



RESHAPING AUSTRALIA'S  
FEDERATION  
A NEW CONTRACT  
FOR FEDERAL–STATE  
RELATIONS

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# CONTENTS

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## ABOUT *RESHAPING AUSTRALIA'S FEDERATION: A NEW CONTRACT FOR FEDERAL–STATE RELATIONS*

This publication, also referred to as *Reshaping Australia's Federation* (or the *Reshaping Australia's Federation* action plan), comprises:

- + An action plan, representing a summary of research and 12-point plan of action recommended by the Business Council of Australia.
- + A study by the Business Council of Australia titled **Intergovernmental Relations in Federal Systems** (Appendix 1)
- + A report by Access Economics Pty Limited titled **The Costs of Federalism** (Appendix 2)

A separately published summary of *Reshaping Australia's Federation* is contained in Part 2 of the BCA 2006 Annual Review (November 2006).

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## PREFACE

The Business Council of Australia (BCA) represents the Chief Executives of 100 of Australia's leading companies. The BCA's objective is to develop and advocate, on behalf of its Members, public policy reform that positions Australia as a strong and vibrant economy and society. The companies that our Members lead represent an important share of Australia's domestic and overseas business activity.

They therefore have a significant interest in government policy, the direction and scope of economic reform and Australia's future prosperity.

Over the past 18 months, the Business Council of Australia has released a number of reports demonstrating the need for Australia to embark on a new round of national reform. In particular, the BCA has shown the direction reform needs to take in the key areas of:

- + workplace relations;
- + infrastructure;
- + taxation; and
- + business regulation.

From this work it is clear that no significant reform is possible without improvements to the operation of Australia's federal system of government. This action plan highlights the costs of inefficiencies in our federal system and maps out a course of action to begin the reform process.

In preparing this action plan, the BCA has consulted with a wide range of individuals with practical experience of federal-state issues, within government, business, academia and the community. The BCA also hosted a forum with many of these individuals on 1 September 2006 to discuss the future direction of the Australian Federation.

The BCA would like to express its appreciation for the contribution made by the following people to the development of this action plan. We note, however, that the views expressed are entirely those of the BCA and the involvement of the following people should not be seen in any way as their endorsement of the views set out in this action plan.

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- + Mr John Atkin
- + Mr Gary Banks
- + Ms Christine Bartlett
- + Professor Robert Baxt AO
- + The Hon. Michael Beahan
- + Mr Roger Beale AO
- + Mr Alec Brennan
- + Dr A.J. Brown
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- + Ms Kathleen Farrell
- + Professor Allan Fels AO
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- + The Rt Hon. Malcolm Fraser AC
- + Mr Wayne Goss
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- + Mr Hugh Morgan AC
- + Mr Terry Moran AO
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- + The Hon. Andrew Robb AO, MP
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- + The Hon. Warwick Smith
- + Professor Gerard Sutton
- + Mr Guy Templeton
- + Mr Don Voelte
- + Dr Neil Warren
- + The Hon. Gough Whitlam AC
- + Mr Roger Wilkins
- + Professor George Williams
- + Mr Steve Wood
- + The Hon. Neville Wran AC QC
- + Ms Heidi Zwar



## KEY MESSAGE

The issue of relations between the Commonwealth and the states has been debated for many years, with intermittent calls for major reform of Australia's system of federalism.

However, in recent times, it has become clear that the system of federal–state relations as it currently operates is increasingly dysfunctional and not geared to meet the increasing economic and social challenges Australia faces.

In the past, the debate has been mainly framed around political and constitutional reasons for change.

The extent of the problems and dysfunctions of the current system of federal–state relations – marked by a lack of consensus on national goals and consistent forward planning – is such that it has become a major barrier to future prosperity.

The challenge of reforming federalism has now become an economic imperative.

Currently, Australia has a system where the lines of responsibilities between the Commonwealth and the states have become chronically blurred and confused.

We have a system in which, because of a growing lack of transparency and accountability, the quantity of government has taken precedence over quality.

As the world becomes more complex and increasingly requires decision making that anticipates rather than reacts to 21st-century challenges, Australia needs a system of government that can manage issues critical to the future of the nation through collaboration and cooperation.

IT IS TIME FOR A NEW CONTRACT  
BETWEEN THE COMMONWEALTH  
AND THE STATES



As this action plan highlights, weaknesses and inefficiencies in Australia's federal system are now costing Australians at least \$9 billion a year. Costs will escalate as dysfunctional federalism continues to affect prosperity and living standards.

We need to sweep away the barriers to progress that have become embedded in transport, health, education, regulation and other key parts of our economy and society where the current system of federal–state relations is clearly failing.

The solutions are practical and do not require radical change. There are benefits from a federal system of government, but these need to be recognised and enhanced.

Major reform also needs to be undertaken to define the roles and responsibilities of the Commonwealth and the states and embed greater cooperation, consensus and accountability in areas that are fundamental to our future prosperity.

The challenge is to strike the right balance.

In this publication the BCA seeks to make the economic case for reforming federalism by highlighting and quantifying the extent of the problems arising from the current relations between the Commonwealth and the states, and proposing realistic solutions for improvement as part of a 12-point action plan for reforming federal–state relations.

Integral to this plan is building greater accountability and transparency into government roles and responsibilities relating to policy development and service delivery.

The plan also involves fast-tracking a 'common market' for Australian business and consumers by removing the significant barriers to the movement of people, goods and services within Australia.

The challenge is clear: there is no better time in terms of our current prosperity and capacity as a nation to address an area that has so far eluded reform but is vital to Australia's ongoing prosperity.

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## EXECUTIVE SUMMARY

### *WHY BETTER FEDERAL–STATE RELATIONS ARE IMPORTANT FOR FUTURE PROSPERITY*

Australia is facing many challenges in the 21st century, including an ageing population and intensifying global competition. There are also new opportunities, such as new markets that are rapidly opening up in the region.

Governments are the main agents of economic management and reform. They establish policy frameworks, settings and limitations that have a major influence on the nation's prosperity. A critical part of their role is to anticipate and manage emerging challenges and opportunities that affect the performance of Australia's economy.

No government in Australia can respond successfully to these challenges and opportunities alone. Australia's federal system means responsibility for vital parts of the economy, for critical policy development and for efficient service delivery is shared across three tiers of government.

How well our federal system works is a key factor in Australia's growth and prosperity.

There is growing evidence that the way Australia's federal system currently operates is becoming a major barrier to future prosperity. In a number of areas, where there is shared responsibility between the Commonwealth and the states, the system is clearly under severe pressure and is struggling to cope with new challenges.

In many ways, the old federal 'contract' between the Commonwealth and the states has broken down. The trend through the 20th century towards the centralisation of power continues unabated. The line between Commonwealth and state responsibilities on major areas of policy development and service delivery has become blurred and confused.

As a result, relations between the Commonwealth and the states, while showing some signs at present of cooperation, have been mostly characterised by buck-passing and ad hoc approaches. The overall result is a lack of consistent consensus and forward-thinking in relation to issues of national importance.

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## THE CURRENT SYSTEM IS FAILING AUSTRALIA

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Weaknesses in the federal system create real problems that put our economic growth and future prosperity at risk.

- + Education and health services suffer through a lack of clear lines of responsibility and from inconsistent directions from different levels of government.
- + Lack of coordination means forward planning and targeted investment in infrastructure has been lacking.
- + The burden of regulation on the community and business grows yearly as governments add to the stockpile of overlapping, duplicated and inconsistent laws.
- + The tax system is subject to a number of inefficient taxes, particularly at a state level, and there is an overall lack of strategic planning around tax reform, despite the increasing importance of the system in attracting investment and creating jobs.

The current arrangements governing federal–state relations were born in horse and buggy times. The Commonwealth and the states need to agree on a modern contract for modern times that can guide us forward into the future.

## *QUANTIFYING THE COST OF POOR FEDERAL–STATE RELATIONS*

The weaknesses and inefficiencies in our federal system are costing Australian taxpayers through higher taxes and poorer quality services.

As part of the BCA's research on the issue, Access Economics has costed conservatively this impost at over \$9 billion every year. These costs result from:

- + Overlap and duplication between the Commonwealth and the states.
- + Cost shifting between governments.
- + Unnecessary taxes imposed by states.
- + Overspending on programs because of lack of oversight or accountability.

The true costs are likely to be significantly higher, with some estimates putting the costs to the economy at \$20 billion a year. If Australia cannot make its federal system work better, these costs will continue to grow – both as direct imposts on business and the community as well as lost opportunities for growth because Australia cannot achieve the reforms needed for future prosperity.

## A RESURGENT COAG?

### GREAT EXPECTATIONS VERSUS A HISTORY OF UNMET EXPECTATIONS

Over the past year, there have been signs that Australian governments have put their differences aside to work together on important issues through the Council of Australian Governments. These include a new national approach to mental health, skills shortages and health and regulation. This is welcomed. However, if using recent history as a guide, recent cooperation is unlikely to result in lasting outcomes.

EXPECTATIONS	REALITIES
Will commitments made by COAG be turned into concrete actions in a timely way?	Past agreements on water, energy reform and transport – some going back to 1990s – have not been translated fully into action. Much of the National Water Initiative agreed to by COAG in 2004 was originally agreed to in 1994. None of the commitments made recently by COAG have been accompanied by specific timelines for action.
Will the level of cooperation shown at recent COAG meetings be sustained?	History shows that under the present system, the levels of cooperation needed to meet current and future challenges are only occasionally achieved and rarely sustained. Since COAG was established in 1992, it has met on average just once a year, usually for a few hours only.
What is being done to make sure cooperation continues?	The short answer is: not a lot. Much of the progress over the last 12 months has come from the energy invested by individual political leaders. Some of these leaders face elections over the next year and it is likely that in the absence of clear timetables and performance indicators for reform, political priorities will take precedence over reform progress.

## *FIXING FEDERALISM – THERE ARE SOLUTIONS*

Australia needs a system of federalism that works much better than it does at the moment. The problems with Australia's federal system are easily identified and well known. In the past, however, finding workable solutions has been difficult.

The BCA considers that the solutions needed are not radical. Instead, much more can be done to make Australia's existing federal structure operate more efficiently and effectively.

The roles and responsibilities of the Commonwealth and states need to be clarified to improve the efficiency of government administration and service delivery and to increase the accountability of governments.

There is also a need to set out performance criteria for governments to make sure that commitments made to improve service delivery or reform key areas of the economy are backed up by timely action.

## *A NEW CONTRACT FOR FEDERAL–STATE RELATIONS*

The BCA proposes a 12-point plan of action to deliver improvements in the operation of Australia's system of federal–state relations. The improvements focus on three core principles:

### 1 CLARIFY ROLES AND RESPONSIBILITIES

### 2 INSTITUTIONALISE COOPERATION

### 3 FIX FISCAL ARRANGEMENTS

## **PRINCIPLE 1: CLARIFY ROLES AND RESPONSIBILITIES**

The actions needed to clarify the roles and responsibilities of the Commonwealth and states are:

### **ACTION 1**

A Federal Convention should be held with a wide range of participants to develop a framework for reassessing the respective roles of the Commonwealth and states.

### **ACTION 2**

The Federal Convention should examine the arguments for and against the Commonwealth Government taking over the management and regulation of key national markets.

### **ACTION 3**

The Federal Convention should report its findings publicly and to COAG.

### **ACTION 4**

Once the Federal Convention has reported, COAG should agree on priority areas where rationalisation of government functions can be achieved quickly and where considerable efficiency gains can be made.

### **ACTION 5**

COAG should request the Federal Commission (see Action 11) to identify government functions that are inconsistent with the framework proposed by the Federal Convention and agree on a program for rationalising these functions.

### **ACTION 6**

COAG should agree to set a deadline of the end of 2007 for significant progress in harmonising those regulatory 'hot spots' already agreed by COAG.

### **ACTION 7**

If significant progress is not made, the Commonwealth Government should develop national business schemes for core areas of business regulation, allowing corporations to elect to opt into those schemes and out of state-based schemes.

### **ACTION 8**

The Commonwealth and state governments should work together to initiate and support an amendment to the Constitution to include an express provision that the states may choose to allow Commonwealth courts to determine matters under state laws and to allow Commonwealth agencies to administer state laws.

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## PRINCIPLE 2: INSTITUTIONALISE COOPERATION

The actions needed to institutionalise better cooperation between the Commonwealth and states are:

### ACTION 9

COAG should be strengthened, including through more frequent meetings (twice yearly) and through providing an independent secretariat.

### ACTION 10

Ministerial Councils should be strengthened by requiring them to prepare annual work programs with key performance indicators (KPIs) and to report half yearly to COAG and publicly on progress against those KPIs.

### ACTION 11

A Federal Commission should be established to identify emerging issues requiring a collective response from governments, advise on response options and report to COAG on progress with implementing COAG agreed reform agendas.

## PRINCIPLE 3: FIX FISCAL ARRANGEMENTS

The action needed to begin the process of fixing fiscal arrangements between the Commonwealth and states is:

### ACTION 12

The Federal Commission should undertake an inquiry and report to COAG on the extent and consequences of vertical fiscal imbalance and horizontal fiscal equalisation, and the feasible options available to overcome any negative consequences.

## 1 | INTRODUCTION

To unite in one grand political league, for mutual protection and defence, and for general advancement, the five Australian colonies ... that the inhabitants of these colonies may henceforth feel and know that they are no longer isolated and detached communities ... but one people, having common interests and common objects, the nucleus and elements of one great Australian nation.

**John Dunmore Lang, 1850<sup>1</sup>**

We should grow at once – in a day, as it were – from a group of disunited communities into one solid, powerful, rich and widely respected power.

**Sir Henry Parkes, 1890<sup>2</sup>**

To say [federation] was fated to be is to say nothing to the purpose; any one of a thousand minor incidents might have deferred it for years or generations. To those who watched its inner workings ... its actual accomplishment must always appear to have been secured by a series of miracles.

**Alfred Deakin<sup>3</sup>**

AUSTRALIA'S FEDERAL SYSTEM HAS GROWING WEAKNESSES AND INEFFICIENCIES

While today it may seem to have been inevitable, Australia only just became a united nation at the beginning of the 20th century. Many of the former colonies, particularly New South Wales and Queensland, were at times reluctant participants in federation discussions, while Western Australia had not yet agreed to join the new Federation when the Constitution Bill was being finalised.

That reluctance foreshadowed an ongoing power struggle between the states and the Commonwealth, a struggle that over time has largely gone in the Commonwealth's favour. Expansive interpretations of the Constitution mean the Commonwealth's power reaches much further than would have been envisaged in the 1890s. Should its constitutional powers be inadequate, the Commonwealth's financial power can be used, to the point where, today, there are few limits upon the power of the Commonwealth.

Nor has the Commonwealth been reluctant to use that power. Successive Commonwealth governments have expanded their involvement in areas that traditionally have been the domain of the states. Increasingly, the states have become financially dependent upon the Commonwealth and subject to greater direction about how funds should be spent.

The world has changed considerably since federation in 1901. Issues that were once clearly the responsibility of the states have taken on a more national character. Natural resource management was once clearly a state responsibility, but increasingly the management of resources such as water, particularly in catchments that cross state boundaries, is becoming an issue of national importance. As the world globalises, barriers to the free movement of people, goods and services within Australia become increasingly anachronistic.

As a result, at the beginning of the 21st century, Australia is left in a situation where it is often not clear which level of government has responsibility for major areas of policy development and service delivery. This is leading to growing inefficiencies and weaknesses in our federal system.

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These weaknesses create real problems that put our economic growth and future prosperity at risk. Lack of coordination means forward planning and focused, strategic investment in our infrastructure has not been happening. The regulatory burden on the community and business grows yearly as governments add to the stockpile of overlapping, duplicated and inconsistent laws. Education and health services suffer through a lack of clear lines of responsibility and inconsistent direction from different levels of government. The problems are compounded when the major areas of economic management and service delivery in Australia are all shared responsibilities: health; education; transport and infrastructure; natural resources; business regulation; and taxation.

These weaknesses and inefficiencies come at a cost to Australia. Duplicated administration and inefficient service delivery impose additional costs on governments (and hence taxpayers). Overlapping regulations and poorly coordinated approvals processes impose unnecessary costs on business. Lack of national consistency and portability in trade qualifications and education reduce the willingness or ability of people to move to new jobs in different states. All of these costs are unnecessary and reduce our competitiveness and prosperity.

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## INEFFICIENCIES COST ALL AUSTRALIANS THROUGH HIGHER TAXES AND POORER-QUALITY SERVICES

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The challenge is how to overcome the weaknesses in our federal system, and capture its strengths, to ensure the Federation serves Australia well in the coming decades. This challenge is made more critical when it is clear that the major pressures Australia faces going forward: an ageing population, fierce global competition, stagnant workforce numbers and productivity; also require a national, and collective, response from governments.

The BCA believes that reform to our federal system is an essential component of the reform agenda Australia needs to lock in prosperity and build a modern Australia – reform that can deliver significant improvements in the foreseeable future. This action plan therefore sets out a course of action that is practical and pragmatic and designed to improve the operation of our federal system in the short to medium term.

## 1.1 | THE REFORM IMPERATIVE

Australia has enjoyed continuous economic growth during the past 15 years. This is the country's reward for two decades of hard economic reform, in areas such as industry restructuring and tariff reduction, financial sector liberalisation, labour market reform, competition policy and taxation reform.

As a result, Australia has risen in terms of its relative prosperity from 18th in the OECD, to 8th.<sup>4</sup> This long run of unbroken economic growth has brought increased prosperity to most Australians. The BCA has calculated that, as a result of past reforms:

- + There are 300,000 more Australians in jobs than would have otherwise been the case.
- + Unemployment is below 5 per cent, when without reform it would have been over 8 per cent.
- + Over 87,000 more Australians are participating in the workforce.
- + GDP per capita is over 10 per cent higher.
- + On average, Australians are over \$83,000 wealthier than they would otherwise have been.<sup>5</sup>

Economic growth is continuing, but there are signs that the benefits of past reforms are running out. Productivity growth has stalled. Interest and inflationary pressures are growing. If we are to lock in our current prosperity, a new round of economic reform is needed to drive continued economic growth.

For this reason, in early 2005, the BCA launched a major campaign calling for a new round of national economic reforms.

During the course of the BCA's campaign, it became apparent that no significant reform is possible without effective cooperation between the federal and state governments. Many of the reforms sought by the BCA, for example to infrastructure planning or business regulation, can only be achieved through closer and more productive working relationships between the states and between the state and federal governments.<sup>6</sup>

The new round of economic reforms must begin now, and reform of our federal system must be part of the agenda. Other individuals and organisations, such as the Australian Industry Group<sup>7</sup> and the Productivity Commission,<sup>8</sup> have also recognised the need for federal reform. It is time for Australia to discuss how to make our Federation work better.

FUTURE PROSPERITY WILL BE  
BUILT ON TODAY'S REFORMS –  
REFORMS THAT ARE IMPOSSIBLE  
WITHOUT BETTER FEDERAL–STATE  
COOPERATION



## 1.2 | THE FEDERAL SYSTEM

Australia is not unique in having a federal system of government. Some 25 nations around the world have federal systems, including the United States, Canada, South Africa, Germany, Austria, India and Malaysia. Federal nations account for 40 per cent of the world's population and about 50 per cent of global GDP.<sup>9</sup> In developing the proposals in this action plan, the BCA has examined the experience and approaches of other federal nations (see Appendix 1).

### FEDERAL NATIONS REPRESENT 40 PER CENT OF THE WORLD'S POPULATION AND AROUND HALF OF WORLD GDP

Australia's Federation consists of three tiers of government: the Commonwealth Government; state and territory governments; and local government. This action plan deals primarily with the Commonwealth and state and territory tiers, as these have the biggest impact on national policy and decision making.<sup>10</sup>

Given Australia's history and geography, it was inevitable that when the nation did unite, it would be under some form of federal system. The former colonies guarded jealously their powers and residual autonomy during the development of the Federation's foundation document, the Constitution, and complete unity under a central government, while canvassed by some, was never a serious likelihood.<sup>11</sup> The size of Australia and its dispersed population also made a federal system the most likely form of government. Apart from China, there is no country the geographic size of Australia that does not have a federal system.

Even without this history and geography, some form of regional decision making and service delivery would be necessary in Australia. In countries such as the United Kingdom, the debate today is about how to devolve power down to the regions.

## A FEDERAL SYSTEM ALLOWS DIFFERENT REGIONAL NEEDS TO BE MET

### 1.2.1 | A FEDERAL SYSTEM – ADVANTAGES

A federal system can deliver a number of advantages. Where responsibilities are allocated across multiple jurisdictions, it is possible for governments to be more efficient, responsive and accountable to particular community needs. For example, voters may see different political parties as better able to deal with state-based issues, or with national issues, and vote accordingly.

Allocation of responsibilities to multiple jurisdictions can also encourage innovation, learning and positive competition between jurisdictions. A state government, for example, may implement an innovative government program. Should that program succeed, it can be replicated by other state governments. Should it fail, the costs of failure are at least limited to just one state (see Exhibit 1).

A federal system also allows greater flexibility, by allowing the provision of some goods and services to be tailored in response to voter preferences, while on the other hand standardised goods and services can be assured by a central government. Voters in Tasmania, for example, may have different needs and priorities to voters in the Northern Territory. In other policy areas, where Australians expect nationally consistent policies and services, these can be delivered by a central government.



## EXHIBIT 1

### STATE POLICY LEADERSHIP

There are a number of examples of where, at various times, state governments have led policy innovation:

- + South Australia led social reform and liberalisation in the 1970s.
- + Victoria first introduced the compulsory wearing of seat belts in 1970.
- + Better business regulation review mechanisms were pioneered by South Australia, Tasmania and Victoria in the early to mid-1980s.
- + Commercialisation and corporatisation initiatives for government business enterprises were led by the New South Wales and Victorian governments in the late 1980s and early 1990s.
- + Development of flexible teaching strategies in education and training was initiated by the Northern Territory in the late 1980s.
- + Case mix funding for public hospitals was pioneered by Victoria in 1993 and is now widely adopted.
- + Industrial relations reforms were begun by states such as Western Australia, Queensland and New South Wales, ahead of national initiatives.

Source: J Pincus, 'Productive reform in a federal system', in Productivity Commission, *Productive Reform in a Federal System*, Roundtable Proceedings, Canberra, 2006; G Craven, *Conversations with the Constitution: Not Just a Piece of Paper*, UNSW Press, 2004.

Federal nations can benefit from competition between their different governments. This competition can occur across one level of government (for example, between the states) or between levels (for example, between the Commonwealth and the states). Competition can, for example, keep pressure on state governments to maintain lower taxation levels, particularly in areas where those paying the taxes (individuals or businesses) can easily move to another state. Similarly, states with better project approval processes are more likely to attract investment than those with cumbersome processes.

Finally, a federal system, particularly with shared and interlocking roles and responsibilities, provides better checks and balances on government power and policy. With more than one government involved, policies and the exercise of power become more contestable. Governments are therefore under greater pressure to ensure their decisions can be defended publicly.

### 1.2.2 | A FEDERAL SYSTEM – DISADVANTAGES

Just because there are theoretical advantages with the federal system, however, does not mean these potential benefits are actually realised. More importantly, even where these benefits do exist, they must outweigh any costs arising from weaknesses or flaws in the federal system, if that system is to be a net benefit to the people it serves.

Federal systems around the world frequently display similar weaknesses (see Appendix 1). These weaknesses typically arise from the challenges of coordinating the interests and imperatives of different layers of government.

### FEDERAL SYSTEMS HAVE INNATE WEAKNESSES THAT MUST BE COMBATED

Having multiple governments invariably leads to multiple legal and regulatory systems. For example, in a country of just over 20 million people, Australia has eight different occupational health and safety regimes, placing different requirements on business, even defining who counts as an 'employee' differently.

Multiple governments can also lead to costly duplication of effort, with two or three different layers of government trying to provide the same or competing services. The Commonwealth Government has recently announced, for example, that it will establish 24 Australian Technical Colleges, at a cost of \$351 million. The announcement has been widely questioned because the technical colleges appear to intrude into areas of traditional state responsibility.

The mismatch between the 'boundaries' of an issue and the jurisdiction of different governments can also frustrate policy development and program implementation. For example, the Murray–Darling Basin traverses four states and one territory, effectively requiring the agreement of five governments to implement basin-wide policies and programs. The interests of the Commonwealth add a sixth government.

Multiple governments can also lead to destructive competition, for example, where governments offer substantial financial incentives to draw investment away from one another. Such incentives may benefit one state to the cost of the nation as a whole. Having different states competing with each other overseas for international investment can also leave potential investors confused and wary of investment in Australia.

Finally, having multiple governments can lead to a breakdown in accountability when it becomes unclear which government is responsible for particular decisions or services. This in turn leads to buck-passing and finger-pointing between governments as they seek to avoid responsibility.

There are definite advantages and disadvantages with a federal system of government. Section 2 of this action plan examines how Australia's Federation is working in practice.

## EXHIBIT 2

### ADVANTAGES AND DISADVANTAGES OF FEDERATIONS

#### Potential advantages:

- + Dispersing power across jurisdictions to encourage more responsive government.
- + Allowing for diversity in the provision of sub-national goods and services in response to voter preferences, while facilitating the provision of common goods and services by a central government.
- + Enhancing the competitive pressure on governments to respond to the preferences of citizens in their jurisdictions.
- + Creating opportunities for inter-jurisdictional learning from different policy approaches.

#### Potential disadvantages:

- + Higher transaction costs from diversity and fragmentation in rules and regulations.
- + Scope for 'destructive' inter-jurisdictional competition.
- + Inefficiencies that arise when functions are not well allocated or where governance arrangements relating to them are poorly designed.

Source: Productivity Commission, *Annual Report 2004–05*, Canberra, 2005.

## 2 | HOW WELL IS AUSTRALIA'S FEDERAL SYSTEM PERFORMING?

Unite yourself and preserve the union, and the benefits of the union will follow. It will require honest, earnest and patient effort, as well as tact and mutual consideration, and without these we shall not fulfil the promise of today.

**Sir Edmund Barton, 1901<sup>12</sup>**

Regardless of the theoretical advantages and disadvantages of a federal system, for Australia to prosper in the decades ahead it needs a federal system that works well. Overall, Australia's federal system functions, but not well enough.

A federal system that works in an intermittent and ad hoc way is not good enough for the challenges and opportunities Australia faces. There is substantial evidence that weaknesses in our federal system are currently outweighing the benefits, and this is costing the nation. In education and health, there are many problems that arise from having these areas run by the Commonwealth and states under a federal system (see Exhibit 3) and there are numerous other problems in other key areas created by the poor performance of aspects of our federal system (see Exhibits 4–6).

### EXHIBIT 3

#### FEDERALISM AND HEALTH

A roundtable hosted by the Productivity Commission in October 2005 identified a range of problems with the Australian health system that arise from the shared responsibilities of the Commonwealth and states for health care:

- + Cost shifting between governments. For example, public hospitals (funded by the states) refer patients being discharged to their general practitioner (subsidised by the Commonwealth), while shortages of aged care places (subsidised by the Commonwealth) result in hospital beds (state-funded) being inappropriately occupied.

- + Funding and delivery arrangements that create barriers to continuity of care and good planning.
- + Access arrangements that differ for public and private hospitals.
- + A complex interface between the public hospital sector and aged care sector.
- + Allocative inefficiency and poor use of competition.
- + Health workforce issues, including the lack of effective formal structural links between the health and education sectors.
- + Poor use of information and communication technologies.

Source: Productivity Commission, *Productive Reform in a Federal System*, Roundtable Proceedings, Canberra, 2006.

## 2.1 | INEFFICIENCIES AND WEAKNESSES

Serious inefficiencies and weaknesses in our federal system are costing Australia. As part of the research commissioned by the BCA for this action plan Access Economics has conservatively estimated that inefficiencies in our federal system are costing Australian taxpayers \$9 billion each year, or over \$1,100 per household (see Exhibit 4 and Appendix 2).<sup>13</sup> This is based on a conservative and partial estimate of the costs only. It does not include costs to business or the economy as a whole. The true costs are almost certainly significantly higher. Others have estimated the costs to be \$20 billion a year.<sup>14</sup> Either way, the costs are large and unnecessary.

## EXHIBIT 4

### A PARTIAL ESTIMATE OF THE COSTS OF INEFFICIENCIES IN THE FEDERAL SYSTEM

The BCA commissioned Access Economics to estimate the costs of inefficiencies in the operation of the federal system. The full details are included as Appendix 2.

In summary, Access Economics has determined a partial estimate of the costs as follows:

TYPE	CATEGORY	COST (\$m, 2005–05)	SOURCE OF INEFFICIENCY
Spending-related inefficiencies	<b>Overlap and duplication</b> due to the need to administer grants between jurisdictions (i.e. a cost of one level of government taxing less than it spends).	\$861	The costs to the federal government of administering grants to the states (SPPs) over and above the cost of either the states or the federal government directly funding and running the programs themselves.
	<b>Cost shifting</b> by the states that results in inefficient spending by the Commonwealth on pharmaceuticals and in public hospital grants.	\$836	Where it would be more efficient for states to provide services such as public hospitals, but services are instead inefficiently provided by (federal-subsidised) pharmaceuticals or GPs or aged care homes. ( <i>Note similar other such sources of inefficiency not counted.</i> )
	<b>Spending above efficient levels</b> by the states due to lack of coordination and/or inadequacies in Commonwealth oversight and accountabilities.	\$2,296	Where state spending is inefficient in achieving program aims because federal interference means state spending is misdirected, or because state ‘gaming’ of federal grants sees them overspend in some areas and underspend in others with the aim of maximising grants received from the Commonwealth, or because the two levels of government fail to coordinate their efforts.
	<b>Overlap and duplication</b> in areas where both states and the federal government are operating at the same time.	\$913	Too many cooks spoiling the broth in areas such as welfare, community health and policing.
	Inefficiencies due to the operation of ‘ <b>horizontal fiscal equalisation</b> ’.	\$215	Grants directed to inefficient states.
Spending subtotal		<b>\$5,122</b>	

TYPE	CATEGORY	COST (\$m, 2005–05)	SOURCE OF INEFFICIENCY
Tax-related inefficiencies	<b>Unnecessarily inefficient state taxes</b> (such as taxes on insurance, land tax, stamp duties on commercial conveyances, other stamp duties, etc.)	\$2,782	Saving in efficiency costs if these were replaced by more efficient taxes such as the GST or payroll tax.
	<b>The efficiency (deadweight) costs of raising taxes to pay for the higher-than-necessary level of spending</b> identified in the spending sub-total on previous page.	\$866	Conservatively costed assuming these are paid for out of GST and/or payroll tax receipts (i.e. from efficient rather than inefficient taxes).
	Failure to centralise tax collection nationally for payroll taxes and taxes on gambling.	\$150	It is inefficient to collect these taxes using state-based bureaucracies.
Tax subtotal		<b>\$3,797</b>	
Total 'higher than necessary costs of government'		<b>\$8,919</b>	

Source: Access Economics, 'The Costs of Federalism', report to the Business Council of Australia (included in this action plan as Appendix 2).

## THE COSTS OF INEFFICIENCIES ARE BORNE BY AUSTRALIAN TAXPAYERS, AND REPRESENT MORE THAN \$9 BILLION A YEAR

Examples of some of these inefficiencies are set out in Exhibits 5 to 7.

## EXHIBIT 5

### ONE NATION ... OR EIGHT

There are many examples of where Australia's federal system is resulting in unnecessary duplication, overlap and inefficiency.

