and has found a massive increase in the last two decades that has added substantially to the complexity of conducting business under Commonwealth law (Figure 7).<sup>88</sup>

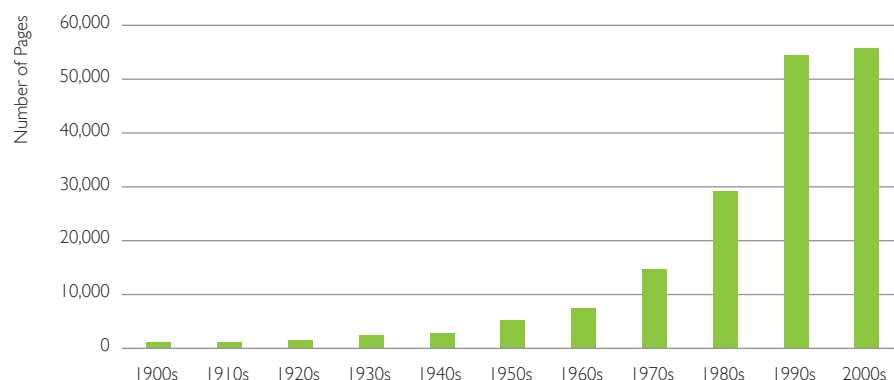
85 Access Economics, 'The Cost of Federalism' in Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal-State Relations* (2006), Appendix 2, para 1.5; and C Walsh, 'Competitive Federalism – wasteful or welfare enhancing?' in Productivity Commission, *Productive Reform in a Federal System* (Roundtable Proceedings, Canberra, 2006), pp 53–84.

86 R Watts, 'States, Provinces, Länder, and Cantons: International Variety among Subnational Constitutions' (2000) *Rutgers Law Journal* 941, at 944.

87 J Roskam, 'Panel Discussion', in Productivity Commission, *Productive Reform in a Federal System* (Roundtable Proceedings, Canberra, 2006), p 327.

88 Business Council of Australia, Submission, Productivity Commission Research Study, *Performance Benchmarking of Australian Business Regulation*, March 2006.



**FIGURE 7 > GROWTH IN COMMONWEALTH PRIMARY LEGISLATION (PAGES)**

While Commonwealth Ministers sometimes claim that people want the Commonwealth involved in areas because it is more competent,<sup>89</sup> the Commonwealth's track record in providing services suggests that big is not always better and that a centralised system does not necessarily result in competence or efficiency. In areas such as defence, where there is no competition from the States, cost over-runs and quality under-runs are prominent, extending to billion-dollar losses on single projects.

#### Defence equipment management<sup>90</sup>

- Collins Class Submarines: \$1 billion cost over-run including new combat systems and repairs.
- Project Bushmaster Infantry Transport: \$170m contract in 1999 for 370 vehicles has escalated to \$329m for 299 vehicles.
- Jindalee Over the Horizon Radar: Four years late and \$500m over budget.
- Amphibious Ships: Four year delay and cost overrun of \$200m for two ships, Manoora and Kanimbla.
- Inshore Minehunter Project: Prototypes costing \$100m built in the 1990s and scrapped.
- Wamira RAAF Trainer: 1980s Australian-designed trainer project costing \$70m scrapped.
- FFG Frigate Upgrade: Cost increase of \$300m and two years late.
- Seasprite Helicopters: 1997 contract for \$667m for 11 helicopters has run six years late to date with 10 helicopters grounded in 2006 despite \$300m cost escalation.

The Commonwealth's administration of immigration detention has also been subjected to mismanagement and incompetence,<sup>91</sup> as has Commonwealth information technology provision<sup>92</sup> and the management of telecommunications and broadband.<sup>93</sup> Serious criticism has been levelled at management of the Commonwealth's funding of regional programs<sup>94</sup> and higher education.<sup>95</sup>

There is the danger that centralism can become a device for accruing power in federal bureaucracies, and the evidence shows that this is not automatically a recipe for superior management and policy development.<sup>96</sup> The alternative is to make better use of our federal system and the advantages that flow from it.

89 S Lewis and M Franklin, 'Public Wants Us In Charge' *The Weekend Australian*, 17–18 February 2007, p 4.

90 P Walters, 'Seasprite headed for junkpile', *The Weekend Australian*, 10–11 February 2007, pp 1–2. See also J Kerin, 'Defence faces \$10b Project Delays', *Australian Financial Review*, 13 March 2007, p 1.

91 M J Palmer, Inquiry into the Circumstances of the Immigration Detention of Cornelia Rau, Report (Commonwealth of Australia, July 2005); Commonwealth Ombudsman, *Immigration Reports Tabled in Parliament and Covering Statement*, 6 December 2005 – 7 February 2007.

92 Australian National Audit Office (ANAO), *The Edge Project*, Audit 40, 2004–05 Performance Audit; ANAO, *Customs' Cargo Management Re-engineering Project*, Audit 24, 2006–07.

93 Australia performs rather poorly in a range of telecommunication infrastructure indicators central to our global economic positioning. For example, Australia ranks 23 out of 32 for OECD country broadband access and stands in stark contrast to like countries such as Canada. See: World Bank, *World Development Indicators*, 2004; OECD, *Communications Outlook*, 2005; and R Haynes, 'Broadband a disgrace: Murdoch', AAR, 15 November 2006.

94 A Mitchell, 'Politics in the Driver's Seat', *The Australian Financial Review*, June 2004.

95 M Corden, 'Australian Universities: Moscow on Molongolo', *Quadrant*, Volume LXIX, Number 11, November 2005, and see [www.australian-universities.com/](http://www.australian-universities.com/) rankings where only between 2 and 6 Australian universities rank in the world's top 100, depending upon the measure used. Contrast the failures of higher education with the success of Australian school students in achieving results well above OECD averages in mathematical and scientific literacy, reading and problem solving: *Program for International Student Assessment, Learning for Tomorrow's World: First Results from PISA*, (OECD, 2003).

96 G Craven, 'Here's an ACT of madness', *The Australian Financial Review*, 16 March 2007, p 82.

### 3.6 FEDERALISM – CONFLICT AND CO-OPERATION

The public impression of federalism, derived from the media, is that it is all about conflict and buck-passing but nothing is ever achieved. This is not the case.

First, the amount of co-operation achieved every day in the federal system is immense: it is just not sufficiently newsworthy. Secondly, where conflict does occur between jurisdictions, it is not necessarily bad. As discussed above, disagreement between jurisdictions on major policy issues can be constructive by ensuring that there is a public debate and that policies are subject to greater scrutiny. Conflict, or even the possibility of conflict, ensures that proposals are measured and well considered, so that they can be publicly defended. Thirdly, while some conflict is negative rather than constructive, and focussed upon passing blame or avoiding responsibility, it tends to be the consequence of the poor implementation of federalism in Australia, rather than the existence of a federal system itself. If the federal system were reformed so that it operated more effectively (see chapter 6), these problems could be largely eliminated.

Co-operation in the federal system occurs on a daily basis. It takes place through co-operative legislative schemes, inter-governmental agreements, the referral of matters by the States to the Commonwealth, the creation of joint administrative or enforcement bodies, the use of Ministerial Councils, and other co-operative schemes such as the joint electoral roll. Co-operation does not necessarily require uniformity or central control of action. A good example of a different type of co-operation is the mutual recognition scheme. Under this scheme, each jurisdiction recognises and accepts the application of the standards for goods and services in the jurisdiction of their origin. If a product is made in Victoria and meets Victorian standards, it may be sold in Queensland without having to meet any different Queensland standards. Similarly, professional or trade qualifications in one jurisdiction are being recognised in the other jurisdictions.<sup>97</sup> The consequence is the creation of national markets without the imposition of uniformity.

Co-operation may also occur amongst States and Territories themselves where there is no need for Commonwealth involvement. For example, on 13 October 2006, the States and Territories entered into an agreement on the harmonisation of key areas of workers' compensation and occupational health and safety arrangements. They also committed to the future harmonisation of regulatory regimes for teacher registration and the administration of payroll tax.

Major reforms to Australia's economy in the last two decades have been achieved by inter-governmental negotiation and co-operation through COAG and the Special Premiers' Conferences, not by High Court decisions or the use of Commonwealth financial power.<sup>98</sup> The fundamental reshaping of the Australian economy<sup>99</sup> and the consequent prosperity achieved in Australia was not the work of the Commonwealth Government alone, but the consequence of State, Territory and Commonwealth co-operation in the development and implementation of the National Competition Policy (NCP), amongst other reforms.

97 The Council for the Australian Federation agreed to expand the recognised trade qualifications at its meeting on 9 February 2007.

98 Victoria, Federal-State Relations Committee, *Australian Federalism: The Role of the States* (2nd Report on the Inquiry into Overlap and Duplication, October 1998), para 3.19.

99 M Keating, 'Performance and Independence: economic policy', in M Keating and G Davis, *The Future of Governance* (Allen and Unwin, Sydney, 2000), Chapter 2.

## National Competition Policy

The success of the NCP was based on three factors:

- 1 **agreement** – it was a co-operative venture, with all governments agreeing on the aims and the means of achieving them from the start;
- 2 **structure** – an independent body, the National Competition Council (NCC), was established to monitor, assess and report on reforms; and
- 3 **sharing the benefits** – the financial benefits of reform did not just flow back to the Commonwealth through income tax, but were shared with the States through NCP payments, giving them the incentive to continue with reform.

The political pain of implementing the NCP, particularly for the States, was great. Some even attributed the Coalition's loss of government in Western Australia to the NCP.<sup>100</sup> Had the NCP been the subject of coercion, rather than agreement, or had there been no independent body to impose rigour, or no sharing in the rewards, the process would most likely have failed.

Hollander has argued that the NCP approach 'enabled the commonwealth to pull the states into line in a way which tied grants did not'.<sup>101</sup> However, it was not a case of the Commonwealth pulling the States into line, but rather one of mutual agreement about what needed to be achieved and the best way of doing it.

In fact, it was the Commonwealth, rather than the States, that proved most reluctant to meet its NCP commitments. In 2003, the NCC accused the Commonwealth of setting a 'poor example' for the States and Territories in its progress in the review and reform of its legislation. For example, it had failed to reassess the Australian Wheat Board's monopoly on wheat exports, despite findings that it was not in the public interest. The NCC concluded that 'compared to other jurisdictions, the Commonwealth's performance was well below average and not commensurate with its leadership role...'.<sup>102</sup> In 2005, only 64 per cent of the Commonwealth's priority legislation complied with NCP, compared with 88 per cent for NSW, 85 per cent for Queensland and 84 per cent for Victoria and Tasmania.<sup>103</sup>

Despite the difficulties, the NCP achieved a great deal of necessary reform and is a good example of co-operative, rather than coercive or opportunistic, federalism. According to the Productivity Commission the actual realised benefits from NCP reforms for the utilities, transport and telecommunications sectors alone represented 2.5 per cent of GDP (\$20 billion) by the year 2000.<sup>104</sup>

Co-operative federalism is not always effective. Better institutional mechanisms are needed to enhance co-operation and ensure that it is not bogged down by delay and neglect. Regular meetings of inter-governmental bodies, such as COAG, that are not within the control of any one jurisdiction, would ensure that co-operative work proceeds regardless of the politics of the day. It is also important that there be a professional and independent assessor of progress. Indeed, increased policy review capacity is essential for effective ongoing reform in Australia.<sup>105</sup> This capacity has been run down.<sup>106</sup>

Clearly, co-operation, while a significant element of our federal system, cannot always achieve the best outcomes. That is why competition remains important, as does a better allocation of functions between the Commonwealth and the States to maximise competition and avoid unnecessary overlap of functions.

100 R Hollander, 'National Competition Policy, Regulatory Reform & Australian Federalism' (June 2006) 65(2) *Australian Journal of Public Administration* 33, at 38.

101 R Hollander, 'National Competition Policy, Regulatory Reform & Australian Federalism' (June 2006) 65(2) *Australian Journal of Public Administration* 33, at 44.

102 National Competition Council, *Assessment of governments' progress in implementing the National Competition Policy and related reforms: 2003*, Volume 1 (AusInfo, Canberra, August 2003), para 4.15.

103 National Competition Commission, *Assessment of Governments' Progress in Implementing the National Competition Policy and Related Reforms: 2005*, pp xxii, xxvii, xxxiv.

104 Productivity Commission, *Review of National Competition Policy Reforms*, Report No 33, Inquiry Report, April 2005.

105 G Banks, *Regulation for Australia's Federation in the 21st Century*, paper presented to the 2006 Melbourne Institute/The Australian Social and Economic Outlook Conference, 2–3 November 2006.

106 L McIntosh, 'Independent public policy research in partisan times', *Canberra Times*, 6 March 2007.

### 3.7 FEDERALISM AND THE GST

The argument is often made that the States, despite having been given financial security through the revenue from the GST, have failed to fulfil their responsibilities, so the Commonwealth is obliged to intervene and assume or oversee State responsibilities in the interests of the Australian people.<sup>107</sup>


The impression is often given that the GST funds were granted in addition to existing State funding, providing the States with a great windfall. In fact, the GST was designed to replace a range of existing State taxes plus the former general Financial Assistance Grants from the Commonwealth. The States remain reliant on the Commonwealth for substantial continuing funding through Specific Purpose Payments (SPPs). The ability of the States to raise their own revenue has been reduced by the requirement that States abolish certain types of State taxes. The Commonwealth remains in full and effective control of the amount of funding received by the States, because it can reduce the amount of new SPPs at its discretion as the amount of GST transfers grow.

Moreover, if one takes into account the abolition of State taxes required by the GST inter-governmental agreement, the grants received by the States from the Commonwealth in 2006 amount to 5.5 per cent of GDP – exactly the same percentage as in 1996. Indeed, the (net) payments to the States over the entire post-GST period remain at levels below the pre-GST average of 6 per cent of GDP for the whole period of the 1980s and 1990s.<sup>108</sup> During the same period, the Commonwealth's revenue rose by a further 2 per cent to 20 per cent of GDP. This is a \$20 billion windfall for the Commonwealth well ahead of State and Territory gains both absolutely and proportionately.

