concept economics

SENATE SELECT COMMITTEE ON STATE GOVERNMENT FINANCIAL MANAGEMENT

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1. INTRODUCTION

This submission examines a number of issues relevant to the financial management of State and Territory Governments in Australia. Section 2 highlights the deterioration in both the fiscal balance and net debt positions of the States and Territories, all the more notable given the revenue increases which have accrued from Commonwealth transfers and from economic growth. This deterioration is largely the result of a surge in infrastructure spending and higher recurrent expenses (both actual and projected), including higher labour costs.

Section 3 examines more closely the relatively poor performance of the States and Territories in the area of infrastructure planning and selection, with examples of highly reactive infrastructure investments and poor project selection by individual jurisdictions. Section 4 outlines key criteria for better infrastructure decision-making with the principle imperative that all levels of government commit to best practice regulation and serious cost-benefit evaluation of projects.

Section 5 examines various approaches to the reform of State and Territory financial management within the broader context of reform of Commonwealth-State relations. While noting potential benefits from the Federal Government’s revival of cooperative federalism, it also highlights some risks and potential pitfalls from this approach.

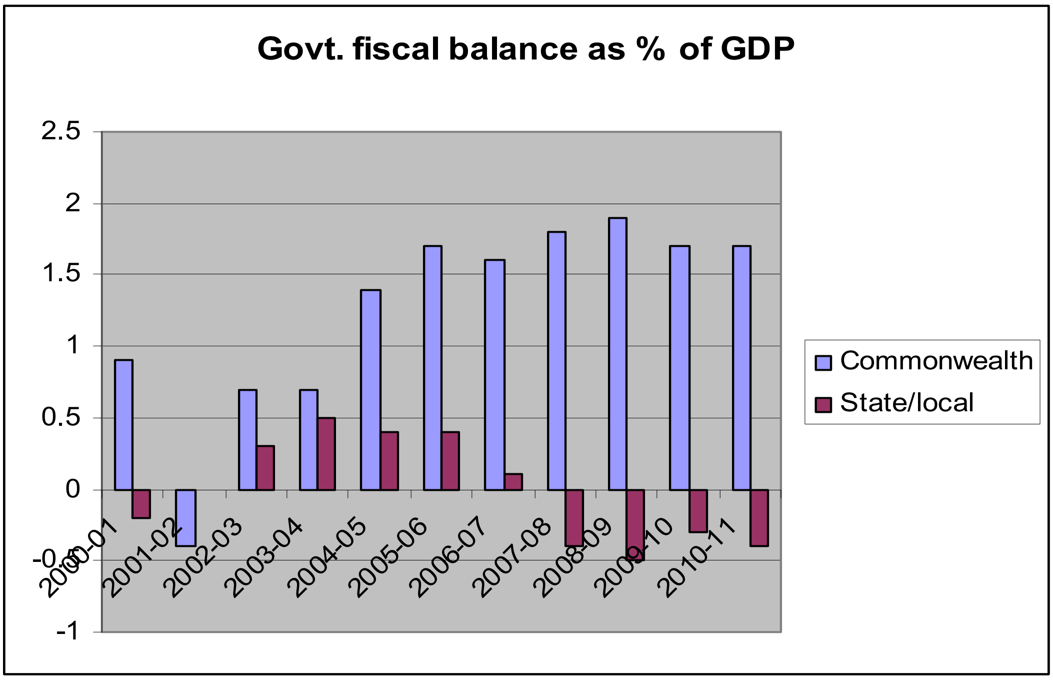
From the perspective of this submission, any sustained improvement in State Government financial management and service provision will require a strong and continuing Commonwealth role in enforcing transparency, holding the States and Territories accountable for outcomes and acting as a source of funding for non-government service providers in areas such as health and education.

2. STATE GOVERNMENT FINANCES

Figure 1 compares Commonwealth and State fiscal balance as a percentage of GDP from 2000-01 with projections through to 2010-11. It shows a significant deterioration in State government fiscal balance in contrast with the strong fiscal balance position of the Commonwealth. The forecast deficits for the States reflect smaller operating surpluses and higher levels of planned capital investment.[1]

[1] Commonwealth Budget Paper No. 3 2008-09, p. 78.

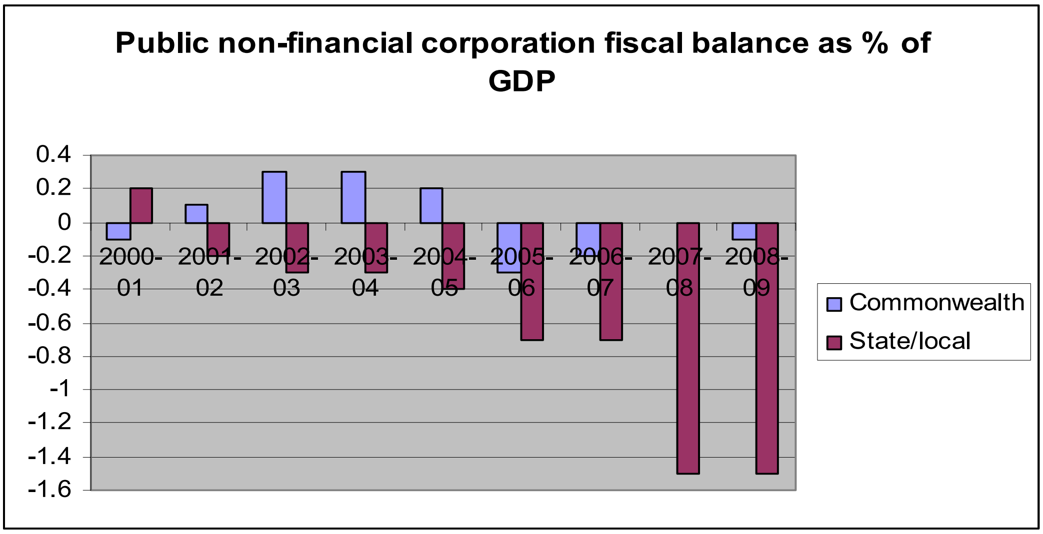
Figure 1: Commonwealth and State Government Fiscal Balance (% of GDP)



Source: Commonwealth Budget Paper No. 3 2008-09, Table C.4.

The 2008-09 Commonwealth Budget shows that consolidated non-financial public sector net debt (including government trading enterprises) has been trending upwards due to higher net debt at the State and local government levels. This largely reflects the financing of State government infrastructure projects.[2] Figure 2 examines the fiscal balance of government trading enterprises, also known as public non-financial corporations, and identifies the significant deterioration at the State level compared with the Commonwealth over the course of this decade.

Figure 2: Public Non-financial Corporations Fiscal Balance (% of GDP)



Source: Commonwealth Budget Paper No. 3 2008-09, Table C.5.