- + Businesses that operate across Australia face, for example, eight occupational health and safety systems, eight ways of calculating payroll tax and eight sets of environmental approvals. In many areas of regulation, Australia's 20 million people face greater regulatory diversity, overlap and duplication than Europe's 457 million.
- + A survey by the Building Products Innovation Council and the Housing Industry Association of building product manufacturing companies has estimated the cost impact of complying with different state and territory building laws to be between 1 and 5 per cent of company turnover. Even at a conservative 2 per cent cost impact, this equates to some \$600 million annually on building product manufactures alone.
- + Westpac has highlighted one simple but bizarre example of duplication, overlap and inefficiency. First aid kits in Westpac branches are required to have different contents depending on which state they are in. A first aid kit in New South Wales has to have dressing tape 2.5 centimetres wide, while in West Australia it has to be 1.25 centimetres. In Victoria, 60 ml of eye wash is a requirement, in Queensland 250 ml, while in South Australia you don't need it at all.
- + Australia has some 1,400 regulatory bodies overseeing Commonwealth, state and local laws and regulations.
- + In 2002, NSW alone had 149 occupational licences, Victoria 136, Western Australia 87, the ACT 69 and the Commonwealth itself another 47 licences.
- + Australian food standards are set by state governments, even though Australians eat food from all over Australia. To try to harmonise food standards, governments have set up joint committees, but each government still retains the right to veto proposed food regulations.
- + An operator of an interstate train in Australia may have to deal with six access regulators, seven rail safety regulators with nine different pieces of legislation, three transport accident investigators, 15 pieces of legislation covering occupational health and safety rail operations, and 75 pieces of legislation with powers over environmental management. Australia has seven rail safety regulators for a population of around 20 million people. In contrast, the United States, with a population of 300 million people, has one rail safety regulator.

- + During the recent debate on business regulation, the CEO of one large corporation identified the costs of multiple regulatory regimes:

We have a direct cost of employment, legal costs, consultancy and senior management time generated by inconsistent laws and regulations around occupational health and safety, payroll tax, workers' compensation, environmental regulation, property transfer laws, tax laws, company law (particularly its inconsistency with globally accepted regulations) and consumer protection laws. We estimated that, if each of these areas was consistent across Australia and, where appropriate, consistent with our international obligations, we could reduce our costs in this area by 20 per cent. This would equate to approximately 0.75 per cent of our revenue and increase our company tax contribution to the economy by \$1–2 million per annum and provide an additional \$2–4 million per annum for investment.

We have opportunity costs of many times that amount. The distraction to our organisation by this regulatory complexity should not be underestimated. If our regulatory framework were rationalised and simplified, our competitiveness would dramatically increase, particularly into export markets. Too many of our managers are spending time distracted by regulatory complexities. Our company has expanded at a rate of 15 per cent per annum for the last four years. Given simple, consistent and sensible regulation we would have been able to increase that growth rate by at least 50 per cent. Apart from the benefits to employment and our balance of trade, it would also have put an additional \$8–10 million into the Treasurer's coffers over that period of time and produced an additional \$24–30 million for further investment.

Sources: Business Council of Australia, *Submission to the Commonwealth Government's Taskforce on Reducing the Regulatory Burden on Business*, December 2005; Productivity Commission, *Reform of Building Regulation*, Research Report, November 2004; D Morgan, 'Facing the Future – Opportunity Beckons', Speech to the Australia-Israel Chamber of Commerce, 29 June 2005; G Banks, 'Reducing the Regulatory Burden: The Way Forward', Inaugural Public Lecture, Monash Centre for Regulatory Studies, Melbourne, 17 May 2006; Australian National Training Authority, *Licence to Skill*, November 2002; Access Economics, 'The Costs of Federalism', (included in this action plan as Appendix 2); K Henry, 'Time to "Get Real" on National Productivity Reform', in Productivity Commission, *Productive Reform in a Federal System*, Roundtable Proceedings, Canberra, 2006.



## EXHIBIT 6

### RAIL GAUGES AND OTHER BARRIERS

In the 1890s, it was agreed that Australia should have a uniform rail gauge to allow trains to move smoothly around the country. This was to be one of the great benefits of federation – a single, efficient national land transport system.

In 2006, Australia still has nine rail gauges. Over 100 years after federation, we have still not achieved one of federation's key aims.

The problem with different rail gauges was that they inhibited the free movement of people and goods around Australia. Before federation, travellers from one state to another had to change trains at state boundaries. While this is no longer the case, there are many other examples of 'rail gauge' problems – state laws or practices that act as barriers to the free movement of people, goods and services within Australia.

- + An electrician licensed in one state in Australia can apply to become licensed in another state. But the word 'electrician' means different things in different states, with different categories and numbers of categories across states, all acting as a substantial barrier to the mobility of skilled workers.
- + The 'Certificate III Hairdressing' is a nationally recognised qualification. But this does not mean that somebody will be considered 'qualified to work' in a state simply because they have a certificate. Different states have different requirements, generally involving different work experience, for people to progress from holding a certificate to being considered 'qualified to work'. As a consequence, qualified hairdressers are not able to move freely between states.

- + Across the eight states and territories there are five different minimum school starting ages. NSW has the youngest, allowing children to start school at four years and five months. In WA and Queensland it is four years and six months, Victoria and the ACT four years and eight months, and in Tasmania it is five years. South Australia has a system of rolling enrolments. The resultant patchwork is a major hurdle for families, creating confusion and contributing to discontinuity in schooling and potentially impacting on rates of school completion. Some children risk boredom by being re-taught material they already know. Others struggle as they attempt to catch up with material that they have not learnt. These problems are faced by the 80,000 children that move states each year.
- + Despite many improvements in the consistency of road transport regulation, there is still no consistency, for example, between Victoria and New South Wales, on maximum load capacities. Even in 2006, a truck travelling up the Hume Highway may comply with the maximum load requirements as it passes through Wodonga, but be in breach once it reaches Albury.

Sources: K Henry, 'Time to "Get Real" on National Productivity Reform', in Productivity Commission, *Productive Reform in a Federal System*, Roundtable Proceedings, Canberra, 2006; Access Economics, *The Costs of Federalism*, (see Appendix 2 of this action plan).



## EXHIBIT 7

### NOT MY RESPONSIBILITY ...

Poorly defined roles and responsibilities can result in cost shifting, buck-passing and finger-pointing, allowing governments to avoid their responsibilities. The health sector is a well known example:

- + As noted in Exhibit 3, cost shifting in the health sector is widespread. Public hospitals (funded by the states), for example, refer patients being discharged to their general practitioner (subsidised by the Commonwealth), while shortages of aged care places (subsidised by the Commonwealth) result in hospital beds (state-funded) being inappropriately occupied.
- + Sometimes it is difficult to work out who is responsible for what:

Our hospitals would be providing a more efficient service to the public if they were not required to provide services that the Commonwealth should be providing.

#### Queensland Premier Peter Beattie

If Premier Beattie is to be believed, [the problem with hospitals] is the federal Government's fault ... he claimed that Queensland was short of doctors because the federal Government had cut medical training places. This is simply untrue.

#### Health Minister Tony Abbott

The Queensland Government is playing its part in providing a first-class health system for Queenslanders but we face being short-changed by the [federal] Coalition Government.

#### Queensland Premier Peter Beattie

I would say to the Premier of Queensland Mr Beattie, Mr Beattie there are no alibis in your failings in health. You can't and you shouldn't blame the Federal Government.

#### Prime Minister John Howard

Sources: P Beattie, *Beattie Calls for Urgent National Health Reform*, Media Release, 15 August 2005; T Abbott, *'Health Reform – Its Possibilities and Limitations'*, Speech to the Queensland Press Club, August 2005; P Beattie, *Premier to Fight for Extra Medical Training Places for Qld*, Media Release, 10 July 2006; J Howard, *Coalition Queensland Election Campaign Launch Speech*, 3 September 2006.

## 2.2 | POOR COOPERATION

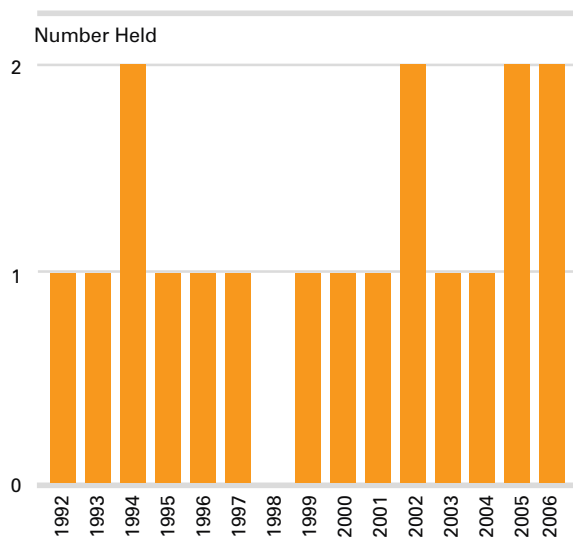
The weaknesses and inefficiencies in our federal system are costing Australians through higher taxes and poorer quality services than necessary. But they are only part of the problem.

As has been argued above, Australia will not face its current and future opportunities and challenges successfully without high levels of cooperation between governments. The history of cooperation, however, has been patchy.

The present vehicle for cooperation between governments is the Council of Australian Governments (COAG), comprising the Prime Minister, Premiers and Chief Ministers and the President of the Australian Local Government Association, supported by a range of Ministerial Councils. COAG was established in 1992<sup>15</sup> and has since met, on average, just once each year, usually for a few hours only (see Figure 1). It is not possible for a federal system to run effectively when its leaders meet only occasionally and then for only a few hours.

The productivity of COAG meetings is also of concern. Typically, COAG meetings have been marked by political theatre rather than collaboration and a shared commitment to action and reform. A notable exception was the meeting of COAG in February 2006, which was welcomed by leaders in attendance as the best in a decade. Productive meetings should be the norm – not the exception – if Australia is to deal effectively with its emerging challenges and opportunities.

FIGURE 1 NUMBER OF COAG MEETINGS HELD, 1992–2006



Source: [www.coag.gov.au](http://www.coag.gov.au)

Australia therefore faces two challenges with its federal system:

- 1 We are suffering unnecessary costs from inefficiencies and weaknesses in the way the Federation operates – these costs are borne ultimately by Australian taxpayers and businesses.
- 2 The levels of cooperation necessary to meet Australia's future challenges are only occasionally achieved and rarely sustained for any length of time.

## 2.3 | A RESURGENT COAG?

Australia's governments met as COAG in February 2006 and recognised the need to work together to implement a new national reform agenda that will allow Australia to lock in prosperity and meet its future challenges.

The reform agenda mapped out by COAG broadly covers:

- + The new national reform agenda, covering reforms in the areas of human capital, competition and regulation.
- + A five-year health reform package.
- + Initiatives to improve mental health.
- + A new national approach to apprenticeships, training and skills recognition, with measures to alleviate skills shortages.<sup>16</sup>

While political leaders are to be applauded for agreeing a wide-ranging reform agenda, a number of vital questions remain unanswered. These include:

- + Will the commitments made by COAG be turned into concrete actions, in a timely way? (See Exhibit 8.)
- + Will the level of cooperation shown at recent COAG meetings be sustained, or is this just a false dawn?
- + What is being done to make sure cooperation continues, particularly given many senior political leaders face elections over the next 12 months?

## EXHIBIT 8

### THE EBB AND FLOW OF WATER REFORM

In 2004, most of Australia's governments agreed an ambitious water reform program, the National Water Initiative (NWI). The stated objective of the NWI is to achieve:

... a nationally compatible, market, regulatory and planning-based system of managing surface and groundwater resources for rural and urban use, that optimises economic, social and environmental outcomes, and is able to adapt to future changes in the supply of, and demand for, water.

The NWI included a number of milestones. The first milestone of the NWI was that, by June 2005, the maximum amount of water that could be traded out of the irrigation areas in the southern Murray–Darling Basin would be increased from two to four per cent per annum. The threshold is supposed to be increased to 100 per cent by 2014.

By mid-2006, this very first milestone had not been achieved, and was not expected to be achieved until mid-2007, three years into the 10-year plan. The chances of lifting the threshold from 4 per cent to 100 per cent in the remaining seven years seems remote.

What makes this all the worse is that much of the ambitious reform agenda agreed in 2004 had previously been agreed by the governments in 1994.

COAG's new reform agenda is a positive step, but means nothing if it is going to follow the path of the National Water Initiative.

Source: Council of Australian Governments Communiqué, 25 June 2004.

### 3 | REALITY CHECK

The rights of self-government of the States have been fondly supposed to be safeguarded by the Constitution. It left them legally free, but financially bound to the chariot wheels of the Central Government. Their need will be its opportunity.

**Alfred Deakin, 1902<sup>17</sup>**

Australia will not continue to prosper without ongoing reform. That reform requires the inefficiencies and weaknesses in our federal system to be fixed. It also requires higher levels of cooperation between governments, on a more sustained basis.

This action plan is designed to start the process of overcoming those problems. Before looking at possible reforms, however, it is necessary to set out a number of features of Australia's federal system that determine what reforms are possible in the foreseeable future.

Australia's federal system has some particular characteristics that can exacerbate its inefficiencies and costs. These have been identified by the Productivity Commission as:

- + A relatively high degree of shared functions between governments, giving rise to a diverse set of intergovernmental arrangements to handle the associated coordination challenges.
- + A strong centralising trend over time (aided, in part, by High Court decisions that have interpreted the powers of the Australian Government in a broad manner), resulting in a relatively high degree of centralisation.
- + A relatively high degree of vertical fiscal imbalance and of transfers directed at fiscal equalisation.<sup>18</sup>

Another characteristic of Australia's Federation is the difficulty of changing its foundation document, the Constitution. The Constitution, which sets out the scope of the Commonwealth's powers, can only be amended with the agreement of a majority of Australians, and a majority of states. Since federation, there have been very few amendments that have given additional powers to the Commonwealth.<sup>19</sup>

These realities need to be taken into account in designing reforms for Australia's federal system that will deliver benefits in the foreseeable future.

### 3.1 | REALITY 1: MORE THAN ONE TIER OF GOVERNMENT

The Constitution entrenches two tiers of government: that of the Commonwealth and of the states. Local government, the third tier, is a creation of the states, but a necessary creation to ensure localised decision making and service delivery.

Despite research indicating growing dissatisfaction with state governments,<sup>20</sup> that sentiment is unlikely to translate into the necessary referendum vote to abolish the states, particularly as state governments would be unlikely to support such a move.

Assumptions that removing the states will somehow fundamentally improve the operation of government in Australia also need to be tested more rigorously. There are many potential benefits for Australia from a federal system of government (see 1.2.1). 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.

Reform proposals that are intended to achieve improvements in our federal system will need to recognise that the system will continue to consist of three tiers of government.

While this paper focuses on Commonwealth–state relations, there is ample scope for reforms at the level of local government. The multitude of local governments adds to duplication, overlap and inconsistency. One approach to reform may be to ask why Perth has more than 30 local governments when Brisbane only has one, despite similar populations.

### 3.2 | REALITY 2: CENTRALISATION

The second reality is the inexorable, long-term trend towards centralisation. As the opening quote to this chapter shows, the likelihood of this centralising tendency was recognised as early as 1902, by constitutional drafter and soon-to-be Prime Minister, Alfred Deakin.

The century since federation has seen considerable growth in the revenue raising and financial power of the Commonwealth. At federation, the Commonwealth was largely funded through its customs and excise powers and was initially restricted by the Constitution to using only one quarter of the revenue it raised for Commonwealth purposes, the rest being remitted to the states or used to pay state debts.<sup>21</sup> Today, the Commonwealth accounts for 80 per cent of total taxation revenue raised by all governments<sup>22</sup> and 54 per cent of all government expenditure,<sup>23</sup> while the states raise 16 per cent of taxation revenue, but spend around 40 per cent.<sup>24</sup>

#### THE COMMONWEALTH RAISES 80 PER CENT OF ALL TAXATION REVENUE

The Commonwealth's financial power comes from its ability to set conditions on the use of money transferred to the states.<sup>25</sup> There are no legal limits on the conditions the Commonwealth may set. For example, conditions may be imposed upon the states even though the Commonwealth would not otherwise have the constitutional power to require that condition to be met.

.....

Apart from financial influence, the Commonwealth's power has grown through the evolving interpretation of the Constitution by the High Court, again foreshadowed in 1902 by Deakin:

I should say that our written Constitution, large and elastic as it is, is necessarily limited by the ideas and circumstances which obtained in the year 1900 ... [Amendment is] a comparatively costly and difficult task and one which will be attempted only in grave emergencies. In the meantime, the statute stands and will stand on the statute-book just as in the hour in which it was assented to. But the nation lives, grows, and expands. Its circumstances change, its needs alter, and its problems present themselves with new faces.

The organ of the national life which preserving the union is yet able from time to time to transfuse into it the fresh blood of the living present, is the Judiciary, the High Court of Australia or Supreme Court in the United States. It is as one of the organs of Government which enables the Constitution to grow and to be adapted to the changeable necessities and circumstances of generation after generation that the High Court operates.<sup>26</sup>

.....

THE HIGH COURT'S INTERPRETATION OF THE CONSTITUTION HAS LARGELY BEEN EXPANSIVE

.....

Initially, the Court sought to define the powers of the Commonwealth narrowly. For example, in early cases, the Court held that a doctrine of 'implied intergovernmental immunity' governed Commonwealth–state relations and prevented governments from interfering with each other.<sup>27</sup> The Court also held that powers that had not been expressly transferred to the Commonwealth were reserved to the states and that the Commonwealth could not intrude into these areas.<sup>28</sup> Both of these doctrines were rejected in the landmark decision of the High Court in the *Engineers* case in 1920.<sup>29</sup>

Since the *Engineers* case, the High Court's interpretation of key constitutional powers, particularly the external affairs<sup>30</sup> and corporations powers,<sup>31</sup> has greatly increased the constitutional reach of the Commonwealth.

.....

THERE ARE NOW FEW LIMITS ON THE POWER OF THE COMMONWEALTH

.....

Reform proposals for the federal system need to recognise that there is a long-term trend towards greater Commonwealth power, beginning almost from federation. In reality, that trend is unlikely to be reversed.

### 3.3 | REALITY 3: SHARED RESPONSIBILITIES

Australia's federal system is notable for the high degree to which responsibilities are shared between the Commonwealth and state governments.

There are only a few areas where the Commonwealth and states clearly have separate responsibility. The Commonwealth has responsibility for national defence and the states have responsibility for law and order, but even these functions will sometimes require cooperation between jurisdictions.

Most of the key areas of government activity are shared responsibilities, such as health, education, transport, infrastructure, natural resources, business regulation and taxation.

For practical or political reasons, these are likely to remain shared responsibilities between the Commonwealth and the states.

.....

AUSTRALIA'S FEDERAL SYSTEM IS NOTABLE FOR THE HIGH DEGREE TO WHICH RESPONSIBILITIES ARE SHARED

.....

An example is the transportation of freight by land. There is a strong argument that the Commonwealth should have primacy in ensuring Australia has an efficient transnational road and rail system that allows the rapid movement of goods within Australia, and in particular, supports dynamic export industries. Equally, there are sound reasons why states should manage regional and urban transport systems that are primarily concerned with the movement of goods and people within a state. Local government, particularly in regional and rural areas, will also have a view on local transport priorities. Allocating full responsibility for land freight transport to just one government makes it highly likely that the valid perspectives of the other two will be overlooked.

Other areas where the Commonwealth and states share responsibility for service delivery include housing, aged care, disability services, child care, environmental management, workers' compensation, occupational health and safety, industrial relations and Indigenous affairs.<sup>32</sup>

When considering practical reforms to the operation of our federal structure that will deliver improvements in the short to medium term, all three of these factors are critical – we have three tiers of government, which share many key functions, yet power is shifting to the Commonwealth. These include the areas where inefficiency, duplication and buck-passing most frequently occur.



### 3.4 | ONE MYTH

It is often assumed that the division of responsibilities between the Commonwealth and the states is set out in the Australian Constitution. In particular, it is often assumed that the Commonwealth's powers are somehow circumscribed by the explicit powers set out in the Constitution.

As has already been noted, increasing Commonwealth power, both through its financial power and expansive interpretations of the Constitution, mean that in fact there are few limits upon the range of issues the Commonwealth can involve itself in.

While the trend towards centralisation has been persistent, it has also been ad hoc, with the Commonwealth's powers growing in different directions and at different rates depending, for example, on the Commonwealth Government's use of its financial powers, the expansion of the coverage of the external affairs power and major judicial interpretations of the Constitution.

The result is that, just over 100 years after federation, there has been a major breakdown in the conceptual framework that underlies the division of powers and responsibilities between the Commonwealth and the states. It is no longer apparent which level of government is primarily responsible for which areas of policy and service delivery.

The Constitution, in practice, says very little about the division of Commonwealth and state powers and federal–state relations.

### THE CONSTITUTION NO LONGER DEFINES COMMONWEALTH AND STATE ROLES

Another consequence of the diminished role of the Constitution is that considerable changes can be made to the federal system without constitutional change. The difficulties of constitutional change cannot therefore be used as a reason for not reforming our federal system.

It is important to note, however, that in requiring a referendum to change the Constitution, it was intended that the Australian people would have a voice in any significant changes to the federal system. If constitutional amendment is to be avoided in reforming the federal system, other forms of engagement with the community will be needed.



## 4 | AN ACTION PLAN FOR FEDERAL REFORM

It raises real questions whether there can, in areas like this where you need the cooperation of three or four states, of whether you can get enough progress quickly enough.

**Prime Minister John Howard, 2006<sup>33</sup>**

Australia's federal–state relations need to be reformed.

Weaknesses and inefficiencies in our federal system impose unnecessary costs on Australian citizens and businesses. A poor record of cooperation between governments raises serious concerns about Australia's ability to meet future challenges.

Were we starting with a blank sheet of paper, we might design a different system of government for an Australia moving into the 21st century. Instead we need to develop a reform program that recognises the realities of our federal system, while delivering tangible improvements to that system.

### 4.1 | AN ACTION PLAN FOR FEDERAL REFORM

This report sets out a 12-point plan of action designed to deliver improvements in the operation of the Australian Federation in the short to medium term. The action plan is based on three principles.

## PRINCIPLE 1: CLARIFY ROLES AND RESPONSIBILITIES

The reach of the Commonwealth has expanded considerably since federation, particularly over the last four decades. At the same time, issues that were once clearly state responsibilities are taking on a national or even international character. As a result, it is no longer clear which matters are, or should be, the responsibility of the Commonwealth, and which should be left with the states.

For the Federation to operate more efficiently, it is essential that the respective roles and responsibilities of the different tiers of government be clarified.

## PRINCIPLE 2: INSTITUTIONALISE COOPERATION

Even with greater clarity around roles and responsibilities, many of the critical issues dealt with by governments will be shared responsibilities between the Commonwealth and the states. This means collaboration and cooperation between jurisdictions will be essential if Australia is to continue its reform program and lock in its future prosperity.

To sustain cooperation and collaboration between the Commonwealth and the states we need to build stronger cooperative processes and structures.

## PRINCIPLE 3: FIX FISCAL ARRANGEMENTS

By international standards, Australia has a large gap between the revenue raising of the central government and the expenditure of the states. When governments are not responsible for their own revenue raising and expenditure, they are less accountable for their performance in both areas.

Changes are needed to the relative fiscal responsibilities of the Commonwealth and states to reduce the size or impact of this revenue–expenditure gap.

## 5 | PRINCIPLE 1: CLARIFY ROLES AND RESPONSIBILITIES

Going forward, it will be important for the Australian Government and the states to clarify roles and responsibilities in order to improve productivity in the provision of services to the public while sustaining government finances. Clarification of roles will require consideration of national strategic priorities and judgements as to the tier of government that is likely to discharge those priorities most effectively.

**Treasurer Peter Costello 2005<sup>34</sup>**

The only way to resolve that is to have a constitutional convention and clearly define who is going to do this, who is going to do that. Get some constitutional certainty.

**Queensland Premier Peter Beattie, 2006<sup>35</sup>**

Clarifying government roles and responsibilities in all areas of government could significantly improve public sector efficiency.

**OECD, 2006<sup>36</sup>**

There is wide recognition across the national and state governments and across the major political parties that the essential first step in reforming Australia's federal system is to get greater clarity about who exactly is responsible for what.

The trend towards centralisation, fostered by the Commonwealth's financial dominance and the expansive interpretation of its constitutional powers, means the Commonwealth is increasingly involved in areas of policy and service delivery that have traditionally been dominated by the states. In an increasingly globalised world, there

is also pressure to deal with more and more issues at a national level. There is also growing dissatisfaction among Australians with state governments in general and an inclination to look to the Commonwealth Government to overcome the perceived weaknesses of their state counterparts.<sup>37</sup>

The result is that the lines between areas of Commonwealth and state responsibility have become blurred. It is no longer clear, for example, whether the states have primary responsibility for health and education, as they traditionally have, or whether the Commonwealth now has a greater role, given its increasing funding of health and education services.

### A MAJOR PROBLEM IS THE PROGRESSIVE BREAKDOWN OF CLEAR ROLES AND RESPONSIBILITIES

The blurring of the lines of responsibility leads to duplication in policy development and service delivery, confusion over accountability and buck-passing and finger-pointing between governments. An efficient federal system is not possible without clearer lines of responsibility between governments.

Reasserting and redefining the responsibilities of the Commonwealth and states does not necessarily require major Constitutional change. Given the expansion of Commonwealth powers, particularly the external affairs and corporations powers, the Commonwealth is likely to have sufficient constitutional power to cover most areas that should fall within its responsibility (although not always as neatly and efficiently as would be the case had it express powers in those areas). Gaps in the Commonwealth's constitutional powers can also be covered by the Commonwealth's financial power. The states have plenary powers, subject only to inconsistent Commonwealth legislation. The Constitution is therefore no longer the major determinant of Commonwealth and state roles and responsibilities.

## 5.1 | PRINCIPLES FOR ALLOCATING FUNCTIONS

The starting point for a renewed federal framework should be agreement by governments on a set of principles that can guide the allocation of responsibilities.

These guiding principles are well known<sup>38</sup> and the principles, if not their application, are largely uncontroversial.

The usual starting point is the 'principle of subsidiarity', which holds that a function should be performed by the lowest level of government practicable. There are four main arguments for the principle of subsidiarity:

- + Local or regional governments are more likely to have a better understanding of the needs of their own citizens and businesses.
- + The closer government policy setters and decision makers are to those affected by their policies and decisions, the more accountable they will be.
- + Local or regional decision making fosters competition between governments, particularly where citizens and businesses can easily move from jurisdiction to jurisdiction.
- + The principle of subsidiarity acts as a counter-force to other pressures that drive increased centralisation within a federal system.

The principle of subsidiarity places downward pressure on a federal system, pushing functions and responsibilities down to lower, more localised levels of government. There are, however, factors that apply pressure in the opposite direction, pushing functions towards the upper or national level of government. In general, functions are more suited to the national government where:

- + There are significant 'spillover' effects that mean a local or regional government is not able to deal fully with an issue – this can arise, for example, with natural resources such as water catchments that cross state boundaries, or with transnational transport systems.
- + There are sizeable economies of scale or scope from delivering a single nation-wide service, or there is such commonality of interests across the whole nation that regional or local variances are unnecessary or wasteful.
- + The costs from overlap, duplication and inconsistency between jurisdictions more than outweigh the benefits from competition between jurisdictions.
- + The mobility of capital and people between jurisdictions is particularly sensitive to differences. For example, significant variations in welfare payments or tax levels can result in the redistribution of people and capital in ways that may not benefit the country as a whole.

How particular functions are allocated often depends on the balance struck between these different and competing principles. The principles themselves may not be contentious, but often their application is, particularly as different functions carry different political opportunities and risks for governments. For this reason, any process to consider how to apply these principles should involve a range of interests outside government, not just the governments themselves. Ultimately, however, it is governments that will settle the distribution of their roles and responsibilities.

## 5.2 | FEDERAL CONVENTION

After a century of federation, Australia needs to have a new discussion about the respective roles and responsibilities of the Commonwealth and states. This needs to be an inclusive, public discussion.

The BCA therefore recommends that governments organise a Federal Convention, to be held no later than 2008, with participants drawn from the community, business and government.

The aim of the Convention should be to agree a framework to be used to clarify the roles and responsibilities of the Commonwealth and states. The framework should be capable of being applied at both the macro and micro levels. That is, it should determine in general terms which functions should lie with the Commonwealth and which with the states. The Federal Convention should also debate how the framework would be applied in key areas such as health, education and water.

The Federal Convention should report its findings publicly and to COAG.

## 5.3 | AN AUSTRALIAN COMMON MARKET?

A starting point for clarifying roles and responsibilities at the macro level is section 92 of the Constitution. Section 92 is one of the critical provisions of the Constitution intended to ensure there is a common market in Australia.<sup>39</sup>

Section 92 states that 'trade, commerce, and intercourse among the States ... shall be absolutely free'. The section was originally interpreted as preventing the states from imposing any restrictions upon trade and commerce across state boundaries. More recently, the High Court has held that the provision has the more limited application of preventing states imposing any form of state-based protectionism.<sup>40</sup>

Despite the High Court's narrower interpretation of section 92, the section highlights the original intention of the Federation's founders that Australia should operate effectively as a common market and that the states should be prevented from unduly interfering with the free movement of people, goods and services across state boundaries.<sup>41</sup>

## AUSTRALIA IS NOT YET A COMMON MARKET

Although it was an original goal of federation, Australia has not yet fully achieved the goal of a common market. There are still many barriers to interstate mobility for people, goods and services (see examples in Exhibit 6).

In addition to interstate barriers, there are other aspects of Australia's federal system that are not consistent with a common market. For example, businesses operating across Australia face multiple and inconsistent regulatory regimes covering:

- + Occupational health and safety law;
- + Workers' compensation;
- + State tax calculations (particularly payroll and stamp duty);
- + Product standards;
- + Equal opportunity and anti-discrimination;
- + Trade and professional licensing;
- + Personal securities; and
- + Environmental laws

Over time, these inconsistencies have grown. From a business perspective, Australia in many ways is moving further away from a common market, rather than closer to one. At a time when globalisation is reducing the trade barriers and differences between countries, the differences across our states are growing (see Exhibit 9).

## EXHIBIT 9

### A NATIONAL CORPORATIONS LAW FOR A COMMON MARKET

The Constitution gives the Commonwealth Government power over 'trading or financial corporations formed within the limits of the Commonwealth'. That power is limited, however, and does not cover, for example, power over how businesses are incorporated.

The Commonwealth lacks the full power to put in place a national scheme for the regulation of corporations, even though corporations form the bulk of nationally operating businesses. For Australia to have a common market, it needs a single national scheme for the regulation of corporations.

To overcome the limits of the Commonwealth's powers, the states have agreed, in some cases reluctantly, to refer their residual powers over corporations to the Commonwealth. This referral of power allowed the Commonwealth to pass the *Corporations Act 2001*, giving Australia a national corporations law.

That national law is built on tenuous foundations. The states have only referred their powers for five years. To maintain a national corporations law, the states had to renew that referral during 2006. While some states acted responsibly and ensured the ongoing certainty of business regulation by referring their powers well before they expired, others preferred to pursue political points by delaying their referral until the last possible moment. As a result, Australia's national corporations law came within two weeks of collapsing.

## EXHIBIT 9 (CONTINUED)

Another worrying development is the decision of a number of states to unilaterally veto changes to the Corporations Act. Under the agreement by which states have referred their powers, the states may veto amendments to the Commonwealth's Corporations Act, even if those changes would pass Federal Parliament. The states have recently exercised that veto in connection to changes to the Act that currently allow just 10 shareholders to force a corporation to hold an extra ordinary general meeting of all shareholders.