Therefore, it cannot sensibly be argued that the States are now 'financially independent' because they receive funding from GST revenue. If the Commonwealth had been serious about giving the States fiscal autonomy, it would have ensured that the States had access to revenue that covered, and eventually exceeded, the loss of State taxes plus the combination of Financial Assistance Grants and the SPPs. It did not do so. Instead, it ensured that the States remained dependent upon Commonwealth funding. It is disingenuous to suggest that the States are failing in their responsibilities because they require Commonwealth funding and that the Commonwealth should therefore take over State policy functions, when this is the system that the Commonwealth deliberately created.

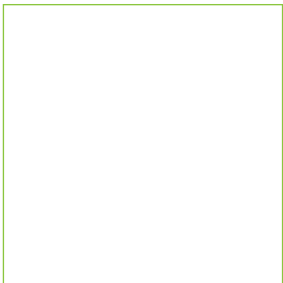
<sup>107</sup> J Howard, 'Reflections on Australian Federalism', Address to the Menzies Research Centre, Melbourne, 11 April 2005, pp 3–4; T Abbott, 'Responsible Federalism' in V Hudson and A J Brown, *Restructuring Australia* (Federation Press, Sydney, 2004) 183 at 190–1; T Abbott, 'A Conservative Case for Centralism', *the conservative*, Issue 1, September 2005, 4, at 4–5; S Santoro, 'In Defence of Federalism' in *the conservative*, Issue 1, September 2005, 6 at 7 and 12; and M Davis, 'Costello berates states over failure of federalism', *The Australian Financial Review*, 28 June 2006, p 1.

<sup>108</sup> R Roberston, *The Facts Missing from Debate on Federal/State Financial Relations*, Macquarie Bank Research Bulletin, 4 July 2006. (There was however an increase in the State share of GDP received from the Commonwealth with GST introduction compared to the very lean years immediately preceding the GST.)



Too often, Commonwealth arguments for taking over State responsibilities boil down to the fact that the Commonwealth has the money to fund necessary reforms while the States do not, rather than questions about which level of government has the greater expertise or skills or is most appropriate to fulfil those responsibilities. For example, the Commonwealth's claim to manage the Murray–Darling Basin seems to be based more on its ability to fund the buy-back of existing water rights than on any superior management capacity. The Commonwealth has been involved in the management of the Murray–Darling Basin since the negotiation of the first Murray–Darling Basin Agreement in 1914, and remains a party to the more recent 1993 Agreement.<sup>109</sup> Commonwealth Ministers chair the Ministerial Council on the Murray–Darling Basin and the Commonwealth and the participating States each appoint representatives to the Murray–Darling Basin Commission, which manages the Basin and water allocations. Responsibility for any inadequacy in the management of the Murray–Darling Basin in the past must be borne by the Commonwealth as well as the participating States.

A better approach to federal–State financial relations would be to ensure that the States either have the capacity to raise their own funds, or receive a sufficient share of overall tax revenue, to allow them to fulfil their responsibilities. Only then, if they failed to do so, ought a question arise as to whether the Commonwealth could do better.



<sup>109</sup> Murray–Darling Basin Agreement 1993 (as amended in 2002), in Schedules 1 and 2 of *Murray–Darling Basin Act 1993* (Cth).



# THE STATE OF PLAY IN AUSTRALIA

The Productivity Commission has noted that the most distinctive features of Australia's federal system include:

- a relatively high degree of shared functions;
- a strong centralising trend over time;
- a relatively high degree of vertical fiscal imbalance; and
- innovative initiatives in co-operative federalism.<sup>110</sup>

The recent history of federalism in Australia brings all these elements into play. On the one hand, there have been significant advances in co-operative federalism through the Special Premiers' Conferences, COAG and the Council for the Australian Federation. This has been possible because of the high degree of shared functions between the Commonwealth and the States. At the same time, the cause of centralism has been advanced by High Court decisions and the effects of vertical fiscal imbalance. This has resulted in a recent move away from co-operative federalism to the current state of 'opportunistic federalism', where the Commonwealth picks and chooses State issues upon which to intervene for political purposes, undermining the federal system as a whole.

## 4.1 COAG TRENDS AND HISTORY

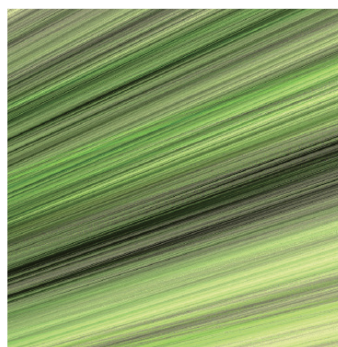
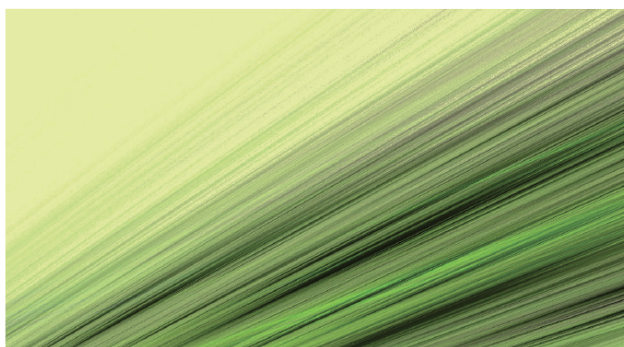
In 1990 the Prime Minister, Bob Hawke, launched a 'new federalism' initiative aimed at achieving microeconomic reform through national co-operation. The initiative commenced with a Special Premiers' Conference in Brisbane in October 1990. The intention was to avoid the acrimony of financial Premiers' Conferences and concentrate on substantial reforms in a co-operative manner.

In November 1991, Premiers and Chief Ministers adopted four principles to guide a review of Commonwealth, State and Territory roles and responsibilities. The first recognised Australia's nationhood and the importance of working co-operatively to ensure that national interests are resolved in the interests of Australia as a whole. The second was the subsidiarity principle, that 'responsibilities for regulation and for allocation of public goods and services should be devolved to the maximum extent possible consistent with the national interest, so that government is accessible and accountable to those affected by its decisions'. The third principle concerned structural efficiency and the need for increased flexibility and competitiveness in the Australian economy, and the fourth concerned the accountability of government to the electorate.<sup>111</sup>

After two special Premiers' Conferences, the process was formalised by the establishment of the Council of Australian Governments (COAG) in May 1992.

<sup>110</sup> J Pincus, 'Productive Reform in a Federal System', in Productivity Commission, *Productive Reform in a Federal System* (Roundtable Proceedings, Canberra, 2006), p 25, at 30.

<sup>111</sup> M Keating and J Wanna, 'Remaking federalism?' in M Keating, J Wanna and P Weller (eds), *Institutions on the Edge?* (Allen & Unwin, 2000), p 136.



COAG achieved a significant number of inter-governmental agreements relatively quickly on subjects such as 'road transport, competition policy, non-bank financial institutions, environmental policy, food standards and mutual recognition'.<sup>112</sup> However, COAG has not always proved an effective co-operative forum. In 2003 the Premiers walked out of COAG, claiming that the Commonwealth was dictating to, rather than negotiating and acting in partnership with, the States, in relation to health funding.

Despite the difficulties of maintaining co-operation, COAG has been largely successful. The most notable COAG success was implementing the National Competition Policy, which commenced in 1995 (see section 3.6). National Competition Policy (NCP) has been described as a 'landmark achievement in nationally coordinated economic reform'.<sup>113</sup>

A decade after the NCP agreement, the Victorian Premier, Steve Bracks, argued that 'a third wave of reform' was needed. The first wave of reform was the opening up of the economy in the 1980s when the dollar was floated, financial markets were deregulated and tariff barriers effectively ended.<sup>114</sup> The second wave, in the 1990s, was National Competition Policy, which focussed on competition and improving the efficiency of infrastructure services and labour markets.

The Premier argued that a third wave of reform was needed to respond to international competition from emerging nations such as India and China and to the consequences of an ageing population. The primary focus of the reforms would be improving the nation's competitive capabilities through the better use of human capital (including reforming health and education to remove barriers to participation in the workforce) and reforms to business regulation and infrastructure provision.<sup>115</sup>

The Victorian Premier also proposed a renewal of 'collaborative federalism', with an independent body established to assess, report on and financially reward the reforms achieved. The aim was to create a culture of continuous improvement.<sup>116</sup> In February 2006, COAG agreed to the new National Reform Agenda (NRA), including the creation of an independent COAG Reform Council and the linking of new Commonwealth funding to reform.

Keating and Wanna have viewed the COAG process as developing a more co-operative institutional relationship than any version of 'new federalism' proposed by the Commonwealth alone. They observed:

**Under the COAG process, there was recognition of the need to facilitate agreement on policy frameworks of joint interest. Not only were the states recognised as significant players whose policy input was crucial, but the Commonwealth also accepted that policy by unilateral decree was ineffective and that it had to work through the states to achieve many of its policy goals.<sup>117</sup>**

112 M Edwards and A Henderson, 'Council of Australian Governments – A Vehicle for Reform' in P Carroll and M Painter (eds) *Microeconomic Reform and Federalism* (Federalism Research Centre, ANU, 1995), p 27.

113 J Pincus, 'Productive Reform in a Federal System', in Productivity Commission, *Productive Reform in a Federal System* (Roundtable Proceedings, Canberra, 2006), p 25, at 41.

114 R Glover, 'Collaborative Federalism: Getting More from the Competition of Ideas' (April 2006) *Public Administration Today* 4.

115 *A Third Wave of National Reform – A New National Reform Initiative for COAG* (Department of Premier and Cabinet, Victoria, August 2005), pp 30-9.

116 R Glover, 'Collaborative Federalism: Getting More from the Competition of Ideas', (April 2006) *Public Administration Today* 4, at 6.

117 M Keating and J Wanna, 'Remaking federalism?' in M Keating, J Wanna and P Weller (eds), *Institutions on the Edge?* (Allen & Unwin, 2000), pp 152-3.

## 4.2 COUNCIL FOR THE AUSTRALIAN FEDERATION

The Council for the Australian Federation was formed on 13 October 2006 to ensure better co-operation amongst the States and Territories and to give them a united voice in their dealings with the Commonwealth. The Council is intended to act as a 'strategic body that can help shape and set the national policy agenda'.<sup>118</sup>

### Council for the Australian Federation

The Council comprises the Premiers and Chief Ministers of all States and Territories and will meet regularly. The Founding Agreement of the Council recites that the objectives of the Council are:

- to provide leadership on and promote innovative solutions to matters important to Australians;
- to promote constructive engagement with the Commonwealth Government and Parliament on matters of national interest;
- to promote and communicate to the Australian people the benefits of Australia's federal system in providing a diversity of policy options;
- to complement the work of the Council of Australian Governments and facilitate COAG-based agreements with the Commonwealth by working towards a common position among the States and Territories; and
- to reach, where appropriate, collaborative agreements on cross-jurisdictional issues where a Commonwealth imprimatur is unnecessary or has not been forthcoming.

To achieve these objectives, the Council intends to seek opportunities for greater consistency and harmonisation of State and Territory laws and practices, take measures to improve coordination with the Commonwealth, and identify and share information on 'best practice' innovations.<sup>119</sup>

The Council states that it does not intend to compete with, or substitute for, COAG. On the contrary, much of its work is intended to complement that of COAG by preparing the ground with joint State–Territory agreement. However, the States and Territories had also become concerned that the Commonwealth had been 'dictating the COAG agenda and undermining co-operation between the States'.<sup>120</sup> The Commonwealth had refused to include matters on the COAG agenda that the States and Territories considered important areas for co-operation.

The establishment of the Council for the Australian Federation provides a forum for those matters to be addressed and for reform to be pursued outside COAG, if necessary.<sup>121</sup> Similar bodies exist in Switzerland (the Conference of Cantonal Governments)<sup>122</sup> and Canada (the Council of the Federation).

At its first meeting, the Council for the Australian Federation stressed the importance of co-operation in the face of increasing global competition, particularly from China and India. It noted the importance of collaborative action to implement the National Reform Agenda and expressed concern at the Commonwealth's unilateral approach to initiatives, particularly in the areas of skills and vocational education and training, that need to be developed in a co-operative and coordinated manner. The Council was also concerned that some co-operative exercises, such as the National Water Initiative and the establishment of the National Water Commission, had lost their co-operative spirit and had become tools for unilateral Commonwealth action.<sup>123</sup>

<sup>118</sup> Council for the Australian Federation, Communiqué, 13 October 2006.

<sup>119</sup> Council for the Australian Federation, Communiqué, 13 October 2006.

<sup>120</sup> D Hughes and S Scott, 'States snub PM with federation forum', *The Australian Financial Review*, 12 October 2006, p 4.

<sup>121</sup> M Ludlow and S Scott, 'States' council idea a waste of money', *The Australian Financial Review*, 22 July 2006, p 5.

<sup>122</sup> C Braun, 'The importance of horizontal and vertical collaboration within the Swiss federal State from the perspective of the Cantons' (2006) 5(2) *Federations* 23.

<sup>123</sup> Council for the Australian Federation, Communiqué, 13 October 2006.



At its second meeting on 9 February 2007, the Council:

- addressed important issues such as water reform and drought;
- agreed upon the development of national principles and best-practice guidelines for urban water planning;
- signed a declaration on climate change;
- agreed to implement an emissions trading system by 2010 if the Commonwealth did not take earlier action to do so;
- endorsed new principles to guide continuing health care reform;
- reaffirmed its commitment to the National Reform Agenda and called for an equal partnership between Commonwealth, State and Territory governments that would provide for the fair sharing of costs and benefits; and
- considered the implementation of measures in response to the High Court's judgment in *NSW v Commonwealth* concerning the validity of the Work Choices legislation.<sup>124</sup>

### 4.3 THE LONG TERM IMPACT OF *NSW V COMMONWEALTH*

One of the main sources of centralism in the Australian federation has been the High Court of Australia. The Court's judgments have ended the notion of State reserved powers and State immunity from Commonwealth action, increased Commonwealth financial dominance in the areas of income tax and excise, and expanded Commonwealth legislative power through a broad interpretation of the external affairs power and the corporations power.

The High Court's decision in *New South Wales v Commonwealth* in November 2006 expanded the application of the Commonwealth's power to make laws with respect to certain types of corporations into the field of industrial relations and beyond.

The Constitution expressly deals with industrial relations in s 51(xxxv), granting the Commonwealth Parliament power to enact laws with respect to conciliation and arbitration for the prevention and settlement of industrial disputes extending beyond the limits of any one State. This meant that for over a century Commonwealth laws could only apply to industrial disputes if there were an 'inter-state' element (even though a 'paper dispute' would suffice), and that the Commonwealth was confined to using 'conciliation and arbitration' to deal with such problems.