2 Commonwealth Budget Paper No. 3 2008-09, p. 80.

Recent State budgets also reveal a substantial increase in expenses by most States and Territories. Going on nominal forward estimates as reported in the most recent Budgets:

- NSW Government expenses will total more than $250 billion from 2007-08 to 2011-12, with planned capital expenditure of almost $69 billion over that period.[3]
- Victorian Government expenses will total around $191.3 billion from 2007-08 to 2011-12, with planned capital expenditure of around $30.4 billion over that period.[4]
- Queensland Government expenses will total almost $135.5 billion from 2007-08 to 2010-11, with planned capital expenditure of around $47.6 billion over that period.[5]
- South Australian Government expenses will total around $67 billion from 2007-08 to 2011-12, with planned capital expenditure of around $11.8 billion over that period.[6]
- Western Australian Government expenses will total around $93.8 billion from 2007-08 to 2011-12, with planned capital expenditure of around $27.5 billion over that period.[7]
- Tasmanian Government expenses will total around $15.6 billion from 2007-08 to 2010-11, with planned capital expenditure of around $2.7 billion over that period.[8]
- ACT Government expenses will total around $17.4 billion from 2007-08 to 2011-12 , with planned capital expenditure of around $3.1 billion over that period.[9]
- NT Government expenses will total almost $19 billion from 2007-08 to 2011-12, with planned capital expenditure of around $3 billion over that period.[10]

As set out in Table 1, most States and Territories (with the exception of Queensland, Tasmania and the ACT) will continue to carry net debt which is projected to grow substantially.

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3 NSW Budget 2008-09, Table 3.1 at Budget Paper No. 2. NSW Budget 2008-09, Table 1.2 at Budget Paper No. 4

4 Victorian Budget 2007-08, Table 3.1 at Budget Paper No. 2 and Victorian Budget 2008-09, Table 3.1 at Budget Paper No. 2. Victorian Budget 2007-08 calculated from note 15 and table 2.9 at Statement of Finances.

5 Queensland Budget 2007-08, Table 1.1 at Budget Paper No.2. Queensland Budget 2007-08, calculated from Tables 9.1 and 9.2 at Budget Paper No. 2

6 South Australia Budget 2008-09, Table A.1 of Appendix A.

7 Western Australia Budget 2008-09, calculated from table 1, p. 134 at Budget Paper No. 3. Western Australia Budget 2008-09, Table 1 at Budget Paper No. 3.

8 Tasmanian Budget 2007-08, Table 1.1 at Budget Paper No. 1. Tasmanian Budget 2007-08 calculated from tables 9.1 and A1.4 at Budget Paper No. 1.

9 ACT Budget 2008-09, Table 2.1.1 at Budget Paper No. 3. ACT Budget 2008-09, calculated from tables E.1 and E.4 at Budget Paper No. 3.

10 NT Budget 2008-09, Table 2.1 at Budget Paper No. 2. NT Budget 2008-09, calculated from tables 8.1 and 8.4 at Budget Paper No.2.

Table 1: Net debt of States and Territories (2007-08 to 2011-12)

	2007-08 ($bn)	2008-09 ($bn)	2009-10 ($bn)	2010-11 ($bn)	2011-12 ($bn)
NSW	4.98	6.19	6.92	7.47	7.81
SA	0.082	0.61	1.154	1.677	1.983
Victoria	2.27	3.74	5.36	6.90	9.46
WA	4.71	7.91	9.03	9.49	11.44
NT	1.48	1.58	1.64	1.69	1.68

Source: State and Territory Budgets, various.

The deterioration in the financial position of the States and Territories will occur at the same time as revenues accruing to States and Territories are projected to rise rapidly. Table 2 sets out projected increases in Commonwealth payments to the States from 2007-08 to 2011-12. Total payment to States in 2011-12, according to the nominal forward estimates, will be more than 16% above the total payment in 2008-09.

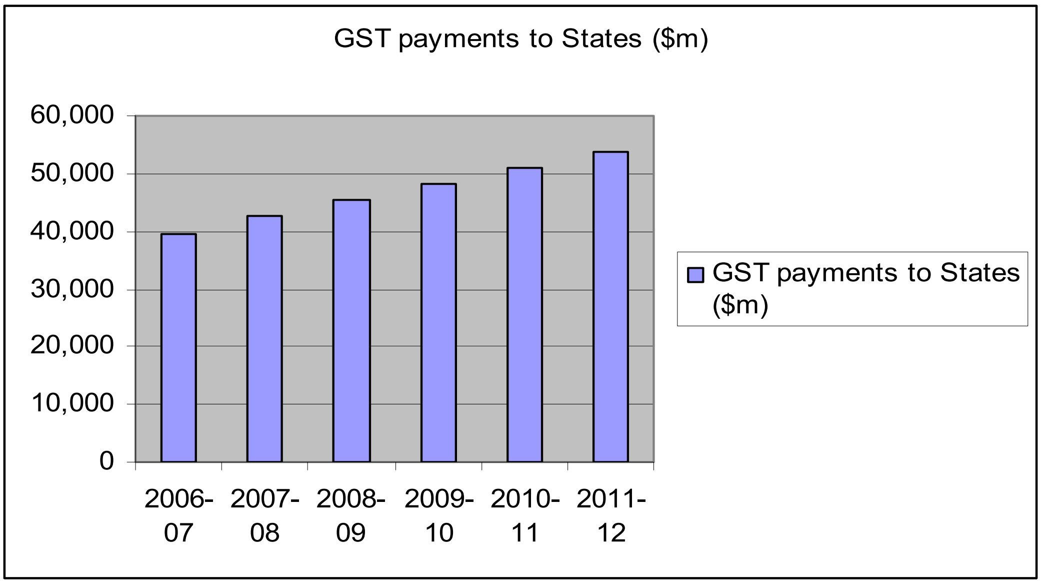
Table 2: Commonwealth Payments to the States

	2007-08	2008-09	2009-10	2010-11	2011-12
Specific purpose payments ($m)	32,207	33,137	34,066	35,251	36,949
General revenue assistance ($m)	42,753	45,458	49,134	51,741	54,475
Comm. payments to States ($m)	74,960	78,595	83,200	86,992	91,424

Source: Federal Budget 2008-09, Budget Paper No. 3, Table 1.1

Figure 3 identifies the projected growth in GST revenues with total GST revenues to the States set to grow in nominal terms by 18.5 per cent between 2008-09 and 2011-12.

Figure 3: GST Payments to the States



Source: Commonwealth Budget Paper No. 3 2008-09, Table 4.5.

These trends suggest significant scope for improved efficiency in financial management at the State and Territory level. The concern is not simply with the deterioration in the fiscal position, though this is significant in terms of macroeconomic policy, given the pro-cyclical nature of the current deterioration. Rather, further concern arises to the extent that this deterioration is symptomatic of basic failures of governance at the State and Territory level, also reflected in their poor management of infrastructure investment.

The poor performance of State and Territory governments in part reflects failure to contain public sector wage costs. In the period from September 1997 to March 2008, increases in the Labour Price Index for the public sector in many States and Territories substantially exceeded those for the private sector. Over the same period, the Labour Price Index for the Commonwealth public sector closely tracked that of the private sector as a whole.

Most noteworthy is New South Wales where State Government wage growth exceeded that in the private sector by over 14 percentage points.