A certain, stable national corporations law is a cornerstone of a common market for Australia. State politicking with late referrals and vetoes of changes to the law show we are still well short of having such a cornerstone in place.

Source: Constitution, s 51(xx); *New South Wales v. Commonwealth (Incorporation Case)* (1990) 169 CLR 482.

## WE SHOULD COMPLETE THE TASK OF CREATING AN AUSTRALIAN COMMON MARKET

Significant gains could be made by continuing the incomplete task of moving Australia to a common market. Such a move would significantly reduce the costs of doing business in Australia, delivering benefits to Australian consumers and improving the international competitiveness of our businesses.

Moving to a common market should also reduce duplication of effort by governments, decreasing bureaucracy, reducing the size and costs of government and thereby saving taxpayers money.

COAG has begun this process, identifying 10 priority cross-jurisdictional 'hot spot' areas where overlapping and inconsistent regulatory regimes are impeding economic activity:<sup>42</sup>

- + rail safety regulation;
- + occupational health and safety;
- + national trade measurement;
- + chemicals and plastics;
- + development assessment arrangements;
- + building regulation;
- + environmental assessment and approvals processes;
- + business name, Australian Business Number and related business registration processes;
- + personal property securities; and
- + product safety.

The COAG process, however, relies on those that have responsibility for the existing disparate regulatory regimes to come up with proposals to harmonise them. Past experience suggests this is likely to result in a time-consuming exercise that delivers only modest improvements.

## A TIME LIMIT SHOULD BE PLACED ON COAG PROCESSES

COAG should agree that, if significant progress towards harmonisation in these 10 areas has not been achieved by the end of 2007, an alternative approach will be adopted, as set out in Exhibit 10.



## EXHIBIT 10

### NATIONAL BUSINESS SCHEMES

Australia is supposed to be a common market; that is, one where people, goods and services can move about freely. In reality, many barriers and inconsistencies between jurisdictions remain. COAG has recognised this and has begun a process of removing some of these barriers and inconsistencies. However, past experience would suggest this process is only likely to have limited success. An alternative approach should therefore be developed and implemented if the COAG process fails to deliver timely results.

The BCA therefore recommends that governments develop national business regulation schemes to cover key elements of business activity.

National business schemes would be based on Commonwealth legislation and would apply consistent regulation throughout Australia. They would be 'opt in' schemes, in that corporations would be able to elect to be covered by the national business schemes. Those corporations that elect to join the national scheme would not be subject to state-based legislation in the areas covered by the national scheme.

National business schemes should be developed for any areas that have significant effects on business but where current COAG processes have failed to deliver timely and effective harmonisation, such as:

- + Occupational health and safety law.
- + Workers' compensation.
- + Product standards.
- + Equal opportunity and anti-discrimination.
- + Trade and professional licensing.

Under this approach, for example, corporations operating nationally would have the ability to 'opt in' to a Commonwealth-run national occupational health and safety scheme and not be subject to state-based schemes.

The advantage of national business schemes is that they would allow nationally operating businesses to be covered by just one set of regulatory requirements across Australia, reducing business operating costs and improving the efficiency of the economy. They are also consistent with competitive federalism, as they increase the choice businesses have about where and how they are regulated, putting competitive pressure on state regulatory schemes.

National business schemes could be introduced by the Commonwealth either in agreement with the states, or unilaterally.

## 5.4 | NATIONAL MARKETS

Just as Australia's 'common market' remains fragmented, despite over a century of federation, so are many specific markets within Australia.

A common market does not require that all aspects of trade and commerce are uniform across Australia. There is no reason, for example, why states should not impose different rates of payroll tax and stamp duty while at the same time harmonising their methods of calculation. Similarly, where markets operate at a regional or local level and are dominated by businesses that do not operate beyond state boundaries, there is no need for uniformity across Australia.

As Australia's economy has grown, however, key elements of the economy have moved beyond the local or regional sphere and have taken on a stronger national character. For example, whereas the management of natural resources such as water or the provision of utilities such as electricity or gas, were once seen as state responsibilities, it is increasingly clear that these matters are now of national importance. Yet many of these issues continue to be managed, often inefficiently, by a collective of governments (see Exhibit 11).

## EXHIBIT 11

### WHAT NATIONAL ELECTRICITY MARKET?

The Australian Bureau of Agricultural and Resource Economics estimates that \$30–35 billion of investment will be required in Australia's energy sector by 2020. Of this, \$11 billion will be required in new electricity generation, and the rest needs to occur in electricity transmission and distribution and our oil and gas sectors. There are a number of disincentives for investors in electricity infrastructure, however, including the lack of a national electricity market.

A national electricity market has been promised since the early 1990s and was 'launched' in 1998. The original objective of the national electricity market was to have one market. Generation would be built where it was most economic, and generators and retailers could optimise trades across state borders.

The national electricity market remains, however, more like five markets than one. In most states generators and retailers largely trade intra-regionally as it is too risky to trade inter-regionally. This is because there is a large risk of transmission lines binding and price separation between regions, which can leave one party to a wholesale trade or hedge still exposed to high prices. While 'insurance' can be purchased through participation in the settlement residue auctions (which can allow parties to access the price difference between regions), this insurance is of no use if the transmission lines are not operating effectively.

Source: Business Council of Australia, *Infrastructure Action Plan for Future Prosperity*, March 2005.



If Australia were truly a common market, we would see national markets operating in key areas of the economy. As the Secretary to the federal Treasury has pointed out, however:

... it may not be too much of an exaggeration to say that the only significant business inputs for which we do have national markets are financial capital, post, telecommunications and aviation.<sup>43</sup>

We do not have national markets in, for example, rail transport, road transport, water, electricity or labour.

Even where we declare we have a 'national market', as with electricity, this can be more in name than reality.

As with the harmonisation of regulation, COAG has put in place processes to improve the management and regulation of areas that should be national markets. Again, past experience suggests these processes will be of limited success.

In 21st-century Australia, there may be a strong case for responsibility for many of these national markets to be transferred to the Commonwealth. This should be done in cooperation with the states, but it may require more direct action by the Commonwealth if cooperation is not effective.

The BCA recommends that the issue of whether the Commonwealth should take over the management and regulation of national markets should be referred to the proposed Federal Convention.

## 5.5 | RATIONALISING FUNCTIONS

Clearly allocating roles and responsibilities will be challenging. So too will be restructuring current government programs to bring them into alignment with the agreed roles of each level of government. It is this process, however, that can deliver significant productivity gains for Australia by overcoming many of the problems set out above.

For a proper allocation of functions, the Commonwealth will need to withdraw from areas of agreed state responsibility, including reducing its use of specific-purpose payments.<sup>44</sup> The states will also need to refer any powers to the Commonwealth needed to overcome that government's constitutional limitations.

The process of rationalising government functions can begin once the report of the Federal Convention has been received by COAG. Based on that report, COAG should agree on priority areas where rationalisation can be achieved quickly or where considerable efficiency gains can be made. COAG should then request the Federal Commission (see 6.3 below) to identify government functions that are inconsistent with the framework proposed by the Federal Convention and agree a program for rationalising those functions.

## 5.6 | EXCLUSIVE AND SHARED RESPONSIBILITIES

The above principles and processes will identify functions that should be managed at a national level and functions that should be managed at a state level. Even after this allocation, however, there will remain responsibilities that, for compelling practical or political reasons, are shared between the Commonwealth and the states. This is one of the realities of the Australian Federation.

There are good and bad models for managing shared responsibilities between the Commonwealth and the states. The bad model usually cited is allocation of responsibilities within the Australian health system. While Australians enjoy relatively good health and our system, overall, delivers a high level of care, there can be no doubt that it is beset with major inefficiencies (see Exhibit 3).

In contrast, the National Transport Commission (NTC) is often cited as an example of a successful cooperative federalism model. The NTC and its predecessor the National Road Transport Commission (NRTC) were established to advise governments on regulatory reform to ensure safe, efficient and sustainable land transport nation-wide. The NTC has an independent Board of Commissioners, appointed by the Commonwealth Transport Minister with the agreement of his state and territory counterparts.

Since it was first established as the NRTC in 1991, the NTC has successfully led reform in a range of areas, including the transportation of dangerous goods, uniform registration, licensing and driving hours for heavy vehicles and Australian Road Rules.<sup>45</sup>

There are a number of reasons why the NTC is seen to have been successful:

- + The NTC is underpinned by an intergovernmental agreement developed by central agencies and signed by heads of government.
- + The NTC has a very specific role, in this case focused on regulatory reform to deliver national consistency.
- + Policies are developed through a robust process of consultation and regulatory impact assessment, consistent with a three year rolling strategic plan agreed by all government transport ministers.
- + There are clearly defined processes and rules for reaching resolutions and voting, with votes carried by the majority.
- + There is a strong commitment from the NTC to engage with its stakeholders and 'owners' to lay the foundations for support for its initiatives.<sup>46</sup>

The NTC model is not, however, without its limitations. Chief among these is that the NTC has no power to require consistency from governments in the implementation of agreed reforms. Individual jurisdictions may choose to diverge from the reform program or can considerably delay implementation of agreed reforms.

## 5.7 | MODELS FOR SHARED RESPONSIBILITIES

Despite these limitations, the NTC is one model for effectively managing shared responsibilities between the Commonwealth and the states.

Other models have also been proposed. For example, a range of alternative models have been proposed to improve the joint management of the health system, including:<sup>47</sup>

### INCREASED STATE RESPONSIBILITY

The Commonwealth sets broad national targets, monitors performance and provides unconditional funding while the states are free to determine how those targets should be met. The states work together or agree to involve the Commonwealth where a national approach is more efficient, such as where economies of scale can be captured. Under this model, the degree of shared responsibility would be minimised.

### NATIONAL JOINT MANAGEMENT

The Commonwealth and states would establish a joint national body to develop and oversee reform in the health sector, including developing a framework for an integrated health care system with nationally agreed policy, goals and objectives. The joint body would also advise on national strategic plans, high-level budget allocations and associated performance measures. It would be staffed by both Commonwealth and state officials and would report to Commonwealth and state health ministers.

### REGIONAL JOINT MANAGEMENT

A similar model to the national joint management approach, but with a separate entity in each state. The Commonwealth would establish with each state a state-based health commission, jointly funded by both governments to provide a range of health care services. The commission's responsibilities would be to manage the funding and planning of all health services in that state, purchase the necessary services from providers and monitor performance against targets agreed between the governments.

### SEGMENTED JOINT MANAGEMENT

Based on the above models, but with joint management confined to specific issues. For example, the Commonwealth and a state may agree a joint management arrangement for aged care to overcome the cost shifting between aged care facilities and hospitals.

Other models for managing shared responsibilities include:

### INCREASED COMMONWEALTH RESPONSIBILITY

The Commonwealth decides the policies and how they will be delivered, then uses its financial power to compel the states to deliver accordingly. In effect, the states become agents of the Commonwealth, their role limited to service delivery within frameworks set by the Commonwealth.

### COMPETITIVE TENDERING

Again, it is the Commonwealth that decides policies and outcomes, but then it goes to the market for the provision of the services. Those services could therefore be provided by either the states or private sector providers.

### PUBLIC CHOICE

Under this model, rather than funding state services, the Commonwealth funds the users of those services. Users then have a choice about where they source their services, whether from state agencies or the private sector.<sup>48</sup>

## EXHIBIT 12

### MANAGING SHARED FUNCTIONS LIKE JOINT VENTURES

Business is familiar with the challenges of co-managing projects, particularly through joint ventures. There are a number of basic principles for successful joint ventures that could guide governments in managing their shared responsibilities:

- + Clearly define and agree the ultimate objective of the joint venture.
- + Clearly define and agree the milestones along the way to achieving that objective.
- + Agree the performance indicators for each milestone.
- + Agree which party is responsible for achieving each milestone.
- + Agree the consequences should a party fail to achieve a milestone.

Each of the above models presents significant practical and political challenges that should not be underestimated. It is also important to recognise that there is no one model that will meet all needs, no 'silver bullet'. What is clear, however, is that there are a range of models available that could be used to improve the efficiency of how governments manage their shared responsibilities.

COAG has recently agreed the basis of a new national reform agenda. As part of its implementation, COAG should apply better approaches for managing shared responsibilities.

## 5.8 | ENTRENCHING COOPERATION IN THE CONSTITUTION

One of the most successful forms of cooperation between the Commonwealth and states has been through cooperative schemes, such as the cooperative scheme that underpinned the former Corporations Law. That approach to collaborative federalism has been undermined, however, by opinions expressed in two cases by the High Court.<sup>49</sup> In particular, the High Court has indicated that there is no ability under the Constitution for the states to invest their powers or responsibilities in Commonwealth courts or officials, to give those bodies powers they could not otherwise have. It is therefore not possible to set up a national cooperative scheme that relies on state powers but is administered by Commonwealth bodies, as was done for the Corporations Law.

As a consequence of the High Court cases, it appears there are major limitations on the ability of the Commonwealth and states to enter into such cooperative schemes. This removes a major avenue for Commonwealth–state cooperation and deprives governments of a major tool for sharing responsibility and rationalising cross-jurisdictional regulation.

The solution is legally straightforward and should be politically uncontentious, although it does require a minor amendment to the Constitution. The problem could be overcome by amending the Constitution to include an express provision that the states may choose to allow Commonwealth courts to determine matters under state laws and to allow Commonwealth agencies to administer those laws.<sup>50</sup> Such an amendment would reopen the opportunities effective cooperative schemes offer for entrenching cooperation across governments to allow them to rationalise and coordinate their shared responsibilities.<sup>51</sup>

The BCA therefore recommends that the Commonwealth and state governments work together to initiate and support an amendment to the Constitution to include an express provision that the states may choose to allow Commonwealth courts to determine matters under state laws and to allow Commonwealth agencies to administer state laws.

While successfully amending the Constitution is difficult, where success has been achieved it has largely been with procedural amendments that are supported by both Commonwealth and state governments and all major political parties. Achieving this support would be essential to the success of the amendment proposed above.

## 5.9 | PROPOSALS FOR CLARIFYING ROLES AND RESPONSIBILITIES

In summary, the actions needed to clarify the roles and responsibilities of the Commonwealth and states are as follows:

### ACTION 1

A Federal Convention should be held with a wide range of participants, to develop a framework for reassessing the respective roles of the Commonwealth and states.

### ACTION 2

The Federal Convention should examine the arguments for and against the Commonwealth Government taking over the management and regulation of key national markets.

### ACTION 3

The Federal Convention should report its findings publicly and to COAG.

### ACTION 4

Once the Federal Convention has reported, COAG should agree on priority areas where rationalisation of government functions can be achieved quickly or where considerable efficiency gains can be made.

### ACTION 5

COAG should then request the Federal Commission (see Exhibit 13) to identify government functions that are inconsistent with the framework proposed by the Federal Convention and agree on a program for rationalising those functions.

### ACTION 6

COAG should agree to set a deadline of the end of 2007 for significant progress in harmonising those regulatory 'hot spots' already agreed by COAG.

### ACTION 7

If significant progress is not made, the Commonwealth Government should develop national business schemes for core areas of business regulation, allowing corporations to elect to opt into those schemes and out of state-based schemes.

### ACTION 8

The Commonwealth and state governments should work together to initiate and support an amendment to the Constitution to include an express provision that the states may choose to allow Commonwealth courts to determine matters under state laws and to allow Commonwealth agencies to administer state laws.

## 6 | PRINCIPLE 2: INSTITUTIONALISE COOPERATION

If there is written on the book of destiny one fact clearer and more significant than any other, in reference to these southern lands, it is the fact that sooner or later, by one sort of contrivance or another, the whole of the boundaries that separate Australian from Australian must come down.

**George Reid, 1898**<sup>52</sup>

For Australia's federal system to meet the challenges and opportunities the country faces, sustained cooperation between different governments is required. At present, the level of cooperation is largely determined by the political imperatives of the day and the personalities of our political leaders.

Arguably the most successful sustained program of cooperation between the Commonwealth and the states has been the implementation of National Competition Policy (NCP). While it has its detractors, NCP has delivered major reforms over a period of years in areas where reform would not have occurred if governments were working alone.

Critical to the success of NCP are its underpinning structures and processes. These include independent assessment of progress implementing agreed reforms and a division of the benefits of reform that included incentive payments to drive the process.

There can be no doubt that for cooperation between governments to work there needs to be political commitment at the highest level of each government to a collaborative reform agenda. Political commitment can be an ephemeral quality, however, and so Australia has seen cooperation and collaboration between governments wax and wane over the years. A critical step in getting cooperation to work on a sustained basis will therefore be to find mechanisms to institutionalise that cooperation.

### 6.1 | STRENGTHENING COAG

The primary vehicle for cooperation and collaboration across the states and Commonwealth is COAG. As noted above, COAG was established in 1992 and has since met, on average, just once each year, usually for a few hours only. While COAG is supported by considerable activity from officials between meetings, COAG is the critical decision-making body and the only forum where our political leaders can agree to work together to resolve national issues.

Our Federation will not serve our current and future needs without an effective vehicle for cooperation and collaboration between governments and for collective policy development and decision making.

To ensure there is an effective vehicle for intergovernmental collaboration, the BCA recommends:

- + that COAG agrees to meet at least twice each year, with meeting dates determined by the Commonwealth in consultation with the states;
- + the location of the meetings alternate between Canberra and the states; and
- + meetings are scheduled for a full day to allow proper consideration of a full range of policy issues.

Another limitation of COAG is the perception that it is a creation and creature of the Commonwealth. Typically, it is the Commonwealth that decides if and when COAG should meet and then largely determines the agenda. Any vehicle for cooperation among governments, to be effective, must be seen to be independent of any one government or tier of government.

To ensure independent administrative support for COAG meetings, the BCA proposes that a small Secretariat to COAG be created, funded jointly by state and Commonwealth governments and staffed by both Commonwealth and state officials.



## 6.2 | STRENGTHENING MINISTERIAL COUNCILS

While COAG is responsible for bringing political leaders together to set reform agendas, much of the issue specific work across governments is carried out by Ministerial Councils made up of the relevant Commonwealth and state Ministers. There are currently 30 Ministerial Councils in operation.

Referring important policy matters to Ministerial Councils for consideration has been equated with giving them the ‘kiss of death’. The development of national uniform defamation laws, for example, was debated by the Standing Committee of Attorneys-General for over 20 years.<sup>53</sup>

There is very little accountability around the performance of Ministerial Councils. Council secretariats are required to provide copies of their minutes to the Department of Prime Minister and Cabinet. They are also required to provide to that department once a year a brief update on key issues and outcomes.

Without stricter performance accountability, there is very little likelihood of Ministerial Councils becoming effective means of progressing issues between the Commonwealth and the states. The BCA therefore recommends that COAG requires all Ministerial Councils to publish each year their work programs for the coming year, including the outcomes the council intends to achieve (in effect, its key performance indicators). Each council should report half-yearly on progress towards these outcomes. Both annual work programs and performance reports should be provided to COAG and should be published on the COAG website.

## 6.3 | FEDERAL COMMISSION

As more and more of the opportunities and challenges facing Australia require a collective response from governments, there is a growing need to anticipate emerging reform issues, to identify and analyse potential policy responses, to test possible policy responses with the public and to monitor progress in implementing the response agreed by governments.

This function is now fulfilled in part by the Commonwealth’s Productivity Commission and by state policy development agencies. This current approach, however, is inadequate. State-based bodies largely focus on the implications of emerging issues for the state and on state-driven responses. The Productivity Commission and other Commonwealth bodies tend to take a more national view, but will still focus more on Commonwealth Government responses and will have limited influence over state governments.



An important role for this function is to foreshadow issues that may not yet be on the political agenda, and to develop objective policy responses to the issues for consideration by governments. While decision making must be left with elected governments, the role of anticipating issues and recommending responses must be given to a body free from the political imperatives of any particular government or interest. Without this independence, the conclusions and advice of the body will be contested as politically biased, with this claim of bias being used by governments to resist reform pressures. For similar reasons, the body must be free to determine its own research program and to make recommendations to COAG on the priority areas for reform.

Such a body would give continuity to the collective responses of governments to major policy issues. At present, COAG's effectiveness is constrained by the political cycles at the state and Commonwealth level. While Australia is currently experiencing an unusual level of political stability across both major tiers of government, the normal pattern is for elections and changes of government to erode the continuity of the COAG agenda. A permanent advisory body would help overcome some of the effect of political cycles without impinging on the decision-making responsibilities of elected governments.

COAG has already taken a step in this direction with the decision to create a COAG Reform Council. It is as yet unclear whether such a council will fulfil all the functions needed to support an effective COAG.

The BCA believes a better approach would be to establish a permanent, non-aligned and independent review and advisory body, the Federal Commission (see Exhibit 13).

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## EXHIBIT 13

### THE FEDERAL COMMISSION

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To strengthen cooperation and to improve the operation of the federal system, the Commonwealth and states should establish a Federal Commission.

#### ROLE

The Federal Commission would be a research and advisory body. Its primary roles should be to:

- + Identify emerging challenges and opportunities that will require a collective response from Commonwealth and state governments.
- + Develop and analyse potential policy responses to these issues and report the results to COAG.
- + Monitor progress by the Commonwealth and state governments in implementing reforms that have been agreed by COAG and report the results to COAG.

#### GOVERNANCE

The Federal Commission would be answerable to all governments, through COAG, and would be independent of any single or tier of government. To strengthen this independence, the Commission should be overseen by a Board of individuals drawn from a range of community, government and business backgrounds.

The Commission should have the power to initiate its own reviews and to conduct public inquiries and consultations. The Federal Commission's reports to COAG should be made public.

#### STRUCTURE

The Federal Commission should be jointly funded and staffed by the Commonwealth and states, with sufficient resources to undertake its role effectively. The Commission should work closely with other research bodies, such as the Productivity Commission.

The effectiveness and function of the Federal Commission should be reviewed after five years.

#### INITIAL ACTIVITIES

An early inquiry by the Federal Commission should be to identify all areas where improvements are needed to make Australia a truly common market. The Commission should also identify those markets within Australia that could operate more efficiently at a national level and any impediments to achieving national markets in these areas. The results of this inquiry should be available for consideration by the Federal Convention.

Following the Federal Convention, COAG should request that the Federal Commission identify government functions that are inconsistent with the framework for Commonwealth and state roles and responsibilities proposed by the Federal Convention.

The Federal Commission should also undertake an inquiry into fiscal arrangements within the Federation, as proposed in the next section.

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In the past few months, governments have made a number of announcements on institutional arrangements designed to underpin federal relations. In February, COAG announced its intention to establish an independent COAG Reform Council to report to COAG annually on progress in implementing the newly agreed national reform agenda. In July, it was agreed that the Productivity Commission would assist the Reform Council in assessing the potential benefits of the new round of reforms.

The states have established the Council for the Australian Federation. The Council's functions include strengthening the position of the states in their dealings through COAG with the Commonwealth, addressing cross-jurisdictional issues without the need for Commonwealth involvement, improving discussion and information sharing between the states and anticipating future developments within the federal system.<sup>54</sup>

From these proposals, it is apparent that governments recognise the need to provide institutional support to underpin federal relations. At present, it is not clear the extent to which the COAG Reform Council, which is still being developed, will meet the needs for which the Federal Commission has been proposed. Will the Reform Council, for example, have the freedom and independence to advise COAG of emerging issues that will need COAG's attention? Will the Reform Council provide public reports on the progress of all governments towards achieving the commitments they make through COAG, particularly as the Reform Council will ultimately replace the National Competition Council?

Stronger institutional arrangements are not only necessary at the highest levels of intergovernmental relations. Stronger institutions are also needed in specific policy areas. A number of these were suggested in the previous chapter as part of the models for better managing shared responsibilities. Another approach is to appoint specific-purpose commissions to examine particularly difficult areas of federal interaction and to recommend to governments ways of improving administration. This approach can be necessary to overcome the entrenched and parochial positions that sometimes exist within governments.

## 6.4 | PROPOSALS FOR INSTITUTIONALISING COOPERATION

In summary, the actions needed to institutionalise better cooperation between the Commonwealth and states are as follows:

### ACTION 9

COAG should be strengthened, including through more frequent meetings (twice yearly) and through providing an independent secretariat.

### ACTION 10

Ministerial Councils should be strengthened by requiring them to prepare annual work programs with key performance indicators (KPIs) and to report half-yearly to COAG and publicly on progress against those KPIs.

### ACTION 11

A Federal Commission should be established to identify emerging issues requiring a collective response from governments, advise on response options and report to COAG on progress with implementing COAG agreed reform agendas.

## 7 | PRINCIPLE 3: FIX FISCAL ARRANGEMENTS

Certainly, the federal system needs fundamental change ... Change that either reinforces the autonomy and the funding base of the states or, alternatively, puts them out of their misery by shifting Australia to a unitary system of government via a referendum.

**NSW Premier Morris Iemma, 2006<sup>55</sup>**

Fiscal arrangements are among the most contentious issues within federal relations. In large part, this is because the Australian federal system is characterised by high degrees of vertical fiscal imbalance and horizontal fiscal equalisation.

### 7.1 | VERTICAL FISCAL IMBALANCE

In an ideal world, governments would raise the funds they need to fulfil their responsibilities. This ensures they are directly accountable to their electorate for both their revenue raising and their expenditure activities. Where this occurs within a federal system, it is known as 'fiscal equivalence'; that is, each government raises its own funds and transfers between governments are unnecessary.

Where governments raise more or less funds than they need, and consequently there are transfers between governments, 'vertical fiscal imbalance' (VFI) occurs. Australia has a high level of vertical fiscal imbalance (although there is a question about the extent of VFI – this is discussed further opposite).

There can be a range of negative consequences from high degrees of VFI, including:

- + Reduced accountability to taxpayers for fund raising and expenditure.
- + Increased risk of duplication and overlap in the provision of government services, particularly where the financially dominant government uses its fiscal power to direct activities in areas traditionally managed by the financially weaker government.
- + Constraints on beneficial tax competition between governments.
- + Weakened incentives for tax and micro-economic reform.<sup>56</sup>

As has already been noted the Commonwealth accounts for 80 per cent of taxation revenue raised by governments<sup>57</sup> and 54 per cent of all government expenditure,<sup>58</sup> while the states raise 16 per cent of taxation revenue, but spend around 40 per cent.<sup>59</sup> As a consequence, there is a large gap between the relative power of the Commonwealth to raise revenue and the needs of the states to allow them to deliver traditional state-based services.

This gap is reduced if the GST is considered a state tax, although whether this is the case is a source of ongoing dispute between the Commonwealth and the states. If the GST is considered a Commonwealth tax with revenues transferred as Commonwealth payments to the states, then Australia's states rely on the Commonwealth for approximately 50 per cent of their funds. If the GST is considered a state tax, that figure falls to approximately 20 per cent.<sup>60</sup> Either way, VFI is a factor in federal relations in Australia.

Given that VFI has negative consequences for the operation of the federal system, consideration should be given to whether and how the negative impacts of VFI can be removed or reduced.

One way to achieve this would be to readjust Commonwealth and state tax bases to remove the VFI. The OECD has recently identified a number of ways in which this could be done.<sup>61</sup> For example, the OECD has suggested that the level of Commonwealth personal income tax could be reduced to allow states to impose their own personal income tax or place a surcharge on the Commonwealth tax. State income taxes could be collected through the Australian Taxation Office to reduce administrative costs.

The OECD has also suggested that the states could increase their fiscal autonomy by broadening their land property and payroll tax bases, while noting that the ratio of property tax revenue to GDP is already high in Australia.

However, a word of caution is required. Australia is under considerable international pressure to reduce, rather than raise, taxes. Any increase in the tax bases of states would need to be offset by equivalent reductions in Commonwealth taxes.

It is also questionable whether significant adjustments to the relative tax bases of the Commonwealth and states are politically achievable. It should be noted, for example, that the Fraser Government offered the states the opportunity to impose income taxes, but this offer was not taken up. The business community would also have strong reservations about significant increases in the taxing power of the states, both in terms of total taxes paid and the potential for increased administrative burdens dealing with a more fragmented tax system.

As an alternative to realigning revenue raising with expenditure, the impacts of VFI could be reduced by increasing unconditional transfers from the Commonwealth to the states. A step in this direction was the agreement between the Commonwealth and the states that the GST revenue would flow directly to the states. Consideration could also be given to returning an agreed portion of personal income tax to the states on a per capita basis (issues of horizontal fiscal equalisation are discussed below). The effect of this would be to increase the proportion of state revenue (sourced from state taxes and Commonwealth transfers) that is available to the states on an unconditional basis. In other words, the financial autonomy of the states would be increased.

The above discussion focuses on reducing VFI by increasing the relative fiscal freedom of the states. VFI could also be reduced, of course, by significantly reducing the areas of state expenditure, requiring a reallocation of functions between the Commonwealth and the states.

## 7.2 | HORIZONTAL FISCAL EQUALISATION

Australia has a long history of horizontal fiscal equalization (HFE); that is, financial support for the less well off (and usually smaller) states. The extent to which we engage in HFE, however, is more a creation of the last few decades. In fact, the OECD has noted that Australia is perhaps unique in its 'attempts to fully equalise the revenue raising capacity and expenditure of its states, despite having the lowest pre-equalisation fiscal disparities'.<sup>62</sup> Australia has a very complex equalisation process, even though the differences between the states, by international standards, are minimal.

Like VFI, HFE potentially raises problems for a federal system. One instance of that is the current debate about the level of funds flowing from some states, like New South Wales and Victoria, to others, like Queensland and Western Australia. Other potential concerns with HFE include:

- + That HFE discourages labour mobility by supporting people to remain in states where their labour contribution is less than it would be if they moved.
- + That HFE penalises reforming states by 'equalising' some of the benefits of reform away from those states.
- + Equally, that HFE rewards inefficient states or acts to soften the pressures that would otherwise drive the need for reform.

It has also been suggested that the current system of equalisation creates deadweight losses of between \$150 and 280 million per annum.<sup>63</sup>

Many of these objections are dismissed by proponents of equalisation, including the Commonwealth Grants Commission, which is responsible for calculating the equalisation payments. The OECD has also noted that the empirical evidence of the impact of HFE on efficiency suggests the impact is not large.<sup>64</sup>

Nevertheless, HFE continues to be an issue for federal relations, particularly for those states that feel they are unjustly subsidising their prosperous neighbours.

## 7.3 | PROPOSALS FOR FIXING FISCAL ARRANGEMENTS

Current problems with fiscal arrangements within the Federation, including VFI and HFE, have negative impacts on the federal system, undermining cooperation and reducing the accountability of governments for their performance in both revenue raising and expenditure.

The solutions to these problems will not be easy, particularly given the extent to which the Commonwealth is now responsible for raising revenue on behalf of Australia's governments. Any proposed solutions will also need to recognise that taxation is a key element of Australia's international competitiveness and that globally the pressure is to reduce, not raise, total taxation levels.

### ACTION 12

The Federal Commission should undertake an inquiry and report to COAG on the extent and consequences of vertical fiscal imbalance and horizontal fiscal equalisation, and the feasible options available to overcome any negative consequences.

## 8 | CONCLUSION

Australia's federal system is a key determinant in how well we meet the challenges Australia will face in the coming decades. Yet, it is clear the system is not working well and is struggling to deliver important reforms that are crucial to future growth in a consistent, cooperative and forward-thinking way.

Without ongoing national reform, Australia's relative prosperity will start to fall and we will slide backwards. Not only do we risk losing the benefits of further reform, but we will also lose the relative benefits of past reforms.

For Australia to achieve these reforms and lock in its current prosperity, we need better cooperation and collaboration from our Commonwealth and state governments. We also need to sweep away the weakness and inefficiencies that are apparent in our federal system.