Section 51(xx) of the Constitution also gives the Commonwealth Parliament power to enact laws with respect to 'foreign corporations and trading or financial corporations' (known as 'constitutional corporations') formed within the limits of the Commonwealth. In the past, this power had been given a limited application. The question in *New South Wales v The Commonwealth* was whether this head of power could be interpreted so widely that it included a power to make laws with respect to the relationship between constitutional corporations and their employees, including industrial relations, regardless of the constraints in s 51(xxxv).

A majority of the High Court took this broad view of the corporations power, with the result that the Commonwealth Parliament can now legislate to enact laws concerning not only the activities of constitutional corporations, but also their relationships with others, be they employees, sub-contractors or those who purchase their goods or services.

<sup>124</sup> Council for the Australian Federation, Communiqué, 9 February 2007.

In doing so, the majority held that the starting point for constitutional interpretation should be the words of the Constitution rather than the federal structure it created and the intended role of the States within that structure.<sup>125</sup> The majority rejected an argument that the corporations power be construed in the context of the federal balance,<sup>126</sup> concluding that the power of a State body to determine industrial matters is not so vital to the functioning of the State as to affect its capacity to operate as a government or exercise constitutional functions.<sup>127</sup>

In his dissenting judgment, Justice Callinan described *New South Wales v The Commonwealth* as 'one of the most important cases with respect to the relationship between the Commonwealth and the States to come before the Court in all of the years of its existence'. He was concerned about the far-reaching consequences for the 'future integrity of the federation as a federation and the existence and powers of the States'.<sup>128</sup>

The significance of this case for the federal system is twofold. First, the High Court has made clear its intent to give full breadth to Commonwealth legislative powers, regardless of the original intent of the framers of the Constitution or federal implications drawn from the structure and text of the Constitution. The protection previously afforded by the High Court against Commonwealth laws affecting the capacity of the States to continue to function as independent governments and exercise their constitutional powers is likely to be applied only in the most extreme of cases.

Secondly, this judgment significantly expands the legislative power of the Commonwealth Parliament, despite the Australian people having rejected such an expansion at four previous referenda.<sup>129</sup>

In his dissenting judgment, Justice Kirby noted that the majority's interpretation of this power would allow the Commonwealth to legislate with respect to traditional State areas such as education (regarding corporatised universities, colleges and private schools), health care (regarding corporatised hospitals, clinics, hospices, pathology providers and medical practices), and other corporate bodies that provide services in the areas of town planning, local transport, energy, environmental protection, land and water conservation, agriculture, and corrective services, amongst others.<sup>130</sup> The Federal Minister for Health and Ageing, Tony Abbott, has suggested that the federal government 'could use the corporations power to regulate workers' compensation and occupational health and safety arrangements' amongst other things.<sup>131</sup>

However, the Commonwealth will still not have complete power with respect to corporations. Section 51 (xx) only applies to trading, financial or foreign corporations. Whether or not a corporation is a 'trading' corporation will depend upon an analysis of whether trading forms a substantial part of its activities. Mere provision of education or health services may not be enough to constitute substantial trading, although the other activities of such bodies-corporate might. For example, the University of Western Australia has been held to be a trading corporation because of its activities in the buying, selling and renting of property, investment and the sale of publications and services, rather than its role in providing education.<sup>132</sup>

By 'strip-mining the Constitution',<sup>133</sup> Commonwealth laws can now cover most, but not all, corporations: they will still not apply to unincorporated businesses or organisations. For example, the Commonwealth's industrial relations laws are expected to cover up to 85 per cent of workers. The result is the continuation of patchwork legislative coverage that cannot completely cover an area without State co-operation. This does not necessarily 'improve' federalism by reallocating powers. Rather, it is likely to exacerbate the problems of federalism by requiring continued duplication while removing the incentive for either the Commonwealth or the States to co-operate.

125 (2006) 81 ALJR 34, per Gleeson CJ, Gummow, Hayne, Heydon and Crennan JJ at [191] – [194].

126 (2006) 81 ALJR 34, at [183] and [196].

127 (2006) 81 ALJR 34, at [392].

128 (2006) 81 ALJR 34, per Callinan J at [619].

129 See the referenda of 1911, 1912, 1926 and 1946 discussed in (2006) 81 ALJR 34, per Callinan J at [709] – [733].

130 (2006) 81 ALJR 34, per Kirby J at [539].

131 T Abbott, 'Responsible Federalism' in W Hudson and A J Brown, *Restructuring Australia* (Federation Press, Sydney, 2004), 183, at 191.

132 *Quickenden v O'Connor* (2001) 109 FCR 243.

133 (2006) 81 ALJR 34, per Callinan J at [676].

#### 4.4 OPPORTUNISTIC FEDERALISM

Justice Kirby has described the outcome of *New South Wales v Commonwealth* as creating a form of 'optional or opportunistic federalism'.<sup>134</sup> He saw it as contrary to the text, structure and design of the Constitution for the States to be reduced, in effect, to service agencies of the Commonwealth.<sup>135</sup>

A similar argument has been made by Conlan about federalism in the United States. He described 'opportunistic federalism' as arising where policy-makers seek to achieve their political and policy goals regardless of the traditional boundaries of behaviour and institutional responsibility. He pointed to federal intervention during the Clinton era on symbolic issues, such as school uniforms, and regarded the Bush administration as even more dismissive of co-operation and traditional responsibilities in the federal system. Conlan concluded:

**Behind the occasional shroud of states rights rhetoric, both libertarian and social conservatives have proved increasingly willing to sacrifice the traditional conservative's preference for institutional deference and limited federal role in favor of promoting their own view of the public good on a national scale – through privatisation, preemption, or the mandating of conservative social values.<sup>136</sup>**

Opportunistic federalism has come at a cost in the United States. The degrading of co-operative relations and the deinstitutionalisation of intergovernmental management was regarded by Conlan as being in large part the cause for the 'miserable response' to Hurricane Katrina.<sup>137</sup>

In Australia there has been a distinct shift at the Commonwealth level to opportunistic federalism. As in the United States, it can be seen in funding for core State functions becoming dependent upon politically symbolic matters, such as making schools funding dependent upon the existence of functioning flagpoles. The Commonwealth funding for school chaplains in competition with school counsellors is another example. Neither flagpoles nor chaplains are self-evidently matters that require the involvement of a national government. Under the principle of subsidiarity, such issues should be allocated to a level of government closer to the people.

Some conservatives, who have traditionally supported the federal system, with its division of powers, checks and balances and smaller governments, have supported the move to centralism by arguing that Commonwealth interference in State functions gives greater liberty and freedom of choice to citizens.<sup>138</sup> The Prime Minister, John Howard, has argued that:

**The desire to have a more national system of industrial relations is driven by our wish that as many businesses and employees as possible have the freedom, the flexibility and the individual choice which is characteristic of the Government's philosophy in the area of workplace relations.... In this area the goal is to free the individual, and not to trample on the States.<sup>139</sup>**

However, other conservatives have argued that by establishing one central industrial relations system that covers the vast majority of the population, and effectively removes competing systems, a choice of systems is removed. Moreover, there is a significant risk that future Commonwealth Parliaments may remove those elements that the Prime Minister regards as giving 'choice'.<sup>140</sup> This is a classic case of 'opportunistic' federalism, where the very structures of federalism that were designed to give choice are destroyed to achieve a particular ideological end, which is itself unlikely to be sustained.<sup>141</sup>

Under 'opportunistic' federalism, the long-term structural damage to choice and diversity is likely to far exceed any short-term choices provided for in a particular policy. Freedom is better protected by a system that divides power and gives diversity and choice, rather than a centralised system that would allow power to be exercised in an oppressive manner in the future.

134 (2006) 81 ALJR 34, per Kirby J at [543].

135 (2006) 81 ALJR 34, per Kirby J at [549]. See also per Callinan J at [779].

136 T Conlan, 'From Cooperative to Opportunistic Federalism' (2006) *Public Administration Review* 663, at 671.

137 T Conlan, 'From Cooperative to Opportunistic Federalism' (2006) *Public Administration Review* 663 at 674; and D Wright, 'How did intergovernmental relations fail in the USA after Hurricane Katrina?' (2005) 5(1) *Federations* 11.

138 J Howard, 'Reflections on Australian Federalism', Address to the Menzies Research Centre, Melbourne, 11 April 2005, p 2; and S Santoro, 'In Defence of Federalism' in *the conservative*, Issue 1, September 2005, 6 at 8.

139 J Howard, 'Reflections on Australian Federalism', Address to the Menzies Research Centre, Melbourne, 11 April 2005, p 2.

140 J Roskam, 'Federalism and the Liberal Party' in *Upholding the Australian Constitution*, Vol 18, (2006) p 369.

141 D Peetz, 'The gap between work and choices', *Griffith Review*, 15, Autumn 2007, pp 153–166.

#### 4.5 FISCAL FEDERALISM

Fiscal federalism in Australia has been marked by the progressive concentration of financial power in the hands of the Commonwealth and the reduction in the capacity of the States to raise sufficient revenue to fund their spending responsibilities.<sup>142</sup>

The financial system established by the framers of the Constitution gave the Commonwealth (in s 90) exclusive power to levy excises – a significant source of tax revenue at the time. This meant that, from the beginning of federation, the Commonwealth had greater revenue than the States, but fewer spending responsibilities. To remedy this imbalance, s 94 of the Constitution provided for the Commonwealth's surplus revenue to be paid monthly to the States. This obligation was swiftly avoided by the Commonwealth appropriating all its surplus revenue to trust funds to ensure that there was never any 'surplus' to be distributed. The High Court held in 1908 that this avoidance mechanism was valid.<sup>143</sup> It continues to be exercised today.

The effectiveness of s 94 was also predicated upon the requirement in s 81 of the Constitution that the Commonwealth only appropriate money from its Consolidated Revenue Fund for 'the purposes of the Commonwealth'. As the Commonwealth's powers, and hence its expenditure responsibilities, were limited, this would have left a significant surplus for the States to receive. However, the Commonwealth has argued, and the High Court seems to have accepted<sup>144</sup> (although the authority is equivocal), that the Commonwealth can appropriate money from the Consolidated Revenue Fund for any purpose it sees fit, regardless of whether it comes within Commonwealth legislative power or not.

The High Court also interpreted widely the power in s 96 of the Constitution for the Commonwealth to make grants to the States that are tied to whatever conditions the Commonwealth seeks to impose.<sup>145</sup> Again, those conditions are not required to relate to Commonwealth legislative powers.

During World War II, the Commonwealth obtained effective control over income tax as an emergency measure. Income tax overtook excise as the dominant source of revenue-raising. After the War, the Commonwealth declined to surrender its dominance of income tax. Again, the High Court upheld its power to do so.<sup>146</sup>

One of the few effective sources of revenue-raising left to the States was the business franchise fees it imposed with respect to tobacco, liquor and petroleum. Although the validity of such fees was upheld by the High Court in a series of cases from 1960 onwards, the High Court held in 1997 that they amounted to excises and were therefore within the exclusive legislative power of the Commonwealth.<sup>147</sup> This cost the States approximately \$5 billion per year in own-source revenue.

142 For a summary of the history of Commonwealth–State financial relations, see: Western Australia, Department of Treasury and Finance, *Discussion Paper on Commonwealth–State Financial Relations* (April 2006), Appendix 1, p 53; and N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements* (Final Report, May 2006), p 150.


143 *New South Wales v The Commonwealth* (1908) 7 CLR 179.

144 *Attorney-General (Vic); Ex rel Dale v Commonwealth* (1945) 71 CLR 237; and *Victoria v Commonwealth and Hayden* (1975) 134 CLR 338.

145 *Victoria v Commonwealth* (1926) 38 CLR 399.


146 *South Australia v Commonwealth* (1942) 65 CLR 373; and *Victoria v Commonwealth* (1957) 99 CLR 575.

147 *Ha v New South Wales* (1997) 189 CLR 465.



The revenue from the GST was intended to substitute for the lost franchise fees as well as replace Commonwealth Financial Assistance Grants to the States. However, the 1999 GST inter-governmental agreement required that certain State taxes also be abolished and that others be reviewed in the future.<sup>148</sup> This further reduced the capacity of the States to raise their own taxes.

The States now receive Commonwealth funding from two main sources. GST revenue is paid to the States according to a formula applied by the Commonwealth Grants Commission aimed at producing 'horizontal fiscal equity' across the jurisdictions. The intention is to ensure that the less-well-off States can provide services at an equivalent level to the more populous States. The other main source of revenue is Specific Purpose Payments (SPPs). These payments are tied to conditions imposed by the Commonwealth. In this way, the Commonwealth can dictate aspects of State policy. In 2006, SPPs amounted to approximately 42 per cent of the total payments made by the Commonwealth to the States.<sup>149</sup>



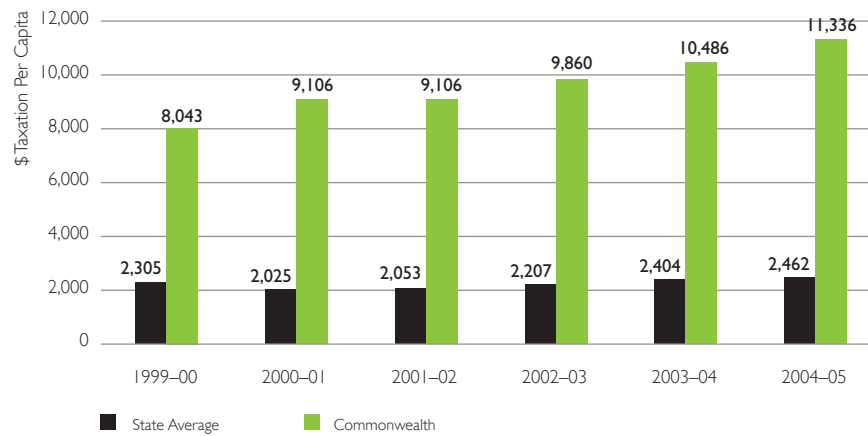
The product of these changes is a fiscal system characterised by substantial imbalance in revenue collection between the Commonwealth and the States, plus substantial imbalance between the Commonwealth and the States in spending, which together are termed Vertical Fiscal Imbalance (VFI). There is, however, a substantial degree of equalisation across the jurisdictions in the distribution of Commonwealth grants, termed Horizontal Fiscal Equalisation (HFE). As explained in section 3.7, the GST has not diminished these characteristics; instead, it has accentuated them.