Table 3: Growth in labour price index Sept 1997 to March 2008 (per cent)

Jurisdiction	Public Sector	Private Sector
NSW	56.8	42.3
Victoria	43.1	43
Queensland	49.7	43.3
SA	52	43
WA	44.1	49.4
Tasmania	47.3	39.7
ACT	49.4	42.6
NT	43.9	40.4
Commonwealth	45.6	43.3

Source: ABS data decomposing data published in ABS Cat No 6345.0 Labour Price Index

3. MANAGEMENT OF INFRASTRUCTURE SPENDING

One reason for the deterioration in the fiscal position of the States and Territories in recent years has been a sharp increase in expenditure on infrastructure. This is not in itself an undesirable development. Indeed greater emphasis on infrastructure investment is to be welcomed. What is concerning, however, is the timing of this expenditure – especially its somewhat reactive nature – and the poor planning that in many instances appears to surround infrastructure decision-making.

Recent increases in infrastructure spending by the States and Territories followed a prolonged period in which the States and Territories placed very low priority on infrastructure investment. In 2005-06, for example, the States and Territories received $47.4 billion more revenue than they had received in 1999-00 ($22.1 billion more in real terms) and yet only $2.1 billion of this was devoted to the net acquisition of non-financial assets.[11] This was despite the fact that during that time it was clear that significant capacity shortages in State and Territory infrastructure had developed. Among the notable examples were urban public transport in New South Wales and the failure to proceed to a timely upgrade of the Dalrymple Bay terminal in Queensland and Port Waratah in New South Wales.

Augmenting these failures, the States and Territories subsequently launched an infrastructure spending spree at a time when unemployment was very low, and demand for skilled labour strong, strengthening inflationary pressures in the economy and, in all likelihood, crowding out worthwhile private sector investment.

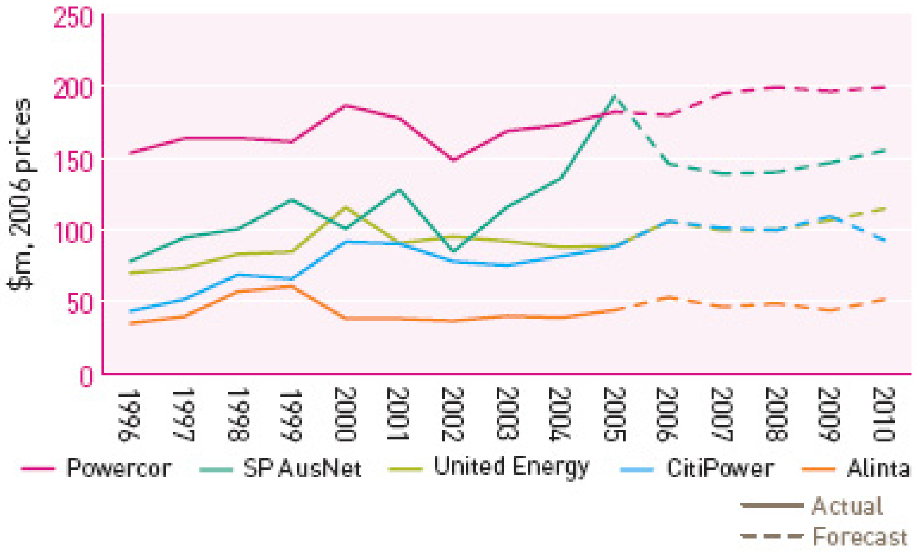
11 Ergas, H. (2007), *The State of the States*, report prepared for Menzies Research Centre, at <http://www.statewatch.com.au/>.

The recent surge in infrastructure spending by the States and Territories is symptomatic of a general pattern of not anticipating and responding in a timely and efficient way to infrastructure needs. Rather, infrastructure problems were allowed to move to breaking point before corrective action was taken.

The volatility of State government infrastructure investment is also notable when contrasted with infrastructure investment by private sector providers. Figure 4 and Figure 5 respectively document the capital expenditure undertaken by electricity distributors in Victoria and Queensland, noting that Victorian electricity distributors are privately-owned whereas Queensland electricity distributors are still owned by the State government.

The clear differences in the pattern of expenditure in the two jurisdictions are telling. Whereas the privately-owned Victorian businesses have engaged in a relatively steady upward trend in investment, expenditure patterns in the State-owned electricity distribution sector in Queensland have been more volatile, with relative stagnation in investment prior to 2003-04 followed by high levels of “catch up” investment from 2004.

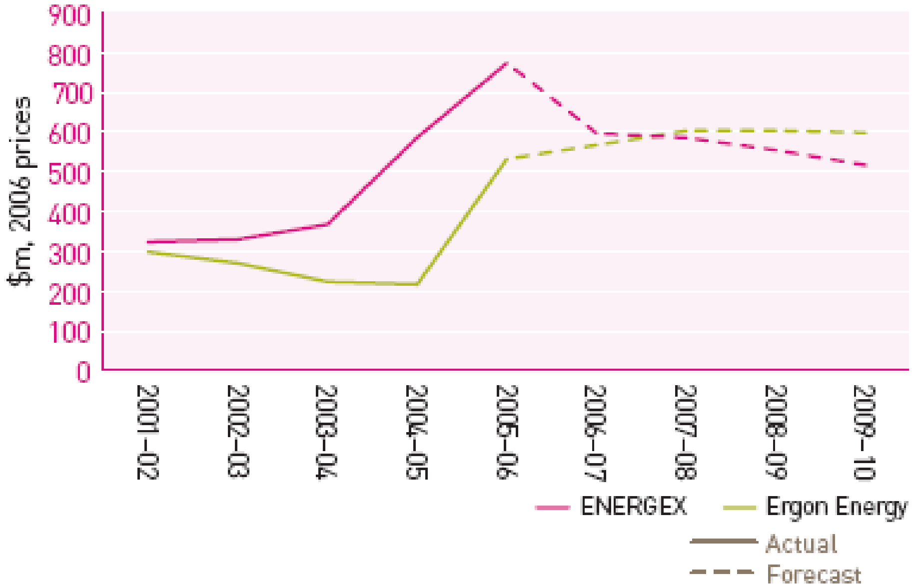
Figure 4: Capital Expenditure by Victorian Electricity Distributors (1996-2010)



Source: Australian Energy Regulator, *State of the Energy Market Report 2007*, p. 154.

