CHAPTER 8
THE PUBLIC SECTOR AND THE FEDERATION

Under Australia's federal system of government, most major services are delivered by the states, but the overwhelming proportion of revenue is collected by the commonwealth. The mismatch of funding and responsibilities is now a major barrier to effective government. Reform in this arcane, complex and politically fraught field is essential to making the most of Australia's long-term opportunities.

Economists call the gap between revenue and responsibilities 'vertical fiscal imbalance'. Australia's extreme imbalance has emerged over more than a century of practice by commonwealth and state governments, as well as constitutional interpretation by the High Court of Australia. The states once administered a number of taxes that are now only applied by the commonwealth (income tax; retail sales taxes on fuels,

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tobacco products and alcoholic beverages) or not at all (inheritance and gift duties). Furthermore, the recent (2013) High Court judgment in *Fortescue v. the Commonwealth* has confirmed the constitutional validity of the commonwealth's recent entry into another field once exclusively occupied by the states: taxation of resource rents for on-shore projects.

From 1971, the commonwealth agreed that the states would have exclusive power to levy the payroll tax with its considerable revenue-raising potential. Over the past three decades the states have whittled its revenue-raising power away bit by bit with exemptions and reductions. Ironically, this was encouraged by business lobbies, which were at the same time seeking increases in the GST, which has much the same effect. The business pressure to reduce the payroll tax and increase the value-added tax reflected a confusion over the point of collection of a tax and the people upon whom its burden ultimately falls.

Not only did the states corrode much of their existing tax base, but they rejected an offer by the Fraser government in the late 1970s to share the proceeds of the income tax. They can be seen as joint authors of their own impecuniousness. Be that as it may, their continuing financial problems affect all Australians.

The gap in funding for state-supplied services is filled by commonwealth grants of two kinds: general purpose and specific. The latter are made available on the

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condition that the states spend them in ways approved by the commonwealth. Both forms of grants are problematic, albeit for different reasons.

General purpose grants comprise the revenue collected by the commonwealth from the GST. The smaller states succeeded in having this distributed according to the unique Australian system of 'horizontal fiscal equalisation', which is administered by the Commonwealth Grants Commission. At the time that the GST was introduced, the two largest states, New South Wales and Victoria, received less than their population share of the grants that the proceeds of the tax were meant to replace, while all the other states and territories were recipients of more than their share. The Victorian government saw merit in the GST as an innovation in public policy and, in an act of national leadership, put aside its state interest to agree to the allocation of funds through horizontal fiscal equalisation. The NSW government was left alone to resist the new system and was unsuccessful. The inadvertent effect of the arrangements for the GST was to expand what had once been a distorting but relatively unimportant element of our fiscal system.

Under the Constitution, the states are responsible for the provision of major services, including health and aged care, the demand for which increases over time as a share of expenditure, while the tax base of the GST is declining. (Health, education and food are excluded from the tax.) And more and more of the goods and services

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actually covered by the tax are purchased online and so avoid liability.

Special purpose grants are problematic because their spread has meant that virtually all of the states' constitutional responsibilities have become joint responsibilities with the commonwealth. Their pervasive nature removes almost all exclusive initiative from the states and negates much, if not all, of the potential value of the Federation.

The two problems together have ensured an extreme lack of transparency in the national political process. It is practically impossible for the residents of a state to apportion responsibility between the state and federal governments for good or poor performance on critically important matters of economic management and the delivery of services. The consequence is that both state and federal political parties announce commitments that depend for their success on complementary action from the other level of government, and electoral competition focuses on attempts to claim credit for successes and avoid responsibility for failures.

In the first period of the Rudd government, a substantial effort was made to correct these problems with special purpose payments. The organising idea was to orchestrate cooperation between the commonwealth and the states on reducing the number of such payments, by agreeing to broad objectives and monitoring performance against them. Some worthwhile progress was made before the relentless march of business as usual

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again increased the number of special purpose grants and confirmed the system's dysfunction. This episode demonstrated the need for more fundamental reform.

THE VALUE OF THE FEDERATION

There are widely differing views on the value of a Federation comprising separate states with sovereign powers, compared with the value of a unitary Australian state. My view is that the Federation is potentially of high economic and political and social value to Australia, generating benefits from decentralisation of delivery, from differing public choices on taxation and expenditure, and from opportunities for competition over different ways of delivering services.