<sup>148</sup> *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations, 1999*, as enacted in Commonwealth, State and Territory legislation.

<sup>149</sup> Allen Consulting Group, *Governments Working Together? Assessing Specific Purpose Payment Arrangements*, Report to the Government of Victoria (June 2006), p 20.

The position over the last five years is set out in Figure 8, which shows the Australian Bureau of Statistics' calculation of State and Commonwealth taxation on a per capita basis. Commonwealth taxation per capita has risen by 41 per cent over the period, as opposed to a 7 per cent increase for the States.<sup>150</sup>

**FIGURE 8 > TAXATION PER CAPITA: COMMONWEALTH AND STATES, 2000–05**



The outcome in 2005, the last year for which official ABS data has been published, is that the Commonwealth directly collects 82 per cent of taxes in Australia. The Commonwealth then transfers 27 percentage points of its collected taxes to the States and Territories, with 16 percentage points of this transfer being GST and 11 percentage points being SPPs.<sup>151</sup> So, of the Commonwealth tax take of \$11,336 per capita, \$3,060 goes to States and Territories. Of this, \$1,813 is GST and \$1,247 are SPPs. The remaining \$8,275 is retained by the Commonwealth. Another way of expressing this is to say that the States and Territories raise 19 per cent of government taxes themselves, but undertake 40 per cent of public spending in Australia. The difference between own-taxes and own-purpose spending is the measure of VFI, which represents some 5 per cent of Australia's now trillion-dollar economy.

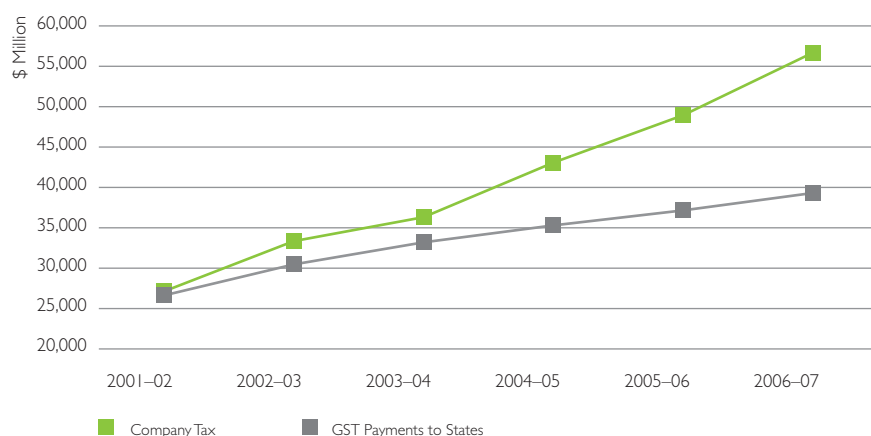
Strong sustained economic growth and Commonwealth control over income and corporate tax have combined to deliver a windfall gain for the Commonwealth in recent years. This has allowed the Commonwealth to adjust statutory tax rates down, while still growing its own revenue receipts faster than the States and claiming to be a benefactor for the States. The benefit to the Commonwealth is apparent in Figure 9, which shows past and projected growth in company tax receipts for the Commonwealth as opposed to the growth of the GST receipts provided for the States and Territories.<sup>152</sup> Total company taxes have grown by 109 per cent over five years while the GST has grown by 48 per cent.

<sup>150</sup> Australian Bureau of Statistics, *Taxation Revenue, 2004–05*, 5506.0.

<sup>151</sup> There are classification problems in arriving at this precise figure depending upon how 'untied grants' are classified (such as First Home Owners Grants), whether capital spending is included and how 'bypass' federal expenditure is classified (such as grants direct to local government or private schools).

<sup>152</sup> Commonwealth Treasury, *Mid Year Economic Fiscal Outlook 2006–07*, (Treasury, Canberra, 2006).

**FIGURE 9 > COMPANY TAX AND GST GROWTH, AUSTRALIA, 2002–07 (\$M)**



A problem with this situation is that the particular service delivery functions of the States and Territories mean that their costs are likely to rise faster than those of the Commonwealth for basic economic reasons beyond issues of good management.

This is because it is harder to enhance productivity in service functions provided by the States, which involve direct personal delivery, than it is in Commonwealth functions, such as tax collection and social service disbursement, which are IT-intensive rather than labour intensive.<sup>153</sup> When this pressure on State unit costs is combined with growth in the scale of activity required in these service areas, the cost pressure on States and Territories is dramatic. For example: prison populations have been growing at 4 per cent per annum, acute-care hospital activity at 8 per cent per annum and children in care notifications at 15 per cent per annum over recent years.<sup>154</sup>

Therefore, the States need a greater share of revenue over time to support their functions, but it is the Commonwealth's revenue share of GDP that has been growing – allowing debt retirement and tax rate cuts, while still supporting Commonwealth expenditure obligations and new spending initiatives. This allows claims of good economic management to be made, although these claims owe much to the legacy of earlier bold economic reform,<sup>155</sup> including co-operative reforms undertaken by the States, recent Chinese economic growth, and Reserve Bank independence and good judgement in interest rate determination.

Some VFI is not unusual in a federation. However, its extent in Australia is the most extreme of any federation in the industrial world. Figure 10 shows VFI across the 1990s in five major federations for which comparable data are available.<sup>156</sup> Australia had the lowest share of State and local own-purpose spending, the lowest share of State and local own-revenue, and the largest relative gap between these two. Vertical fiscal imbalance is shown in the height difference between the columns for own-revenue and own-purpose spending for each country. The height of the columns (especially the own-revenue column) further indicates the degree of fiscal decentralisation. The higher the column the more decentralised the system, all else being equal.

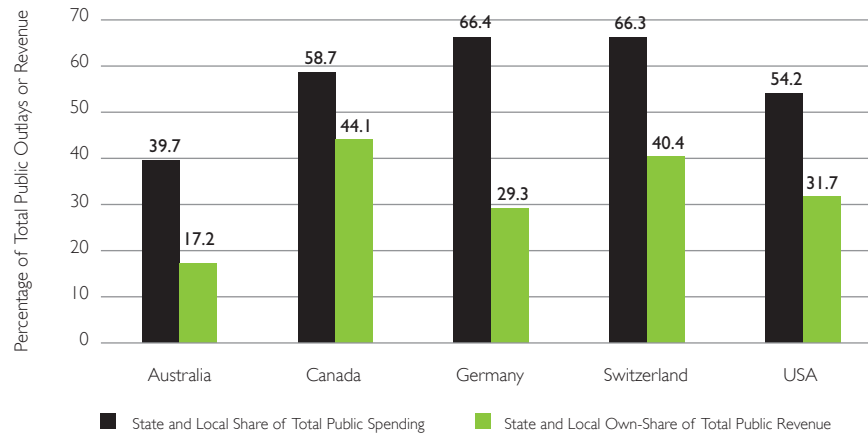
153 W Baumol, *Economic Dynamics* (Macmillan, London, 1970), Chapter 18.

154 Productivity Commission, *Report on Government Services 2007* (Productivity Commission, Canberra, January 2007) and earlier years.

155 The benefits of structural reform can be slow to emerge but can continue across several decades or more. N Ferry, *Tariffs and Economic Growth* (EPAC, Canberra, 1996).

156 OECD, *Revenue Statistics*, various; IMF, *Government Finance Statistics Yearbook*, various. Australia's position would look worse if GST were not included as a State tax, as it is here in data provided to the OECD by the Commonwealth Government, but not endorsed by the Australian Bureau of Statistics.

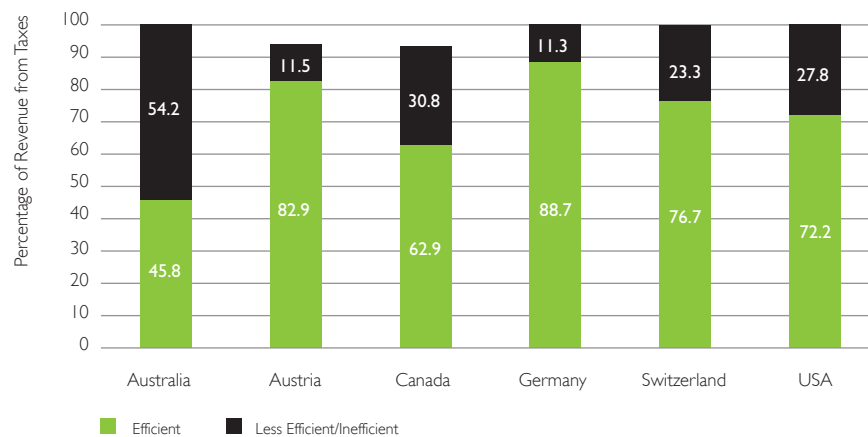
**FIGURE 10 > VERTICAL FISCAL IMBALANCE: SELECTED FEDERATIONS, 1990s**



Essentially, Australia has the greatest amount of vertical fiscal imbalance and is the most centralised federation of the major comparable federal nations – and it also happens to have the highest level of fiscal equalisation.

Particular symptoms of centralisation have emerged. One is State reliance upon a narrower own-source tax base than other federal countries. Figure 11 indicates how Australia is out of step with practice elsewhere in this respect, and has an especially high reliance upon property and transaction taxes (which can be seen as taxes on mobility, activity and flexibility and are classified by economists as relatively inefficient taxes).<sup>157</sup> They are more detrimental to economic activity than are broader-based and more diverse tax structures.

**FIGURE 11 > STATE TAX BASES AND EFFICIENCY: SELECTED FEDERATIONS, 2004**



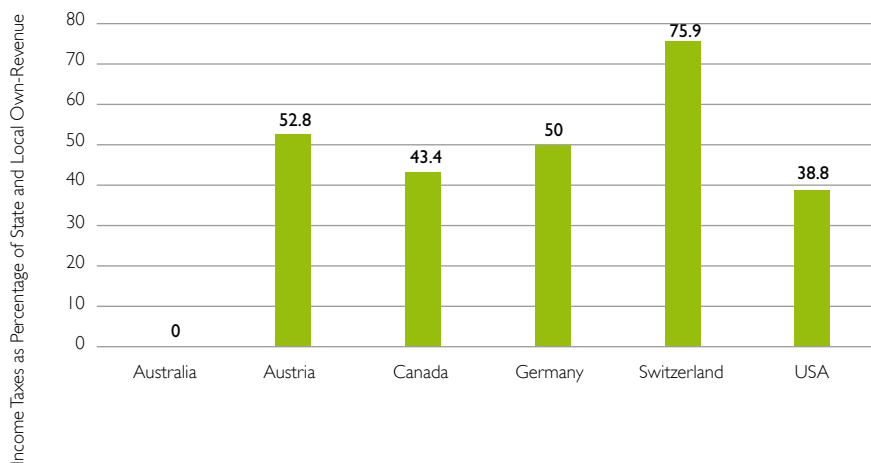
The result is that not only do the Australian States have a smaller level of own-taxes, as seen in Figure 10, but that the actual types of taxes available to State and local government in Australia are more restricted and concentrated heavily on a few activities – this means certain areas experience much more government involvement than other parts of society. This is seen even more clearly in looking at the taxes to which Australian States do not have access. Figure 12 shows the situation in relation to income taxes.<sup>158</sup> Australia is the only one of the major federations where States do not have access to income taxes for own-revenue.

157 N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements* (Final Report, May 2006), p 67. Other taxes' cannot be classified for Austria and Canada, so the components for these countries do not total to 100 per cent.

158 N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements* (Final Report, May 2006), p 65.

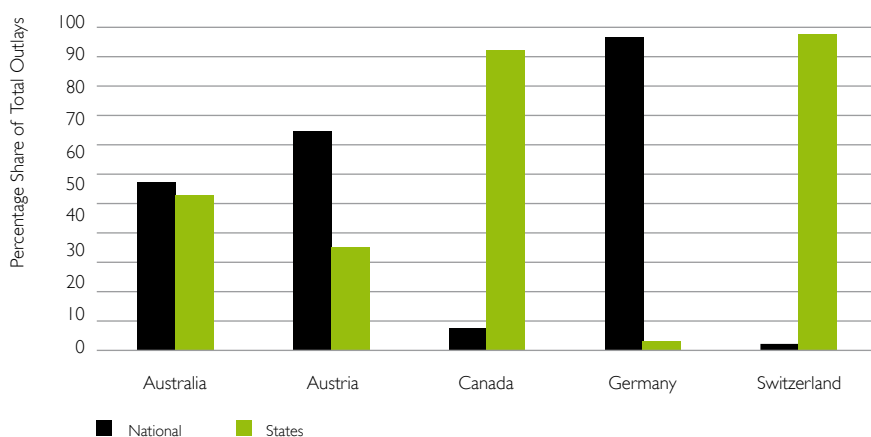


**FIGURE 12 > STATE GOVERNMENT ACCESS TO INCOME TAXES: SELECTED FEDERATIONS, 1965–2004**



Australia's general fiscal arrangements also mean that areas where there are major expenditure roles for both levels of government (such as health and education) are more common in Australia than in most other federal nations. Figure 13 shows the share of health outlays for different levels of government in the same federations.<sup>159</sup> Australia stands out in the mix of responsibilities across levels of government, with all the concomitant problems of incentives for cost-shifting between jurisdictions and lack of transparency and accountability to the public – problems with which Australians are familiar.

**FIGURE 13 > NATIONAL–STATE SHARES IN PUBLIC HEALTH OUTLAYS: SELECTED FEDERATIONS, 2004**



159 N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements* (Final Report, May 2006), p 37. The USA is not included due to data incompatibilities.



## ASSESSING OVERALL ECONOMIC BENEFIT AND COST

A key task in any discussion about federalism is to assess how Australia's federal system works overall for the people of Australia. Does its existence and distinctive operation benefit Australians or not?

While it is helpful to point to advantages and problems of federalism in general descriptive terms, it is important also to seek to judge the total benefits and costs of those considerations. It is necessary to understand how influences, such as innovation through federalism, balance out against other influences, such as duplication from multiple jurisdictions.