Figure 5: Capital Expenditure by Queensland Electricity Distributors

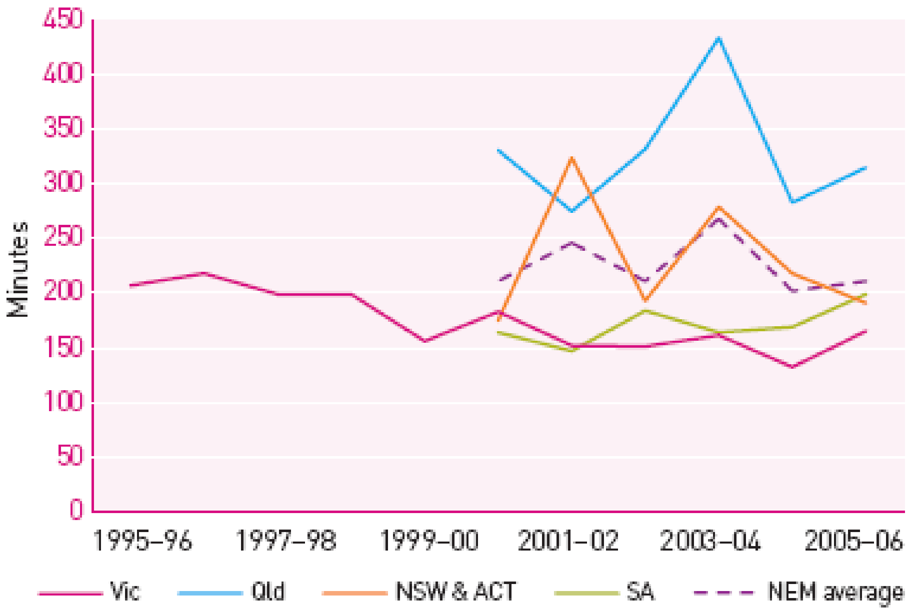
(2000-01 to 2009-10)



Source: Australian Energy Regulator, *State of the Energy Market Report 2007*, p. 154.

The failure of the Queensland Government to invest in a timely manner led to a serious reduction in the reliability of electricity supply. This is evident by a significantly higher fault incidence performance compared with other States (Figure 6). Outages in 2004 induced the Queensland Government to establish an independent panel to review the service delivery of Queensland electricity distributors. A key finding of the panel was that the distributors had focused unduly on improving financial performance at the expense of undertaking capital expenditure and maintaining service quality at acceptable levels.

Figure 6: System Average Interruption Duration Index (1995-96-2005-06)



Source: Australian Energy Regulator, *State of the Energy Market Report 2007*, p. 160.

Separate from the problem whereby significant lags were followed by catch-up infrastructure spending is the issue of selection of infrastructure projects so as to best serve the needs of taxpayers. This requires careful and rigorous evaluation of projects in terms of cost-benefit analysis.

Unfortunately, the States and Territories disclose virtually no information about the evaluations undertaken of investment infrastructure programs. Taxpayers cannot therefore have any real confidence that the debts that are being incurred on major infrastructure projects will not simply require substantially higher taxes in the years to come, taxes not offset by a commensurate flow of benefits from the infrastructure projects undertaken.

The experience of various States suggests there is a serious problem here, though it is not a problem related solely to the States and there is room for significant improvement at the Commonwealth level as well. Requiring public disclosure of cost-benefit analyses of all government-funded infrastructure investment programs, regardless of jurisdiction, would increase accountability for what are significant taxpayer-supported outlays.

Too often, “pork barrel” projects consume resources that would be better spent elsewhere. While inefficiencies in the allocation of infrastructure funds are nothing new, the problems they create have been aggravated by the States’ recent investment splurge.

That splurge has fuelled labour market shortages and steeply increased construction costs. Thus, in the case of roads, estimates suggest that construction costs per completed road kilometre are up by as much as 30 per cent in an 18 month period, meaning that the community is getting far less for the outlays than it would have secured had the spending been better spaced in time.

Additionally, as the scale of spending has increased, inefficiencies in the management of that spending have become ever more obvious. New South Wales is a case in point.

Thus, the NSW State Infrastructure Strategic Plan (SISP) for 2002 listed projects across all sectors, in most cases with a budget and expected completion date. By late 2004, an audit of 88 of the key projects revealed $752 million in cost over-runs, one in four projects delayed, and one in ten projects dead or abandoned. By May 2006, the same list (with an estimated total project value of $11 billion), had reached timetable blowouts of around 40 years, and cost blowouts of $1.7 billion. And an assessment of the 2007-08 capital works budget papers shows 187 projects delayed, 219 years of total delays and an overall blow-out of $2.6 billion.

These issues will not be resolved without fundamental reform of how State infrastructure programs are run. Pouring more money into those programs without needed reforms taking place will simply squander the community’s scarce resources.

4. REFORMING INFRASTRUCTURE DECISION-MAKING

Given the problems that have surrounded State and Territory infrastructure planning, it is useful to outline some broad premises to highlight the reform challenge. From the perspective of this submission, these are as follows:

1. There is nothing magical about infrastructure investment. Ultimately, it is a cost like any other, even though the stream of benefits generated by that investment is exceptionally

durable. There is no virtue in having more infrastructure rather than less; rather, the crucial issue is that the costs associated with infrastructure be incurred efficiently, that is, in a way that maximises the net benefit to society.

2. It is crucial to get infrastructure investment right. This is because many infrastructure assets are difficult to replicate, and some are natural monopolies. This means that under-investment in infrastructure is not self-correcting: alternative sources of supply will not develop, or develop efficiently, if existing suppliers are prevented from engaging in timely and efficient capacity expansion. The resulting bottlenecks are therefore likely to impose particularly severe constraints on economic growth.

3. If properly regulated, most infrastructure investment should be commercially viable and private capital markets should be able to fund most of the infrastructure investment that is socially desirable. Moreover, it is usually desirable that it be so funded, as the "market failures" associated with private ownership are generally less severe than the "government failures" associated with public ownership, even when account is taken of claimed benefits of public ownership in terms of a lower cost of capital.[12]

4. That said, there are complex contracting issues associated with private ownership of infrastructure, and the efficiency comparison between ownership modes is affected by the extent to which those issues can be satisfactorily resolved.

5. Additionally and importantly, there are areas of infrastructure which are not generally capable of being funded commercially. These include the bulk of the road network, which is unpriced and funded through taxation, and the "community service" component of the conventional public utilities.

It is appropriate in the light of these premises to untangle government ownership from the operation of commercially viable infrastructure such as energy utilities, as many States have done and as NSW proposes to do now. The proposed privatisation of electricity generation in NSW is in that sense a step in the right direction, though the precise form of that privatisation is obviously also crucial to any assessment of its economic merits. As for social concerns, while in some instances fully legitimate, these are best addressed through appropriate regulation, rather than government ownership.

As noted above, there are areas (including transport infrastructure) where social returns on infrastructure investment exceed private returns and where social returns are difficult to capture efficiently through user charges. These areas are therefore not as amenable to private/commercial ownership. In this case, government will continue to play a role that goes beyond mere regulation insofar as it has to either invest in and operate or facilitate the investment and operation of the required infrastructure.

The primary issue in these areas is not the availability of funding *per se*, as governments can and do finance these activities through taxation. There is no inherent advantage in replacing that funding with funding from other sources, unless those other sources are more efficient in raising funds (i.e. impose a lower deadweight loss), in selecting and managing projects, or both.

12 This is not to accept the contention that the public sector cost of capital is indeed very low. Rather, it is clear that the social discount rate exceeds the risk free rate, except when the net income stream is expressed in appropriately measured certainty equivalents.

While claims that other sources will raise funds more efficiently are often unconvincing,[13] it is at least possible that they could do better in selecting and managing projects. Certainly, experience in transport suggests there is scope for improving efficiency in that respect.