But whatever one's views, we are currently in the worst of all possible worlds. The states do not have the fiscal freedom with which to deliver the potential benefits of Federation. And the commonwealth does not have the capacities for effective central exercise of the powers of government.

Reform of federal arrangements might seem a bridge too far. Unfortunately, the problems are so large that without change they will remain a major barrier to the effective delivery of a range of services that are essential to both good economic performance and to equity in Australia, including health, education and transport infrastructure. I put forward for discussion just one set of Long-Term List

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changes to federal financial relations that would help bring about a higher Australian standard of living.

First, there should be a far-reaching review of commonwealth and state functions, with each being unambiguously allocated to one or other level of government. I would leave constitutional responsibility for funding disability services and Indigenous development unambiguously in the hands of the commonwealth. For the rest, ending ambiguity is more important than how the division of responsibility falls. Whitlam and Abbott once thought that hospitals should lie within the commonwealth's area of responsibility. Rudd suggested during the 2013 election campaign that responsibility for technical and further education should pass to the commonwealth. These would all be matters for discussion.

Second, the imbalance between revenue and responsibility that remains after the reallocation of powers and responsibilities should be met in two ways: the states should make greater use of their power to raise revenue; and all of their revenue from the commonwealth should be unambiguously and irrevocably delivered as general purpose grants.

In the case of tax, there is considerable scope for expanding revenue from a number of relatively efficient sources: payroll, land (on unimproved value rather than transactions) and resource rent taxation.

A review of federal financial relations, which was foreshadowed by the prime minister during the election

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campaign, will almost certainly leave some imbalance requiring funding from the commonwealth. Specific purpose grants should be avoided. General purpose grants could usefully take all or a specified proportion of some commonwealth taxes. The GST and the MRRT would be candidates.

If any such revenue were entirely transferred to the states, as it is and should continue to be for the GST, the states would take responsibility for decisions on the tax rate and any other changes that affect the amount of revenue collected. Where it is sensible to allow for variation in the rate of a tax among states, each jurisdiction can set the rate within its own boundaries. Where administrative reality requires a common rate of tax across Australia, a constitutional agreement can specify how changes are to be made.

SIMPLIFYING INTERSTATE EQUALISATION

The aim of the Commonwealth Grants Commission's 'horizontal fiscal equalisation' is to give all states and territories the same capacity to provide services to citizens. On the revenue side, a state receives a higher proportion of GST revenue if it collects less revenue per capita than the average when applying the average taxes in the average way. If the 'average' involves an inefficient tax at a high rate, any state or territory that does not apply that tax at that rate will see its share of GST revenue fall. A state with

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unusually large opportunities for raising revenue from some source (for example, Western Australia for mining royalties) will have its share of GST revenue reduced (after a lag) if it exercises this opportunity.

On the expenditure side, the more it costs to provide services within a state or territory, the higher a proportion of GST revenue this state or territory receives (whether or not it actually provides the services). The extra costs of providing a service are known as 'disabilities'.

The system of horizontal fiscal equalisation diverts the attention of officials whose main responsibility would otherwise be good public policy and administration, especially in the smaller jurisdictions. It obscures and weakens accountability for the consequences of good and poor budget management. It creates financial risks for a state that is reducing the costs of providing services. It systematically penalises states that experience higher rates of economic growth, whether the improved performance comes from luck or good management. And it removes incentives for the application of economically efficient forms and rates of taxation, with this being especially important for the natural resource industries.

An elaborate process of measuring disabilities on raising revenue and provision of services generates a wide range of positive (especially for the Northern Territory, Tasmania and South Australia) and negative (especially for Western Australia, Victoria and New

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South Wales) outcomes. One consequence is the emergence of a disproportionately large public sector in the major recipient states.

A new system for the distribution of general purpose grants from the commonwealth obviously requires much discussion and would be contentious. There is no chance of consensus among the states, so leadership must be exercised by the commonwealth. As the source of the revenue being disbursed, it has the authority to take control.

At present, the huge variations in per capita entitlements from the GST revenue pool derive heavily from two sources: the cost of providing services to Indigenous Australians (which are especially important in the Northern Territory) and the greater capacity of Western Australia to generate revenue from mining royalties. There is also a general tendency for the less populous states to receive larger amounts per person (the Northern Territory, Australian Capital Territory, Tasmania and South Australia).