Any reforms to our federal system, however, need to be practical and pragmatic if they are to have a chance of delivering real improvements in the foreseeable future. Reform needs to recognise the realities of our multi-tiered system of government and the wide range of responsibilities that governments share. They also need to recognise that there is a long term and apparently unstoppable trend towards greater Commonwealth power.

Importantly, reform should recognise that Australia is not a federation by accident. There are real benefits from a federal system of government and these need to be preserved and enhanced. At the same time, we live in a globalising world and increasingly, many issues require a national response. The challenge is to strike the right balance.

From a business perspective, Australia could greatly benefit from completing the task begun with federation of establishing a true Australian common market.

To begin the process of federal reform, the BCA has proposed a 12-point action plan based around three key principles to deliver improvements in the operation of the Australian Federation in the short to medium term:

### 1 CLARIFY ROLES AND RESPONSIBILITIES

### 2 INSTITUTIONALISE COOPERATION

### 3 FIX FISCAL ARRANGEMENTS

**WE NEED A NEW DISCUSSION ABOUT THE AUSTRALIAN FEDERATION – AND THE BCA INTENDS TO BE A PROMINENT VOICE IN THAT DISCUSSION.**



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# APPENDIX 1

## INTERGOVERNMENTAL RELATIONS IN FEDERAL SYSTEMS

## INTERGOVERNMENTAL RELATIONS IN FEDERAL SYSTEMS

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## 1 | INTRODUCTION

Australia, like many other systems of government around the world, is a federal system. Federations, while divided into different levels of government inevitably have a degree of interdependency between governments. Inescapably there arises a degree of conflict or ineffective governance. For example, disputes may arise between different governments on the basis of service provision or infrastructure, constitutional jurisdiction, fiscal arrangements (e.g. vertical fiscal imbalance or spending powers) or environmental or social issues.

Most federations have developed a system of intergovernmental consultation and cooperation to deal with such issues, and to manage and foster cooperation between governments. The character of intergovernmental arrangements is unique to each federation, and depends on various factors such as history, geography, population, size and formal federal arrangements. While intergovernmental processes and arrangements are a common feature of federations around the world, the form of such arrangements varies depending on the specific circumstances of each federation.

Comparisons of intergovernmental arrangements of different federations can provide insights into how Australia's intergovernmental arrangements might be strengthened, and the pitfalls that might be faced if reform of intergovernmental arrangements is not achieved. Many federations are grappling with similar issues to those being faced in Australia and there are lessons to be learned from those countries.

Various issues need to be considered.

Firstly, should the intergovernmental arrangements be federal–state or interstate? In most federal systems, both forms are used. For example, Canada and Switzerland and more recently Australia, have recognised the need for interstate formal arrangements by establishing a forum for achieving consensus across sub-national governments on issues, including federal–state. On the other hand, most federations have some form of federal–state forum that deals with both vertical and horizontal collaboration. Such federal–state forums generally vary from federation to federation in the degree of institutionalisation and formality.

Secondly, a consideration of the degree of formality of intergovernmental arrangements is required. The types of forums that have been established across federations vary from formal (e.g. constitutional entrenchment) to informal (e.g. meetings called on an ad hoc basis). 'As Australia has illustrated, constitutionalization is not essential, but extra-constitutional formal councils do have an advantage over merely ad hoc bodies'.<sup>1</sup>

In considering similar issues in Canada, one commentator stated:

... the intergovernmental institutions will need to be genuinely collaborative in character, rather than instruments for intergovernmental imposition. But provision for some formal institutions to improve intergovernmental collaboration and reduce friction and conflict in Canada would appear to be overdue. At the same time, in establishing formal institutions to improve intergovernmental collaboration it will be essential to ensure that they are open, transparent, accessible and responsive in order to avoid any public sense that they will contribute to a 'democratic deficit'.<sup>2</sup>

.....

Thirdly, consideration of forums that may not be linked to government or political persuasions may be required. What has hampered collaboration and outcomes in many federations has been a focus on political 'jockeying' and buck-passing rather than long-term perspectives. There may be some alternative systemic institutional arrangements that can be developed to achieve greater accountability, transparency and independence in policy setting initiatives. This would involve establishing an institution made up of individuals with policy expertise and who are not influenced by political views. This jointly funded federal–state body would be primarily dealing with issues relating to the federal system and be able to provide research and data on federalism and prepare reports on the state of the federation and other special issues as they arise.

Fourthly, consideration of appropriate accountability and transparency as well as collaboration that can be achieved from intergovernmental fiscal arrangements must also be a high priority. Policy making and the ability to implement decisions as well as accountability for policy making are inextricably linked; any consideration of intergovernmental arrangements cannot avoid consideration of fiscal arrangements. These arrangements differ across federal systems depending on the formal arrangements (e.g. constitutional as well as legal interpretation) as well as historical and other developments. While it may be difficult for Australia to emulate other jurisdictions in terms of fiscal arrangements (e.g. taxation arrangements are politically sensitive and difficult to alter) it may be worthwhile to highlight how Australia differs from other countries, and why this should be reviewed for long-term effectiveness.

The BCA has argued since 2005 that Australia needs a new national reform agenda, highlighting four key areas for reform: tax, infrastructure, regulation and workplace relations. Some of what the BCA sought in terms of specific reform actions was delivered when the Council of Australian Governments (COAG) agreed in February 2006 to a new reform agenda covering education, training, infrastructure and regulation.

These positive responses, however, have been reactions to specific problems and do not represent a holistic approach to issues that arise with Australia's federal system. COAG needs to be driving the reform agenda that anticipates reform issues and positions Australia to be able to compete in the future in a global economy. This has led the Productivity Commission to comment:

Collective and cooperative action will be especially important in responding to future challenges – such as globalisation, environmental sustainability and population ageing – because of the extensive cross-jurisdictional elements associated with the challenge. The Commission has highlighted the need for national coordination in a number of key reform areas, including health, the environment and freight transport, and has emphasised the strong leadership role required from CoAG.<sup>3</sup>

Cooperation between governments in Australia is essential for facilitating a variety of reforms to improve Australia's performance and productivity. Effective intergovernmental relations are necessary to reduce the overlap and duplication of regulation and service delivery and to facilitate decision making by different levels of government. They are 'also necessary if the virtues of federalism are to be realised in Australia.'<sup>4</sup> Accordingly, high-level leadership, as well as a systematic way of identifying, agreeing and implementing reforms (including refining and monitoring progress), is necessary.

## 2 | FEDERAL SYSTEMS

Federal systems consist of different levels of government, commonly a national or central government and a set of regional or sub-national governments (e.g. states in Australia, provinces in Canada, Länder in Germany and states in the United States).

What broadly distinguishes federal systems from unitary systems is that legislative power rests with the central government in a unitary system, but is divided and shared between the different levels of government in a federal system. The division of powers in a federal system is generally governed by a constitution. 'In a federal system of government, sovereignty is shared and powers divided between two or more levels of government each of which enjoys a direct relationship with the people.'<sup>5</sup>

Ronald Watts, former Principal of Queen's University, Kingston, Ontario and Fellow of the Institute of Intergovernmental Relations, provided a discussion of federations worldwide in his background paper, 'Federalism Today', presented at the International Conference on Federalism in August 2002:

Federalism provides a technique of constitutional organization that permits action by a shared government for certain common purposes, together with autonomous action by constituent units of government for purposes that relate to maintaining their distinctiveness, with each level directly responsible to its own electorate. Indeed, taking account of such examples as Canada, the United States and Mexico in North America, Brazil, Venezuela and Argentina in South America, Switzerland, Germany, Austria, Belgium and Spain in Europe, Russia in Europe and Asia, Australia, India, Pakistan and Malaysia in Asia, and Nigeria, Ethiopia, and South Africa in Africa, some 40 percent of the world's population today live in countries that can be considered or claim to be federal, and many of these federations are clearly multicultural or even multinational in their composition.<sup>6</sup>



### 3 | WHAT ARE INTERGOVERNMENTAL RELATIONS?

Intergovernmental relations are the responses that have been developed to facilitate cooperative policy making among divided governments within a federal system. Intergovernmental relations are supposed to play a 'bridge-building' role to bring a degree of coordination and cooperation to divided powers.

The federal systems of most countries have arisen because of the historical circumstances of those countries and commonly as a means of creating stability and union among a group of 'states' that have varying characteristics. The founders of those federal systems focused on formal constitutional rules and the division of powers between the states as a means of establishing a stable union. Most federal systems did not formally include the need for subconstitutional and informal arrangements for intergovernmental coordination and cooperation.<sup>7</sup> In addition, many federal systems have built in mechanisms within their constitutions making it difficult to amend the constitution (and therefore the limitation has made it difficult for those countries to later incorporate formal constitutional intergovernmental arrangements into their constitutional arrangements). It has been common for modern federal systems to develop informal intergovernmental relations in response to their own unique federal circumstances:

Changing political, economic and social realities are less likely to be addressed by formal constitutional amendments. Instead, there is growing reliance on intergovernmental treaties or accords.<sup>8</sup>

## 4 | AUSTRALIA'S FEDERATION – HOW IS IT OPERATING?

Australia's federation has a number of distinctive features, including:

- + A comparatively high degree of shared functions between governments.
- + A strong centralising trend over time.
- + A relatively high degree of vertical fiscal imbalance (with transfers directed at fiscal equalisation).
- + Innovative initiatives in cooperative federalism (such as mutual recognition schemes, harmonisation schemes and national standards).<sup>9</sup>

The Australian Constitution creates a highly concurrent federal structure, which means that intergovernmental relations are very important for the system to operate effectively. The powers that are not specifically assigned to a level of government in the Australian constitution ('residual' powers) reside with the states. There are only a few 'exclusive' powers of the Commonwealth, and a broad set of 'concurrent' powers between federal and state (section 51 of the Constitution) with the federal jurisdiction having paramountcy where there is conflict. 'So the Constitution not only mandates overlapping powers, it also facilitates them ...'<sup>10</sup>

In addition, the states are highly financially dependent on the Commonwealth (vertical fiscal imbalance). This means that the Commonwealth has become involved in many areas of policy making that would otherwise be the responsibility of the states. This means that there is overlap (both vertical and horizontal) in the operations across governments. The distribution of authority, coupled with vertical fiscal imbalance, means that conflict is a feature of the management of the Australian system, and that the 'smooth functioning of a federation so concurrent in its structure is dependent upon effective intergovernmental relations.'<sup>11</sup>

## EXHIBIT 1

### CONCURRENCY OF POWERS

Because there is a tendency to think about governments fulfilling 'functions', it would be easy to slip into thinking of this discussion as being about how functions will tend to be comparatively sorted – that is, divided. The reality is that all things that are appropriately categorised as policy functions – health, education, welfare, defence, law and order, labour markets, environment, agriculture and many more, involve collections of activities with quite different shaped cost functions and, correspondingly, different spheres of government are likely to have a comparative advantage in providing different activities, even allowing for the possible gains to them from coordination with other governments up or down the production chain. So for example, in welfare policy 'activities' range from setting tax and cash benefit structures through labour market training programs to the provision of public housing or of shelter for homeless persons.

Source: C Walsh, 'Competitive federalism – Wasteful or Welfare Enhancing?' Productivity Commission *Productive Reform in a Federal System*, Roundtable Proceedings, Canberra, 2006, p. 63.

.....

Governments are the main agents of economic management and reform. They establish policy frameworks, settings and limitations that have a major influence on a nation's current and future prosperity. A critical part of their role is to anticipate and manage emerging economic challenges and opportunities that can affect the performance of Australia's economy.

Governments, as economic managers, should discharge three key responsibilities:

- + **Anticipating** possible or emerging economic barriers and opportunities – in a fast-moving, global environment, successful economies must anticipate emerging risks and opportunities and respond accordingly.
- + **Agreeing** on the reforms necessary to avoid the barriers and seize the opportunities – under a federal system, most solutions will require the agreement and commitment of more than one level of government.
- + **Implementing** the agreed solutions – successful implementation is most likely where the goals of reform, and the progress towards those goals, are transparent and governments are held to account for their performance.

While there may be benefits arising from the inherent competition in Australia's federal system, there must also be a mechanism to ensure efficiency. Detrimental effects such as overlap, duplication and disputes about responsibility must be avoided while achieving a long-term strategic vision for the future. The costs of overlap and duplication and inefficiencies in Australia's federal system are highlighted in the Access Economics report, *The Costs of Federalism* (Appendix 2), and estimated to be approximately \$9 billion. There are obvious economic advantages therefore to reducing the unnecessary costs and to ensuring a strategic, comprehensive, long-term strategy is established. How can this be done in the context of such interdependence and competition across governments?

To anticipate, agree and implement policy reform for the good of the economy, there is a strong need for intergovernmental cooperation in Australia. Through the Special Premiers' Conferences and COAG, among other initiatives, a number of cooperative arrangements as solutions to specific problems have been implemented in Australia since the 1990s. An example of a substantially successful initiative was the National Competition Policy (NCP) framework. However, although the success of those initiatives is commendable, a process to ensure that there is ongoing consideration of policy reform initiatives is essential.

Gary Banks, Chairman of the Productivity Commission, suggests that the success of the NCP reform process was attributable to:

- + Recognition by all governments of the need for reform.
- + Broad agreement on the priority areas.
- + A solid framework and information base to guide policy prescriptions.
- + Some highly effective procedural and institutional mechanisms to implement reform.<sup>12</sup>

Do similar frameworks exist to ensure successful initiatives such as NCP occur in the future in other areas (e.g. infrastructure, tax, regulation, health, education)?

Notwithstanding the improvement in Australia's economic performance in recent years, inefficiencies and performance gaps remain and will need to be addressed if Australia is to meet significant challenges ahead. Many of the areas offering the potential for significant benefits extend beyond the existing NCP reform agenda, but share in common the fact that coordinated national reform has a real and important role to play.<sup>13</sup>

What is required is a method of ensuring that the three objectives outlined above (anticipating, agreeing and implementing) can be met across the Australian economy – and that there is a shared vision for the operation of the Federation. Consideration should therefore be given to establishing systemic changes within Australia's federal structure to facilitate the identification of potential or emerging economic challenges and opportunities and appropriate responses to those. Intergovernmental institutions provide a stable framework for negotiations and a framework for effective decision making.

## EXHIBIT 2

### THE NECESSITY FOR POLITICAL LEADERSHIP AND REFORM

Many participants stressed the importance of cooperation between governments in facilitating a variety of reforms that could materially improve Australia's productivity and growth performance. In this context, several participants stressed the need for high level political leadership and dialogue for developing and refining reform initiatives and monitoring progress over time ...

Source: Productivity Commission, *Productive Reform in a Federal System*, Roundtable Proceedings, Canberra, 2006, p. 13.

There appear to be two main deficiencies in Australia's federal system that are causing inefficiencies, duplication, overlap as well as a lack of transparency and accountability of governments and their actions and short-termism in focus towards the operation of the federal system. These are:

- + A lack of adequate institutions for intergovernmental relations that will enable anticipation, agreement and implementation of agreed policy by governments.
- + A lack of appropriate funding arrangements to reduce inefficiencies in our federal system.

Under these two main topics, this study considers the experience of a number of other federal systems to ascertain whether there are lessons to be learned that could be applied or adapted to solve some of the emerging problems in Australia's federal system.

## 5 | INTERNATIONAL COMPARISONS

The Productivity Commission has noted that 'about 25 of the world's 193 countries have federal systems of governance, accounting for about 40 per cent of the world's population and about 50 per cent of global GDP.'<sup>14</sup>

Lessons can be learned from other federal countries and the way their systems of federation operate. Other federations may be adopting new and innovative approaches to creating an efficient federal system and fostering cooperation between jurisdictions, or alternatively their federal systems may have deficiencies that should be avoided (and therefore can provide examples about 'what not to do' within Australia's own federal system).

Most federal systems have had similar experiences in the division of powers in their constitutions. In general, the division of powers has been more fluid than possibly anticipated, and areas of concurrent responsibility have created disunity between powers:

While these realities have been present from the earliest days, they became qualitatively more significant in the twentieth century and in particular since the emergence of the active state from the 1930s onwards. The rising need for welfare and social policies spawned a new practice of shared programs and joint financing schemes. Social policy, which were generally the domain of the subnational governments, increasingly depended on fiscal transfers. Fiscal federalism ... became a main preoccupation of federal systems.<sup>15</sup>

Intergovernmental relations exist in all federal systems, regardless of the structure or history of the countries' institutions:

This flows from the inevitable fact of interdependence among their constituent governments, a result of the complexities of the contemporary policy agenda and the impossibility, even when the inspiration was to draw water-tight compartments, of drawing clear and separate lines of responsibility.<sup>16</sup>

In particular, older-style federations such as the United States, Canada and Australia, while attempting to provide for a division of powers in the constitution, didn't anticipate the fluidity and degree of overlap that would eventually be associated with such responsibilities. Those countries did not build formal intergovernmental arrangements into their constitutions. As a result, informal and ad hoc arrangements have developed for intergovernmental relations in those systems. In Australia, as '... in Canada, therefore, intergovernmental institutions must respect the overriding principle of accountability to executives of their respective legislatures. Rather than being part of the fundamental constitutional design, intergovernmental mechanisms are 'add-ons' responding to the reality of interdependence, but with little or no legal or constitutional status.'<sup>17</sup>

## 6 | INTERNATIONAL FEDERAL SYSTEMS: A BRIEF OVERVIEW

Hueglin and Fenna identify four basic models of federalism: Canadian; American; German; and European Union.<sup>18</sup>

Canada has an executive federal system with some powers allocated to particular levels of government and some concurrent powers in the constitution. Canada has a strong tradition of provincial autonomy. The lack of legitimate provincial senate representation as well as conflicts over the division of powers means that intergovernmental relations plays a politicised role, with policy making being competitive between the jurisdictions. Canada has an extensive system of intergovernmental relations. The provinces and federal government have ministers for intergovernmental relations. The intergovernmental relations are informal with the most predominant negotiations taking place at First Ministers' Conferences (FMCs) chaired by the Prime Minister and attended by provincial premiers. Regional Premiers' Conferences have also gained prominence on the intergovernmental landscape and more recently a Council of the Federation was established under agreement as an inter-provincial body. Two countries that have similar style federations to Canada are Australia and India.

The United States has a presidential federalist model. In the US, state governments have no direct access to the process of national law making and there is no formal institutionalised intergovernmental body or arrangement to deal with intergovernmental issues. This arises from the political system in the United States in which the federal and state governments are co-sovereign as well as the huge size and diversity of the political and social environment in the US. For example, there are 50 states and over 87,000 local governments in the US,<sup>19</sup> and therefore there is great difficulty in developing a system that represents all of those interests and can reach a consensus view. Instead, most intergovernmental entities are ad hoc and short-lived committees, task forces and working groups created for intergovernmental lobbying and negotiation on specific issues. For example, states lobby the federal government through state organised institutions (e.g. National Governors' Association and National Conference of State Legislatures):

Intergovernmental relations also tend to take the form of 'picket-fence federalism' in which each policy field has its own intergovernmental relations. Federal and state bank regulators, for example, know each other and interact with each other ...

These arrangements have the advantage of dividing the huge intergovernmental system into more intimate, personal, and manageable set of relations. The disadvantage, however, is the difficulty of co-ordinating intergovernmental policy across fields.<sup>20</sup>

Federal systems such as Mexico, Venezuela, Brazil and Argentina have adopted American-style federations with their own unique characteristics.



.....

In Germany, the integrated federal model emphasises collective responsibility for legislation and implementation, and therefore more formalised and institutionalised intergovernmental relations. Most national legislation requires approval of the Länder governments in the Bundesrat before it is then implemented and delivered by Länder governments. Cooperation is also required for a number of constitutionally established joint tasks. There are regular prime ministerial conferences and summit conferences with the chancellor, aimed at coordinating legislative and policy cooperation. South Africa has adopted a variation on the German style of federation.

The European Union (EU) is a cultural federalist model consisting of member states with different histories, languages and social, legal and economic systems. Europe has two legislative chambers – a European Parliament representing European populations on a majoritarian basis and a Council of Ministers representing European governments. An executive European Commission is a government-appointed body of policy experts and acts like a cabinet. The principal intergovernmental decision making institution of the European Union is the Council of Ministers. The Council of Ministers makes decisions on proposals suggested by the Commission (the Commission proposes policies and legislation to the Council and is responsible for the administration and monitoring of implementation of treaties and decisions of the European Union).<sup>21</sup>

The European Union is based on the rule of law. This means that everything that it does is derived from treaties, which are agreed on voluntarily and democratically by all member states. Accordingly, the intergovernmental conferences of the European Union have enabled the successful agreement and establishment of several treaties for the European Union.

Spain has adopted an innovative intergovernmental relations mechanism in response to European integration. A 'Conference on Union Affairs' is held to establish Spain's position in European affairs (see Exhibit 4).

It is difficult to compare intergovernmental relations (IGR) in different countries. Such relations will be unique depending on many factors including the history and make-up of the country (e.g. nationalities, geography, and religious divisions), the type of federal system, the division of powers and the fiscal relationships:

Patterns of IGR, then are largely the result of such factors external to IGR itself. In none of these countries are institutions of IGR so strongly entrenched that they have strong independent effect on the behaviour of political actors. They are reactive and responsive, rather than determinative of the character of the federation. This is not to say, however, that policy makers in each of these countries can ignore the task of improving their machinery for co-operation.<sup>22</sup>

It is also difficult applying the lessons from other countries to Australia, which has its own characteristics:

Because intergovernmental relations are for the most part the result of subconstitutional and often informal arrangements, it is not so easy to distinguish country specific models.<sup>23</sup>

There are a number of challenges facing Australia that should be identified and tackled now, rather than in an ad hoc and reactive manner. This can only be achieved through better formal intergovernmental cooperative institutional mechanisms. The Victorian Federal-State Relations Committee in its report, *Federalism and the Role of the States: Comparisons and Recommendations*, commented that:

Although Australia's intergovernmental bodies have developed a great deal over the past ten years, they do not have the robust institutional character displayed by many of the institutions in the other federations visited by the Committee.<sup>24</sup>



## 7 | PRINCIPLES OF INTERGOVERNMENTAL RELATIONS

What are the ideal principles that should guide intergovernmental relations?

### 1. EFFECTIVENESS

Intergovernmental relationships must be established so that they are capable of achieving policy objectives that have been set (and so that there is the capability of avoiding duplication and overlap).

### 2. TRANSPARENCY

Effective information about policy objectives and decision making must be in the public domain so that there is clarity around the bases for decisions and actions as well as greater pressure brought to bear on governments to maintain the federal reform agenda and be accountable for progress and outcomes of reform.

### 3. ACCOUNTABILITY

Governments must be subject to appropriate checks and balances to ensure their actions and decisions are scrutinised and justified.

### 4. EFFICIENCY

Intergovernmental relationships must be capable of achieving objectives in a timely manner free from political capture or stalling, and against a long-term vision.

### 5. INDEPENDENCE

Actions and decisions must be free from undue influence from political or private interests. They must have high-level commitment.

## 7.1 | EFFECTIVENESS

***Intergovernmental relationships must be established so that they are capable of achieving the policy objectives that have been set (and so that there is the capability of avoiding duplication and overlap)***

Recent experience in Australia suggests we need to be much better at anticipating barriers and opportunities. Bottlenecks in key export infrastructure and the lack of a strategic approach to tax reform are just two prominent examples of our failure to anticipate emerging economic challenges.

The record on cooperation and agreement across governments in Australia is not strong. At present, it can be too easy for one level of government to avoid its responsibilities by levelling blame at another. It can be too easy for governments to weaken their commitment to reform under pressure from vested interests. The pressure on governments to work cooperatively may only be intermittent.

Some key questions here are the extent to which intergovernmental processes ensure that there is:

- + An effective formal structure or mechanism to properly anticipate policy reform initiatives as well as ensure effective intergovernmental meetings.
- + Administrative mechanisms to facilitate appropriate analysis, research and national reform priorities free from parochial interests (including information and clarity of objectives as well as a commitment to using those structures on a regular and frequent basis).
- + Flexibility to determine innovative solutions.

## AN EFFECTIVE FORMAL STRUCTURE OR MECHANISM

If intergovernmental relationships are informal, complex or uncertain, they can lead to inefficiencies. Instead, institutionalised and formalised frameworks can ensure that there is a clear framework for both policy research and identification as well as intergovernmental meetings. What should result from such institutionalisation is medium- and long-term development strategies – rather than ad hoc and reactive policy making.

The 2006 COAG agreements were positive, including the setting up of a new oversight body, the COAG Reform Council (CRC). Details of these initiatives, however, remain sketchy.

While the agreements at COAG appear to be a significant step forward, the process by which the agreements were reached actually highlights the weaknesses of the current institutional arrangements in our federal system of government.

It is debatable whether COAG members would have been willing to agree a new national reform agenda without considerable community and business pressure. Further, history has shown that COAG meetings can often be dominated by political positioning rather than policy leadership. Whether the ambitious reform work program and timetables agreed recently by COAG will be met will be a major test of intergovernmental cooperation and the institutional arrangements that underpin it. We therefore need to consider permanent institutional and structural arrangements to ensure the strengths of a federal system are captured, while its many pitfalls are avoided.

Should the intergovernmental arrangements be federal–state or interstate? Most federations have established arrangements of both forms. For example, Canada and Switzerland and more recently Australia, have recognised the need for interstate formal arrangements by establishing a forum for achieving consensus across state governments on issues, including federal–state issues.

On 21 July 2006, leaders of all Australian states and territories announced the formation of a new Council for the Australian Federation. The Council was inspired by Canada's Council of Federation (see Exhibit 3). South Australian Premier Mike Rann was appointed the inaugural chair of the council – the first of its kind since the Australian Federation was formed in 1901. It is proposed that the council will meet at least twice a year with members being the heads of each state and territory. There will be a permanent secretariat based in Canberra and funded by the states and territories. The chairmanship will rotate between Premiers and Chief Ministers on an annual basis. In brief, the functions of the council are to:

- + Find the best common position among states and territories of COAG-based agreements with the Commonwealth.
- + Where appropriate, reach joint agreements on cross-jurisdictional issues where a Commonwealth imprimatur is unnecessary, or has not been forthcoming.
- + Develop better procedures for the states and territories to share and exchange information and identify best practice policy and programs.
- + Anticipate future developments within the federal system, including decisions by the Commonwealth Government that might have a significant impact on states and territories.

The formation of the Council for the Australian Federation acknowledges the need to formalise and institutionalise such arrangements. However, the forum is an interstate arrangement. The exclusion of the national sphere of government can limit its effectiveness. In the Canadian context, this was discussed with respect to the inter-provincial Council of Federation, where it was thought that establishing a body to 'fight' against the national sphere might increase the tensions between the spheres rather than foster cooperation:

A true Council of the Federation would ideally include all the members of the federation. And despite the degree of decentralization that may have taken place in Canada during the past three decades, the federal government remains an important partner. To build a more powerful agency of the premiers at this time may simply serve to reinforce the cleavage between the two constitutionally recognized orders of government ... In contrast, a [national-provincial] Council of the Federation would begin with a bargaining position but hopefully end with tradeoffs and compromises necessary to produce a 'national' solution acceptable to most if not all parties.<sup>25</sup>

What degree of institutionalisation (and therefore formality) is required? The types of forums that have been established across federations vary along a spectrum of formality (e.g. constitutional entrenchment) to informality (e.g. meetings called on an ad hoc basis).

The need for formal arrangements to ensure the effectiveness of intergovernmental relationships has been recognised in overseas jurisdictions. For example, a 1999 Intergovernmental Relations Audit conducted in South Africa described the intergovernmental relations framework in South Africa as 'a largely informal, interacting network at national, provincial and local levels, still relatively rudimentary but nonetheless developing into a method of intergovernmental relations, more or less appropriate to our institutional arrangements'<sup>26</sup> and recommended that due to the proliferation of informal intergovernmental structures, more coordination should be implemented in order to 'avoid duplication and ensure linkages with other IGR fora.'<sup>27</sup> In South Africa, there is use of statutory instruments to set up intergovernmental bodies. This led to the conclusion that: 'National government's powers of supervising and supporting provinces (and that of provinces in the case of local government) as well as the power of intervention by respectively national and provincial government should be spelled out clearly in legislation.'<sup>28</sup>

.....

The deficiencies associated with a lack of formal institutionalised arrangements can be seen in the Argentina's political landscape. With over 24 states and no formal institutionalised framework, many inefficiencies have resulted in the Argentinean federal system. While federal–provincial councils comprising of the federal minister responsible for the area in question and the provincial counterparts, have developed to deal with specific sectors such as education, domestic security, infrastructure, investment and public councils, they are associated with problems:

... these new opportunities serve more as forums for generating consensus than as bodies that make decisions that are binding on the parties. In many cases, valuable consensus developed after difficult deliberations are watered down over time because they are not implemented. Generally speaking, these organizations have lacked decision-making capacity and continuity over time, and have responded more to the political necessities of the day than to medium or long-term strategies. Finally, they are unable to replace negotiations based on personal relationships and the capacity to exert pressure with criteria may be unavoidably political in nature, yet at least established in advance of the particular negotiations under way and based on proper indicators.<sup>29</sup>

Many believe that the Australian National Competition Policy (NCP) was an example of a successful outcome in a specific sector, providing a useful case study for what contributed to the success of the agreement. Factors identified as underpinning the success of NCP include:

- + Recognition by all governments of the need for reform.
- + Agreed priorities for reform.
- + A solid conceptual reform framework and program.
- + Strong procedural and institutional arrangements and mechanisms to address implementation issues and to monitor progress.
- + The provision of financial incentives for progressing agreed reforms.<sup>30</sup>

What seems clear is that a degree of formality and institutionalisation is needed to make these arrangements work (especially for long-term implementation and monitoring). Various structures or mechanisms as examples are highlighted in the exhibits below. There are several different alternative arrangements that have evolved overseas in intergovernmental relations. For example, they may be constitutionally entrenched (and therefore more stable and formal) or evolve in an ad hoc manner as a response to specific economic circumstances:

The alternatives here range along a continuum. At one end intergovernmental deliberations are primarily about exchanging information and ideas, they provide a forum for discussion. In the middle are processes that emphasise bargaining, negotiation, and persuasion, but with the governments remaining responsible to their own legislatures and electorates for the actions they take. At the other extreme are intergovernmental institutions that can make formal decisions, binding on all the parties.<sup>31</sup>

### Constitutional arrangement

A constitutionally entrenched institutional intergovernmental arrangement may have the benefit of certainty because no individual state will be able to remove its agreement or mandate. However, such an arrangement may lack flexibility. It may be possible to incorporate a degree of flexibility by granting the Commonwealth Government the power to legislate and vary the structure of the intergovernmental arrangements, if requested to do so by all the states.<sup>32</sup> It would be very difficult to implement a constitutional amendment in Australia, however, given the difficulty associated with amending the Constitution by referendum. It is worth noting that the founding fathers of the Australian Federation recognised the need for an independent body to deal with trade issues arising from federation by incorporating a provision in the Australian Constitution for an Inter-State Commission: 'There shall be an Inter-State Commission, with such powers of adjudication and administration as the Parliament deems necessary for the execution and maintenance ... of the provisions of the Constitution relating to trade and commerce ...' (section 101 of the Australian Constitution). The Inter-State Commission was established by statute to fulfil this role, however it was allowed to lapse after the High Court found that its adjudicatory powers were in violation of the Constitution's requirement for a strict separation of judicial powers.