To be convincing, any attempt at such assessment should look at the following:

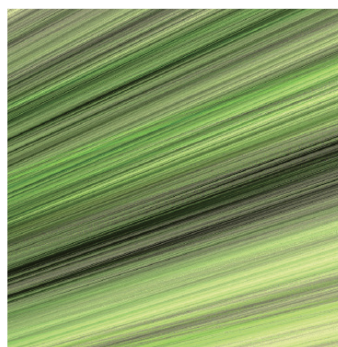
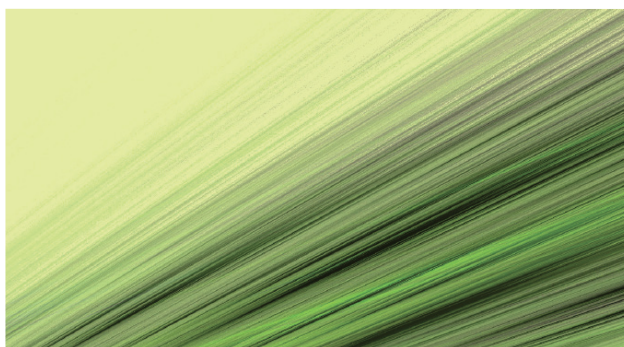
- all costs and benefits, and not just a partial cost analysis or anecdotal benefit lists;
- a longer-term perspective so that conclusions do not just reflect variable current circumstances;
- direct estimation based on relationships observed and measured in the real world rather than simulations or hypotheticals; and
- international insights, not just the Australian experience, which is necessarily restricted in providing information about impacts and options outside that experience.

Analysis embodying all of these features was undertaken for this report. Technical details are provided in Appendix 1.

Growth in income per capita was adopted in this analysis as the overall measure of performance. It is the standard measure of material wellbeing that is widely used in international comparisons and is readily available from official statistical compilations. Movements in GDP per capita over time will reflect the outcome of all economically measured benefits and costs of federalism. If the effect of federalism is detrimental, then – all else being equal – unitary countries should do better by this measure over time.

For this report, the entire period since 1950 is covered. This provides a full half-century of experience to examine the differences in income growth performance between unitary states and federal states for the 21 OECD countries for which such long-term data reliably exists. These performance data allow a direct estimation to be made of the economic impact of the type of political system chosen.

When the impact of the simple fact of federation on average income growth is estimated, statistical regression analysis indicates that for the last half-century federations grew on average by 15.1 per cent more than unitary states, after controlling for different GDP starting points. However, this net economic benefit of federation can be said to be exaggerated because this classification of countries simply differentiates federal and unitary states. In fact, while federations on average are more decentralised than unitary states, some unitary countries have substantial delegation to regional and local authorities (for example Italy), and some federations have substantial centralisation of power despite formal state legislative autonomy (for example Austria and Australia).



To capture the nuances of fiscal decentralisation alternative estimates may be provided of the benefits of such decentralisation overall and for individual countries. The measure available for this is the share of own-tax revenue for state, regional and local governments in total public tax revenue. This measure allows for subtle practical overlaps across the federal divide. Because it is a continuous measure we can use it to compare both the average difference experienced by federations overall, compared to unitary states, and the particular position of an individual federal country such as Australia.

Using this measure, we calculate that the average advantage of federal countries from their levels of fiscal decentralisation is 7.8 per cent, with the decentralisation that typifies federations therefore contributing positively and significantly to per capita GDP growth. Interestingly, the best performing unitary states (the Scandinavian countries) are also typified by a high degree of fiscal decentralisation.

A third and conceptually superior approach to estimating the impact of federal arrangements is to use each of these two measures jointly, that is, the fact of federation and the degree of fiscal decentralisation, allowing for their interplay. This allows for both political decentralisation and financial decentralisation. This analysis shows that Australia has gained a 10.46 per cent average benefit from being a federation. It also achieves a 5.63 per cent benefit from its precise level of fiscal decentralisation relative to the average fiscal decentralisation of unitary states. The sum of these two effects when estimated together (16 per cent) is less than the sum of the two effects when estimated separately (23 per cent), reflecting the partial overlap between them as allowed for in joint estimation. Of the two effects, the former reflects the institutional autonomy of sub-national governments, and the latter reflects the fiscal position on own-tax revenue as a proportion of overall public revenue.

The specific advantage achieved by Australia through the federal structure itself is a sum of \$4,507 per capita in 2006 – or \$11,402 per average household. This is a major achievement and benefit for Australians and reflects the continuing legacy to Australians today of the nation's founding fathers.

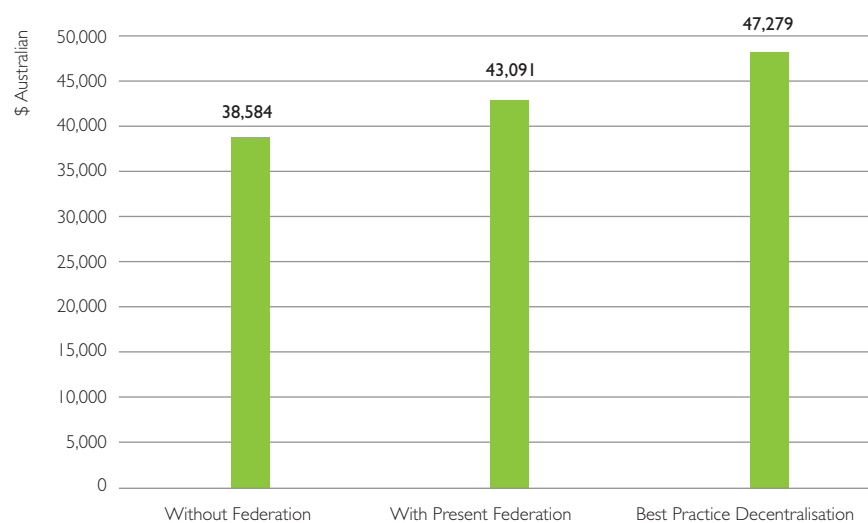
However, it is important to also recognise that Australian federalism is now very much centralised because of its fiscal position (see section 4.5). This is different from the form of federation that applied in the earliest period of federation. Given the limited actual degree of decentralisation in Australia today, the federalism dividend could be larger still by moving to greater fiscal decentralisation.

At present our level of fiscal decentralisation does deliver a benefit of \$2,426 per capita, relative to the average fiscal stance of unitary states. But were Australia to reform its federal fiscal decentralisation arrangements even to only the average degree of such decentralisation for all OECD federations, Australian average incomes would be likely to increase by another \$2,925 per capita annually. The increase would be \$4,188 compared to the present if we moved to the best federal practice as defined by Canada, Germany, and Switzerland. Figure 14 summarises these calculations.

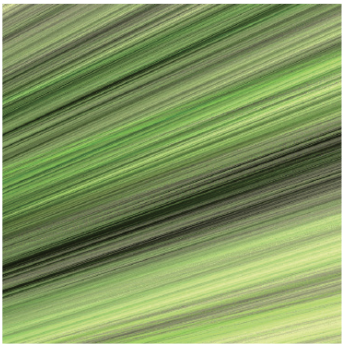
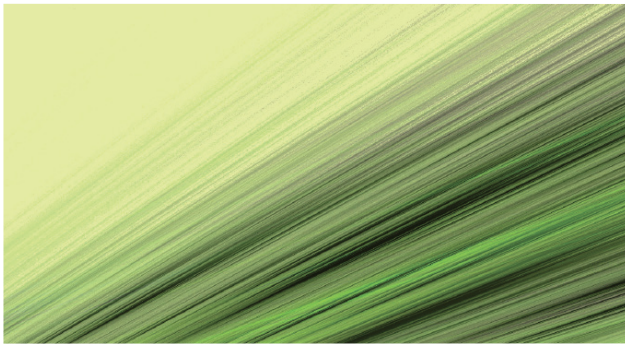
The figure affirms that Australia benefits by a little over 10 per cent by being a federation. This is the economic pay-off from political decentralisation. However, the fiscal position within our federation could be improved further and this and the associated practices and behaviours could provide a future 6.75–9.72 per cent further benefit over the present. The 7 per cent improvement comes from reaching average OECD federal practice and the 10 per cent future improvement would come from matching OECD best-three federal practice. This would be the pay-off from better fiscal decentralisation.

Naturally, average income growth does not capture all dimensions of wellbeing. For example, it does not take into account wider social or environmental outcomes. But on the social front at least, Castles<sup>160</sup> earlier work found either neutral or superior results for federation.

**FIGURE 14 > AUSTRALIAN GDP PER CAPITA UNDER ALTERNATIVE SYSTEMS**



<sup>160</sup> F Castles, 'Decentralisation and the Post-War Political Economy', *European Journal of Political Research* 35(5), 1999. Castles has also found a superior performance of federations on inflation – presumably reflecting local policies reducing natural rates of unemployment which allows the monetary authority to run lower inflation outcomes (see Figure 4 above).



# OPTIONS FOR THE FUTURE

Although many of the arguments against federalism are misconceived, others point to real deficiencies in the operation of our federal system. If we are dissatisfied with the operation of federalism in Australia, what are the options?

## 6.1 ABOLISH THE STATES AND ESTABLISH REGIONAL GOVERNMENT

Some have suggested that the States no longer have a worthwhile role to fulfil and that substantial economic savings could be made by abolishing them.<sup>161</sup> If the States were abolished, some form of decentralisation of power and functions to regions would still be needed.<sup>162</sup> The Business Council of Australia has noted that with its dispersed population and large geographic distances, 'some form of regional government seems inevitable in Australia, whether it is through semi-autonomous state governments or through Commonwealth controlled regional governments'.<sup>163</sup> As noted above, unitary countries such as the United Kingdom, Italy and France have recently taken substantial steps to devolve both functions and fiscal powers to sub-national units.

The number of regions suggested for Australia range from 25,<sup>164</sup> to 30–50,<sup>165</sup> to 51.<sup>166</sup> Instead of six States, there would be multiple regions seeking representation, power and funding, making co-operation more difficult and potentially exacerbating the problems already identified with the federal system. For example, regional governments would still need funding, but it is unlikely that setting up 30 to 50 different tax systems would be efficient or acceptable, so the amount of vertical fiscal imbalance would be likely to increase, as would the resulting problems of blurred responsibility, cost-shifting and buck-passing. Even if the regions had their own tax systems, only those encompassing large cities would be likely to raise adequate amounts, with the rest relying upon even greater levels of horizontal fiscal equalisation to survive.

If State and local governments were to be abolished in favour of a two-tiered system of central and regional governments, the result would be a shift in power and control further away from the people. For example, the people of Tamworth and Narrabri could find that decisions about their local libraries, parks and sporting facilities would be made by a regional body in Armidale, rather than by people who are part of their local community. Decisions about schools and hospitals would be made by the central government in Canberra, as it would not be feasible to run 30 to 50 education or health systems.

The benefits of federalism, such as competition and innovation, would be harder to achieve because of the smaller population bases of most regions. Transaction costs would be higher in servicing a small population and it is unlikely that there would be a bureaucracy of sufficient size and depth to produce innovative policy.

The ability of a region to influence the Commonwealth Government, or obtain representation in the Cabinet or in any national institution, would be limited.<sup>167</sup> The composition of the Senate would be skewed, with presumably no more than one or two Senators being elected for each region, effectively removing the representation of small parties.

161 R Hall, *Abolish the States!* (Pan Macmillan Australia, Sydney, 1998), p 24; S Bennett, 'The politics of the Australian federal system', *Research Brief* (Cth Dept of the Parliamentary Library, 1 December 2006), p 27; J Soorley, 'Do we need a federal system? The case for abolishing State governments' in W Hudson and A J Brown (eds), *Restructuring Australia* (Federation Press, Sydney, 2004), 38 and 40–1; and J Pearlman, 'Vote 1 – abolish Parliament: Democrat push to shed tier', *The Sydney Morning Herald*, 9 March 2007, p 6.

162 A J Brown, 'Federalism in Australia – new life or old tricks?', ABC Online News Opinion, 9 February 2007.

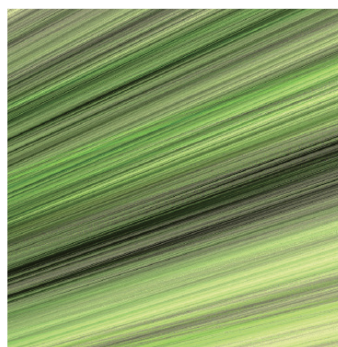
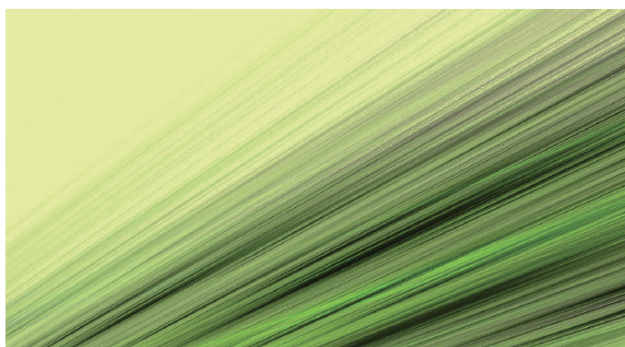
163 Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal–State Relations* (2006), p 17.

164 L Tanner, *Open Australia* (Pluto Press, 1999), p 210.

165 R Hall, *Abolish the States!* (Pan Macmillan Australia, Sydney, 1998), p 36; and J Soorley, 'Do we need a federal system? The case for abolishing State governments' in W Hudson and A J Brown (eds), *Restructuring Australia* (Federation Press, Sydney, 2004), 38 at 45.

166 C Hurford, 'A republican federation of regions: Re-forming a wastefully governed Australia' in W Hudson and A J Brown, *Restructuring Australia* (Federation Press, Sydney, 2004), 47 at 50.

167 C Saunders, 'The constitutional framework for a regional Australia' in W Hudson and A J Brown (eds), *Restructuring Australia* (Federation Press, Sydney, 2004), 63 at 75–6.



It is unlikely that any formal move to abolish the States would succeed. It would face an even higher constitutional hurdle than ordinary constitutional reform, because such a change would affect the representation of all States in the Commonwealth Parliament and therefore trigger the requirement in the penultimate paragraph of s 128 of the Constitution that the referendum be approved by a majority in each individual State as well as an overall majority.

There is also an argument that formal constitutional amendment could not achieve the dissolution of the 'one indissoluble Federal Commonwealth' established by the Constitution and that a constitutional revolution would be required to repudiate the Constitution and establish a new one. Neither outcome is likely.