This huge, distorting, opaque and contentious apparatus could be replaced with surprisingly little initial disturbance if there were equal per capita entitlements to the pool of revenue, after making special arrangements for the higher overhead costs of government in smaller states, differences in proportions and locations of Indigenous citizens, and differences in taxable mineral endowments.

The meeting of the minimum costs of government in each jurisdiction can be seen as an unavoidable cost of the Federation. This simple reality could be reflected, in

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transfers from the common pool, by provision of a lump sum relating to the basic machinery of government. In 2002, Vince Fitzgerald and I suggested a lump sum payment of $100 million to each state and territory. That amount might double if a new system were to be introduced later this decade.

TAXING RESOURCES WITHIN THE FEDERATION

A new approach to mineral rent taxation would be at the core of a new federal compact. Differences in capacity to raise royalties from minerals production are now the major cause of variations across jurisdictions. The Commonwealth Grants Commission distributes this royalty revenue across the states, in proportion to population and with a lag of several years. As a result, the share of Western Australia has declined sharply in recent years and seems likely to continue to do so until the state receives less than half of the average Australian grant per person.

Taxing the resources industry has become a major problem for our Federation. There is a widespread understanding of the need for a fundamental departure from the status quo. This departure cannot be to leave all of the taxation power and revenue with the state of origin: that would be too great a violation of Australian perceptions of interstate equity. And not only Australian: all countries with major inter-regional variations in minerals revenues have mechanisms for substantial redistribution.

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One consequence of the averaging away of resource revenues is that the states have little incentive to introduce economically rational levels and forms of taxation and royalties. A consequence of the particular formulae used by the Grants Commission is that the states are fiscally compelled to apply royalties in an economically distorting form.

Simply by way of illustration, let us say that analysis of the public interest identified the optimal form and rate of resource taxation as that of the Petroleum Resource Rent Tax (PRRT), which was legislated for new projects in the mid-1980s. This happens to be close to the form although not the rate of the MRRT introduced in 2011. We can leave aside the transitional arrangements for the MRRT and extension of the PRRT, as these become unimportant in later years.

My suggestion is that the commonwealth should apply the PRRT and MRRT in areas within state jurisdictions at half of what has been the established rate – say 20 per cent. The commonwealth could therefore be seen as utilising half of the 'optimal' taxation capacity of the resources industries. The commonwealth's revenue from this source would be placed in the general purposes grant pool, alongside the GST and some other revenue sources. The states would be invited to occupy the other half of this potential taxation space. Appropriate transitional arrangements would be introduced for established mines – taking account of the fact that investors in the resource

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industries would be given a number of years' notice of the change.

The commonwealth would invite the state or territory host of a project to apply the MRRT to its half of the taxation capacity. The state could choose to vary the rate from 20 per cent if it wished to do so. The commonwealth would collect the tax for the state. If some states and territories simply chose to duplicate the commonwealth's rate of tax, thus exhausting the taxation capacity, this would be a good outcome for economic efficiency. Alternatively, the state could ask the commonwealth to levy and to collect an additional portion of MRRT or PRRT at a rate of its choosing.

Or else, the state could choose to apply a royalty in a form and at a rate of its choosing. Neither the additional resource rent tax nor the additional royalty would be deductible against the commonwealth resource rent tax, although both would be deductible (not creditable) against commonwealth corporate income tax. So all of the resources revenues would be returned to the states – half directly to the state of origin, and half to the pool for general purpose grants to be allocated across the states and territories.

Good governance and the High Court in *Fortescue v. the Commonwealth* suggest that this result for resource taxation should be achieved through agreement between the commonwealth and the states.

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A NEW FEDERAL AGREEMENT

Such an agreement would only be possible in the context of a comprehensive revision of federal financial relations. The political difficulties of this change to the overall structure of federal financial relations would be large, but the suggested arrangements could be phased in over time. This process would be accompanied by guarantees of minimum payments to the states and territories under the new arrangements: for example, the commonwealth could guarantee that a state or territory's share of the general purpose grants pool would not cause the real value of grants (replacing current general purpose and specific purpose payments) to fall by more than 1 per cent per annum. What matters is that we move steadily towards satisfactory long-term arrangements.