In road, for example, estimates using the Bureau of Transport and Regional Economics' Road Infrastructure Assessment Model (RIAM) suggest that road capacity exceeds the economic level in 25 per cent of the National Highway System and up to 45 per cent of roads in regional South Australia.[14] While these uneconomic investments have been going on, upgrades to the Pacific Highway, which are compelling in cost-benefit terms, have been long delayed.

Equally, in intermodal rail, which largely fails to earn a commercial rate of return,[15] the recent commitment to develop an inland rail link between Melbourne and Brisbane is very difficult to justify.[16] That link is likely to both be uneconomic in itself and to further reduce the East Coast line's limited ability to achieve economies of density. Fundamentally, if the costs of addressing the structural problems of the East Coast line exceed the benefits – which they may – then it is not sensible to spend even more building an alternative that cannot handle the bulk of the rail freight task.[17]

No more defensible, on cost-benefit grounds, is the Victorian Government's decision to spend over $700 million upgrading regional passenger rail services: and to do so without renewing the track with gauge-convertible sleepers – a very modest expense that could have possibly been a positive aspect of the scheme.[18]

13 An example is the claim that it is more efficient to fund roads through tolls than through taxes, so that PPPs should be used to build toll roads. This seems plainly incorrect. Were tolls indeed more efficient than taxes, and were government no less efficient than other sources of funds in project selection and management, then the government should build the roads, and charge tolls that are above the marginal externality cost of congestion by an amount sufficient to reduce the most distorting taxes up to the point where marginal deadweight losses are equalised. More generally, for many local public goods (such as street lighting and other local amenities), it is difficult to improve on the efficiency of properly-structured land taxes.

14 These estimates also find that maintenance expenses depart from efficient levels in a third of New South Wales roads, by length, and an even greater share of the National and regional South Australian road systems.

15 Intermodal rail in Australia suffers from enduring difficulties, not least a freight task in which the volumes naturally suited to rail are relatively small. These difficulties have been aggravated by quality problems in the rail network, with those problems being most acute in the approaches to Sydney. Vertical separation post-Hilmer produced some, significant, efficiencies in the short run, but probably made the underlying difficulties even more intractable. The result has been an intermodal rail network that is not generally commercially viable. The principal exception in that respect is the East-West corridor, but even there, access charges are below the long run replacement cost of the track.

16 To the best of my knowledge, there are no studies suggesting that the magnitude of the Brisbane to Melbourne freight task would be capable of supporting such a line any time before 2020. Rather, it seems clear that even on optimistic projections as to the magnitude of that task, and the share of it that could go by rail, an inland link would not be commercially viable. As for the period subsequent to 2020, it seems unlikely, on the balance of probabilities, that such a link could be viable, so that the risks involved in its construction are substantial. Obviously, the viability of such a link would be diminished were the East Coast Line improved. Equally obviously, it makes little sense to both improve the East Coast Line and build the inland link. As a result, the relevant issue is which of these options is more efficient: the answer is clearly the former, as it would also secure density economies from Sydney traffic. In short, if it makes sense to continue to invest in intermodal rail (which may or may not be the case), then the efficient investment is likely to be in addressing the bottlenecks that affect the East Coast Line.

17 If intermodal rail is to have any future on the East Coast, the issues associated with the accesses to Sydney need to be addressed. Funding from AUSLINK is being used to construct a Southern Sydney Freight Line (SSFL), consisting of a dedicated freight line for a distance of 30 kilometres between Macarthur and Sefton in southern Sydney. The objective of the SSFL is to provide a third track in the rail corridor specifically for freight services, allowing passenger and freight services to operate independently. The resulting single track (which will run next to the Main South Line between east of Sefton Park and south of Macarthur) should greatly reduce rail freight bottlenecks through southern Sydney and improve freight transport flows between Southern destinations and Sydney ports. While this will be a substantial improvement, the physical constraints on access will persist on the Northern approaches to Sydney, which are of obvious importance for rail flows to and from Queensland.

18 The current Victorian State government came into office with a commitment to convert most (but not all) of its railways to standard gauge (most of the intrastate lines in Victoria are broad (Irish - 1600mm - 5'3") gauge). As of yet, that conversion has not occurred. When rail has timber sleepers and changes gauge from broad to "standard" (Scottish - 1435mm - 4' 8.5"), all that is required is to drill additional holes into the sleepers and shift the rail inwards. However, if

These distortions in resource allocation reflect politicised decision-making in the presence of soft budget constraints. In theory, hardening those budget constraints could improve the efficiency with which the decisions were taken. This would most obviously be the case if the decision-maker did not internalise (i.e. capture) the political benefits associated with otherwise inefficient projects but did internalise efficiency gains in the construction and operation of the assets.

One approach that attempts to reduce the “pork barrel” element in infrastructure finance involves greater reliance on Public-Private Partnerships (PPPs), which are claimed to import to infrastructure investment the discipline of private sector budget constraints. The assumption, simply put, is that since the providers of finance secure no gains from politically popular but commercially unviable projects, those projects that are not viable will not be funded.

While PPPs deliver on that promise in some cases, in others, the criteria used to decide as between alternative funding options, the risk allocations that ultimately prevail and the pricing arrangements all appear inconsistent with even elementary economics.

Obvious examples of difficulties with PPPs include the Airport Rail link in Sydney and – though views on this instance differ – the Sydney Cross-City Tunnel. Both of these projects involved substantial renegotiation, which materially altered the effective risk allocation. Equally, the urban rail franchises in Melbourne were renegotiated following the exit of National Express in December 2002. This is not to say that any of these projects were necessarily welfare-reducing but rather to highlight the many difficulties involved in designing effective PPPs. These difficulties are reflected in the high transactions costs associated with establishing PPPs, with those costs usually being in the order of 3-10 per cent of construction costs.

Additionally, the mere fact that private investors can be interested in financing an infrastructure project is far from guaranteeing that that project is efficient.

Thus, even very inefficient projects can be made commercially viable through direct or indirect government subsidies. These forms of assistance may be very opaque indeed. “Traffic shaping” measures, for example, have been used to divert traffic flows to PPP-financed road segments. The economic costs of these measures obviously fall in the first instance on motorists (in the form of additional congestion and hence travel-time costs) and subsequently to some degree on land values, but are real nonetheless. Similarly, ancillary concessions – such as rights to develop adjacent land – have been used to bolster the viability of rail projects. Finally, implied government guarantees, associated with the scope for refinancing, are a form of contingent liability that bears on taxpayers and that is rarely properly accounted for.

there are concrete sleepers, which are shaped for the gauge, there is a need to reshape for both gauges. As a result, the only way to regauge with concrete sleepers is if the sleepers have been made that way in the first place. If so, it is simple to unclip and reclip the rail - a relatively cheap option; if not, the costs are very high.

Moreover, even if the efficiency of PPP-type arrangements were improved, they are of limited applicability in important areas of infrastructure (such as densely meshed urban road networks, and the local and secondary roads that account for a large part of ongoing outlays) where there is little scope to define viable, stand-alone, projects. The overall outcome can be that poor projects proceed but at even higher economic cost and with less transparency. Ultimately, PPPs are only as good as the governments that make them.