## 6.2 CONTINUE THE CENTRALIST DRIFT

The current approach of the Commonwealth Government is to assume control of various aspects of State policy, either through tied grants or the expansive exercise of its legislative powers, and reduce States to the function of service provision.<sup>168</sup>

As Wilkins has pointed out, successive Commonwealth Governments have not shown any great desire to take over service delivery.<sup>169</sup> They have realised that this would involve huge expenditure and political risk, and it is doubtful that the Commonwealth would be able to manage many services, such as hospitals, any more efficiently than the States.<sup>170</sup> Instead, the Commonwealth appears to be seeking policy control so that States and Territories provide services at the Commonwealth's bidding.

The Commonwealth Treasurer, Peter Costello, has envisaged the States becoming 'more like division branches of head office'.<sup>171</sup> The Commonwealth may also choose to fund competing service providers directly, effectively marginalising the States and Territories.<sup>172</sup> This policy is aimed not at the abolition of the States, but rather the eventual 'withering away of the States'.<sup>173</sup>

This path has been criticised on the grounds that it loses the benefits of federalism while exacerbating its weaknesses, creating the worst of all possible worlds. Mike Nahan from the Institute of Public Affairs has pointed out that making the States entirely dependent upon the Commonwealth would make them 'even less responsible', resulting in greater blame-shifting and lack of accountability. He has criticised the centralist thrust, arguing that 'just because something is in the national interest doesn't mean it should be run from Canberra'.<sup>174</sup>

Michael Chaney, the President of the Business Council of Australia, has also been critical of allowing the 'gradual, arbitrary decay of the federal system to continue, with power concentrated in Canberra'. He has pointed to the consequences of this choice being 'growing confusion over government responsibilities, increased duplication and overlap, a sluggish reform program, and endless buck-passing and finger-pointing between governments'. Chaney argued that unless action was taken to reform the federal system, the States would decline in importance and Australia would lose the benefits that flow from a federal system.<sup>175</sup>

168 K Wiltshire, *Economic and Political Review* (CEDA, February 2005), p 32.

169 R Wilkins, 'A New Era in Commonwealth-State Relations?' (April 2006) *Public Administration Today* 8, at 11.

170 J Howard, 'Reflections on Australian Federalism', Address to the Menzies Research Centre, Melbourne, 11 April 2005, p 6; and National Commission of Audit, *Report to the Commonwealth Government* (AGPS, Canberra, June 1996), p 52.

171 M Davis, 'Costello berates states over failure of federalism', *The Australian Financial Review*, 28 June 2006, p 1.

172 R Wilkins, 'Federalism: Distance and Devolution' (2004) 50(1) *Australian Journal of Politics and History* 96, at 201; K Wiltshire, *Economic and Political Review* (CEDA, February 2005), p 32.

173 T Abbott, 'Responsible Federalism' in W Hudson and A J Brown, *Restructuring Australia* (Federation Press, Sydney, 2004), 183 at 192.

174 M Nahan, 'Improve federalism by cutting duplicity', *The Australian*, 4 July 2006, p 12.

175 M Chaney, 'Act together or kiss the federation goodbye', *The Australian Financial Review*, 22 November 2006, p 59.

### 6.3 MAKE FEDERALISM WORK BETTER

As the Prime Minister, John Howard, has stated, the federal structure of the Australian nation will remain, and the 'responsibility of all of us ... is to make the federal system work better for all the Australian people'.<sup>176</sup> We need to make the most of the advantages of federalism while reforming its operation to remove or reduce the disadvantages. The potential economic gains from moving to best practice in federalism were presented in chapter 5. Some options to achieve that outcome are considered below.

#### A The reallocation of roles between federal and State governments

There is a growing consensus across politics, business and the community that there needs to be a reallocation of roles in our federal system. Where it is possible to isolate a particular area of policy, and allocate it in its entirety to one level of government, this enhances responsibility, provides clarity to those who use particular services and avoids the problems of cost-shifting and buck-passing.

##### Consensus on the need to reallocate roles

- Commonwealth Budget Papers have called for the clarification of Commonwealth and State roles and responsibilities in order to improve productivity.<sup>177</sup>
- John Hewson has argued that 'Australia desperately needs a new "deal", where responsibilities are clearly allocated – for example, the Commonwealth might take the industrial-relations responsibilities, giving total control of hospitals and schools to the States.<sup>178</sup>
- Bob Carr has called for the re-allocation of the spending responsibilities of the States and the Commonwealth, including the possibility of the States handing some responsibilities, such as universities, to the Commonwealth, while having undiluted State responsibility for other areas restored.<sup>179</sup>
- Kevin Rudd has stated that reform of the roles and responsibilities of the Commonwealth and States is 'desperately needed'.<sup>180</sup>
- Nick Greiner has called for a 'serious review of the ... federal compact' to sort out 'who does what to whom' and establish 'clear responsibilities' for the States and the Commonwealth.<sup>181</sup>
- COAG recognised in 2005 the need to clarify roles and responsibilities in the health system and reduce duplication and gaps in services.<sup>182</sup>
- The OECD, the Productivity Commission (in the area of health), the Australian Industry Group, the Business Council of Australia and academics have all called for such a reallocation.<sup>183</sup>

The allocation of legislative power in the Constitution, which was undertaken in the 1890s, needs to be reconsidered today. It needs to take into account changes in the world, such as new developments in information technology and communication, as well as globalisation and the operation of modern economies. The most commonly used principle for making such an assessment in federations today is subsidiarity.<sup>184</sup>

Under this principle, functions should be undertaken by the States and Territories or their local governments, unless this is not practicable. Factors that will influence the allocation of a matter to the Commonwealth or the States include whether it is a matter of national interest, such as defence, or whether national standards are required as a measure of equity, such as social security support. Other important factors include whether significant spillovers into other jurisdictions are involved, whether significant economies of scale could be achieved and whether the harmonisation of policy is needed to increase efficiency.<sup>185</sup> These factors are the core rationale for central government functions and should guide the distribution of powers. They should be respected, but not exceeded.

176 J Howard, 'Reflections on Australian Federalism', Address to the Menzies Research Centre, Melbourne, 11 April 2005, p. 1.

177 Commonwealth, *Budget Strategy and Outlook 2005–06*, Budget Paper No 1, 10 May 2005, p. 4–18.

178 J Hewson, 'What price federalism?' *The Australian Financial Review*, 4 March 2005, p. 86.

179 R Carr, 'Productivity Growth and Micro-economic Reform', Speech to CEDA, 27 February 2004, pp. 5–6.

180 K Rudd, 'The Case for Cooperative Federalism', Address to the Don Dunstan Foundation, Queensland Chapter, 15 July 2005, p. 27.

181 S Burrell, 'It's time to rethink the economics of federation', *The Sydney Morning Herald*, 27 February 2007.

182 COAG Communiqué, 3 June 2005.

183 OECD, *Economic Surveys: Australia*, (July 2006), p. 15; J Pincus, 'Productive Reform in a Federal System', in Productivity Commission, *Productive Reform in a Federal System* (Roundtable Proceedings, Canberra, 2006) p. 25 at 48; Australian Industry Group, 'Ai Group calls for "Hilmer-Style" Inquiry into Federal State Relations', Media Release, 1 June 2005; Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal–State Relations* (2006), p. 34; S Evans, 'Federation in tatters', *The Sydney Morning Herald*, 18 November 2006, p. 27; A Lynch, 'The die is cast and it is time to reshape Australian federalism', *The Sydney Morning Herald*, 15 November 2006, p. 13; G Williams, 'Expensive way to run a country', *The Australian*, 8 December 2006, and 'So much government, so little done', *The Sydney Morning Herald*, 13 March 2007.



The common use of the principle of subsidiarity in federations means that the allocation of expenditure responsibilities between different levels of government is relatively consistent in federations across the world. Warren has noted that central governments tend to deal with defence and social protection; state governments tend to deal with education and public order. Economic affairs, housing and community amenities tend to be shared responsibilities. Health and environmental protection tend to be the primary responsibility of one level or the other, rather than a shared responsibility. In contrast, the overlap of federal and State expenditure on education and health in Australia is unusually high.<sup>186</sup> While much work has already been done in sorting out the roles and responsibilities of the States and the Commonwealth in the areas of utility services and economic regulation, it is human services, such as health and education, which are most in need of assessment.<sup>187</sup>

There are two ways of dealing with a reallocation of functions. The first is the higher level 'clean lines' approach, in which defined subjects of jurisdiction are allocated to each level of government. For example, the Commonwealth Government's National Commission of Audit suggested that States be responsible for preschool, primary and secondary education, with Commonwealth funding of secondary education being through untied grants. The Commission suggested that the Commonwealth take full responsibility for vocational education and training and higher education.<sup>188</sup>

Such an approach could be achieved through formal constitutional reform, although this would be unnecessary. While constitutional reform would give greater symbolic value to a reallocation of powers and responsibilities, the same practical outcome could be achieved by other measures. Where the Commonwealth did not already have formal legislative power, it could be referred to the Commonwealth by the States under s 51 (xxxvii) of the Constitution. State power and responsibility could be enhanced by the Commonwealth vacating the field and ensuring that the States have the fiscal capacity to meet their responsibilities.

Not all areas of government are susceptible to 'clean lines' divisions.<sup>189</sup> There will always be a need for areas of shared responsibility.<sup>190</sup> This means that a second approach needs to be taken to reallocation – not in relation to responsibilities, but in relation to allocating roles in managing those shared responsibilities.<sup>191</sup> Better mechanisms for co-operation are also needed to avoid 'border issues', to ensure the coordination of government services and to avoid cost-shifting.<sup>192</sup>

## B The improvement of mechanisms for inter-governmental co-operation

COAG has proved an important mechanism for achieving co-operative reforms, but its effectiveness has waxed and waned depending upon personalities and political events.

The Business Council of Australia has recommended the institutionalisation of COAG to ensure its continuing effectiveness regardless of these influences. The Council has suggested regular COAG meetings, held at least twice a year and scheduled to run for a full day to give time for the proper consideration of a full range of policy issues. It has also recommended that efforts be made to remove the perception of COAG as a creature of the Commonwealth by ensuring that the timing, chairing, hosting and agendas of meetings are determined jointly, rather than by the Commonwealth alone.<sup>193</sup>

## C The reform of federal–State financial relations

Most complaints about the operation of the federal system concerning duplication, buck-passing, excessive administrative burdens, lack of accountability and lack of coordination can be traced back to the use of specific purpose payments (SPPs) by the Commonwealth Government. SPPs are grants made to the States subject to strict conditions on their use, which allow the Commonwealth to control aspects of State policy.

In the 2006–7 financial year there are at least 90 distinct SPP programs providing \$28 billion to the States or directly to non-government schools and local governments. SPPs account for 42 per cent of total payments made by the Commonwealth to the States.<sup>194</sup> The requirements in many SPPs that States match funding and maintain existing efforts mean that up to 33 per cent of State budget outlays can be effectively controlled by SPPs, reducing State budget flexibility.<sup>195</sup>

184 Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal–State Relations* (2006), p 23 and Appendix 2 by Access Economics, p 14; N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements* (Final Report, May 2006), p xxix; National Commission of Audit, *Report to the Commonwealth Government* (AGPS, Canberra, June 1996), pp 44–5; and T Abbott, 'Responsible Federalism' in W Hudson and A J Brown, *Restructuring Australia* (Federation Press, Sydney, 2004), 183 at 185.

185 Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal–State Relations* (2006), p 23; N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements* (Final Report, May 2006), pp 32–3; National Commission of Audit, *Report to the Commonwealth Government* (AGPS, Canberra, June 1996), p 45.

186 N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements* (Final Report, May 2006), pp xxx–i.

187 R Wilkins, 'A New Era in Commonwealth–State Relations?' (April 2006) *Public Administration Today* 8, at 11.

188 National Commission of Audit, *Report to the Commonwealth Government* (AGPS, Canberra, June 1996), pp 58–9.

189 M Keating and J Wanna, 'Remaking federalism?' in M Keating, J Wanna and P Weller (eds), *Institutions on the Edge?* (Allen & Unwin, 2000), pp 134 and 141.

190 B Galligan, 'The future of Australian Federalism' in S Prasser and G Starr, *Policy & Change – The Howard Mandate* (Hale & Iremonger, 1997), 85 at 93.

191 R Wilkins, 'Federalism: Distance and Devolution' (2004) 50(1) *Australian Journal of Politics and History* 96 at 99.

192 J Pincus, 'Productive Reform in a Federal System', in Productivity Commission, *Productive Reform in a Federal System* (Roundtable Proceedings, Canberra, 2006), p 25, at 28 and 44; and R Wilkins, 'A New Era in Commonwealth–State Relations?' (April 2006) *Public Administration Today* 8 at 10.

- 193 Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal–State Relations* (2006), p 35. See also: G de Q Walker, *Ten Advantages of a Federal Constitution* (Centre for Independent Studies, Sydney, 2001), p 56.
- 194 Allen Consulting Group, *Governments Working Together? Assessing Specific Purpose Payment Arrangements*, Report to the Government of Victoria (June 2006), pp 6 and 20.
- 195 N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements* (Final Report, May 2006), p xxxix; and National Commission of Audit, *Report to the Commonwealth Government* (AGPS, Canberra, June 1996), p 43.
- 196 Access Economics, 'The Cost of Federalism' in Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal–State Relations* (2006), Appendix 2, p 18.
- 197 A Morris, 'Australia: Equity, Imbalance and Egalitarianism' in R Blindenbacher and A Ostien Karos (eds), *Dialogues on the Practice of Fiscal Federalism: Comparative Perspectives* (Forum of Federations, 2006), p 4.
- 198 R Garnaut, Discussant Comments, in Productivity Commission, *Productive Reform in a Federal System* (Roundtable Proceedings, Canberra, 2006), 85 at 93.
- 199 COAG Communiqué, 25 February 1994.
- 200 Allen Consulting Group, *Governments Working Together? Assessing Specific Purpose Payment Arrangements*, Report to the Government of Victoria (June 2006), p 6.
- 201 For more detailed criticism, see: Access Economics, 'The Cost of Federalism' in Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal–State Relations* (2006), Appendix 2, p 33; and Allen Consulting Group, *Governments Working Together? Assessing Specific Purpose Payment Arrangements*, Report to the Government of Victoria, (June 2006) pp 48–9.