### Statutory mechanism

A permanent formal intergovernmental body may be established by a scheme of uniform legislation. This approach would be advantageous because it would create a reasonably certain statutory arrangement which would be transparent and given the force of legislative power (such as other bodies created by legislation including the Australian Securities and Investments Commission and the Australian Competition and Consumer Commission). The degree of independence afforded a statutory body would be greater because of the certainty and entrenchment of the arrangements. The problem associated with this approach is that individual states may decide to remove their legislative mandate. However, such an arrangement would be more likely to be easily achieved than a constitutional amendment by referendum and might be able to be dealt with along the lines of the Inter-State Commission.

In some federal systems, the recognition of the need for intergovernmental relations has resulted in the development of a system of 'summitry'; for example, COAG in Australia, FMCs in Canada and the European Council in the European Union. In Australia and Canada, the lack of formality of those arrangements has had its problems. In the European Union, the European Council originated informally, and eventually it was agreed that it would meet twice yearly, in accordance with the council presidency, which rotates every six months among the member states, and that extraordinary meetings could occur on specific issues. The need to formalise such arrangements has been recognised. The yet-to-be-ratified constitutional treaty will establish the European Council as one of the EU institutions.<sup>33</sup>

### Government department

A permanent formal government department staffed by Ministers could be established. This approach would have the advantage of having certainty, transparency, funding and high-level support from government. It would, however, only operate at one level of government (e.g. Commonwealth) and while it may be able to assess federal issues it would have similar pitfalls to the Productivity Commission in that it is controlled by one level of government and takes its goals and objectives from government (rather than being able to independently determine its scope of work). The Department of Constitutional Affairs in the United Kingdom, for example, has some role in managing constitutional arrangements (e.g. courts, the justice system, human rights and modernising the constitution). However, as the UK is not a federation the arrangements are not directly applicable to Australia's federal system (see Exhibit 13).

### Formal agreements

A formal agreement between levels of government may have the advantage of being more easily achieved. A formal agreement has been utilised by the Canadian provinces to establish the Council of Federation because a state may be able to remove its mandate (see Exhibit 3). Australia also saw the state and territory leaders announce the formation of the Council for Australian Federation. However, the arrangement may suffer from a degree of uncertainty and a lack of transparency. In Canada, the problems (such as short-termism) associated with an agreement were seen in a federal-provincial agreement in 1985, which contained a five-year commitment to annual conferences. However, it was not renewed despite strong provincial pressure to do so. The trend in recent years has been towards less frequent, and less formal 'First Ministers' Meetings' rather than 'Conferences'.<sup>34</sup>

### A series of conferences

The Intergovernmental Conferences in the European Union have worked well to assist in the development of treaties. However, they suffer from a lack of permanency and focus on a particular issue. A series of conferences is more likely to be a successful intergovernmental arrangement at a functional level, rather than a long-term economic policy perspective.

Another question is the level of institutionalisation of intergovernmental arrangements. What is clear is that the greater the formality, accountability and transparency that can be achieved at any level, the better the outcomes that can be achieved. The success of the NCP process shows that even at functional levels, a degree of formalisation can contribute to successful outcomes. Intergovernmental relations generally operate at two levels. On one level, political leaders will meet at some forum (e.g. conferences) and make reform decisions. Ongoing business then requires intergovernmental cooperation at a functional level. Although the functional processes of reform implementation are beyond the scope of this paper, it is worth noting that there are a number of innovative formal intergovernmental arrangements at a functional level.



In Australia, Ministerial Councils are convened regularly on various issues, with varying degrees of success:

The underlying logic in the Westminster system is one of adversarial, competitive, majoritarian, winner-takes-all politics. Despite frequent and eloquent calls for greater harmony and co-operation among constituent governments, this pattern tends to be reflected in the conduct of intergovernmental relations in Canada and Australia. This is especially so when issues rise to the senior political levels, and thus questions of overall strategy, power and status. In both countries – and in others such as the United States – co-operation is greater lower in the administration, where officials are more likely to share common professional values and similar clienteles.<sup>35</sup>

However, because the meetings lack a public profile and those attending are not the Premiers and Prime Minister, there is a lack of accountability and transparency at a public level associated with the process. Although there may be some good outcomes associated with those meetings, there is no transparent method for the public to identify necessary reform areas or monitor the results of the meetings.

Similar functional arrangements exist in other jurisdictions to deal with specific sectors. They have an important role to play, but, like the Australian Ministerial Councils, they generally respond to reform issues that have already been identified and do not anticipate problems and are not accompanied by the required degree of high-level transparency and accountability.

In Canada, Ministerial Councils ‘... in recent years ... have greatly increased in number, have become more institutionalized, and have played a more formal role in carrying out mandates assigned by first ministers. These workhorses of the system now operate in fields such as social-policy renewal, forestry, transportation, education and the environment.’<sup>36</sup>

In South Africa, a number of informal MINMECs (consisting of the relevant minister and provincial MECs) have been established. They deal mainly in coordinating concurrent national/provincial development. They coordinate policy development and the implementation of policies and legislation. The MINMECs are supported by Technical MINMECs, consisting of a senior official of the national department concerned and senior line functionaries from the provincial governments. The Technical MINMECs give technical and administrative support and advice to the political MINMECs. There is no provision for the enforceability of the decisions of these bodies.

In the European Union, there is a committee system that involves the informal interaction between member state governments and the European executive at a policy level. There is a committee for all of the EU’s main activities, and the members are policy specialists from the national government administrations. In Brazil, public consortiums have been established under federal law which aim to promote the common interest of various jurisdictions in certain matters.<sup>37</sup>



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### State/private lobby groups

There is a strong history of state organisations and private organisations that lobby the federal government in the United States. While this may have achieved some successful individual outcomes, there are problems associated with inter-provincial bodies and lobbying tactics. They are ad hoc arrangements dealing with specific issues, rather than having a long-term objective and an economy-wide focus. Such a process enhances the conflict between the different levels of government and the purpose is to present a 'state' view rather than institutionalise agreement and cooperation between different levels of government. Accordingly, this form of institutionalisation would suffer from a lack of cooperation, accountability, long-term focus and independence.

### Legally incorporated body

In Canada, those Ministerial meetings that have a set of formal institutional arrangements appear to have the greatest degree of intergovernmental collaboration. For example the Canadian Council of Ministers of the Environment is a legally incorporated body. It has a rotating chairmanship among the 14 jurisdictions on an annual basis and a permanent secretariat that is funded on a pro rata basis according to population. This has led one commentator to state: 'It is not surprising that the consistency and outcomes from this Ministerial grouping exceeds that of any other counterparts.'<sup>38</sup>

Consideration should also be given to the institutionalisation of intergovernmental forums that may not be linked to government or political persuasions but instead carry a degree of independence. What has hampered collaboration and outcomes in many federations has been political 'jockeying' and buck-passing rather than long-term perspectives. There may be some alternative intergovernmental arrangements that achieve greater accountability, transparency and independence, and accordingly better outcomes (e.g. the Productivity Commission in Australia). (This is discussed in 'Independence' below).

While the full details of the powers and role of the CRC are yet to be worked out, the CRC is unlikely to be in a position to independently monitor the progress of COAG in implementing the national reform agenda or to initiate its own reviews of the economy and set new targets for future reform. However it is constructed, the CRC is unlikely to have a role in anticipating future economic challenges for consideration by COAG. Further, one of the challenges is to determine, where there is agreement, how it should be implemented and how progress on implementation should be monitored. Even where agreement is reached, there is potential for the implementation to be undone: 'Some unravelling of previous consensus is even evident in 'old' areas, like the national energy market.'<sup>39</sup>

To ensure effectiveness of Australia's intergovernmental arrangements what is needed is the formal institutionalisation of a permanent independent intergovernmental body at a federal–state level as well as an independent body (to be called in this paper the Federal Commission). Such formalisation could be through a scheme of cross-jurisdictional uniform legislation, which has worked well in the United States (see Exhibit 8) or by formal agreement (but this may have less permanency and stability than a statutory arrangement.) Some examples of intergovernmental arrangements from other federal systems are highlighted below. They are not exhaustive, but illustrative of the different types of structures that have evolved.

## FOUNDING AGREEMENT

### EXHIBIT 3

#### CANADA – COUNCIL OF FEDERATION

On 5 December 2003, Canada's Premiers set up the Council of the Federation under the Council of Federation Founding Agreement. It is an institution for collaborative intergovernmental relations. The Council of the Federation was created by Premiers so that the provinces and territories could play a leadership role in revitalising the Canadian federation and building a more constructive and cooperative federal system. The Council of the Federation's objectives are to:

- + Promote interprovincial-territorial cooperation and closer ties between members of the Council, to ultimately strengthen Canada.
- + Foster meaningful relations between governments based on respect for the Constitution and recognition of the diversity within the federation.
- + Show leadership on issues important to all Canadians.

The governments of the 10 provinces and of the three territories of Canada, as represented by their premiers, are members of the Council.

The premiers of the provinces take turns chairing the Council according to the rotation established by the Annual Premiers' Conference. The term of office of the chair is one year. The chair acts on behalf of the Council according to the mandates received from it.

The Council of Federation Founding Agreement provides that there will be an annual meeting of the Council of the Federation each summer in the province of the incoming chair. In addition, there will be at least one other meeting to be held in a province or territory each year in a location to be determined by the Council.

The decisions of the Council are reached by consensus. The Council may decide, from time to time, to hold special meetings to which it may invite the Federal Government.

A Steering Committee has been established, composed of the deputy ministers responsible for intergovernmental relations or such other representative designated by a member. The Steering Committee is chaired by the deputy minister of the province chairing the Council. The Steering Committee reports to the Council and assists the Council and supports the Committee of Ministers in the performance of their respective mandates. The Steering Committee prepares the meetings of the Council and carries out the study, research and analysis mandates that it receives from the Council, and sets up and supervises the Secretariat.

The Secretariat reports to the Steering Committee, which is also its board of directors. The head of the Secretariat is appointed by and reports to the board of directors. The Secretariat assists the Steering Committee in the preparation for meetings of the Council and performs any task that the Steering Committee assigns to it. The Secretariat is funded by the members on a pro rata basis, according to their respective populations.

The Premiers' Council on Canadian Health Awareness is under the responsibility of the Council of the Federation, as is the Secretariat for Information and Co-operation on Fiscal Imbalance.

Some of the initiatives that have arisen from the Council include the national transportation strategy announced on 8 December 2005. The strategy recognises that the federation was built on a vision, expressed in a railway, to unite the country from coast to coast. Recognising that Canada's provinces and territories have a range of differing infrastructure needs, premiers identified Canada's transportation system as one of the most important foundations of the country's international competitiveness and noted that it is key to ensuring a better standard of living for all Canadians.

Source: [www.councilofthefederation.ca](http://www.councilofthefederation.ca).

## EXHIBIT 4

### SPAIN – CONFERENCE ON EUROPEAN AFFAIRS

Spain's entry into the European Union triggered an innovative intergovernmental response. In a 1994 agreement, the national government and the Autonomous Communities set up a general Conference on European Affairs (as well as a number of policy-specific sectoral conferences) in order to coordinate Spain's position on European affairs. There are several meetings a year which are usually preceded by self-coordinating meetings among the Autonomous Communities (joint positions are decided on the basis of one vote per Community which are then communicated to the national government).

Source: TO Hueglin & A Fenna, *Comparative Federalism: A Systematic Inquiry*, Broadview Press, Canada, 2006, pp. 242–243.

## EXHIBIT 5

### RUSSIA – STATE COUNCIL

With 89 constituent units as part of the Russian federal system, there are clearly divergent cultural, economic, climatic and environmental factors between the units. There is often a lack of clarity in the division of powers in the Russian constitution, or a considerable degree of overlapping jurisdiction.

President Putin set up a consultative body in 2000 called the State Council. This body consists of all of the heads of the executive branches of the constituent units and meets quarterly at the request of the Russian President to discuss particular issues.

Within the State Council, a Presidium was set up, consisting of seven members drawn from the State Council on a rotating basis. Meeting monthly, the Presidium is able to discuss and analyse the major initiatives undertaken by the federal government.

Also within the State Council, various working groups prepare proposals for economic and political reform. The members of the working groups haven't been limited to State Council members and include 2–3 State Council representatives, highly qualified experts and other political representatives. Some of the areas that the working groups have been set up to deal with include federalism, energy production and distribution, improvement of federal administration and development of local government.

Source: JP Meekison (ed.), *Intergovernmental Relations in Federal Countries*, A Series of Essays on the Practice of Federal Governance, Forum of Federations, 2002, p. 67.



## EXHIBIT 6

### SOUTH AFRICA – PRESIDENT’S CO-ORDINATING COUNCIL

The President’s Co-ordinating Council is a non-statutory body and therefore its decisions are not formally binding or enforceable. It consists of the President (chairperson), the nine provincial premiers and the minister for provincial and local government. It meets twice a year. Its functions include the enhancement of the ability of provincial executives to make inputs on the formulation of national policies, the promotion of inter-provincial dialogue, dispute resolution at an inter-provincial level as well as between provinces and national government, improving cooperation between the national and provincial spheres of government (also as regards the strengthening of local government), and the coordination of cost-cutting programs (e.g. rural development and urban renewal).

Source: JP Meekison (ed.), *Intergovernmental Relations in Federal Countries*, A Series of Essays on the Practice of Federal Governance, Forum of Federations, 2002, p. 77.



## STATUTORY INSTITUTIONALISATION

### EXHIBIT 7

#### SOUTH AFRICA – VARIOUS INTERGOVERNMENTAL FORUMS

South Africa's federation is determined by the Constitution of the Republic of South Africa 108 of 1996. The Constitution recognises three tiers of government (federal, provincial and local). Further, there are 9 provinces in South Africa.

A number of intergovernmental forums have been set up under statutory arrangements to deal with specific issues.

For example, the Budget Council set up under the Intergovernmental Fiscal Relations Act 97 of 1997 consists of the Minister for Finance as chairperson and the MECs for Finance (Members of the Provincial Executive Councils) and the chairperson of the Financial and Fiscal Commission. The Budget Council must be consulted by federal, provincial or local governments regarding the provincial sphere, proposed policy or legislation affecting the provinces and issues relating to the management or monitoring of any provincial finances. No direct mechanism is made for an enforcement mechanism.

The Council of Education Ministers is established under the National Education Policy Act 27 of 1996. It consists of the Minister and Deputy Minister of Education and the nine MECs for Education (in their capacity as political heads of provincial education). Observer status is given to the national Director-General of Education and the chairpersons of the National Assembly's Portfolio Committee on Education and the NCOP's Select Committee on Education. Its functions include the promotion of national education policy, the sharing of information, the coordination of matters of national interest to the national and provincial government. In addition, the Minister must consult it before legislation is submitted to Parliament. No direct provision is made for an enforcement mechanism.

Amongst other statutory bodies are the Heads of Education Department Committee, Department of Foreign Affairs: Directorate Intergovernmental and Provincial Protocol, the Financial and Fiscal Commission and the Loan Co-ordinating Committee.

Source: JP Meekison (ed.), *Intergovernmental Relations in Federal Countries*, A Series of Essays on the Practice of Federal Governance, Forum of Federations, 2002, p. 77.

## EXHIBIT 8

### UNITED STATES – ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS

An American formal intergovernmental body was established from 1959–1996 called the Advisory Commission on Intergovernmental Relations (ACIR). ACIR was established by the 86th Congress (Public Law 86-380; 73 Stat 703) as a 'permanent, bipartisan body of 26 members, to give continuing study to the relationship among local, state, and national levels of government'. The Act provided that the Commission would:

1. Bring together representatives of the federal, state, and local governments for consideration of common problems.
2. Provide a forum for discussing the administration and coordination of federal grant and other programs requiring intergovernmental cooperation.
3. Give critical attention to the conditions and controls involved in the administration of Federal grant programs.
4. Make available technical assistance to the executive and legislative branches of the Federal Government in the review of proposed legislation to determine its overall effect on the federal system.
5. Encourage discussion and study at an early stage of emerging public problems that are likely to require intergovernmental cooperation.
6. Recommend, within the framework of the Constitution, the most desirable allocation of governmental functions, responsibilities, and revenues among the several levels of government.
7. Recommend methods of coordinating and simplifying tax laws and administrative practices to achieve a more orderly and less competitive fiscal relationship between the levels of government and to reduce the burden of compliance for taxpayers.

The Advisory Commission on Intergovernmental Relations consisted of 26 individuals, three members of the President's Cabinet, three U.S. House members, three U.S. senators, four governors, three state legislators, three country commissioners, four mayors and three private citizens.<sup>40</sup>

Prior to the ACIR, there were other statutory intergovernmental bodies in the US such as the Intergovernmental Relations Commission. Many of the states in America have their own Advisory Commissions on Intergovernmental Relations that are also set up under statutes and are permanent intergovernmental bodies. For example, the Advisory Commission on Intergovernmental Relations (ACIR) for the State of Connecticut is a 24-member agency created in 1985 to study system issues between the state and local governments and to recommend solutions as appropriate. The membership is designed to represent the state legislative and executive branches, municipalities and other local interests, and the general public. The role of ACIR, as contained in Section 2-79a of the Connecticut General Statutes, is to: (1) serve as a forum for consultation between state and local officials; (2) conduct research on intergovernmental issues; (3) encourage and coordinate studies of intergovernmental issues by universities and others; and (4) initiate policy development and make recommendations to all levels of government. Six meetings of the ACIR are to be held in 2006. There are permanent staff and officers.

Source: <http://www.library.unt.edu/gpo/ACIR/Default.html> and <http://www.opm.state.ct.us/igp/acir/acircal.HTM>.



## EXHIBIT 9

### UNITED STATES – INTERGOVERNMENTAL POLICY ADVISORY COMMITTEE

One current intergovernmental consultative body in the US is the Intergovernmental Policy Advisory Committee (IGPAC) to the US Trade Representative (USTR). This committee was established in 1988 at the insistence of state and local officials who became concerned about the potential impacts of trade agreements, such as NAFTA and WTO, on traditional state and local powers. Each state needed to establish a 'single point of contact', usually in the Governor's office.<sup>41</sup>

The IGPAC is a federal trade advisory committee composed of state and local officials appointed by USTR (or the President). IGPAC was formed with the Trade Act of 1974, and participation has varied over the years based on state and local officials' concerns. IGPAC is comprised of representatives from the executive, legislative, and judicial branches of state, county and municipal governments, as well as associations of state and local officials.

The IGPAC, part of USTR's statutory advisory committee system, is the committee charged with providing trade advice from the perspective of states and localities.

IGPAC is able to initiate its own work independently of USTR and also responds in reports to proposed trade agreements for the Administration and Congress. These reports are made public on USTR's website.

Under the Uruguay Round and NAFTA implementing legislation, USTR also created the single State Point of Contact (SPOC) system, whereby the Governor's office in each state designates a single contact to coordinate state trade policy input to the USTR. The SPOCs regularly receive Federal Register Notices, press releases, notifications and requests for advice on specific matters and are invited to participate in briefings and meetings.

Additionally, USTR officials frequently meet with gatherings of state and local representatives around the country at their annual meetings and conferences.

Source: [www.ustr.gov](http://www.ustr.gov).

## AN INTERGOVERNMENTAL BODY – TO BE FORMALLY ESTABLISHED BY TREATY

## EXHIBIT 10

### EUROPEAN UNION – EUROPEAN COUNCIL

The European Union (EU) was set up to consist of the:

- + European Commission as the main policy-making executive.
- + European Council of Ministers as the main legislative body.
- + European Parliament as a secondary body of democratic representation and legitimacy.

However, like other federal systems, intergovernmental relations can evolve outside of the formal institutional arrangements. A need for intergovernmental meetings or 'summitry' was found to be required. What evolved were regular meetings of the European Council, which 'soon became the most important agenda-setter for the EU even though they did not have a formal basis in the original treaties.'

The European Council, composed of the heads of government of the member states, meets twice a year to discuss the broader political and economic direction of the European Union. Each meeting is followed by a written report to the European Parliament and a verbal report by the President of the European Council.

The European Council originated informally, and eventually it was agreed that it would meet twice yearly, in accordance with the council presidency, which rotates every six months among the member states, and that extraordinary meetings could occur on specific issues. The need to formalise such arrangements has been recognised, and the yet-to-be-ratified constitutional treaty, will establish the European Council as one of the EU institutions.

Source: TO Hueglin & A Fenna, *Comparative Federalism: A Systematic Inquiry*, Broadview Press, Canada, 2006, pp. 239–240.

## SERIES OF MEETINGS FOR A SPECIFIC PURPOSE

### EXHIBIT 11

#### EUROPEAN UNION – INTERGOVERNMENTAL CONFERENCES

The EU has an intensive network of intergovernmental committees and conferences involving senior levels of national civil services.

The Single European Act of 1987, which prepared the grounds for completion of the internal market, and the 1993 Maastricht Treaty, which established the EU in its current institutional form, were the result of European Council agreements. In both instances, the European Council initially established a so-called Intergovernmental Conference (IGC) for the preparation and drafting of the treaty revisions eventually adopted. The IGC are an ongoing series of intergovernmental meetings involving government leaders, ministers and the civil service. For example in the case of the IGC leading up to the conclusion of the Single European Act, the foreign ministers met several times between September 1985 and January 1986.

In addition to the IGC meetings, a European Council meeting in 1985 dealt with the single market and two 'working parties' of high-ranking officials negotiated the details in between the meetings.

Source: TO Hueglin & A Fenna, *Comparative Federalism: A Systematic Inquiry*, Broadview Press, Canada, 2006, pp. 239–240.

## PRIVATE SECTOR BODIES

### EXHIBIT 12

#### UNITED STATES – VARIOUS PRIVATE SECTOR BODIES

Because of the unique circumstances of the US political system, the private sector has an important role in intergovernmental relations.

About half of all federal aid to state and local governments is ultimately expended by private, non-profit organisations (i.e., NGOs) that perform public services, such as health and social welfare. Second, most high- and mid-level federal, state and local administrators are members of the same nationwide professional and scientific associations within their respective fields of policy responsibility and expertise. Within these associations, federal, state and local officials share information and interact with each other, while also interacting with relevant academics and colleagues in the private for-profit and non-profit sectors. These associations generate a considerable amount of intergovernmental co-operation and policy formulation by developing legislative ideas enacted by the Congress and/or state legislatures, adopting professional and scientific standards adhered to by all members, and performing intergovernmental dispute resolution functions.

Source: JP Meekison (ed.), *Intergovernmental Relations in Federal Countries, A Series of Essays on the Practice of Federal Governance*, Forum of Federations, 2002, pp. 4 and 35.

## GOVERNMENT DEPARTMENT

### EXHIBIT 13

#### UK – DEPARTMENT FOR CONSTITUTIONAL AFFAIRS

The Department for Constitutional Affairs (DCA) was established in 2002.

The Secretary of State and Lord Chancellor is supported by a Ministerial team, which, together with the Permanent Secretary and senior departmental officials, forms the Ministerial Executive Board. This Board benefits from the experience and input of non-executive directors.

The Ministerial Executive Board (MEB) is supported by a Departmental Management Board, chaired by the Permanent Secretary. The executive members of the MEB, together with the DCA Director of Human Resources, form the Departmental Management Board.

DCA is the government department responsible for upholding justice, rights and democracy: the foundations of a civilised society. DCA works from the simple rule that it exists to serve the public – not the providers.

The DCA's role is to drive forward the reform and improvement of the legal and justice system in England and Wales. It is responsible for upholding the rule of law and for reforming and safeguarding the constitution so that they serve the public effectively.

The DCA is also responsible for the administration of the courts in England and Wales (including HM Courts Service) and for the overall management of legal aid (through sponsorship of the Legal Services Commission). Also associated with DCA are a number of organisations such as the Public Guardianship Office, the Law Commission, the National Archives and HM Land Registry

Source: [www.dca.gov.uk](http://www.dca.gov.uk).

### ADMINISTRATIVE MECHANISMS TO FACILITATE DECISION MAKING

A lack of administrative support, clear charter or objectives and processes can reduce the effectiveness of intergovernmental arrangements. For example, the Victorian Federal–State Relations Committee has commented in relation to COAG that:

... it is principally the Department of the Prime Minister and Cabinet that undertakes the preparatory work for the Council of Australian Governments' meetings. The Commonwealth thus dominates the operation of the Council of Australian Governments, inhibiting the capacity of the States to use it as an effective forum, and undermining its role as a federal decision-making body.<sup>42</sup>

## SECRETARIAT

In Canada, many federal–provincial meetings are provided with organisational and secretarial services through an intergovernmental body, the Canadian Intergovernmental Conference Secretariat. As federal–provincial relations have become more important, all governments have established offices, attached to the First Minister, to oversee the province's intergovernmental affairs.<sup>43</sup> In addition to serving federal-provincial First Ministers' meetings, the Secretariat serves the Annual Premiers' Conference, the Eastern Canadian Premiers' and New England Governors' Conference and the Western Premiers' Conference. The core of the Secretariat's work, however, is providing services to multilateral meetings of Ministers and Deputy Ministers in virtually every sector of government activity. Although designated a federal department for the purposes of the *Financial Administration Act*, by an Order-in-Council on 29 November 1973, the organisation is in fact an agency of the federal and provincial governments. Not only is its budget supported by these two orders of government, but its staff is selected from both federal and provincial governments, and the Secretariat reports annually to all governments that it serves. The Victorian Federal–State Relations Committee commented that the permanent Secretariat serving different levels of government provides 'an institutional 'memory' which eases executive decision making'.<sup>44</sup>

Even in the United States where the focus is on lobbying by the states through organisations such as the National Governors' Association and the National Conference of State Legislatures, those organisations have permanent secretariats to support the members of those organisations. The secretariats provide administrative, research and policy support and facilitate communication between members and the organisations.<sup>45</sup>

## INSTITUTIONAL SUPPORT

In Canada, the First Ministers' Conferences have 'no continuing institutional support,<sup>46</sup> no staff serving it, no routine procedure for following up business and reporting back. As a result, the frequency and usefulness of meetings has varied. The Annual Premiers Conferences (APCs) in Canada on the other hand, between the provincial premiers, have evolved into a more institutionalised body. APCs are held every August under a rotating chair and the meeting is supported by civil servants and an on-going agenda of work that connects one meeting to another. The assistance of civil servants enables the provision of position papers, issuing of communiqués and launching of projects to be undertaken by ministers.<sup>47</sup> Autonomous work can be initiated at the meetings. 'It was at one of these meetings that the social-union initiative was begun, which resulted in the Social Union Framework Agreement (SUFA)'.<sup>48</sup>

The importance of institutionalisation through regularity of meetings and designated government staff can be seen in some of the commentary and analysis on the subject. One commentator writes in respect of the Canadian system:

When there is a commitment to the using the mechanisms on a regular basis, patterns of behaviour result. To take the most obvious and prominent example, the First Ministers Conference, holding regular such events helps to create an environment favourable to cooperation. First Ministers themselves have the knowledge that they will have full opportunity to discuss their concerns with their colleagues. Not unimportantly, they come to know each other better. Of equal or possibly greater significance, their staff have to engage with each other in the preparation of such major events and in looking after the follow-up. This dynamic helps to establish a network of individuals accustomed to working with each other, developing a level of familiarity, confidence and trust that enables them to engage in collaborative ways to help minimise conflict.<sup>49</sup>

.....

In 2003, in response to the ad hoc nature of the other federal–provincial institutions in Canada, the Council of Federation was set up between the provincial premiers and territorial leaders. Set up under a Founding Agreement it also establishes a permanent steering committee and a permanent Secretariat. Federal and provincial governments staff the steering committee, which reports to the Council, and provides research (among other things). The body is funded by the members on a pro rata basis and meets at least twice yearly. The Council does not include the Prime Minister, but ‘such inclusion may only be a matter of time’.<sup>50</sup> If successful, the Council would signal a profound transformation of the Canadian federal system, from a classical parliamentary federation to a new model more akin to the German and European council governance.

In Germany, the Conference of Minister-Presidents has a preparatory stage whereby the heads of state chancelleries and senate chancelleries and the head of the Federal Chancellery meet one week prior to the conference. For the conferences of specialised ministers, the state secretaries of all the ministries at the Länder and federal level meet one week before the conference.

It appears therefore, that in order for the intergovernmental relations to be successful, a degree of formal institutionalisation is required, including regular meetings, sufficient resources and support from civil servants, an independent and rotating chair, an agenda that connects one meeting to another, a contributory funding formula, the ability to initiate projects autonomously and a framework for following up business and reporting back. These are essential elements of a system that operates well and facilitates successful outcomes.

In Canada, one commentator notes that there are lessons that can be learned from the different types of intergovernmental mechanisms that have developed in that country:

The lesson I draw from the forgoing is that if you are serious about getting significant results from intergovernmental relationships, the likelihood of success is greatly enhanced if there is a pattern of regular meetings (not at the whim of the chair), a secretariat to ensure that the necessary work is done, and a contributory funding formula. On the point of the secretariat, experience shows that if you want to have truly integrated efforts, you need the assistance of a dedicated staff, whose sole function is to prepare the Conference to do the work desired and to ensure there is follow up action to the meetings. The additional benefit of the presence of a secretariat is that it provides a responsibility point separate from the chair, and can provide the continuity needed in view of frequent changes of government and political leadership. In cases where sustained effort is required, a professional dedicated secretariat can be the ‘keepers of the flame’.<sup>51</sup>

.....

In Canada, it was noted that significant investment in the machinery of the processes was important to achieve tangible outcomes. A secretariat is an important element of that machinery because it provides a permanent watch on the federalism agenda and facilitates continued cooperation between governments:

The dividing point between the transitory and the more substantial processes seems to occur around whether there is sufficient commitment to working collaboratively to establish a permanent secretariat. That is the point at which individual governments or agencies begin to give over some functions to a shared effort, and it generally entails a financial contribution. Comparison with international examples, notably the European Community, would seem to support this finding.

Establishing a secretariat means creating a staff that has as its sole purpose the advancement of the common goals of the parties. Other advantages are that having an ongoing centre of coordination allows an intergovernmental effort to weather electoral cycles, changes in leadership, and varying levels of commitment, all the while maintaining a consistent purpose and identity.<sup>52</sup>

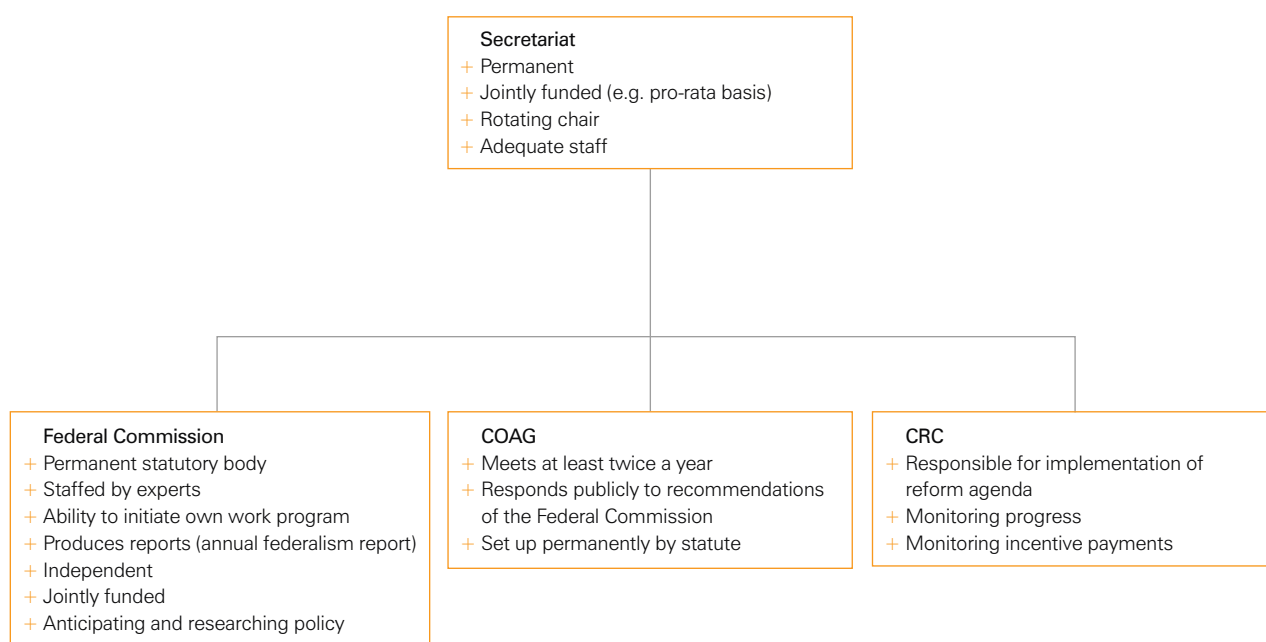
The Victorian Federal–State Relations Committee recognised the benefits to be gained from permanent administrative arrangements to support COAG, stating:

An Intergovernmental Secretariat would not only enable an increased workload to be met; it would also reduce the political control exerted by the Commonwealth over the Australian intergovernmental process, and would enhance the institutional character of the Council of Australia Governments by creating a sense of continuity between meetings.<sup>53</sup>

**Conclusion:** To ensure effectiveness, adequate administrative arrangements may be required including the establishment of a permanent intergovernmental Secretariat to provide administrative and policy support (to the CRC, the Federal Commission and COAG); an independent and rotating chair; and sufficient resources (e.g. staff). Other considerations are whether there should be consensus or majority voting mechanisms, the funding of both the Secretariat and the Federal Commission and the role of the Secretariat (e.g. research and agenda setting).