The Commonwealth Grants Commission could be given two roles: reporting on the fiscal health of the Federation independently of the political interests of the commonwealth or any state; and assessing the amount of the lump sum payments necessary to cover the minimum overhead costs of government. If one or other state or territory found itself in difficult short-term fiscal circumstances, the independent commission could make recommendations on temporary special grants. This would return the role of the Commonwealth Grants Commission to something like that in the 1930s, when it was first established.

Now, over a century after the federal compact, is a

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good time to review thoroughly the distribution of powers between the two levels of sovereign government. This is unlikely to lead to a shrinking of formal commonwealth powers; it may lead to their expansion. But if change in the division of powers is not possible, let us confirm the established division and introduce fiscal arrangements that will allow it to work efficiently. Whatever the outcome of the review, let us establish a norm in which the states have unambiguous fiscal authority within their jurisdictions, and in which the commonwealth's intervention mainly takes the form of provision of advice and comparative information, assessment of performance, analysis of policy and definition of national norms where they are appropriate.

I say mostly, because the dynamics of politics will from time to time propel the commonwealth into areas of state sovereignty. But let us see such initiatives as deviations from a desirable norm.

SOLVING THE TRANSPORT STAND-OFF

In the meantime, we can do something quickly to solve one of the most debilitating problems of the Federation. Nowhere has the cost and absurdity of the overlapping commonwealth and states been greater than in funding major transport infrastructure. Commonwealth and state each undertake to fund part of some major infrastructure project if the other level of government funds the balance

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– often after purely political assessments and without consulting one another.

The dysfunction of these arrangements reached bizarre depths when the commonwealth, in early 2013, undertook to fund a proportion of an underground railway across Melbourne if the Victorian government matched its commitment. For its part, the state government undertook to fund a major proportion of an underground *road* across Melbourne if the commonwealth matched *its* commitment. There was no evidence of rigorous analysis of the economic value of the road project – so far as the community was concerned, little evidence of any analysis at all. Whether or not one or other of the projects goes ahead, the electorate will be unable to allocate responsibility for the result.

There is a simple remedy for these problems. The commonwealth would withdraw from decisions on which transport projects should proceed and their implementation. It would establish an independent authority with a strong capacity for analysis. This could be built from Infrastructure Australia. The independent authority would undertake rigorous cost-benefit studies of projects from a national point of view. It would define a list of projects with benefits exceeding costs that would qualify for commonwealth funding. If a state or territory wished to proceed with any project on the list, it could draw down a substantial fixed proportion of the capital expenditure requirements (say, 50 per cent in normal

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circumstances) as a loan from the commonwealth, at the commonwealth's long-term borrowing rate. The state or territory government would be entirely responsible for the project.

The commonwealth authority would look only at the economic costs and benefits of various projects. It would have no bias for or against particular transport modes: road and rail projects would each be judged according to their economic contribution. The effectiveness of the proposed approach would depend on the quality of analysis and planning within the states. They would need to develop their own independent, transparent assessment mechanisms. In contrast with current practice, state planning would focus on cost-effective integration of the different transport modes.

There is another problem with major infrastructure that is not caused by the federal framework, but which could be eased considerably as part of the proposed reform of federal financing. Australian governments can borrow over long periods at low rates of interest – on average, over the last century, for ten years at around 2 per cent per annum in real terms. It is not obvious that the 'risk' of devoting funds to carefully assessed infrastructure projects is greater than that of spending money in other ways and thereby accepting the risk – indeed, the certainty – of continued increase in transport and congestion costs within our major cities. And yet assessments of public investment in transport infrastructure typically

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apply discount rates that incorporate allowances for risk that make the rates many times higher than the real cost of borrowing to government.

At the discount rates currently applied to infrastructure projects in Australia, no transformation ever seems worth doing. All major structural change in transport takes many years to implement, and most of the benefits are discounted to trivial values by the use of high discount rates. These are sometimes called market interest rates, although the market rate at which governments can borrow is more like 2 than 7 or 8 per cent in real terms.

For the states, one reason for caution about borrowing for infrastructure is that modest increases in debt may trigger a ratings downgrade and so increase the cost of past debt as well as impose political costs. Partial commonwealth funding would ease this problem. The matching loans would be on the commonwealth's balance sheet alone, but would be serviced by the state. Guarantees of servicing the loans could be made by securing them against general purpose grants.

The matching loans would be available whether the state was managing infrastructure projects directly or through the private sector. In the latter case, the cost of the project would be lowered to the extent that it is not funded at the higher private-sector discount rate.

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