### Criticisms of the use of SPPs

- Access Economics has stated that SPPs 'often impose excessively detailed and distorting conditions on how the States exercise even their (constitutionally) exclusive functions. As a result, tied grants can be costly intrusions into State functions and responsibilities, resulting in overlap, duplication and other inefficiencies'.<sup>196</sup>
- Alan Morris, Chairman of the Commonwealth Grants Commission, has argued: 'Commonwealth interference in traditional state areas has led to the roles and responsibilities of different spheres of government becoming blurred, giving rise to duplication, overlapping and cost-shifting'.<sup>197</sup>
- Professor Ross Garnaut has observed: 'There is a sense in which [SPPs] have completely undermined the federal character of governance in Australia. There is hardly a single function now of a State Government, or hardly an important one, that does not receive some specific purpose grants, with conditions applied, from the Australian Government. This turns every State function into a concurrent function'.<sup>198</sup>
- COAG has noted that 'the practice of tied grants has sometimes led to duplication and confusion of roles and responsibilities between the States, Territories and the Commonwealth'.<sup>199</sup>
- Allen Consulting has criticised SPPs on the ground that 'instead of being focused on achieving agreed outcomes, in many cases they centre on inputs and bureaucratic processes and controls; they are typically burdensome and impede efficiency; they have tended to create tension between governments rather than promoting collaboration or partnership; and they lack incentives or frameworks for pursuing improvement'.<sup>200</sup>

There are many examples of failings in SPP programs. These include the *Skilling Australia's Workforce* agreement, which imposes highly prescriptive requirements not related to training outcomes, rewards inefficiency, and fails to provide incentives for improving the quality of training.<sup>201</sup> Similar criticisms have been made that the Schools Quadrennial Funding Agreement is inflexible, imposes prescriptive and burdensome administrative requirements out of proportion to the funding received, is focused on inputs and processes rather than outcomes, and makes funding conditional on matters unrelated to education.<sup>202</sup>

The National Commission of Audit advised the Commonwealth Government in 1996 that the following principles should apply to funding arrangements:

- For programs entirely the responsibility of the States, funding should be in the form of general purpose grants, allowing the States allocative discretion between specific programs.
- For programs where there is joint Commonwealth/State responsibility, funding should go to pools that extend to all related programs, rather than being earmarked to specific programs. Again, this allows the States some allocative discretion within funding pools.
- Where specific purpose payments (SPPs) are considered necessary, the Commonwealth should focus on specifying policy objectives and establishing improved accountability frameworks and give the States greater freedom in designing program delivery.<sup>203</sup>

Such an approach has the benefits of allowing flexibility, reducing administrative costs, enhancing coordination and avoiding cost-shifting. These principles are closely related to the allocation of responsibilities, as discussed above, and the need for a better allocation of roles where responsibilities are shared.

Options to improve the operation of SPPs include reforming their operation so that they:

- support the achievement of outcomes agreed by the States and the Commonwealth;
- permit flexibility by focussing on those outcomes rather than on inputs or processes, and by not compartmentalising funding into narrow subjects;

- include incentives to find more efficient ways to achieve the desired outcomes;
- complement and coordinate with other existing State policies to avoid overlap and confusion amongst those who seek to use government services;
- avoid micromanagement and the imposition of costly reporting and administration requirements; and balance obligations, contributions and risk-sharing.

The reform of fiscal federalism need not stop with reform of Specific Purpose Payments. SPP reform could and should provide a stimulus for more holistic reform. Both Labor and Coalition governments have reformed many elements of the tax structure and tax levels in recent decades. However, these have largely ended up as piecemeal reforms.

Serious tax reform would recognise that Australia overtaxes incomes and undertaxes spending compared to other OECD economies. Our overall tax take is at the lower end of industrial economies as a share of GDP but is strongly biased toward income tax sourcing. Both personal income taxes and corporate income taxes represent higher shares of public revenue in Australia than in most comparable countries.<sup>204</sup>

Reform could extend further to revisiting horizontal fiscal equalisation as well as vertical fiscal imbalance and the structure of taxation. The pursuit of such equalisation in Australia exceeds the pattern in all other comparable federations. As a consequence, it provides greater disincentives for sub-national governments to seek and provide efficient delivery of government services. At a minimum, more transparent and less complex equalisation processes with improved incentives for efficiency could be developed.

The vehicle for review is undefined in Australia, either constitutionally or by precedent from practice. Certainly, Australia has no automatic mechanisms for such a review. This could be an issue for the proposed constitutional convention. If such a review leads to reform in the right direction it would help to reap the \$86 billion reform dividend from better federalism that awaits Australians.<sup>205</sup>

#### D Constitutional convention and constitutional reform

Many of those advocating a reallocation of responsibilities between the Commonwealth and the States have also called for a constitutional convention to be held in 2008, a decade after the republic constitutional convention, to consider the pressing need of reform of Australia's federal system.

The Business Council of Australia has called for a convention to 'agree a framework to be used to clarify the roles and responsibilities of the Commonwealth and the States'. In particular, the Council wants the convention to debate how the framework would apply to the key areas of health, education and water.<sup>206</sup> The Queensland Premier, Peter Beattie, has called for an 'open' constitutional convention to redefine the roles of the Commonwealth and the States,<sup>207</sup> as well as the role of the Senate in representing the States.<sup>208</sup> He has been joined by the South Australian Premier, Mike Rann, who sees a convention and any subsequent referendum, as a means of giving Australians the say they were denied by the High Court in *New South Wales v Commonwealth*.<sup>209</sup> Others who have supported the call for a constitutional convention include academics,<sup>210</sup> commentators,<sup>211</sup> the Council for the Australian Federation<sup>212</sup> and the Local Government Association of Queensland.<sup>213</sup>

Major constitutional reform is not necessary to achieve a reallocation of powers and responsibilities, because of the existing high level of concurrency of powers and the power for the States to refer matters to the Commonwealth. However, it would be useful to insert in the Constitution a mechanism to support federal-State co-operation, including the referral of Commonwealth powers to the States (the reverse of s 51 (xxxvii)), the cross-vesting of judicial power (so that federal courts can hear matters concerning both State and federal jurisdictions), and the conferral of functions on federal or State officers to enforce co-operative schemes.<sup>214</sup> Consideration might also be given to making the process for the appointment of High Court judges more transparent and independent of government, given their vital role in adjudicating on matters of federalism.

Constitutional reform could also assist in a rebalancing of the fiscal powers of the Commonwealth and the States to avoid the problems associated with vertical fiscal imbalance.

202 Allen Consulting Group, *Governments Working Together? Assessing Specific Purpose Payment Arrangements*, Report to the Government of Victoria (June 2006) pp 44–5.

203 National Commission of Audit, *Report to the Commonwealth Government (AGPS, Canberra, June 1996)*, p 48.

204 R Warburton and P Hendy, *International Comparison of Australian Taxes* (Treasury, Canberra, 2006).

205 This figure reflects the per capita gain from Australia moving to mean OECD practice for federal fiscal decentralisation, as shown in Figure 14, multiplied by total population. A move to better than average performance would produce a higher estimated benefit.

206 Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal–State Relations* (2006), p 24; and M Chaney, 'Act together or kiss the federation goodbye', *The Australian Financial Review*, 22 November 2006, p 59.

207 ABC, Lateline Transcript, 4 May 2006, 'Beattie says the IR laws compromise constitutional powers', p 1.

208 P Beattie, 'Commonwealth must take a fresh look at federalism', *The Australian*, 30 November 2006.

209 M Rann, 'Constitutional convention need to sort out Fed/State relations', News Release, 15 November 2006.

210 Dr A Lynch, 'The die is cast and it is time to reshape Australian federalism' *The Sydney Morning Herald*, 15 November 2006, p 13; and Prof G Williams, 'Expensive way to run a country', *The Australian*, 8 December 2006.

211 S Burrell, 'It's time to rethink the economics of federation', *The Sydney Morning Herald*, 22 February 2007; and Editorial, 'States of disarray: it's time to fix the federation', *The Sydney Morning Herald*, 10–11 March 2007, p 36.

212 Council for the Australian Federation, Communiqué, 9 February 2007.

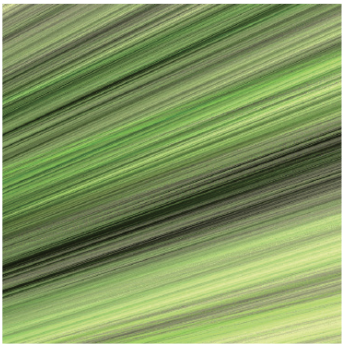
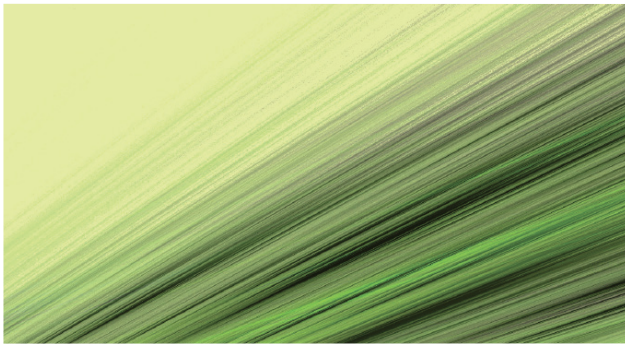
213 Local Government Association of Queensland, 'Councils Support Call for Constitutional Convention', News Release, 2006.

214 Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal–State Relations* (2006), pp 32–3.



## CONCLUSION

There are many popular myths in Australia concerning federalism that are not borne out by the evidence. We need a more sophisticated debate in Australia about our federal system – one that is less insular and takes into account international experience of federal and unitary systems, and one that fairly balances the economic and social advantages against the disadvantages of federal systems. If we can achieve such a debate, we will be better placed to reform our federal system to take full advantage of the substantial benefits it could deliver, while eliminating or reducing the problems about which all Australians are only too aware.





## APPENDIX I: TECHNICAL ANALYSIS

Many qualitative arguments may be advanced about the relative benefits and costs of federal and unitary political structures. Such arguments are common overseas, but in Australia the conventional wisdom among commentators is that centralism and unitary political structures are preferred.

This appendix reports analysis which uses international evidence to examine the performance of federal systems and to position Australia within that experience. The analysis achieves this by examining a long period so that the fundamental effects of structures can be isolated, rather than generalising from the short term. The analysis directly estimates effects, rather than using simulation or hypothetical or assumed relationships. This approach differs from some recent welcome quantitative analyses introduced into Australian debates on federalism in recent years.

One much-cited study is by Drummond,<sup>215</sup> which used statistical regression analysis to look at the relationship between population and public expenditure for Australia's States and Territories for the years 1999 to 2001. Drummond used the relationship to estimate how much public spending varies with the population and what expenditures are fixed costs for each jurisdiction. From this, he concluded that government duplication in Australia's federal arrangements may cost more than \$20 billion, relative to a more decentralised system of governance, because the present system harbours 'excessive numbers of public officials ... in extravagantly duplicated roles'.

The regression work in the Drummond study is based on direct estimation, which is valuable. However, it has other problems. In particular, it looks at costs only, and over a very short period. It also draws only on Australian evidence. Thus, it runs the risk of massively increasing the likelihood of error in its calculations when it extrapolates outside the experience reflected in the Australian data used.

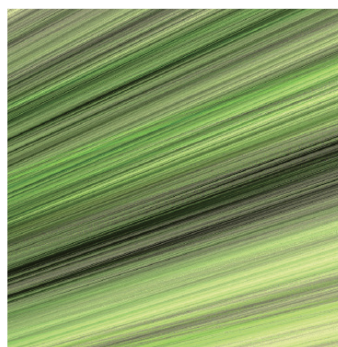
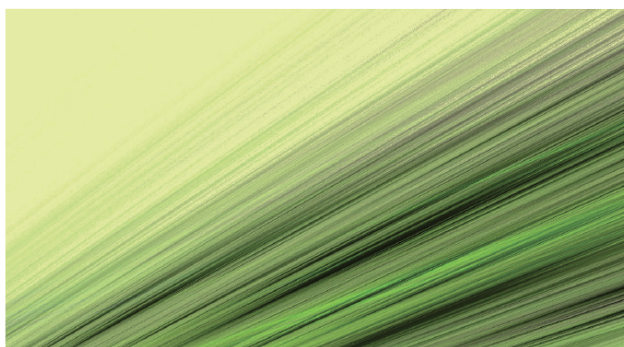
The other major recent study much cited in public discussion of federalism is the Access Economics study conducted for the Business Council of Australia.<sup>216</sup> This analysis is also helpful in contributing to debate, but its contribution needs to be substantially discounted by the fact that in its numerical assessment it chose to focus only on costs, with no similar quantification allowed for benefits – despite it being standard procedure in examining public legislation, regulation, spending and taxes to examine both benefits and costs, preferably by estimation of the magnitudes of both.<sup>217</sup>

The Business Council of Australia's analysis must be further qualified to the extent that the driving forces in generating its numerical conclusion are a key set of arbitrary assumptions made about how large the percentage inefficiency effects are. These percentages are then applied to actual public spending magnitudes at a given time, but the actual inefficiency parameters (the percentages used) are quite hypothetical. They are seemingly plucked from the air without documentation or derivation – so we must rely upon the analyst's intuition, wisdom, experience or even prejudices.

215 M Drummond 'Costing Constitutional Change: Estimating the Costs of Five Variations on Australia's Federal System' (2002) 61(4) *Australian Journal of Public Administration* 44.

216 Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal–State Relations* (2006), Appendix 2.

217 Office of Best Practice Regulation (2006), *Best Practice Regulation Handbook*, Canberra: Productivity Commission.



A typical assumption in the BCA analysis is as follows:<sup>218</sup>

**If the amount of SPPs paid by the Commonwealth and spent by the States in these functional areas is 10 per cent above efficient levels on account of inadequacies in Commonwealth oversight and accountability mechanisms, then SPPs paid by the Commonwealth to the States in these functional areas could be \$2.3 billion higher than necessary.**

The 'if' is the key characteristic of this form of analysis and drives the conclusions. Eight such 'if' assumptions of percentage savings are made and applied to each of the current public activity levels in major areas of shared Commonwealth–State responsibility. This generates a so-called total 'higher than necessary costs of government' of \$8,919 million for 2004–05 or \$450 per Australian.