FIGURE 1 A POTENTIAL STRUCTURE FOR THE FEDERAL SYSTEM



## FLEXIBILITY TO DETERMINE INNOVATIVE SOLUTIONS

The relationships need to be flexible enough to accommodate changing policy perspectives and ideals in society. Therefore the options available for solving problems and the division of powers should not be rigid, but those options should be capable of meeting the challenges of a changing economy. Accordingly what is required is officials at a high level who have the power to make decisions and regular meetings and relationships that can ensure there is the flexibility to determine innovative solutions.

Other considerations associated with effectiveness are the frameworks and options for enabling agreement on various issues. In Australia there have been many examples of the flexible and workable solutions that have arisen from intergovernmental agreement making (e.g. mutual recognition, harmonisation).

While the possible options for agreement making and the division of responsibilities are beyond the scope of this comparison paper, what is clear is that there have been numerous and flexible agreements on a variety of issues. Intergovernmental negotiation must therefore have the capacity to recognise the flexible arrangements that are available, and not to be constrained by historical or other perceived constraints. For example, in Canada the 1995 Agreement on International Trade and the 1999 Social Union Framework Agreements included sections on dispute resolution and avoidance.<sup>54</sup> Similar mechanisms for ongoing implementation review and negotiation could also be incorporated in Australian solutions to ensure the effectiveness of any outcomes reached.



.....

In Canada, the Council of Ministers of the Environment (discussed previously), in the absence of clear constitutional assignment of authority, were able to assign roles and responsibilities to particular governments based on two key principles: a single-window approach and the assumption that roles should be assigned to the government best able to carry them out.<sup>55</sup> Accordingly, experts that are capable of determining frameworks and innovative solutions will be necessary.

Cooperation and agreement is needed in key areas of the Australian economy to ensure that innovative solutions can continue to be found in the future. For example, one commentator has argued in relation to health:

While it was necessary to have a consistent national framework, the way in which health care is organised and delivered should vary across States to suit local circumstances and local community priorities. Indeed, a strength of federal systems is the diversity they allow which is most conducive to policy innovation and service improvement ... a complete redesign of the current system involving the integration of Australian and State Government health care programs through funds-pooling and budget holding – implemented to suit each State’s circumstances – was necessary if the underlying problems were to effectively addressed ...

In practice such a redesign would be “complex, difficult and time-consuming”. It would also require a great deal of collaboration among the Australian and State Governments in respect to governance systems, organisational and workforce development, as well as considerable institutional effort to support change.<sup>56</sup>

Previously discussed were the reasons that NCP was successful. These included institutionalised monitoring mechanisms to ensure implementation of agreements and monitoring incentive payments. Accordingly, the CRC will need to be set up – with appropriate institutionalisation – to ensure its monitoring processes are adequate.

**Conclusion:** To ensure effectiveness, institutional governmental arrangements also need to have a sound ‘theoretical’ framework and basis for decision making, including the flexibility to determine innovative solutions. For example, mandated principles of federalism/goal setting as a framework for dividing responsibilities may be one method as a basis for decision making.

## 7.2 | TRANSPARENCY

***Effective information about policy objectives and decision making must be in the public domain so that there is clarity around the bases for decisions and actions as well as greater pressure brought to bear on governments to maintain the federal reform agenda and be accountable for progress and outcomes of reform.***

Transparency is needed to ensure the actions and decisions of the political decision makers can be judged against the policy objectives being pursued, and greater credibility is given to the findings of those who have met and negotiated outcomes.

High levels of transparency also increase the understanding of and commitment in the community to the recommendations of the political leaders and the reasoning behind the recommendations. One study of the intergovernmental processes in Canada has identified transparency and accountability as a significant factor in the success of intergovernmental relationships, stating:

The failures ... lies not in the lack of ability of our players and processes to find solutions, but rather in the inability to gain the public understanding and acceptance deemed necessary to ratify the products of negotiations ... A more detailed critique of executive federalism was ... that the practice was unduly secret, fostered a low level of citizen participation, weakened accountability to legislatures and frustrated matters making in onto the public agenda, leading to unresolved conflicts between governments.<sup>57</sup>

Accordingly, transparency can be increased by publicly available agendas for intergovernmental meetings as well as publicly available reports outlining outcomes or recommendations from meetings. The influence such agendas and reports will have on governments should be increased by the public availability of the documents, therefore ensuring that there is sufficient pressure on governments to consider and implement agreed reforms.

One commentator has asked:

How open, transparent, responsive and accessible are the mechanisms established for the conduct of the IGR? The more important these processes are in the political life of a society the more it is necessary to subject them to the same democratic tests as are applied to other institutions. The question of the possible 'democratic deficit' is common to all systems of multi level government – indeed it was invented to address problems in the European Union.<sup>58</sup>

Successful intergovernmental relations that have resulted in concluded agreements, have a number of characteristics that can act as a guide towards formulating a useful model for Australian intergovernmental relations. For example, the conclusion of intergovernmental agreements in Canada such as the Constitution Act 1982 and the 1980 National Energy Program (NEP) have had a number of similar characteristics including:<sup>59</sup>

- + Open lines of communication.
- + Officials doing preparatory work identifying all the issues that need to be addressed, terminology used, data required, assumptions made and points of contention.
- + Dampening expectations as to probable outcomes and refraining from dire predictions.
- + Determining where compromise lies and looking for new innovative solutions.

For example, open communication lines and transparent information means that different viewpoints can be identified and assessed prior to the meeting. This enables background research and ideas to be developed. 'Clearing out the underbrush' in this manner proved useful in the Canadian NEP negotiations when 'both sides working together conducted a detailed analysis of the different assumptions and consequences on which the two positions were based.'<sup>60</sup>

In the United States, there has been discussion about the Intergovernmental Policy Advisory Committee (IGPAC) to the US Trade Representative (USTR). For example, a non-profit public interest organisation called Public Citizen writes that:

Inherent structural problems make the IGPAC inadequate to the task of ensuring that state and local governments are provided a meaningful opportunity to give their prior informed consent before being bound to trade agreement rules. IGPAC members are selected by, and serve at the will of, the USTR. Even so, USTR is not required to respond to the committee's recommendations. IGPAC's comments to USTR are general, rather than covering state-specific commitments to trade agreement obligations. Only 22 states are currently 'represented' on the 48-person committee. Plus, representatives from a state are not representing that state in an official capacity, but rather are appointed to represent general state and local interests.<sup>61</sup>

**Conclusion:** To increase transparency there are a number of methods that can be employed. For example, if a Federal Commission were established it could provide independent and publicly available reports to COAG on policy items. Such reports could make recommendations, which would encourage all governments to consider the issues. Further, if a Secretariat were established then publicly available agendas and preparatory material could be developed prior to any meeting of COAG (agendas must flow from one meeting to another) – this would enable public discussion of policy items prior to the meetings.

## 7.3 | ACCOUNTABILITY

***Governments must be subject to appropriate checks and balances to ensure their actions and decisions are scrutinised and justified.***

The outcomes and recommendations of intergovernmental meetings and negotiations must have sufficient credibility in order to ensure that governments are motivated to properly implement the recommendations. A method of achieving greater credibility and accountability is through sufficient quality research to back up the recommendations. High levels of transparency increase accountability. In addition, good governance structures are necessary to ensure that the political leaders are accountable for the outcomes.

Accountability is necessary on a number of levels. Firstly, accountability forces governments to actually identify and assess reform issues and therefore to hold regular and necessary meetings between jurisdictions. Without such accountability, the governments may more easily be able to avoid having to deal with issues at all.

Secondly, accountability of responsibility for reform issues that are identified is necessary to prevent different layers of government from 'buck-passing' and for actual implementation to take place. If there is 'buck-passing', necessary projects and reforms may not be implemented, because there is no-one responsible for them. This may be enhanced by a transparent intergovernmental relations process, with clearly identified outcomes and publicly allocated responsibilities. Some degree of accountability can be achieved by appropriate fiscal arrangements (discussed in more detail below). However, institutionalised arrangements should also be directed at ensuring accountability can be achieved. For example, each of the meetings must be linked together (e.g. via appropriately drafted agendas and pre-prepared research papers) to ensure that continued accountability for reform is maintained.

Currently, the process in Australia has become captured by political interests, at the expense of the economy and certainty. Even where there has been an agreed distribution of powers, political interests can impact on the processes. This has been seen recently with the Corporations Act. While the states were due to refer their powers for a further period of time to the Commonwealth, the process was caught up in political jockeying, which had a negative impact on certainty and the operations of business. These sorts of events should be limited through accountability mechanisms, to ensure the avoidance of harmful actions that negatively impact the economy.

## EXHIBIT 14

### CORPORATIONS ACT AND REFERRAL OF POWERS

'State governments are leaving it to the last minute to renew crucial legislative measures underpinning the national system of corporate regulation, creating uncertainty for business, investors and regulators.

The states have been angry that the federal government used its own constitutional power over corporations to support its new Work Choices legislation, which overrides state industrial legislation.

There has been concern in Canberra that the big Labor states are retaliating by failing to make the referrals needed to underpin the Corporations Act until the last minute. The Corporations Act effectively relies on a mixture of state and federal constitutional powers because of High Court rulings in the 1990s curtailing the federal government's own powers.'

Source: M Davis, 'States Let Costello Sweat on Business Law', *The Australian Financial Review*, 2 June 2006.

In Germany, the problems with a lack of accountability have been seen:

Since 1969 the trend towards the unitary federal state has been considerably increased by the fact that, in practice, a comprehensive integrated system was installed through the introduction of tasks in which the federal government partly finances original tasks of the Länder (e.g. the building and extension of institutions of higher education, the improvement of the regional economic structure, the improvement of the agricultural structure and coastal protection, research funding) and through the creation of common taxes (income and corporate tax (turnover tax)). Based on the American models, this integrated system was called cooperative federalism. In the meantime this system has not only proved to be crippling, but also problematic from the democratic point of view, because everybody can be made responsible for everything, and therefore nobody is responsible for anything. For this reason efforts are currently being made to break up this integrated system again, thus achieving greater transparency with regard to decision-making and responsibility, and permitting more competition between the federal government and the Länder. However, despite these efforts Germany is still far removed from having a system of pure competitive federalism.<sup>62</sup>

In Canada, a lack of transparency has been shown to potentially reduce the success and the accountability of outcomes. The First Ministers Conferences (FMCs) for example can vary in their transparency and therefore the accountability of the meetings to the public and their understanding of the processes:

The failures, and that is the judgement that almost universally attaches to these exercises, lies not in the lack of ability of our players and processes to find solutions, but rather in the inability to gain the public understanding and acceptance deemed necessary to ratify the products of the negotiations.<sup>63</sup>

.....

Commentators have suggested that one of the best examples of significant reform in Australia was the National Competition Policy (NCP) and that its success was due to, among other things, a strong level of leadership and that:

If we could replicate it, I think it would be a step forward. It is not a bad model because it had an accountability aspect to it.<sup>64</sup>

Every so often in Australia, certain strong personalities of leaders will result in some useful outcomes at COAG and productive reform agendas being established. However, it is inadequate that such a process depends entirely on the personalities and attitudes of leaders. Instead mechanisms should be established to ensure that federal issues and agendas are a consistent issue of politicians and not driven by particular personality types.

Accordingly, there needs to be a level of leadership and independence to ensure that reform initiatives are consistently assessed. Heads of government should view intergovernmental cooperation as an ongoing obligation, rather than an ad hoc reactive process. The Victorian Parliament's Federal-State Relations Committee commented:

In Canada, a majority of governments have a Minister for Intergovernmental Relations, who is able to assist the Premier or Prime Minister in dealing with these matters. Adopting this in Australia would increase the political and bureaucratic focus on intergovernmental matters, and would allow an appropriate political authority to manage and direct the business of intergovernmental relations. A Minister with responsibility for intergovernmental relations would ensure continuity in each States' approach to intergovernmental relations. The Minister may be directly involved in all intergovernmental negotiations, or support other Ministers involved in such negotiations.<sup>65</sup>

**Conclusion:** Accountability can be increased by ensuring that an independent body to do research on policy issues is established – called a Federal Commission in this paper (see discussion in 'Independence'). The Federal Commission should have a clearly publicised charter (e.g. its make-up and objectives and role). The outputs of the Federal Commission should also be made public. Further, accountability can be increased by more frequent meetings of COAG (see 'Efficiency') as well as a Secretariat (see 'Effectiveness'), which will ensure that there is a continued dialogue and agenda that the participants must address and cannot avoid.

The preparation of agendas for COAG meetings should link the meetings together – creating an ongoing accountability of ideas. The transparency of discussions, agreements and outcomes of COAG – with clearly allocated lines of responsibility – may also increase accountability.

For governments, a Minister for each level of government should be given the responsibility for intergovernmental relations.



## 7.4 | EFFICIENCY

***Intergovernmental relationships must be capable of achieving the objectives in a timely manner, free from political capture or stalling, and against a long-term vision.***

While political pressure can build up to overcome short-term political and parochial interests, commitments to reform are meaningless unless they are implemented fully and in a timely way. Elections, leadership changes and reaction from vested interests, including in business, can undermine the reform agenda and erode political will over time.

While there is currently some appetite for a national reform agenda across governments in Australia, this has not always been the case. Accordingly, the intergovernmental arrangements must ensure that there is continuing commitment to a national reform agenda over the long term, and to ensure that any agreed reforms are properly implemented despite potential changes in political will.

Currently COAG is the main forum for policy setting, but the problems with this forum can be short-termism and political capture. Accordingly there needs to be a force that can raise issues of importance to the economy that may not be politically palatable. A Federal Commission could be a permanent standing body that is able to conduct its operations free from political dynamics and in an efficient manner despite a changing environment. In addition, the funding and independence of the intergovernmental body must be assured to enhance the effectiveness of the intergovernmental operations in a changing political and social landscape.

There is a need to constantly assess the state of the economy and ensure it is operating in an efficient, effective and competitive manner. While the meeting of COAG in June 2005 appeared to be successful, John Howard commented afterwards that it was the most cooperative and productive of its kind that he had attended in nine years as Prime Minister. It is inappropriate for the key intergovernmental body to have only had one productive meeting in nine years and for such relations to only take place in times of limited opportunity.

### EXHIBIT 15

#### WINDOWS OF OPPORTUNITY ARE NOT ENOUGH

... there was currently a rare opportunity for progressing economic reform at a national level, both in relation to completing unfinished business under NCP and to embracing new initiatives discussed at the June 2005 meeting of CoAG. One participant spoke about 'six months of blue sky' between electoral cycles 'a window of opportunity that we want to make the most of if we can.'

Source: Productivity Commission, *Productive Reform in a Federal System*, Roundtable Proceedings, Canberra, 2006, p. 14.

.....

It was outlined previously that governments have three roles to play: anticipation, agreement and implementation. All three of these aspects must be capable of being delivered in an efficient and timely manner. Further:

The value of ongoing and frequent intergovernmental meetings should not be discounted. In the final analysis, effective intergovernmental relations are dependent on strong personal relationships and mutual trust and respect between individuals.<sup>66</sup>

Regularly scheduled meetings have been found to be useful in some overseas intergovernmental models. In Canada, for example, the meetings of Ministers of Finance and their deputies have been found to be successful because of their regularity since 1941 and the build up of 'trust ties' among those involved in the process. While the meetings are not conflict free, the regularity of the meetings has ensured that the people involved in the meetings know and trust each other. This increases the likelihood of understanding each other's perspectives and hence finding mutually agreeable and workable solutions. The benefits of such regular meetings have been described as follows:

They have ongoing opportunities to exchange views and search for workable solutions. A great deal of information is exchanged and those involved in the processes experience and face common problems, whether they be inflation, tax policy or deficit reduction. The personal relationships that develop have been an important factor in overcoming many of the irritants which arise and which have the potential of escalating into more serious problems.<sup>67</sup>

In Canada, the First Ministers Conferences are a gathering of provincial premiers and the Prime Minister of Canada. The meetings are called by the Prime Minister and their frequency has varied according to the preference of the Prime Minister of the day:

From 1927 to 1944, there were approximately eight federal-provincial conferences involving First Ministers, ten from 1945 to 1959 and fifteen from 1960 to 1969. After the constitutional conferences of 1969–1971, federal-provincial conferences at the level of Ministers and First Ministers became incorporated as an integral and regular component of governance in the Canadian Confederation. Federal-provincial conferences may involve meetings of the First Ministers (Prime Ministers), meetings of Ministers or meetings of Deputy Ministers and officers of agencies representing different levels of government and sponsored by their ministers.<sup>68</sup>

Regularity also ensures that there is a permanent agenda that governments must be addressing, and therefore increases governments' accountability to that agenda.

Meeting regularly creates the assurance that there is a 'table' to which to bring initiatives or irritants. Equally important, it provides for a level of familiarity between the First Ministers and an opportunity for the public to become knowledgeable about the process, issues and viewpoints.<sup>69</sup>



In Germany, the Conference of Minister-Presidents meets at least twice a year, while the conferences of specialised ministers meet at least every six months. The provincial governments or Länder in Germany have a unique position because they have an ability to influence federal legislation through the Bundesrat. The Länder are entitled to introduce bills into the Bundesrat and have a power of absolute or suspensive veto in certain matters. A process of political consultation and coordination between the Federal Chancellery and the Bundesrat has been developed whereby:

A Minister of State on the level of Parliamentary State Secretary has been entrusted with this task ... His main point of contact at the Bundesrat is its consultative Council, which is composed of 16 Land plenipotentiaries representing Land interests vis-à-vis the Federation. As a rule, this body meets with the Minister of State at the federal Chancellery on a weekly basis. They primarily come together to prepare Bundesrat meetings. They also discuss on a confidential basis, all other issues requiring co-ordination between the Federation and the Länder.<sup>70</sup>

The Victorian Constitutional Committee has recognised the comparative deficiency in the number of intergovernmental meetings that have been held in Australia compared to overseas jurisdictions. Since 1990 there have been four Special Premiers Conferences, one Heads of Government meeting and seven Council of Australian Governments meetings.

In Germany and the European Union, intergovernmental bodies meet far more frequently than they traditionally have in Australia. The European Council meets every six months, and the Council of Ministers meets, on average, nearly twice a week. German Heads of Government meet every two to three months, and the Bundesrat sits in plenary session every third week. The Bundesrat must also be convened if demanded by the Bund, or at least two Länder.<sup>71</sup>

**Conclusion:** To ensure efficiency there must be an agreed number of meetings of COAG per year (e.g. at least 2 per annum) as well as agreement that COAG will respond to the recommendations of the Federal Commission in a given time frame.

## 7.5 | INDEPENDENCE

***The actions and decisions of intergovernmental relations must be free from undue influence from political or private interests. They must have high-level commitment.***

The Productivity Commission has a very important role in Australia's economic competitiveness in identifying reform priorities for Australia, and conducting detailed research and making recommendations on potential solutions. The Productivity Commission's contribution to the understanding of our federal system has been seen in a number of reports it has produced, including the recent compilation of materials from the 2006 Roundtable Proceedings in Canberra entitled *Productive Reform in a Federal System*. The Productivity Commission's role in federal–state relations is limited however:

- + The research priorities are set by the Commonwealth Government (and therefore potentially guided by political interests of the day rather than long-term objectives) and there is limited opportunity for the Productivity Commission to set its own work priorities.
- + There is no 'buy-in' by the state governments (either in terms of the direction of the Productivity Commission's work agenda, the funding of the Commission or the outcomes).
- + There is no requirement for the Commonwealth Government to respond to the reports of the Productivity Commission, and therefore less accountability for the findings.

Two considerations relating to independence are:

1. Ensuring that a research body such as the Federal Commission is able to consider reform priorities and initiatives that may not be politically palatable as well as propose solutions without influence from political interests (e.g. division of powers between levels of government).
2. In addition, COAG requires some independent, institutionalised mechanisms to ensure that it is not captured by one specific jurisdiction/level of government.

## SETTING ITS OWN WORK PRIORITIES

The Federal Commission should be free to achieve the policy objectives without interference (including political, financial and operational independence). As a matter of principle, the greater the independence, the greater should be its level of accountability and transparency. Just some of the reasons that independence is important are the need to establish a credible and expert body; ensure a degree of transparency and accountability to the wider community; and create a long-term stable economic environment free from short-term political or private sector influences.

Independence may be achieved by ensuring that the body is staffed by representatives and experts from a variety of backgrounds and political influences, including from both state and federal government. Some examples of where there are experts/private individuals involved in intergovernmental relations are the working groups within the Russian State Council and the US Advisory Commission on Intergovernmental Relations (see Exhibit 5) and the Health Council of Canada (see below). Similarly, the intergovernmental body should be jointly funded by state and federal government so that it is not reliant upon any one sphere of government. This was seen in the funding arrangements in the Canadian Council of Federation.

The Council of Australian Governments is currently an ad hoc body. Meetings are called by the Prime Minister, and much preparatory work is undertaken by the Department of Prime Minister and Cabinet. This means that the Commonwealth dominates the Council. Mandated meetings of the Council of Australian Governments would enhance the Council as a forum for joint Commonwealth–State decision making.<sup>72</sup>

## INSTITUTIONAL MECHANISMS

The Federal Commission must therefore be able to form its own work program and create its own agenda, so that it can review aspects of the economy that may not be politically expedient or agreeable. This should allow the problems associated with buck passing or lack of agreement across governments to be avoided.

In order to be effective, the Federal Commission must also be sufficiently funded so that it can conduct wide ranging reviews and be staffed by experts. The staff must have sufficient knowledge and experience to be able to make economy wide assessments about the future of Australia's economy and to make recommendations about a national reform agenda.

It was encouraging that the most recent COAG communiqué in July 2006 outlined more details about the COAG Reform Council (CRC), which was proposed to be independent and would comprise up to six members. The CRC will comprise a Chairman appointed by the Commonwealth, a Deputy Chairman appointed by the states and territories, and four members to be agreed by COAG, with at least one member having the appropriate skill sets with regional and remote experience. COAG would agree on staffing arrangements for the CRC. However, it still remains unclear what the exact role of the CRC would be but it will be primarily involved in monitoring implementation and therefore unlikely to be anticipating or researching new policy areas. In particular, it is unlikely to have the opportunity to initiate its own work and to anticipate new challenges facing the economy.

As previously discussed, many mechanisms for intergovernmental relations, where they are not formalised and institutionalised, will vary in their frequency and transparency depending on the political will of the leaders at the time. It is essential that the frequency, transparency and accountability are not determined by the political agendas, but that there are mechanisms for forced regularity of meetings, monitoring the progress of agreements and implementation of reform on an on-going basis.

In Canada, the politicisation of the intergovernmental process led to a loss of legitimacy of the process and a lack of satisfactory outcomes:

A new type of 'summit federalism' began to emerge, with all the paraphernalia of international conferences, flags, government limousines, rolling cameras, and press conferences after lengthy and often night-long meetings behind closed doors. Yet all the orchestrated hype could not prevent the eventual constitutional settlement of 1982 being concluded without Québec. After Trudeau's departure in 1984, two further attempts of bringing Québec into the constitutional fold ultimately failed because the process itself had begun to lose legitimacy and because support for the recognition of Québec as a distinct society faltered in English Canada.<sup>73</sup>

High-level leadership is crucial to ensure that reform priorities are consistently monitored. Without institutionalised mechanisms to pressure those high-level leaders to meet and agree a reform program, reforms will stagnate. For example, the NCP reforms in Australia were an example of successful outcomes from intergovernmental relations. However, commentators have highlighted that the 'difficulty of replicating it, of course, is that the circumstances that gave rise to the NCP are almost totally unlikely to emerge again.'<sup>74</sup>

Further, it is essential that the intergovernmental arrangements have independence to ensure the regularity of meetings as well as adequate outcomes from the meetings. The lack of such independence of COAG has resulted in various problems, including infrequent meetings, lack of transparent agenda and decision making and politicised outcomes. Indeed 'COAG meets only briefly and only once a year ... The underlying reality, though, is not entirely consistent with this image. COAG has no statutory – let alone constitutional – foundation; it has not changed the powerful imbalance in Australian federalism; and it is an institution existing and functioning at the pleasure of the Prime Minister.'<sup>75</sup>

Finally however, it must be recognised that our democracy depends on the elected representatives being the ultimate decision makers. Accordingly, each government must answer to its own democratically elected legislature. For this reason, intergovernmental bodies 'must remain non-legal and consensual instruments. They are not a substitute for any parliament or legislature'.<sup>76</sup>

A number of independent and effective intergovernmental bodies have proven useful when applied to a specific sector of the economy. The National Competition Council (NCC) in Australia and the Health Care Council of Canada (HCC) are examples of these types of bodies (see Exhibit 16).

## EXHIBIT 16

### HEALTH CARE COUNCIL OF CANADA

The Kirby Report, *The Health of Canadians – the Federal Role*, (October 2002) and the Romanow Commission on the Future of Health Care in Canada (November 2002) both identified the value of an independent council informing Canadians on health care matters while promoting accountability and transparency. The Prime Minister and the Premiers accepted the advice of those reports and Canada's First Ministers established the Health Care Council of Canada in their 2003 Accord on Health Care Renewal and enhanced its role in the 2004 Ten Year Plan.

Funded by the government of Canada, the Council reports to the Canadian public and operates as a non-profit agency. There are 26 councillors including representatives of federal, provincial and territorial governments, experts and citizen representatives. Councillors have a broad range of experience bringing perspectives from government, health care management, research and community life from across Canada. The Members of the Council are rather like a corporate board of directors, performing a liaison function between the Council and Canada's First Ministers, as well as approving the Council's budget. Supporting the work of the Health Council of Canada is a small secretariat located in Toronto.

Source: [www.healthcouncilcanada.ca/en/](http://www.healthcouncilcanada.ca/en/).

**Conclusion:** Independence might require the following considerations, among other things:

- + Establishing a Federal Commission with an ability to determine its own work program; a funding formula to ensure 'buy-in' by all levels of government; staffed by experts from a variety of backgrounds; and a rotating chairmanship.
- + For COAG, considerations may include mandated meetings (not called by any particular level of government).

## 8 | INTERGOVERNMENTAL FISCAL ARRANGEMENTS

In Australia, the taxing powers of the states are limited by the Constitution and historical political circumstances. Neil Warren recently completed a report for the New South Wales Government titled *Benchmarking Australia's Intergovernmental Fiscal Arrangements*, and stated that:

The conclusion of this study is that Australia performs comparatively poorly in intergovernmental fiscal arrangements ... Australia's system of intergovernmental fiscal arrangements is characterised by very high vertical fiscal imbalance (VFI) due to inadequate State tax powers, and complex and high level equalisation.<sup>77</sup>

Theoretically there are certain principles that can be used to assess the efficiency of the intergovernmental fiscal arrangements of a federation. Neil Warren highlights thirteen benchmarks by which to assess such arrangements. While a detailed assessment of such benchmarks are beyond the scope of this paper, a brief discussion and comparison of Australia's intergovernmental fiscal arrangements follows (although the complexity of such an analysis means that all issues will not be discussed here). Neil Warren highlights four main categories (expenditure responsibilities, tax assignment, intergovernmental fiscal transfers and dynamic federalism) that might be used to design and evaluate a fiscal system, but states in relation to such an assessment: '... the nature of the arrangements is very complex. A whole range of issues need to be taken into account when determining the appropriate mix of expenditure responsibilities, taxing powers and intergovernmental transfers where necessary.'<sup>78</sup>

### 8.1 | REVENUE RAISING

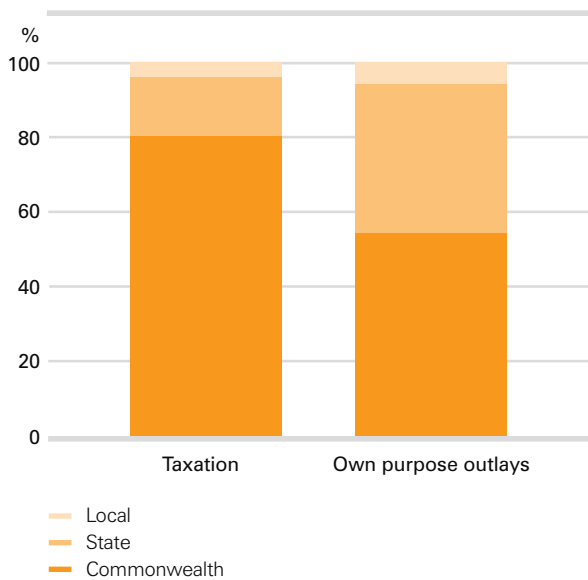
In general: 'As the subsidiarity rule expresses, powers and responsibilities should be allocated to the lowest practical order of government. This applies on both the taxing and the spending sides.'<sup>79</sup> Ideally, this would mean that governments would have fiscal resources equal to their spending responsibilities and 'that way the government providing the benefits to the voters also inflicts the pain, and thus a measure of accountability is in operation'.<sup>80</sup>

Vertical fiscal imbalance (VFI) occurs where the allocation of revenue between the federal and state governments does not match the expenditure responsibilities of those governments. VFI is measured as a ratio of the federal government's revenue (measured as a percentage of total government revenue) to its expenditure (measured as a percentage of total government expenditure).<sup>81</sup>

All federations have a degree of VFI, which has arisen from a number of circumstances including the growth in personal and corporate income tax as a source of revenue (which are generally controlled at a national level, although there is variation in the degree to which national governments dominate taxation revenue).