As a result, there is no merit in simply seeking an increase in the role of PPPs, absent very significant improvements in the quality of the contracts on which they are based. They do not ensure that projects are more efficiently selected than would occur in any event, and the evidence on their overall performance is very mixed. Moreover, particularly for projects that are “too big to fail”, poorly designed PPPs may end up simply “privatising profits while socialising losses”. Finally, especially where PPP contracts lack transparency, they can encourage rent-seeking, in which proponents of PPPs incur wasteful outlays – including in contributions to political parties – that are of no benefit to the community.

In short, Australia’s infrastructure problems are not short term in character. Resolving them requires a real willingness to ensure all levels of government lift their game in terms of how infrastructure projects are selected and managed.

The role of the Federal Government’s new body, Infrastructure Australia, in relation to these challenges is as yet unclear. At least the promise has been made of a more transparent and rigorous framework for analysing and funding infrastructure priorities. It is to be hoped that this promise is fulfilled.

If, however, Infrastructure Australia proves little more than a vehicle for transferring Commonwealth funds to State Governments without reform of infrastructure decision-making and governance arrangements, it has the potential to merely waste taxpayers’ money. Large-scale investment from a Building Australia Fund, or indeed from any other public sector source, does not absolve the Commonwealth Government of its responsibility for ensuring that State and Territory Governments improve their decision-making processes and tackle pressing regulatory problems that, in some cases, are holding back commercial investment in much-needed infrastructure. Indeed, the hypothecated nature of these funds itself raises very serious concerns, as it means that taxpayers’ resources may be devoted to infrastructure even when the marginal benefits of deploying those resources to other uses would be greater.

Overall, the imperative in relation to infrastructure spending is not a national approach *per se,* but rather a fundamental commitment by all levels of government to best practice regulation, including genuine transparency and serious cost-benefit evaluation of projects.

5. FEDERALISM REFORM CHALLENGES

More broadly, further reforms are required to enhance the accountability of State and Territory governments to taxpayers and to put in place better incentives for efficient investment and recurrent expenditure. There is ample opportunity to achieve this through intergovernmental agreements. This would also be the appropriate vehicle for reform given the financial contribution that the Commonwealth makes to the States.

One proposed approach goes under the heading of **"competitive federalism"**. The purest form of this approach proposes a clear assignment of responsibilities within the federation between the Commonwealth and the States in order to completely remove any overlap and duplication of functions between the various tiers of government (Commonwealth and States) followed by a clear assignment of revenue raising devices between the levels of government and removal of any vertical or horizontal fiscal imbalances (i.e. any further transfers between the Commonwealth and States or redistribution between States).

The form of competition most valued under a competitive federalism perspective is horizontal competition – that is, competition between the States and Territories to satisfy the demands of their population in the best possible way including through efficient delivery of appropriate services. To adopt the terminology of Hirschman,[19] "exit" via migration between States is the main enforcer of horizontal competition under competitive federalism. It is envisaged that people and businesses will "vote with their feet" by moving to a State offering a political, social and economic environment more to their liking. Governments at the State and Territory level compete by experimenting with different policies or variations on what others have tried. In the long run there is expected to be movement by all States and Territories towards the arrangements which best meet the needs of the populations that choose to reside within them.

Under this view of the world, the simultaneous involvement of more than one government in a single area is regarded as wasteful duplication. It also creates accountability problems because such overlaps mean that no single government can be held responsible for poor performance and there is scope for blame shifting between the governments with overlapping roles.

This view has some basis in the economic literature in models of federal systems in which competition between sub-national units drives the national unit to efficient outcomes.[20] However, there are also inherent problems with this simple picture.

Firstly, one issue is what specific federal division of governmental powers and responsibilities is most appropriate today and into the future. This is a controversial question and one which can be very difficult to settle once and for all. Setting up the "correct" division of powers and responsibilities requires a large fixed cost investment in getting the division right in the first place. Future policy flexibility may be reduced as a consequence and a new consensus must be reached for reassignment of powers if circumstances dictate that new powers are needed to deal with the inter-State implications of issues such as management of the natural environment.

19 Hirschman, A. (1970) *Exit, voice and loyalty: Responses to declines in firms, organizations and states,* Harvard University Press.

20 See Tiebout, W. (1956) 'A Pure Theory of Local Expenditures', *The Journal of Political Economy,* 64 (5), pp. 416-24.

Secondly, historically, the kind of horizontal competition envisaged by proponents of competitive federalism has led to inefficiencies – in other words, horizontal competition between States does not always lead to the most efficient policy mix. The problem is well illustrated by the history of payroll tax.[21] In essence, all states have eroded the payroll tax base by increasing the tax-free thresholds faster than the rate of wage inflation even though, after land taxes, most economists regard a broad based payroll tax as a relatively efficient tax.[22] While the introduction of the GST as a growth-based tax with revenues available to the States should have better facilitated competition between the States, its introduction has not, in reality, improved the quality of tax competition.

Finally, the competitive federalism perspective may ignore or underemphasise another form of competition, namely vertical competition. This is where the Commonwealth itself competes against the States and Territories, individually or collectively to better deliver services to communities within those States and Territories.[23]

The new Federal Labor government has placed federal-state relations and by extension so-called **"cooperative federalism"** back on the agenda by recently giving a central role to the Council of Australian Governments (COAG) to pursue intergovernmental agreements to facilitate further reforms to healthcare, Indigenous affairs, education and training and the environment among other areas.

The basic premise of cooperative federalism is that governments at different levels interact cooperatively and collectively to address common problems. Under a cooperative federalism model, the gains from cooperative behaviour are seen to outweigh any benefits of competitive tension (whether horizontal or vertical) in the federation.

This approach was deployed in implementing National Competition Policy in April 1995 when the Commonwealth, States and Territories agreed to a nationally coordinated program of microeconomic reform. Among other things, this program extended competition laws to government businesses and the professions, reformed public monopolies, and introduced third-party access regimes for infrastructure providers. The crux of the approach was for the Commonwealth to make so-called 'incentive payments' to the States and Territories contingent on the achievement of agreed reform targets or milestones.

There were many reasons why this cooperative approach to reform may have been necessary to achieve the full scope of possible reform benefits from competition policy.

Firstly, at the time, the States lacked a source of tax revenue that was clearly linked to overall economic growth, while the Commonwealth had such a source in the income tax. As a result, arguably most of the efficiency improvements from reform would flow into the Commonwealth's tax base rather than into that of the States. Measures were therefore needed to secure the States' cooperation in implementing reforms in a context where they would not otherwise capture the full benefits through increased revenue collection. A system of offsetting incentive payments from the Commonwealth to the States consequently made sense as a means of securing such cooperation.