In other words, the estimates are arbitrary in terms of the percentages which drive them. Moreover, these are then characterised as estimates of spending 'from which ordinary Australians are getting zero benefit'.<sup>219</sup> This assertion of 'zero benefit' is contrary to qualitative discussion elsewhere in the same BCA document of possible benefits. But the quantitative work itself does not actually estimate benefit or hold benefit constant in any meaningful way. It is a partial study (of cost) only. It is also a hypothetical approach and not one based on direct estimation. Despite this, the report's \$9 billion conclusion has been much-cited in the media and in policy discussion, without attention to qualifications of this kind.

The analysis for this present report is based upon regression estimation using data for 21 OECD countries including Australia, with the performance variable and the governance explanatory variables data averaged over the whole half-century since 1950. To explain the growth of these 21 countries, a basic model is provided in work by Dowrick and Nguyen<sup>220</sup> and this has been applied to political institutions by Castles and Dowrick.<sup>221</sup> The analysis in these earlier works, and a successor study by Castles,<sup>222</sup> does not use data beyond 1990. In this present report, the period of analysis is extended to the year 2000, the latest year for which all data needed are available. The analysis is restricted to the 21 older OECD states as the long-run data needed is available for them, and not newer members, and has been compiled by the OECD on a consistent basis. This is also consistent with the data treatment in Castles and Dowrick and the estimation results obtained are very similar.

If the basic growth relationship in this literature is used for the whole of the second half of the twentieth century, the impact of federal political institutions themselves can be estimated by identifying them statistically using a 'dummy variable'. Under this approach it is found that, for the last half-century, federations have had a 15.1 per cent advantage in average income growth, controlling for their differential catch-up opportunities.

Similar recent results are also found in the few other single country studies in this area, at least for developed countries, such as the work of Thiessen.<sup>223</sup> This is different from results for developing countries, a situation common in growth analysis generally. For federal benefits to be reaped, relatively non-corrupt, socially stable and democratic conditions should be in place, as noted by Feld, Zimmerman and Doring.<sup>224</sup>

- 218 Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal–State Relations* (2006), Appendix 2, p 45.
- 219 Business Council of Australia, *Reshaping Australia's Federation – A New Contract for Federal–State Relations* (2006), Appendix 2, p 50.
- 220 S Dowrick and T Nguyen, 'OECD Comparative Economic Growth in the Post-War Period: Evidence from a Model of Convergence', *American Economic Review*, Volume 7 Number 5, 1989, pp 1010–30.
- 221 F Castles and S Dowrick, 'The Impact of Government Spending Levels on Medium-Term Economic Growth in the OECD, 1960–85', *Journal of Theoretical Politics*, Volume 2 number 2, 1990, pp 173–204.
- 222 F Castles, 'Decentralisation and the Post-War Political Economy', *European Journal of Political Research*, Volume 36 Number 5, August 1999, pp 27–53.
- 223 U Thiessen, 'Fiscal Federalism in Western Europe and Selected Other Countries: Centralised or Decentralised? What is Better for Economic Growth? DIW Berlin, manuscript 2003; U Thiessen, 'Fiscal Decentralisation and Economic Growth in "Rich" OECD Countries: Centralisation or Decentralisation?', *Economic Bulletin*, Volume 41 Number 5, May 2004, pp 175–182.
- 224 L Feld, H Zimmerman and T Doring, 'Decentralisation and the Productive Efficiency of Government' Institute for the Study of Labor, Germany, *IZA Discussion Paper No 2477*, December 2006.

An alternative to direct assessment of sub-national autonomy itself is to use a measure of the average degree of fiscal decentralisation (own-tax share of state, regional and local governments) over the whole period. Naturally, federations on average are more decentralised than unitary states, but this is not uniform and some federations are more centralised than some unitary states. When fiscal decentralisation is used in this way to explain growth in average incomes it is found that, on average and controlling for different starting points of the various countries post-war, this measure too is a significant explainer of growth. The average advantage of federations in their practice of fiscal decentralisation is found to be 8 per cent, comparing the effect of the average federal decentralisation to that for unitary states.

A third approach is to incorporate both the autonomy measure and the fiscal decentralisation measure in the one estimating relationship. This allows their overlap to be reflected in the estimation and while their interplay does reduce statistical precision somewhat, the results are conceptually preferable and the estimated impacts are consistent with expectations from the separate use of the measures in the first two approaches. Under this third approach the average federation benefit is found to be 10.46 per cent, and the average fiscal decentralisation benefit is 5.63 per cent (relative to the average for unitary states). Naturally the federation benefit applies only to constitutional federations, but the decentralisation benefit can apply to those unitary states that do adopt decentralised revenue-raising policies and can be less beneficial than the average for more fiscally centralised federations.

In Australia's case our income growth position could be improved upon by 6.79–9.72 per cent, depending upon whether we moved to average federal practice on decentralisation or best federal practice (Canada, Germany, Switzerland). This would go some way to Australia bridging the income and productivity gap with countries such as the United States. There still remain issues of scale and distance and of culture, but institutional capital is an important source of competitive advantage.

The estimating equations supporting these results are reported in Appendix Table A1. The first equation links real GDP per capita growth (in purchasing power parity terms) to two things: the economic starting position for each country and whether that country is a federation or not. This latter checks for the effect of constitutionally autonomous sub-national governments. The federalism effect is calculated by taking the federalism coefficient as a percentage of the average growth rate for the federal countries.

The second equation substitutes the measure of fiscal decentralisation for the fact of federalism. This checks for the effects of the degree of fiscal decentralisation, which is not an alternative measure of federalism, but of the fiscal stance adopted in relation to revenue that is raised at sub-national level. The fiscal decentralisation effect overall for federations is calculated by multiplying the coefficient for fiscal decentralisation by the average level of fiscal decentralisation for the federal countries, then deducting the same calculation for unitary countries and relating the difference to the average growth rate of the federal countries.

The third equation incorporates both of the governance measures, in recognition that they do represent different, though overlapping, forces. The same calculation techniques as for the first two equations are applied to gauge the respective effects of institutions and fiscal decentralisation for the joint estimation. Results for particular countries can be obtained by identifying their federal or unitary status and their own level of fiscal decentralisation. The impact of these can then be compared to their own growth rates and those of other countries.

These results indicate important contributions from institutional autonomy for sub-national governments and benefits from fiscal decentralisation, and this may seem to contradict some expectations that, in a globalised world, national centralisation is better protection.<sup>225</sup> In fact, this is something of an outdated view in the world of economic ideas. Older national-oriented notions of Keynesian and Monetarist policies and national border liberalisation policies have become supplemented by newer ideas of endogenous growth and new economic geography, which point to the importance of local skill formation, infrastructure and innovation as the sources of growth.<sup>226</sup>

225 G Banks, 'Regulation for Australia's Federation in the 21st Century', Paper presented to the 2006 Melbourne Institute/The Australian Economic and Social Outlook Conference, November 2006, p 3.

226 P Romer, 'Increasing Returns and Long-Run Growth', *Journal of Political Economy*, Vol 94, No 5 (Oct 1986), pp 1002-1037; P Krugman, 'Increasing Returns and Economic Geography', *Journal of Political Economy*, Vol 99 No3, (June 1991), pp 483-489; R Florida, *The Rise of the Creative Class*, (Pluto Press, Sydney, 2003).



In reporting these statistical results it may be observed that the relationship used explained economic growth performance with a minimum set of variables viz. the starting point in the growth stakes (1950 real GDP per capita) and the governmental structures and processes of interest for this report (federation and fiscal decentralisation). There are many other determinants of growth (for example investment in education, business investment, innovation, social capital etc.). However, numerous cross-country studies in economics have found the 'starting point' or 'catch-up' variable to be consistently important, justifying its inclusion here, especially for long-run analysis rather than short-term movements in growth rates.

The omission of other variables which are not of direct interest here is only a problem if the omitted variables are correlated with the variables of direct interest viz. federation or fiscal decentralisation. For example, if all federations were geographically large, it might be geography that really explained the outcome not federalism. They are not, so this factor is not included. Alternatively if all federations or decentralised polities were Anglo-American then parliamentary, language or cultural factors might be said to be the root causes of growth. Yet other federations such as Germany, Switzerland and Austria preclude this concern, as does the variety of unitary states. The countries included are quite diverse in characteristics (for example federations range from Switzerland to Canada and unitary states from Japan to France).

It is difficult to discern other excluded variables that are systematically related to fiscal decentralisation and likely to influence growth. The overall explanatory power of the statistical estimation obtained is already high, being consistent with predicting 81 per cent of the growth variation. Tests for any bias from excluded variables in this specification (for example investment rates), did not find problems.<sup>227</sup> These estimates therefore accept catch-up, deem excluded investment variables (education, physical investment) as uncorrelated, and incorporate key political variables.

The clearest correlated variable with federalism is fiscal decentralisation, hence the importance of the joint estimation model as the conceptually preferred equation for the regression results in this report, despite some loss of formal statistical significance on the individual measures. This loss is expected and inherent in dealing with potentially collinear variables such as political and financial decentralisation. It is safer in this circumstance to treat the estimates obtained in the joint estimation as broad indicators of order of magnitude. But the same governance variables in the separate equations meet statistical significance tests at the 5 per cent and 10 per cent levels and so give confidence that these joint estimates are quite reasonable after due allowance for the overlap between federalism and fiscal decentralisation. This is also a conservative approach, choosing to understate the decentralisation contributions.

It is also noteworthy that the calculation provided in the present report of a federalism dividend from improved practice, is quite consistent with the recent calculations by the Productivity Commission on the benefits possible from COAG's National Reform Agenda.<sup>228</sup> The Commission does not provide an overall figure for GDP gain, but it does say that the possible gains are 2 per cent of GDP from competition and regulatory reform, 6 per cent of GDP from workforce participation reform, and 3 per cent of GDP and from human capital productivity reform. Various caveats apply: aggregation is not straightforward, program costs are not examined, reform coverage is incomplete, and these are 'outer envelope' estimates of benefit. However, the range of potential achievement from better federal-State action seems compellingly similar. Of course, the Commission's study does not address how these results are to be achieved politically.

Both statistically and theoretically, the outcomes reported here seem to hold up well. Australia's present federation is estimated to produce a net benefit over the average unitary state of \$4,507 per capita, plus an existing fiscal decentralisation benefit of \$2,925. These benefits can be contrasted with the Business Council of Australia/Access Economics cost-only estimate of the disadvantages of federalism of \$450 per capita. Further, the move to reform federal-State relations in the direction of greater fiscal decentralisation could provide a decentralisation reform dividend of up to an additional \$86 billion a year. This means that a greater pay-off from further fiscal decentralisation could be added to the existing benefits of Australia's political decentralisation.

227 F Castles, 'Decentralisation and the Post-War Political Economy', *European Journal of Political Research*, Volume 36 Number 5, August 1999, pp 27-53.

228 Productivity Commission, *Potential Benefits of the New Reform Agenda*, February 2007.

## APPENDIX TABLE A.1

### Estimated equation for Federal Governance Impact on Growth

#### Equation 1: Federal Institutions

Dependent Variable: GROWTH

Method: Least Squares

Sample: 1 21

| Variable           | Coefficient | Std. Error            | t-Statistic | Prob.    |
|--------------------|-------------|-----------------------|-------------|----------|
| C                  | 4.696755    | 0.222464              | 21.11244    | 0.0000   |
| GDP_1950           | -0.001686   | 0.000207              | -8.143026   | 0.0000   |
| FEDERALISM         | 0.388835    | 0.211277              | 1.840408    | 0.0823   |
| R-squared          | 0.804273    | Mean dependent var    |             | 2.930378 |
| Adjusted R-squared | 0.782525    | S.D. dependent var    |             | 0.837821 |
| S.E. of regression | 0.390711    | Akaike info criterion |             | 1.089868 |
| Sum squared resid  | 2.747795    | Schwarz criterion     |             | 1.239085 |
| Log likelihood     | -8.443610   | F-statistic           |             | 36.98232 |
| Durbin-Watson stat | 2.313394    | Prob(F-statistic)     |             | 0.000000 |

#### Equation 2: Fiscal Decentralisation

Dependent Variable: GROWTH

Method: Least Squares

Sample: 1 21

| Variable           | Coefficient | Std. Error            | t-Statistic | Prob.    |
|--------------------|-------------|-----------------------|-------------|----------|
| C                  | 4.488289    | 0.218370              | 20.55364    | 0.0000   |
| GDP_1950           | -0.001675   | 0.000194              | -8.645641   | 0.0000   |
| FISCAL DEC         | 0.016939    | 0.007982              | 2.122056    | 0.0480   |
| R-squared          | 0.813979    | Mean dependent var    |             | 2.930378 |
| Adjusted R-squared | 0.793311    | S.D. dependent var    |             | 0.837821 |
| S.E. of regression | 0.380900    | Akaike info criterion |             | 1.039002 |
| Sum squared resid  | 2.611521    | Schwarz criterion     |             | 1.188219 |
| Log likelihood     | -7.909518   | F-statistic           |             | 39.38175 |
| Durbin-Watson stat | 2.098674    | Prob(F-statistic)     |             | 0.000000 |

**Equation 3: Federal Institutions and Fiscal Decentralisation**

Dependent Variable: GROWTH

Method: Least Squares

Sample: 1 21

| Variable           | Coefficient | Std. Error            | t-Statistic | Prob.    |
|--------------------|-------------|-----------------------|-------------|----------|
| C                  | 4.607212    | 0.219155              | 21.02261    | 0.0000   |
| GDP_1950           | -0.001796   | 0.000209              | -8.613122   | 0.0000   |
| FEDERALISM         | 0.268868    | 0.214304              | 1.254614    | 0.2266   |
| FISCAL DEC         | 0.013054    | 0.007875              | 1.657558    | 0.1157   |
| R-squared          | 0.831504    | Mean dependent var    |             | 2.930378 |
| Adjusted R-squared | 0.801770    | S.D. dependent var    |             | 0.837821 |
| S.E. of regression | 0.373023    | Akaike info criterion |             | 1.035292 |
| Sum squared resid  | 2.365490    | Schwarz criterion     |             | 1.234249 |
| Log likelihood     | -6.870568   | F-statistic           |             | 27.96429 |
| Durbin-Watson stat | 2.081296    | Prob(F-statistic)     |             | 0.000001 |