At one extreme lies Australia, where a high degree of fiscal centralization has funded a high degree of policy centralization. At the other extreme lie Switzerland and Canada, where revenues are more evenly balanced between national and subnational levels of government. The outlier is the EU, which ... has taken quite a different direction, one reflecting its quite different circumstances.<sup>82</sup>

FIGURE 2 VERTICAL FISCAL IMBALANCE IN AUSTRALIA

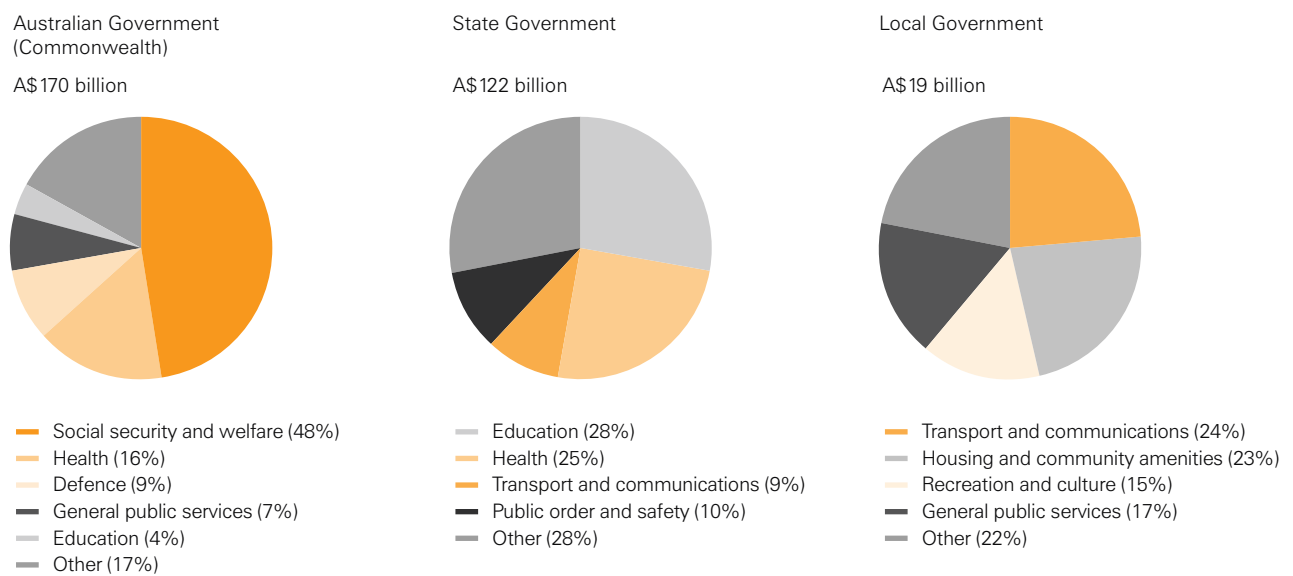


Source: N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements*, Final Report to the New South Wales Government, May 2006, Figure 4, p. 51 (2004–2005 data).

Note: own purpose outlays include compensation of employees, use of goods and services, social benefits and other expenses, but do not include consumption of fixed capital, interest, subsidies and grants.

In Australia, while there is sharing of spending responsibilities in many categories (e.g. health and education) there is no sharing in taxing responsibilities. The Commonwealth has control over some of the broadest based taxes (e.g. personal and corporate income tax and customs and excises). The states, on the other hand, receive the GST (a consumption tax), for which the rates and base are set and can only be changed with agreement by all of the states, the endorsement of the Commonwealth and both Houses of Federal Parliament. The states are able to levy taxes, for example on property (e.g. rates) and payroll taxes.

Accordingly, a large vertical fiscal imbalance arises because the largest taxes are collected at the Commonwealth level, but a considerable amount of spending responsibility rests at a state (or local government) level.

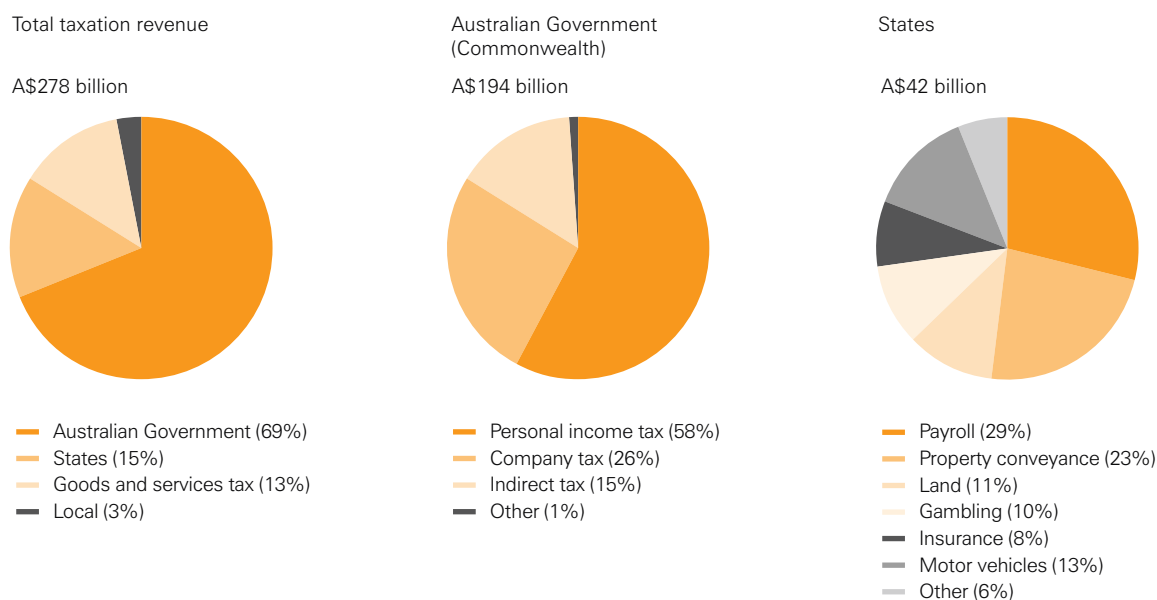
FIGURE 3 **DECOMPOSITION OF PUBLIC EXPENDITURE BY FUNCTION AND GOVERNMENT LEVEL** Own purpose expenditure, 2004–05

Source: OECD, *Economic Surveys: Australia*, Volume 2006/12, July 2006, p. 76 (The Treasury, Australian Government and ABS [2006], Government Finance Statistics 2004–05, cat. No. 5512.0).

Note: Australian Government excludes specific purpose payments (SPPs), state government includes SPPs to the states but excludes SPPs through the states to local government, local government includes SPPs.



FIGURE 4 **SOURCES OF TAX REVENUE** Per cent of total, 2004–05



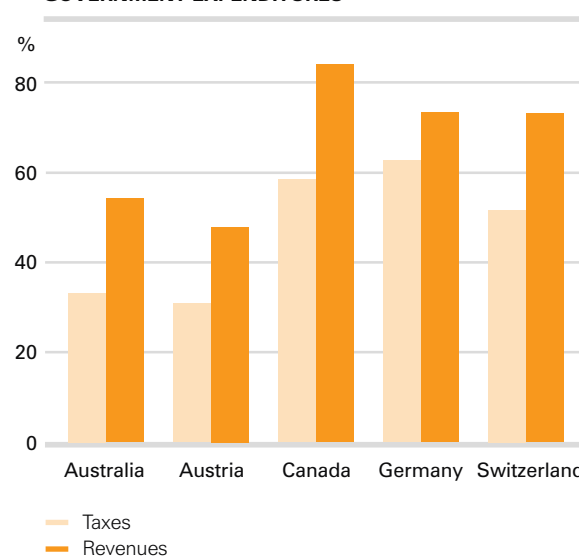
Source: OECD, *Economic Surveys: Australia*, Volume 2006/12, July 2006, p. 77 (ABS (2006), Taxation Revenue Australia (cat No.5506.0) and national authorities.

Note: All GST revenue is collected by the ATO but distributed to the states. Therefore the Australian Government revenue of 194 billion excludes GST and is excluded from the chart depicting state revenue.

VFI results in the need for the Commonwealth government to transfer funds to State governments to make up for their revenue shortfalls. The problem with such transfers is that accountability between the raising of revenue and the responsibilities for funding certain programs can become blurred. For example, the Commonwealth can avoid accountability for expenditure of funds, because the states have responsibility for a lot of the expenditure. Similarly, states can either become unable to provide certain services through lack of revenue raising capabilities, or alternatively claim they cannot provide such services due to lack of funding from the Commonwealth. States may also be less able to provide the services demanded by their electorates if much of their funding is 'tied' to conditions set out by the Commonwealth. Ensuring that revenue raising abilities and expenditure responsibilities are aligned may increase the chances of accountability for levels of governments in reaching their commitments.

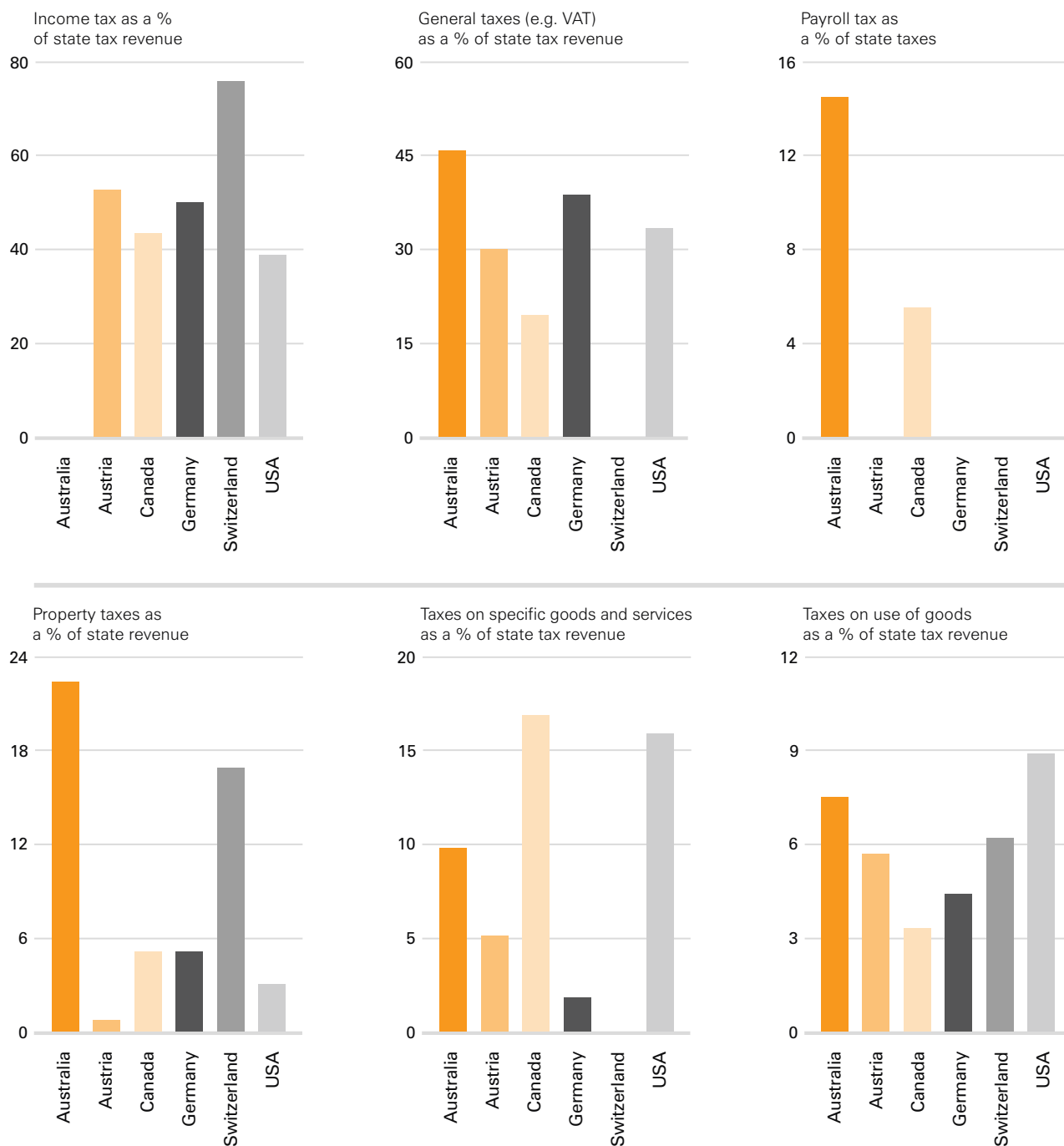
In Australia, there is a very high degree of VFI, which has increased over time and is one of the largest among comparable federations.

**FIGURE 5 STATE GOVERNMENT OWN-SOURCE TAXES AND REVENUES AS A PROPORTION OF STATE GOVERNMENT EXPENDITURES**



Source: N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements*, Final Report to the New South Wales Government, May 2006, Figure 8, p. 56 (Government Finance Statistics Yearbook 2004, International Monetary Fund).

FIGURE 6 STATE GOVERNMENT DEPENDENCE ON PARTICULAR TAXES



Source: N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements*, Final Report to the New South Wales Government, May 2006, Figure 10, pp. 65–66 (OECD Revenue Statistics 1965–2004, Table 136).

In Canada, Germany and Switzerland, the states have a greater capacity to spend from own source revenues than the states in Australia. Similarly, state governments depend to a greater extent on transfers from the Commonwealth government.

As a result, it is harder to hold governments to account for the revenue raising and expenditure:

Australia represents the most acute case of VFI, with the Commonwealth controlling all major tax sources and engaging in massive annual transfers to the states. Through idiosyncratic judicial interpretation, the states have been prevented from levying their own general sales taxes and thus lack that important revenue source available to subnational governments in Canada and the United States. Through the coercive spending of the Commonwealth ... the states have been excluded since 1942 from the income tax. They were granted all the net revenue from the national value-added tax (the 'GST', Goods and Services Tax) introduced in 2000. However, that remains a Commonwealth government tax and the revenues are effectively an intergovernmental transfer. The Australian states rely on transfers for almost half their entire budgetary needs.<sup>83</sup>

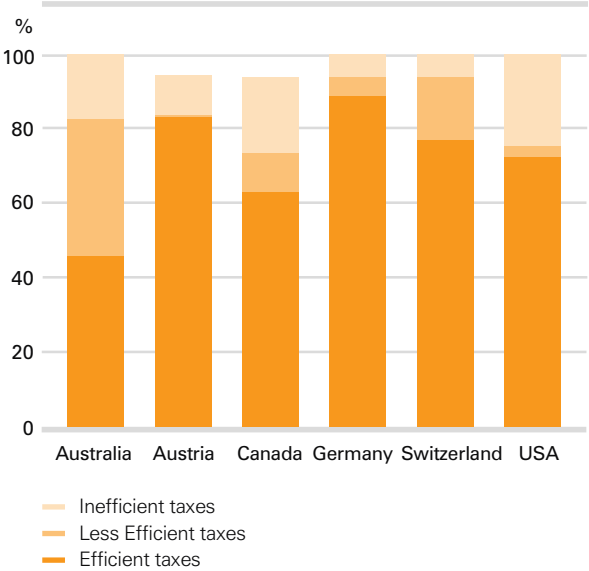
In some circumstances, it makes sense for some taxes to be collected centrally as this ensures efficiency and lowering of costs. Accordingly, the GST collected at a central level is a form of efficiency in the Australian taxation system.



However, the flexibility for states to impose taxes is limited, and often limited to inefficient taxes, which will ultimately place a cost burden on the economy. Because the states lack access to the most efficient sources of taxation, this limits their ability to increase their revenue in a manner that will not increase the cost burden to the economy:

A further simplification which should be considered would involve broadening the GST base. Revenue from this measure could be used to reduce the direct tax burden on labour and further address the vertical fiscal imbalance. However, such a change in the tax base would require the agreement of all state governments and would also require significant changes to the financial arrangements between the federal and state governments.<sup>84</sup>

FIGURE 7 PROPORTION OF STATE GOVERNMENT TAX REVENUE FROM EFFICIENT SOURCES



Source: N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements*, Final Report to the New South Wales Government, May 2006, Figure 11, p. 67 (OECD Revenue Statistics 1965–2004, Table 136).

Note: taxes include taxes on incomes and profits, payroll taxes, property taxes, general taxes (e.g. VAT), taxes on specific goods & services, taxes on use of goods and 'other taxes'. 'Other taxes' have not been included in Figure 7 so Austrian and Canadian taxes do not sum to 100 per cent.

Neil Warren writes in relation to the states' revenue raising efficiency:

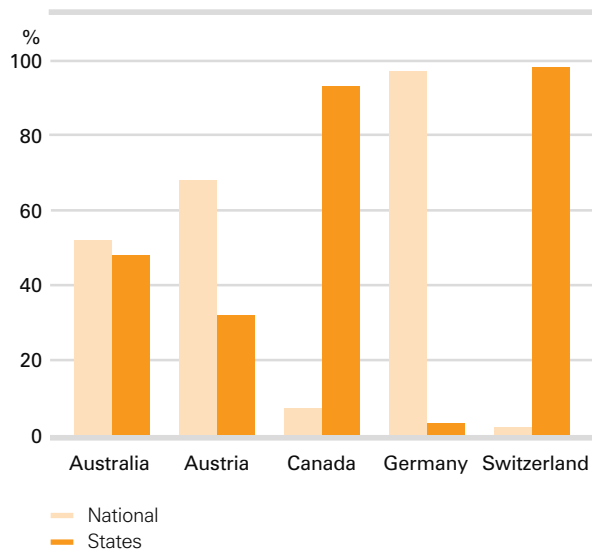
Australian states rely on efficient taxes for a smaller proportion of their tax revenue than other federations ... The result would look even worse if the GST was not included as a State tax by the OECD, from which the data in [the figure above] is drawn.<sup>85</sup>

There are methods of overcoming or altering this centralising trend. This has been seen in some overseas jurisdictions like Canada, where the taxing powers were restored to the provinces over time and the conditionality on the remaining transfers was reduced. 'By the late 1990s, provincial reliance on cash transfers had been almost halved to 13 per cent of their total expenditures.'<sup>86</sup> Other countries have also been reviewing and undertaking reforms in relation to their fiscal relations. In Italy, for example, the regions have been assigned new taxing powers and a new system of interregional transfers has been developed (this process of reform is as yet incomplete).<sup>87</sup>

## 8.2 | SPENDING

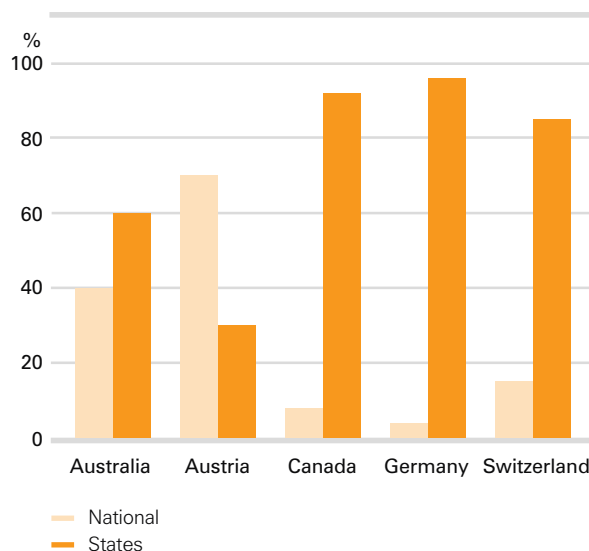
There is a pattern of spending responsibilities across federations (with some exceptions). In general, Australia differs from other federations in relation to health and education spending, and this therefore increases the likelihood of policy duplication and blame shifting in those areas that are shared.<sup>88</sup> However, even those shared responsibilities that are commonly shared among federations (e.g. economic affairs, housing and community amenities) will have the risk of lack of accountability if appropriate fiscal and coordination mechanisms are not properly considered.

FIGURE 8 HEALTH EXPENDITURE –  
CENTRAL GOVERNMENT V STATE GOVERNMENT



Source: N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements*, Final Report to the New South Wales Government, May 2006, Figure 1, p. 37 (Government Finance Statistics Yearbook 2004, International Monetary Fund).

FIGURE 9 EDUCATION EXPENDITURE –  
CENTRAL GOVERNMENT V STATE GOVERNMENT



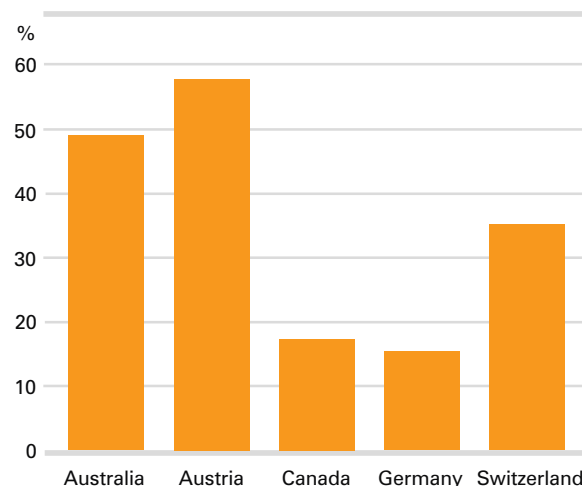
Source: N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements*, Final Report to the New South Wales Government, May 2006, Figure 2, p. 37 (Government Finance Statistics Yearbook 2004, International Monetary Fund)



While there are a number of federations that have shared spending responsibilities between levels of government in certain areas of the economy, the 'lack of transparency appears to be less problematic where State governments have relatively high levels of fiscal autonomy, as in Canada and the USA.'<sup>89</sup>

In Australia, GST revenues collected by the Commonwealth are automatically provided as revenues to the states.<sup>90</sup> However, there is a comparatively high degree of other transfers from the Commonwealth to the states in Australia as well.

FIGURE 10 **TRANSFERS AS A PROPORTION OF STATE GOVERNMENT EXPENDITURE**



Source: N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements*, Final Report to the New South Wales Government, May 2006, Figure 9, p. 57 (Government Finance Statistics Yearbook 2004, International Monetary Fund).

Section 96 of the Constitution allows the Commonwealth to 'grant financial assistance to any State on such terms and conditions as the Parliament sees fit.' These transfers are commonly known as conditional grants or Special Purpose Payments (SPPs).

Conditional grants have become commonly used in federations and have led to a major centralising trend. 'Those who pay the piper call the tune in federal systems as elsewhere. The stronger fiscal position of central governments has proven a tempting and powerful lever for the extension of central government power into areas of subnational jurisdiction.'<sup>91</sup> In Australia, SPPs to the states make up about 13% of Commonwealth expenditure, and include areas that are traditionally the spending responsibility of the states (e.g. health and education).

Section 96 of the Constitution has been given broad interpretation by the courts and the High Court, which 'has interpreted this as precluding any possible limitations on the conditions that the Commonwealth imposes on state governments through the spending power. Indeed, it has endorsed the use of the spending power as a weapon to exclude the states from access to the kind of tax bases that would reduce their dependence on such grants.'<sup>92</sup> For example, the High Court upheld the ability of the federal government to make grants to the states contingent on the states agreeing not to impose income tax, and banning state sales taxes.

Therefore, giving the states access to greater taxing powers (e.g. allowing a broader GST taxation base) may have the effect of reducing SPPs from the Commonwealth Government to the states.

In Spain, there has been a process of reform whereby healthcare and social services spending has been assigned to Autonomous Communities. France has also undergone a reform process whereby public functions such as higher education, industrial policy and regional infrastructure have been decentralised (constitutional reform of 2003).<sup>93</sup> In Germany, an expert panel has been established to consider the allocation of responsibilities in the federal system.<sup>94</sup>

A simpler system of inter-governmental transfers involving so-called 'specific-purpose payments' would contribute to a clearer specification of spending responsibilities. The specific-purpose payments should become less complex and inflexible. A first step would be to develop an outcome/output performance and reporting framework for each SPP. This is an ambitious task as outcome/output measures of service delivery are difficult to clearly define, measure and enforce in a robust way. Nevertheless, such frameworks could ultimately lead to a move towards the funding of such payments on an outcome/output basis in certain areas, such as education.<sup>95</sup>

The OECD notes, however, that the UK experience shows that outcome-focused performance targets should be clear. Those targets should be simple to quantify and audit (and should be tied to financial incentives such as the competition payments that proved useful in the NCP reforms).

### 8.3 | FISCAL EQUALISATION

It is common among federations around the world for the national government to distribute funds to the states (as previously discussed), and it is also common for equalisation across states to occur. Horizontal Fiscal Equalisation (HFE) occurs when funds are transferred from one subnational region to another to ensure that some form of uniformity of service provision occurs.

In Australia, compared to some other federations such as Canada and Switzerland, there is no reference to HFE in the Constitution. However, even though there is no reference to HFE, Australia has a complex system of HFE. In fact, Australia employs a system that attempts to fully equalise the revenue-raising capacity and expenditure needs of the states, even though it has one of the lowest pre-equalisation fiscal disparities.<sup>96</sup>

In Australia, VFI and HFE are integrated, with the large volume of Commonwealth transfers (including GST revenues) being divided among the states according to the equalization formula. Since 1993, an autonomous agency, the Commonwealth Grants Commission, has had statutory responsibility for those allocations ...<sup>97</sup>

There are a number of different examples of equalisation formulas employed across jurisdictions, each with their own characteristics (and benefits and pitfalls). For example, in Australia the complex equalisation formula ensures that weaker states are 'brought up to the national average' and that 'stronger states are brought down'.<sup>98</sup> In Germany, equalisation is almost 'punitive' in character, given that surplus revenues are distributed directly from affluent to poorer Länder.<sup>99</sup> This has led to some criticism of the equalisation program in Germany, as it is suggested that it removes the incentives for Länder to perform well or improve their performance. In contrast, in Canada the richest state (Alberta) is excluded from the calculation of the national average, which means that the poorer states are brought 'up to the adjusted average without bringing the richer ones (Ontario and Alberta) down'.<sup>100</sup>

At the other extreme, the United States practices very little systematic equalisation (which may arise from the historical formation of the federation and the presidential system of government).<sup>101</sup>

There are differing views on the efficacy of fiscal equalisation, particularly as such a practice modifies market outcomes. For example, some argue that subnational governments lose the incentive to improve their performance if equalisation practices diminish the costs and benefits of the market outcomes and signals. 'Most fiscal equalisation methodologies in comparator federations are significantly less complex and more transparent than in Australia.'<sup>102</sup>

## 8.4 | MONITORING

It is important for countries to assess their intergovernmental fiscal arrangements on a regular basis. Over time revenue raising and expenditure responsibilities in federal systems evolve, often on an ad hoc basis and relating to changes in the local economy and global environment. Whether the intergovernmental fiscal arrangements are optimal requires an assessment across the board of the fiscal arrangements.

Changing circumstances have meant that the original intentions of founders of federations may not fit with a modern economy because: 'The classic legislative federations were established in an altogether different era when the size and scope of government were limited, and it was relatively easy to divide responsibilities and to imagine two levels of government operating in their own spheres with little clash or overlap ... The 'mixed economy', the welfare state, the rise of environmental policy, and the enormous increase in taxation have all greatly complicated policy making in a system of divided jurisdiction – as have the vastly greater mobility of labour, geographical scope of economic activity, and quality of communication and transportation.<sup>103</sup>

Many other countries have undergone assessments of their fiscal arrangements:

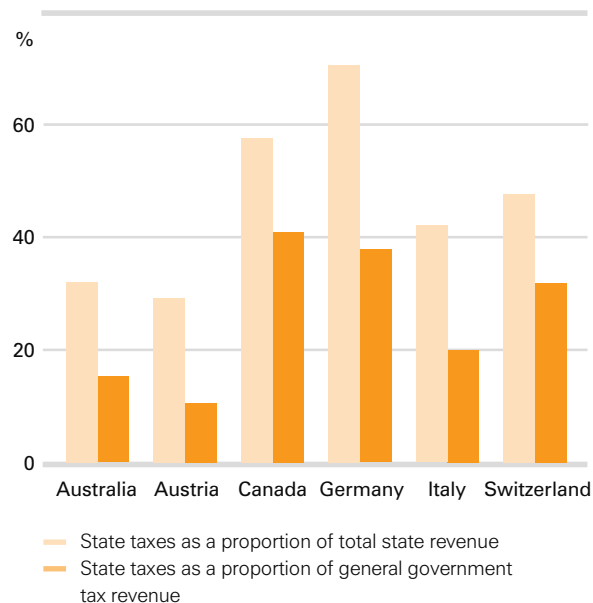
Australia needs to reconsider the allocation of expenditure responsibilities between levels of government, and the consequent assignment of tax bases and intergovernmental financial transfers. Over recent years, Belgium, Germany and Switzerland have all significantly revised their federal arrangements. Reforms are underway in Italy, and Austria comprehensively reviews its intergovernmental arrangements every four years.<sup>104</sup>

## 8.5 | POLICY

What is clear is that there are a variety of potential models of fiscal federalism that may be employed in Australia, and many examples of different methods from overseas. Furthermore, there is little constitutional constraint on what might be done from a fiscal perspective. The arrangements that are currently in place have arisen over time from historical circumstances. Australian states have comparatively low levels of fiscal autonomy compared with overseas countries. Perhaps a comprehensive review of intergovernmental fiscal arrangements and comparative analysis with overseas models may yield some insights into what might be a more optimal arrangement.

One level of government may have the constitutional authority but not the fiscal resources or ability to contain spillovers, while the other level of government may have the resources and reach but no the requisite authority.<sup>105</sup>

FIGURE 11 MEASURES OF FISCAL AUTONOMY



Source: N Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements*, Final Report to the New South Wales Government, May 2006, Figure 12, p. 73 (Government Finance Statistics Yearbook 2004, International Monetary Fund; note data not available for USA).

.....

What is clear is that if the subnational governments are given more taxing responsibilities, then accountability must also be assured through a process of adequate assignment of responsibilities.

With regard to the revision of subnational government financing systems, the reforms pursued have the general aim of improving decentralised governments' accountability, by assigning them more tax autonomy and by providing more flexibility in the use of central government financial transfers. In Italy, Spain and France decentralisation has been coupled with the assignment of new taxing powers to subnational governments.<sup>106</sup>

## 9 | CONCLUSION

There are a number of themes arising from this international comparison of intergovernmental arrangements that could provide examples of practical solutions in the Australian context. In summary, some of the considerations could include:

- + **A formal institutional arrangement or mechanism** – a permanent independent intergovernmental body at a federal–state level (e.g. formal institutionalisation of COAG) as well as a permanent independent policy body (in this paper called the Federal Commission). Such formalisation could be through a scheme of cross-jurisdictional uniform legislation or by formal agreement.
- + **Administrative mechanisms to facilitate decision making** – including the establishment of a permanent intergovernmental Secretariat to provide administrative and policy support (to the CRC, the Federal Commission and COAG); an independent and rotating chair; sufficient resources (e.g. staff). Other considerations are whether there should be consensus or majority voting mechanisms within the decision-making bodies, the funding of both the Secretariat and the Federal Commission and the role of the Secretariat (e.g. research and agenda setting).
- + **Flexibility to determine innovative solutions** – a sound ‘theoretical’ framework and basis for decision making (for example, mandated principles of federalism/goal setting as a framework for dividing responsibilities may be one method as a basis for decision making).
- + **Transparency** – for example, if a Federal Commission were established it could provide independent and publicly available reports to COAG on policy items. Such a report could make recommendations that would put pressure on all governments to consider the issues. Further, if a Secretariat were established then publicly available agendas and preparatory material could be developed prior to any meeting of COAG (agendas must flow from one meeting to another) – this would enable public discussion of policy items prior to the meetings.
- + **Accountability** – achieved by ensuring that an independent body to do research on policy issues is established – called a Federal Commission in this paper (see discussion in ‘Independence’). The Federal Commission should have a clearly publicised charter (e.g. its make-up and objectives and role). The outputs of the Federal Commission should also be made public.
- + **Efficiency** – there must be an agreed number of meetings of COAG per year (e.g. at least 2 per annum) as well as agreement that COAG will respond to the recommendations of the Federal Commission in a given time frame.
- + **Independence** – the Federal Commission should have the ability to determine its own work program, a funding formula to ensure ‘buy-in’ by all levels of government, staffed by experts from a variety of backgrounds and a rotating chairmanship.
- + **Review of federal fiscal arrangements** – a review of fiscal arrangements should be undertaken to obtain a greater degree of responsibility and transparency about which level of government is responsible for delivering outcomes in which policy areas. Comparisons with overseas countries reveal that reform of fiscal arrangements is possible and has been undertaken overseas.