[21] See the discussion in Pincus, J. (2008), 'Six myths of federal-state financial relations', available at http://ceda.com.au/public/research/federal/six_myths_federal_state.html

[22] Pincus, J. (2008) 'Six myths of federal-state financial relations', available at http://ceda.com.au/public/research/federal/six_myths_federal_state.html

[23] Pincus, J. (2008) 'Six myths of federal-state financial relations', available at http://ceda.com.au/public/research/federal/six_myths_federal_state.html

Secondly, the States' revenue base was largely inefficient, as it depended on tax sources (including implied taxes on public utilities) that caused substantial distortions to producer and consumer decision-making. The Commonwealth's revenue sources, such as income tax, which would fund the competition policy payments, were somewhat less distorting. There was therefore an added gain to the economy that came from replacing a more distorting by a less distorting source of income.

Finally, the payments may also have reflected "spill-over" effects, whereby reforms by each State flowed largely to the benefit of other States and Territories. Had those "spill-over" effects been large, it is possible that (absent offsetting Commonwealth payments) some States would have borne more in costs than they secured in efficiency gains, even in the long run. However, too much can be made of this argument. In practice, it is doubtful whether the spill-over effects were all that great. A more likely scenario is that the largest States would have borne the bulk of the costs and secured the bulk of the efficiency benefits. Moreover, even if there were some spill-overs, the net benefits to each State still likely outweighed the costs each State had to bear, especially given a coordinated reform program. Aside from the fiscal issues, it would therefore have been sensible for each State to go along with the reform program, even if some part of the benefits was captured by others.

In any case, the NCP reforms delivered substantial economic gains. The Productivity Commission has calculated that changes in infrastructure industries associated with the reforms added 2.5 per cent to Australian living standards.[24]

The Commonwealth's revival of the COAG model of cooperative federalism as a means of improving governance deserves cautious support, especially when compared to a simple 'competitive federalism' approach or further centralisation, but with serious caveats.

Firstly, the Federal Government's proposal to reintroduce 'incentive payments' to the States as a means of motivating intergovernmental cooperation has little to recommend it as good policy.

Today's situation is radically different from that in the mid-1990s. In particular, the GST means that the States now benefit from a very effective growth-linked tax source. To the extent that reforms will increase the income base going forward, those gains will flow to the States in line with the growth in GST revenues. Of course, there are arguments about the overall split of revenues between the States. However, those arguments have no direct bearing on the funding of particular reforms and, in any event, could not be resolved sensibly through payments linked to individual policy changes. As a result, the major justification which there may have been in the past for compensating payments no longer exists.

24 Productivity Commission (2005) "Modelling Impacts of Infrastructure Industry Change over the 1990s", Supplement to Review of National Competition Policy, Productivity Commission Report No. 33, Canberra, February, cited in Pincus, J. (2008) 'Six myths of federal-state financial relations', available at http://ceda.com.au/public/research/federal/six_myths_federal_state.html

There is also an obvious incentive problem with using such payments when they are not needed. If the signal the Commonwealth sends is that it is willing to pay the States to undertake changes that they should undertake in any event, then the response will be continued demands for payments. Having made so much of its ability to get the States to agree, the government would then have to cave in to a succession of demands for payment that have no merit.

Even if the individual payments this gives rise to are small, the cumulative costs of such an approach would be substantial. The crucial fact is that each dollar paid to the States must come from somewhere – and where it comes from is Commonwealth taxes. Bribing the States into doing the right thing requires those taxes to be higher than they would otherwise be, as well as diverting taxes to State governments that, as has been demonstrated, often make poor use of resources. The risks in this respect are magnified by the political element involved in dividing up payments among the States, with the obvious danger that large, unjustified payments will be made to States that are close to elections. Those payments will then be squandered on projects that are politically attractive, but have little real value. The payments may therefore end up offsetting the gains from the reforms.

There is, more generally, a need to beware the temptation of cooperative federalism degenerating into collusive federalism, absent the natural political rivalry between governments of different parties. The unfortunate reality is that governments that share a political affiliation are likely to find it more difficult to be openly critical of each other, and thereby ensure a high level of transparency as to outcomes, when doing so could compromise the electoral prospects of the party they represent.

One means of avoiding this temptation is for the Commonwealth to take a measure of "tough love" – that is, a willingness not merely to support the States and Territories in the exercise of their functions, but also to hold them accountable when the need arises.

Tough love requires the ability to give effect to a credible framework of incentives, and to do so in a timely and effective manner. There are some threats that are not especially credible because they would be so complex and costly for the Commonwealth to carry them out. For example, it is easy to say that if the States and Territories do not lift their game, the Commonwealth will take over the public hospital system as the current Federal Government has done; whether this is a credible threat is more difficult to ascertain. Nor should it be the role of the Commonwealth to bail out State and Territory Governments when they are not performing up to the mark.

A critical factor that can affect the credibility of a Commonwealth commitment to hold State and Territory Governments accountable for service delivery outcomes is the extent to which consumers can turn to sources other than the States and Territories to provide services. Health care and education are areas where Commonwealth funding in the last decade has helped encourage the development of alternatives to the services provided directly by State and Territory Governments.

Initiatives undertaken by the former Coalition Government led to a marked increase in the proportion of Australians holding hospital Private Health Insurance (PHI), with that proportion rising since 1996 from 33.5 per cent to 43.5 per cent.[25] At the same time, increasing PHI coverage has permitted the growth of a substantial private hospital sector, which has expanded consumer choice and provided useful performance benchmarks for assessing performance in the public hospital sector.

As that process played itself out, an increasing share of Commonwealth health care funding was devoted to private sector alternatives. Thus, in the 2005-06 financial year, the Commonwealth provided over 90 per cent of the funding to private hospitals.[26] This area of expenditure has grown eight-fold since 1995-96, from $381 million to $2,639 million, with government expenditure on private hospitals rising over that period from less than 3 per cent of the total hospital funding budget to just under 11 per cent.[27]

When account is taken of that shift, the Commonwealth share of direct hospital funding has remained stable over the period – in 1995-96, the Commonwealth accounted for 50.33 per cent of total (Commonwealth plus State and Territory) expenditure on hospitals; in 2005-06, the Commonwealth's share of total hospital funding was 49.98 per cent.[28]

Put simply, there has been a rebalancing from funding of public providers to a somewhat greater weight on private providers. That rebalancing largely reflects (though it has doubtless also permitted) choices made by patients and their families, as well as by medical professionals – primarily, a choice to make greater use of private health care facilities. Facilitating this type of competition can provide a powerful incentive to the States and Territories for them to improve the performance of their public hospital systems, though obviously they also need to access to the resources that requires.

A similar trend emerged in relation to schools funding whereby the former Coalition Government significantly expanded funding for non-government schools. While Commonwealth spending increased in real terms for both government and non-government schools, the share of Commonwealth funding going to non-government schools has risen significantly from 58 per cent in 1995-96 to an estimated 68 per cent in 2003-04.

Together with the abolition of the previous Labor Government's "New Schools" policy (under which administrative measures were applied that substantially restricted new non-government schools from opening), the increase in non-government school funding in the past decade has promoted contestability in education and provided greater choice, especially to many low and middle income families who traditionally could only rely on school services provided by the State and Territory education departments.[29]

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25 Private Health Insurance Administrative Council (PHIAC) 2007, Membership Statistics at <http://www.phiac.gov.au/statistics/membershipcoverage/table1.htm> at 23 October 2007.

26 Australian Institute of Health and Welfare (AIHW) 2007, Health Expendiiture Australia 2005-06, Health and Welfare Serioes, No. 30, Cat. No. HWE 37, Table A3.

27 Ibid both points from Table 18.

28 Ibid Table A6 and AIHW 1998, Australia's health services expenditure to 1996-97, Health Expenditure Bulletin 14, 19 November Table 35.

29 The extent of the restriction under the New Schools Policy was material: as of late 2007, some 359 new schools, of which 109 are low fee schools (i.e. schools that charge fees of less than $2,000) have opened following its abolition.

There is a strong case for continuing the development of alternative service delivery channels, in the form of private health insurance and private hospitals in the case of the health system, and of non-government schools in the case of education. This is important in terms of providing choice to consumers, encouraging innovation and efficiency in service delivery (including by State and Territory Governments) and in responding to the pressures that demographic, social and economic change creates for these services.

The unfortunate reality is that the substantial increases in funding that have flowed to the States and Territories since the beginning of this decade (from both own-source and Commonwealth revenue) have not yielded anything like the improvement in government services they should have. Too often, reform has fallen foul of public sector unions who prefer featherbedding and a "quiet life" to the disciplines of competition and choice.

While public sector service providers are essential and must be given appropriate resources, they need to adapt to a world in which consumers can exercise greater choice. And, over the longer term, the resources they receive must reflect the success they achieve in effecting that adaptation. It is thus by expanding choice and contestability that the Commonwealth can most effectively improve the performance of State and Territory governments.

It is important to keep this in mind given what clearly are the high hopes that have been invested in a more cooperative federalist model, though one which appears to have distinctly centralist tendencies in areas such as health and education. Needless to say, what is important is not a national or cooperative approach *per se*. Nor should processes of regulatory harmonisation be valued in themselves.

Much more important is the framework of incentives established for individuals and service providers, especially in areas such as health and education where governments play a central role in determining the economic space within which competing providers can operate. What is required is not merely repair with more funding, but rather genuine reform that changes incentives and enhances choice for consumers.

Increases in government funding will doubtless be required to improve public services significantly, but future growth in funding should be tied closely to reform. Moreover, what is needed is a funding model geared to careful irrigation, not "flash floods". There is already ample evidence to suggest that flash floods (especially in an economy at or near full employment) simply push up costs to the ultimately detriment of taxpayers and with little in the way of lasting improvement in government services.

6. SUMMARY AND CONCLUSIONS

The following points summarise the main conclusions of this submission:

- Recent years have seen a significant deterioration in both the fiscal balance and net debt positions of the States and Territories, all the more notable given the revenue increases which have accrued from Commonwealth transfers and from economic growth.

- A sharp increase in the net debt of public non-financial corporations at the State and local government level largely reflects the financing of State government infrastructure projects.

- Most States and Territories have also increased expenses at the same time as revenues accruing to States and Territories have continued to rise with strong growth in Commonwealth payments to the States (including GST revenues). Recent State budgets suggesting these trends will continue.

- These developments raise concerns relating both to macroeconomic policy (given the pro-cyclical nature of expansionary budget policies) and to the planning, project selection and management of State infrastructure projects. Relatively rapid growth in public sector wage costs at the State level also points to scope for improved State financial management.

- The current infrastructure spending spree by the States and Territories followed a period of relative neglect of infrastructure investment in which significant capacity shortages and strains were allowed to emerge in a number of areas. A failure to anticipate and respond to infrastructure needs in an efficient and timely way highlights the need for far-reaching reform to ensure better allocation of infrastructure funds. This is not a problem related solely to the States and there is room for significant improvement at the Commonwealth level as well.

- Greater reliance on Public-Private Partnerships is one approach to reducing the "pork barrel" element in public sector infrastructure financing, based on importing the discipline of private sector budget constraints. Ultimately, however, PPPs are only as good as the governments that make them and a number of examples suggest there is no merit in increasing the role of PPPs absent very significant improvements in the quality of the contracts on which they are based.

- The key imperative in relation to infrastructure spending is a fundamental commitment by all levels of government to best practice regulation, including genuine transparency and serious cost-benefit evaluation of projects. While the establishment of Infrastructure Australia by the Commonwealth Government holds out the promise of improved decision-making, if it proves little more than a vehicle for transferring Commonwealth funds to State Governments without reform of infrastructure decision-making and governance arrangements, it has the potential to waste even more taxpayers' money. The hypothecated nature of the funding provided to Infrastructure Australia is also a matter for concern.

- Improving the accountability and financial management of State and Territory Governments is central to the broader issues surrounding reform of the Federation. Of the two broad models of reform – "competitive federalism" and "cooperative federalism" – the latter has been given new prominence by the current Federal Government as the basis for addressing key national challenges. There are potential gains from the revival of this approach, especially when compared to a simple model of competitive federalism or greater centralisation.

- Important caveats should be noted, however, especially in light of the changes in tax arrangements post the GST and unconvincing arguments on the need for “incentive payments” to the States as a means of motivating intergovernmental cooperation. Bribing the States to do the right thing has little to recommend it as good policy and, in certain circumstances, creates incentives for cooperative federalism to degenerate into collusive federalism.

- It is critical, therefore, that the Commonwealth put in place a credible framework of incentives based on a measure of “tough love” – that is, a willingness not merely to support the States and Territories in the exercise of their functions, but also to hold them accountable when the need arises. It should not be the role of the Commonwealth to bail out State and Territory Governments when they are not performing up to the mark.

- A key element of a credible framework of incentives is a continued commitment by the Commonwealth to ensure consumers can turn to sources other than the States and Territories to provide services. This is important in terms of providing choice to consumers, encouraging innovation and efficiency in service delivery (including by State and Territory Governments) and in responding to the pressures that demographic, social and economic change creates for these services.

- Health care and education are obvious areas where Commonwealth funding in the last decade has helped encourage the development of alternatives to the services provided directly by State and Territory Governments. There is a strong case for continuing the development of alternative service delivery channels, in the form of private health insurance and private hospitals in the case of the health system, and of non-government schools in the case of education.

- The unfortunate reality is that the substantial increases in funding that have flowed to the States and Territories since the beginning of this decade (from both own-source and Commonwealth revenue) have not yielded anything like the improvement in government services they might reasonably have been expected to permit. What is required is not merely repair with more funding, but rather genuine reform that changes incentives and enhances choice for consumers. Future funding growth should be tied closely to reform with funding provided in the form of careful irrigation, not “flash floods”.

- Increasing spending without real reform, and prior to real reform, has been shown time and again to be wasteful. For example, experience in the UK and elsewhere shows that simply pouring resources into reducing waiting times for elective surgery does little to address the underlying problems, with the increased spending being largely dissipated on increased payments to scarce medical personnel. Rather, so as to ensure taxpayers get “value for money”, it is crucial that States and Territories reform their provision of public services. Providing competition to those services – competition that is often stymied by the highly subsidised basis on which public services are provided – is a key element in providing real incentives for those reforms to occur.