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# APPENDIX 2

## THE COSTS OF FEDERALISM

REPORT BY ACCESS ECONOMICS PTY LIMITED  
FOR THE BUSINESS COUNCIL OF AUSTRALIA

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## EXECUTIVE SUMMARY

### AUSTRALIA'S FEDERAL SYSTEM – AND THE REFORM IMPERATIVE

**Australia's current prosperity is closely tied to the reformist policies pursued over the past two decades** by many governments (Federal and State, Labor and Coalition). Those governments had the courage to deregulate financial markets and float the \$A, unwind decades of protection, carry through much of the 'national competition agenda', privatise or corporatise many public enterprises, and begin labour market and tax reform.

**But further reform – and the greater prosperity it could bring – is increasingly falling foul of the overlaps and inefficiencies in our federal system of government.**

And it is all too easy to blame 'other governments' (the Australian Government, or other States) for a lack of progress on reforms that could help to address these failings in the flawed operation of our federation.

There are obvious dangers in that failure. As the Secretary of the Federal Treasury has argued, it is time for our federal system to 'embrace the logic of markets':

*The two biggest threats to economic reform in Australia are an aversion to the logic of markets and stubborn parochialism. Neither of these threats is new.*

*Parochialism and an aversion to markets will never deliver an efficient national electricity market, national markets for labour, a national market for water, or efficient road and rail freight networks.*

*These enduring threats to economic reform pose substantial risks to the cost structure of Australian producers facing increasingly intense competition from the dynamic emerging economies of China and India. And unless tackled courageously, they will consign us to a permanent productivity gap with the top half of the OECD — and a reversal of the recent narrowing of the GDP per capita gap.*

*The expansive CoAG, and related, reform agenda provide an unusual opportunity for policy makers at all levels of government to embrace the logic of markets in labour, energy, water and land transport; and to embrace the spirit of cooperative federalism. If they do, there is a very real chance that our peers in Washington and Paris will be talking about the golden age of Australian economic performance for decades to come. (Henry, 2006, at p 342)*

Similar comments have been made by Professor Ross Garnaut, who notes that:

*Every area of policy reform-delivery, delivery of services of all kinds, taxation in general and reform of the whole range of competition policy issues ends up depending on federal-state financial issues. ... the next wave of productivity raising reform is going to depend on the quality of federal-state relations. (Garnaut, 2006, at pp 85-6)*

There is reason to hope. In particular, the last two meetings of the States and the Federal Government (CoAG meetings) have spelt out a reform agenda.

Yet that CoAG reform agenda – while ambitious compared with the failures of the past – falls well shy of what could be achieved. **We can do better.**

*... although Australia's per capita GDP relative to that of the United States improved by 6 percentage points from 1990 to 2002, to 76 per cent of the US per capita GDP, this only restored Australia's relative position held in the 1970s and falls short of where it was in 1950. (OECD 2005, p. 30)*

*... it may not be too much of an exaggeration to say that the only significant business inputs for which we do have national markets are financial capital, post, telecommunications and aviation. Yet the case for governments facilitating the development of highly efficient national markets for key business inputs in a country as remote and geographically fragmented as ours is overwhelming. (Henry, 2006, at p 342)*

Unless we face up to these challenges, there is a considerable risk that the hard won gains in Australian living standards (from the political courage that produced the reforms of the past) will be lost. Or, as the Productivity Commission (2006) put it, **“Since our federal system is here to stay for the foreseeable future, the important thing is to get the best out of it”**.

To examine how to get the best out of our federal system, the Business Council of Australia (BCA) has commissioned this report from Access Economics:

- ❑ It considers the ideal federal system, and then compares that with the operation of Australia's federal system.
- ❑ It highlights the gap between those two using case studies of flawed federalism.
- ❑ The report goes on to attempt to quantify the cost to Australians of that gap.

## THE FOUR MAIN PROBLEMS

In a small economy such as Australia's, we have to learn to get along. Only the harmonisation of rules and regulations across State and Federal jurisdictions can help to overcome the inefficiencies, high transaction costs and uncertainties for businesses and families arising from being subject to too many governments making too many rules and regulations. That is all the more true in that the complex reforms we now need almost always cover a range of Federal and State portfolios – so the necessary degree of cooperation becomes very high.

We identify four main problems with achieving more reform.

The first is **the blame game**. In brief, reform involves both political courage and political pain. As economists often note, there are usually large and identifiable losers from reforms (who can lobby effectively against 'doing something'), while there are typically many small winners from those same reforms – and these 'wins' may not be apparent for some time, and are not obviously linked in the understanding of voters to the reforms which created those gains. That makes reform fragile. Hence State and Federal bureaucracies (who often see themselves as potential losers from the changes involved in reforms) find it all-too-easy to ward off reform by blaming each other for problems and inactivity. That is made harder still as the Federal Government has a finger in almost all the activities of State Governments, typically through some special purpose payment (SPP), with conditions applied.

Professor Ross Garnaut describes the risks in the following hypothetical example. Say “the Victorian Government wants to clean up some highly inefficient part of the medical sector, [then] it will be told by the health department in Victoria that you cannot change whatever it is that requires reform because Victoria’s commitments and expenditures are locked into a federal-state agreement on specific purpose payments. [Or] if there is any attempt by the Federal [and State] Treasuries to work in favour of ... reform, ... you will have very close cooperation between the [Federal and State] health departments to ensure that neither the Federal Treasury nor the State Treasury gets a look in.”<sup>1</sup>

The second is **the weakest link**. Even when State and Federal Governments do see the advantages of reform achieved through cooperation, they typically set up committees to coordinate policies and oversee reforms. That makes sense, but these committees typically or effectively allow their members a veto. With nine governments as members, there is usually at least one government just months away from an election. Given that reforms typically create big losers (often vocal interest groups) and many small winners, that allows interest groups to go to town on the weakest link – the government closest to an election, or the government most nervous about the polls.

For example, after careful crafting of a series of compromises, the State and Federal Governments had finally agreed on reforms of road transport, including increases in road user charges for heavy trucks – a much needed reform. However, the Australian Government junked that at the last moment in the latest Federal Budget. The Australian Government similarly proved to be the weakest link in selling the Snowy Hydro scheme. It makes no sense for governments to own such commercial enterprises. However, as soon as the Australian Government caved on the Snowy, so too did NSW and the Victorians – a triumph of talkback radio over good policy. Or, similarly, blocking actions by various State Governments stalled for four years a simple proposal to allow Arnotts to fortify orange juice with calcium.

The third is **fuzzy logic**. Australia’s constitution already leads to rather more overlap in functions than that seen in most other federations. However, the more complex that modern living gets, the fuzzier grows the line between Federal and State responsibilities. That is because government programs in education, training, health, aged care and welfare are increasingly interacting with each other, creating more and more incentives for the States and the Australian Government to try to push costs on to each other. Our federation has never been so complex, and the dollars it churns have never been this large. That complexity – and the associated increase in the ‘fuzziness’ in dividing lines between State and Federal programs – has made cooperation harder to achieve, and hence reform harder to achieve.

For example, there used to be clearer lines between GP services, hospital beds and residential aged care beds. That is much less true now.

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<sup>1</sup> Productivity Commission (2006), *Productive Reform in a Federal System*, Roundtable Proceedings, Productivity Commission, Canberra.



The fourth is **globalisation**. People and money are becoming more mobile. Because of that, it makes increasing sense for taxes to be raised at the Federal level – as taxes are easier to avoid or get competed away at the State level. But that keeps increasing the gap between what the States raise for themselves and what they spend – which keeps increasing federal transfers, which keeps increasing federal demands for control and accountability, which keeps undermining the rationale for having different State Governments anyway (allowing them to be different). Nor does globalisation just have implications for taxes. It also has implications for the spending and regulatory decisions of the States. Years ago businesses were less likely to operate beyond the boundaries of their home State – but now they are increasingly likely to have to deal with State-level rules and regulations covering a myriad of areas.

For example, and as the Federal Treasury Secretary has noted, Australia has a “plethora of inconsistent State-based regulatory requirements for occupational licensing, occupational health and safety, road transport, water trading, and so on”.

### WHAT IS THE COST OF THIS MESS?

The end result of these problems would be funny – if it didn’t cost ordinary Australians lower living standards. In brief, Australia’s federal system suffers from:

- (1) too much overlap,
- (2) too big a mismatch between what the States get via taxes and their spending,
- (3) too heavy a Federal hand in areas of State responsibility,
- (4) too much ‘destructive competition’ across jurisdictions, and
- (5) too little cooperation across States and between States and the Australian Government.

How much does that cost?

A simple rule of economics is that **somebody pays**.

If our federal structures and operation fall short of the ideal or efficient federal structure and operation, then that will show up as:

- (1) **Higher than necessary costs of government** (and hence as higher taxes and less government services for a given amount of government spending).
- (2) **Higher than necessary costs of doing business** (due to higher compliance costs arising from overlap and duplication – and the higher taxes too).
- (3) And, as a result of the above two factors, **lower than necessary living standards for ordinary Australians** (as the first two factors show up as higher prices and taxes than necessary, as well as less government services and lower wages than necessary).

Most analyses of ‘the costs of federalism’ focus on the first factor – indeed, on a subset of (1): the costs of inefficiencies in spending (often called ‘overlap and duplication’), rather than also adding in the costs of the inefficiency of State taxes relative to Federal taxes.

Our own estimates in this report allow for both inefficiencies in spending and the inefficiency of State taxes. Even so, that means they are just an estimate of (1) – we do not attempt to estimate (2), and so our cost estimate is just a subset of the costs of a federal system that falls short of an efficient (‘ideal’) federal system.

## THE 'GOVERNMENT' COSTS OF FLAWED FEDERALISM, 2004-05

Type	Category	Cost (\$m, 2004-05)	Source of inefficiency
Spending-related inefficiencies	<b>Overlap and duplication</b> due to the need to administer grants between jurisdictions (ie, a cost of one level of government taxing less than it spends)	\$861	The costs to the Federal Government of administering grants to the States (SPPs) over and above cost of either the States or the Federal Government directly funding and running the programs themselves
	<b>Cost shifting</b> by the States that results in inefficient spending by the Commonwealth on pharmaceuticals and in public hospital grants	\$836	Where it would be more efficient for States to provide services such as public hospitals, but services are instead inefficiently provided via (Federal-subsidised) pharmaceuticals or GPs or aged care homes. <i>(Note similar other such sources of inefficiency not counted.)</i>
	<b>Spending above efficient levels</b> by the States due to lack of coordination and/or inadequacies in Commonwealth oversight and accountabilities	\$2,296	Where State spending is inefficient in achieving program aims because Federal interference means State spending is misdirected, or because State 'gaming' of Federal grants sees them overspend in some areas and underspend in others with the aim of maximising grants received from the Commonwealth, or because the two levels of government fail to coordinate their efforts
	<b>Overlap and duplication</b> in areas where both States and Federal Government are operating at the same time	\$913	Too many cooks spoiling the broth in areas such as welfare, community health and policing
	Inefficiencies due to operation of <b>'horizontal fiscal equalisation'</b>	\$215	Grants directed to inefficient States
Spending sub-total		\$5,122	
Tax-related inefficiencies	<b>Unnecessarily inefficient State taxes</b> (such as taxes on insurance, land tax, stamp duties on commercial conveyances, other stamp duties etc)	\$2,782	Saving in efficiency costs if these were replaced by more efficient taxes such as the GST or payroll tax
	<b>The efficiency (deadweight) costs of raising taxes to pay for the higher-than-necessary level of spending</b> identified in the spending sub-total above	\$866	Conservatively costed assuming these are paid for out of GST and/or payroll tax receipts (ie, from efficient rather than inefficient taxes)
	<b>Failure to centralise tax collection</b> nationally for payroll taxes and taxes on gambling	\$150	It is inefficient to collect these taxes using State-based bureaucracies
Tax sub-total		\$3,797	
Total 'higher than necessary costs of government'		\$8,919	

Altogether, based upon conservative assumptions, Access Economics estimates that the *fiscal* costs in Australia's current federalism system – the higher than necessary costs of government compared with an efficient ('ideal') federation could be almost \$9 billion in 2004-05. (The details are as spelt out in the table above.)

This represents an estimate of spending from which ordinary Australians are getting zero benefit, and hence having to pay the tax to finance that spending – all for nothing.

And this estimate only covers the ‘government’ costs of inefficient federalism in Australia.

As noted above, there are also likely to be broader ‘private’ costs of inefficient federalism – where costs fall on to businesses and families due to overlapping and excessive State regulations. Not costed in this report are either the compliance costs to business of the excessive levels of tax and regulation involved in our less-than-optimal federation, or the deadweight (efficiency) losses arising from having multiple and inconsistent layers of rules and regulations on Australian businesses.

How high might these ‘private’ costs be? It is not unreasonable to assume that the costs of point (2) above would be higher than the ‘government’ costs in point (1) – perhaps notably higher.

Yet even without allowance for the latter costs, the almost \$9 billion estimate of ‘government’ costs of flawed federalism identified in this report implies a cost of **almost \$450 a year for every Australian, or over \$1,100 a year for every household.**

**That’s a lot to waste.**

## **Access Economics**

### **September 2006**

## 1. FRAMEWORK FOR THE ANALYSIS

The Business Council of Australia (BCA) has requested Access Economics to examine the ways in which Australia's federal system of government is underperforming.

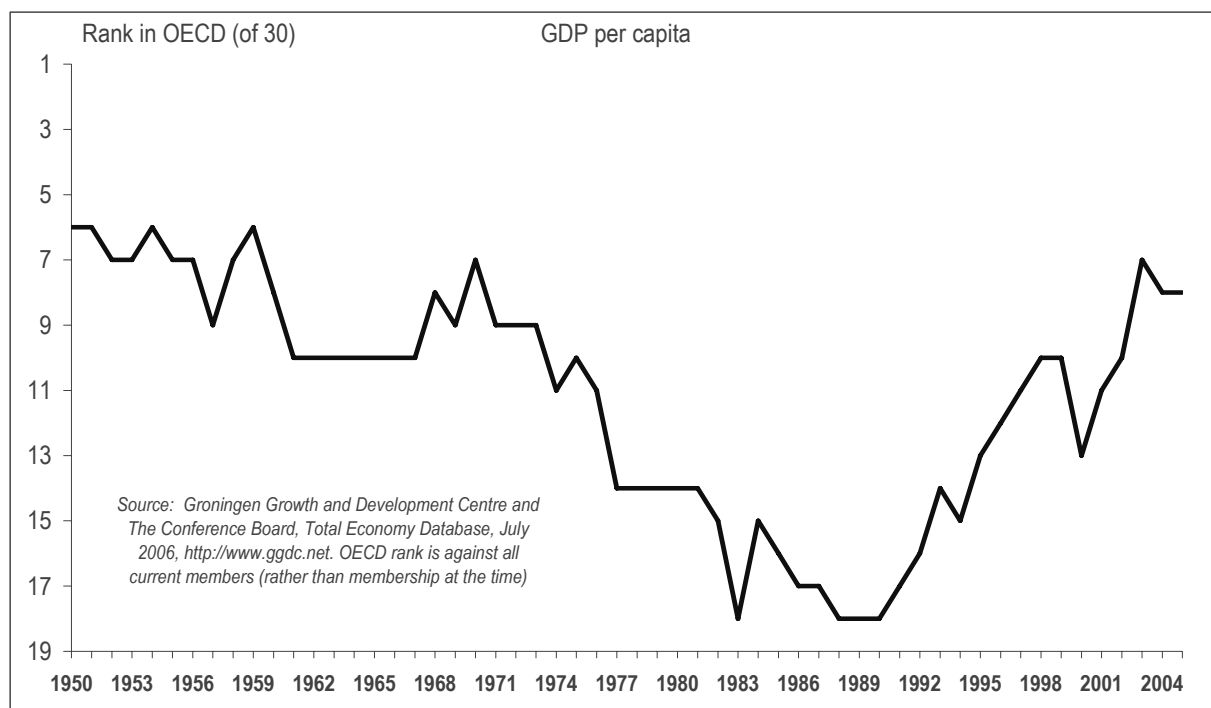
**In brief, Australia's federal system suffers from:**

- (1) too much overlap,
- (2) too big a mismatch between what the States get via taxes and their spending,
- (3) too heavy a Federal hand in areas of State responsibility,
- (4) too much 'destructive competition' across jurisdictions, and
- (5) too little cooperation across States and between the States and the Australian Government.

Australia's future prosperity – as the Federal Treasury reminds us – relies heavily on our ability to increase productivity and participation.

The reasoning is straightforward. Our living standards depend on the effectiveness with which we work (productivity) and the length of our working lives (participation). It is Australia's success on both those fronts relative to the other developed nations in the OECD which has seen our relative ranking on income per head within the OECD do something very unusual since the early 1990s.

**FIGURE 1: AUSTRALIAN LIVING STANDARDS – RANK WITHIN THE OECD**



As Figure 1 shows, Australian living standards slipped behind those in the other developed nations for much of the twentieth century. It was not until after Australia adopted a series of reforms (freeing up financial markets, floating the \$A and opening up to global competition, pushing through national competition policy, reforming our taxation system and labour markets) that Australia's productivity growth and the increase in our participation moved ahead of that in other developed nations.

That improvement in productivity and participation underwrote a remarkable turnaround in Australia's prosperity – we turned the corner on our living standards, from a ranking of 18<sup>th</sup> in the OECD in the early 1980s and again in the early 1990s, to 8<sup>th</sup> now. Indeed, Australia's recent economic growth performance has been excellent. Since beginning a series of reforms in the early 1980s, Australia's GDP growth has averaged 3.6% a year, with that representing growth in GDP per head of 2.4% a year since 1983. Those rates can be compared with the respective averages for the twentieth century as a whole, which saw average annual GDP growth of 3.4% and GDP per head of 1.7%.<sup>2</sup>

**But past performance is no guarantee of future performance.** The impressive reforms of times past – pursued by both State and Federal Governments, and both Coalition and Labor Governments – has slowed more recently.

The Business Council is of the view (and Access Economics wholeheartedly agrees) that a better performance of our federation can markedly assist in furthering reforms to the Australian economy. Many of the outstanding items on the reform agenda require close cooperation between the States and/or between the States and the Commonwealth. And that is where strengthening and refocussing CoAG comes in.

Unless we face up to these challenges, there is a considerable risk that the hard won gains in Australian living standards (from the political courage that produced the reforms of the past) will be lost. Or, as the Productivity Commission (2006) put it, "Since our federal system is here to stay for the foreseeable future, the important thing is to get the best out of it".

To examine the potential for doing better, this report considers the ideal federal system, and then compares that with the operation of Australia's federal system. It highlights the gap between those two, and how that shows up in poor performance in our economy. The report goes on to attempt to quantify the cost to the economy of that gap.

## 1.1 STRUCTURE OF THIS REPORT

**Chapter 1** starts by:

- asking what might be the 'ideal' (efficiency) outcomes of a federal system, and
- identifying the types of inefficiencies that can arise in reality under a federal system.

**Chapter 2** provides a stocktake of the major inefficiencies in our federal system (in each case, describing the nature and sources of the gap between 'ideal' and 'reality', the culprit government and who ultimately bears the costs involved).

**Chapter 3** quantifies, to the extent possible, the main inefficiencies in terms of:

- the impact on other governments,
- the direct impact on other sectors, and

<sup>2</sup> Treasury (2001), *Australia's Economy Since Federation*, the Treasury Round Up, Centennial Edition, 2001.

- the indirect impact on other sectors.

## 1.2 WHAT IS A FEDERAL SYSTEM?

Federal systems of governance are common – they cover rich countries (such as the US, Canada and Germany) and poor ones (such as India). Together, federations account for about 40% of the world's population and about 50% of the global economy.

*Essentially, federalism is a system of governance which provides for action by a national or central government for certain common functions together with independent actions by sub-national units of government, with each level of government accountable to its own electorate. (Pincus, 2006, p 26)*

A citizen of a federation gets to vote for at least two governments, each of which operates over the same area and with separate powers of taxing, spending and regulation.

Australia's federation comprises three tiers:

- the Federal Government, with designated and delegated powers;
- six State Governments, with residual powers, and two Territory Governments, with State-type powers; and
- local government authorities with delegated powers and responsibilities.

The division of powers under the Australian constitution provides the Federal Government with a small number of exclusive powers and a large number of areas where it shares powers with the States. State Governments retain responsibility for all other matters.

### **The constitutional division of powers**

The Australian constitution provides the Federal Government with some exclusive powers; primarily in respect of customs and excise duties, the coining of currency and holding of referendums for constitutional change.

This division of powers also provides the government with a large number of areas under Section 51 where it shares responsibilities in parallel with the States.

However, where State laws conflict with those of the Federal Government in these areas, the laws of the latter prevail (Section 109).

State Governments have retained (residual) responsibility for all other matters.

The Federal Government can influence State policies and programs by granting financial assistance on terms and conditions that it specifies (Section 96). And, over and above that, Federal powers have tended to grow over time. For example, while the constitution does not mention many specific functions (such as education, the environment and roads), the Federal Government can legislate in these areas under various powers (such as using its external affairs power in support of an international agreement covering the environment).

Presently, there remains considerable room for improvement in developing effective cooperation between the States and the Federal Government. While some cooperative arrangements are in place, they have proven less than robust to challenges in the High Court.

The BCA (2006) has noted that “there are major limitations on the ability of the Commonwealth and States to enter into such cooperative schemes”.

### 1.3 SCOPE OF THIS REPORT

This report explores the costs to Australian living standards of overlaps and inefficiencies in our federal system.

We focus on the first **two tiers** of government. Furthermore, our references to the States and to State Governments include reference to the Territories and to the Territory Governments.

Our focus also is on **practical** ideals and solutions, as significant improvements can be made to how the federal system works *without* major changes to the powers or responsibilities of different tiers of government and without significant Constitutional change.

The recent report by Neil Warren (2006) for the NSW Government concentrated (like the Garnaut-Fitzgerald Report (2002) before it) on evaluating federal financial relations.

In contrast, we are mainly concerned with analysing the consequences of the current allocation of **expenditure responsibilities and taxing powers** between the levels of government. While inefficiencies arising because of grants arrangements under our federal system are important, they are secondary to the inefficiencies that can arise from the allocation and operation of expenditure responsibilities and taxation powers by different governments within a federal system.

Furthermore, while the Warren report focused solely on **vertical** issues, we are also concerned with **horizontal** issues. Inefficiencies in policies and services can arise horizontally (across States) as well as vertically (between the Federal Government and the State Governments).

We therefore include an assessment of both State-State (horizontal, or inter-jurisdictional) and Federal-State (vertical, or intergovernmental) relationships.

### 1.4 THE BENEFITS OF A FEDERAL SYSTEM

#### Federal systems have both advantages and disadvantages

There are advantages with federal systems:

- 1) Federal systems encourage governments to be more responsive by keeping power closer to the ‘level’ of the voters.
- 2) Not all groups of voters want the same thing. Some States 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.
- 3) And that diversity can help States learn from (and compete against) each other – if a policy works well in one State, it may well be adopted in others.



Yet there are also disadvantages with federal systems:

- 1) Governments have economies of scale – so there are higher costs from the overlap and duplication in a federation: the choice in favour of the ‘diversity’ offered by a federal structure also implies the deliberate foregoing of the greater economies of scale available to more centralised government.
- 2) And the relative size of such opportunity costs is growing as globalisation leads to increased commerce across State and national boundaries. That means the inefficiencies, higher transaction costs and uncertainties associated with being subject to rules and regulations set by more than one government are rising in relative terms.
- 3) Competition between governments can be bad as well as good – such as sweetheart deals via payroll tax exemptions.
- 4) The (constitutional) allocation of power between the Federal and State Governments can be badly designed, leading to governments having the ‘wrong’ responsibilities, or sharing too many responsibilities.
- 5) In addition, the benefits of competition can often be overstated. While one State may be better in some fields, chances are it will be worse in others. Given the very high costs (and risks) for businesses and families in moving between States, the latter is at best a weak discipline on State policies.
- 6) And there is a risk of a lack of scrutiny in smaller jurisdictions. After all, part of the judgement as to what is working well and what isn’t comes to us via media, business and academic scrutiny, but there may be a lack of critical mass to achieve that in smaller jurisdictions. Worse still, that scrutiny may result in perverse judgements – with bad policies lauded, and good ones rubbished.

By dispersing power across governments, a federal system adds to electoral competition, providing more opportunities for this discipline to be exercised by voters over time.

In fact, federal systems offer two additional forms of competitive discipline on governments – ‘horizontal’ and ‘vertical’ competition.

**Horizontal competition** refers to the discipline imposed on governments by the possibility of citizens (and businesses) exercising their right to relocate from one State or nation to another (‘voting with their feet’) in response to fiscal and regulatory differences. Some States may differentiate themselves by taxing less and spending less, or taxing more or spending more, while others may choose to emphasise education over health spending, or vice versa. While the option of migration opens up the possibility of horizontal competition between Australian States and other nations as well as among the States themselves, federal systems make this form of competition stronger, since it is normally much easier to move within a nation than between nations.

**Vertical competition** arises where either the Federal or State Governments enter a specific area of responsibility (spending or taxing) in direct competition with the other level of government. Such ‘vertical’ competition is unique to federations. Federations provide their governments and citizens with an important opportunity for comparing performance and learning from what other jurisdictions are doing and how they are doing it.

## 1.5 WHAT CONSTITUTES AN IDEALLY-FUNCTIONING FEDERAL SYSTEM?

How should a federal system operate if its potential benefits are to be maximised while the potential costs are minimised?

Or, in other words, **who should do what?**

- ☐ Should it be the Federal or State Governments in charge of particular responsibilities (and the spending programs that go with them)?
- ☐ Who should raise what taxes?
- ☐ And should States only spend as much as they raise through taxes – or should there be subsidies from one level of Government to another?

These questions go to the heart of the issue of what is an ideal Federal structure.

The longstanding consensus among economists is that it makes sense for the States to have a range of responsibilities to allow them to tailor their policies to their voters (rather than a 'one size fits all' rule from Canberra), but that it also makes sense for most taxes to be raised at the federal level.

In turn, that then means deciding whether:

- ☐ to let the States spend more than they tax, relying on federal subsidies to make up the gap (risking overlap, duplication, finger-pointing and the like), or
- ☐ to restrict State spending responsibilities to the level of tax they raise.

Again, in turn, that leads to the next question – if the latter, or if there are moves to reduce the amount of transfers from the Australian Government to the States, should that shift occur by taking spending responsibilities away from the States, or by giving the States greater taxing powers?

That is a vital issue. In times past, economists and politicians mostly thought it made sense to give the States more taxing powers – for example, Malcolm Fraser mused about doing so.

But the pendulum is swinging, because the economy is changing. In particular, globalisation is resulting in a relative increase in transactions across borders – there is greater mobility among people, business operations, the sourcing of business inputs, and capital.

That means there is a steadily improving case for taxes to be raised at the Federal level – and hence there is a steadily building case for taking spending responsibilities away from the States. The debate on the latter revs up from time to time. For example, ex-NSW Premier Bob Carr has called for a reduction in the overlap of responsibilities via a swap of functions.

### WHO SHOULD BE RESPONSIBLE FOR WHICH 'SPENDING PROGRAMS'?

#### The 'subsidiarity principle' – and the caveats to it

Economists see advantages in responsibility for a particular function resting, where practicable, with the *lowest* level of government that can do it well. This rests on three main considerations:

1. State Governments are more likely to understand the needs of their voters – the argument is that decisions specifically affecting far north Queensland are better made in Brisbane than in Canberra.
2. In turn, voters in far north Queensland can have their voices heard more readily in Brisbane than in Canberra, and can more readily lobby to have policies aimed at their particular needs and concerns.
3. And if their voices are not heard, then – if the problem they have is with a decision or policy made in Brisbane, they can always move to another State (“vote with their feet”). In contrast, if the problem they have is with a decision or policy made in Canberra, they have to move to another nation to avoid it.

In contrast, economists prefer the Federal Government to have charge where:

1. The implications of policies ‘spill over’ State borders (for example, policies affecting the likes of business operations, or long distance trucking, or water flows).
2. There are big economies of scale and scope with centralising policies (for example, macroeconomic policymaking, defence and foreign affairs).
3. Having State-by-State differences in rules and regulations is a burden on those who regularly trade across State boundaries (for example, in regulating banks and companies).
4. There are big differences in capacity across States – for example, if only one State has huge oil deposits, it makes sense for resource taxes to lie with the Federal Government rather than with individual State Governments.
5. Where capital and people can readily move to avoid State-level policies that affect them. For example, and as history has shown, you can’t have only some States levying death duties, as retirees will move. Similarly, you couldn’t try to levy taxes on personal or company income or capital gains at the State level, or have notably different welfare entitlements by State, as those policy differences would be undermined over time by people moving. **Hence the ideal federal system would promote national markets for people and for business inputs.**

The above discussion does indeed suggest some spending responsibilities are better in the hands of State Governments than the Federal Government. But what proportion of the total might that be? There is no clear cut answer to that in the international practice, although the spending share of Australia’s States ranks highly in the international league ladder:

*There is no consistent pattern in the size of State governments – they range from less than a fifth of total government expenditures (Austria 17 per cent) to almost half (Canada 45 per cent), with Australian, German and Swiss State governments approximately 40 per cent, 22 per cent and 33 per cent, respectively. (Warren, 2006, at p 54)*

Partly Australia’s States rank highly on this measure because the degree of shared responsibilities is high here. In turn, that leads to another key question – if even the ideal federal structure has shared responsibilities, then how should then be managed?

Overlap, duplication and inconsistency in ‘shared’ responsibilities can arise vertically (between the Federal Government and State Governments) or horizontally (across State Governments).

- ❑ **‘Sharing’ works best** where there is a clear delineation of the respective roles of the different levels of government in a manner which enhances accountability and minimises duplication and overlap, and where there are clear and appropriate coordination mechanisms in place. Coordination needs to establish clear policy strategies and set priorities, assign responsibility for implementation, resolve funding issues, and ensure effective performance monitoring is in place – the BCA’s proposed Federal Commission would address these issues. These arrangements should include mutual recognition regimes, the harmonisation of regulation, the adoption of national standards, better governance arrangements to promote effective coordination in areas of shared responsibility, and the use of integrated inter-jurisdictional frameworks to develop and oversee the implementation of various reform measures.
- ❑ **But ‘sharing’ works worst** where the demand for particular programs is closely related, such as where State Governments fund the emergency departments of hospitals, while the Australian Government subsidise the medical centre next door to the hospital emergency department.
- ❑ However, for many areas of shared responsibility, it may be neither practical nor appropriate to cede responsibility entirely to one level of government. Furthermore, shared functions aren’t always inefficient. In some cases, overlapping responsibilities – and the resultant political competition – could drive better outcomes for voters (Walsh (2006)). That is, sharing leads to additional costs and inefficiencies, but the competition resulting from the sharing of responsibilities has the potential to result in offsetting cost savings.

## TAX ASSIGNMENT

Ideally, each level of government should finance its assigned functions with funds that it raises itself (the principle of **‘fiscal equivalence’**).

However, there is a tension here with broader economic efficiency considerations which require:

- ❑ The Federal Government to levy taxes on highly-mobile tax bases (to help avoid businesses and families moving between States due to tax considerations).
- ❑ The Federal Government to levy taxes on tax bases which are very uneven across States so as to ensure fairness.
- ❑ The Federal Government to levy taxes on tax bases with cross-border externalities (such as pollution or greenhouse taxes or user charges for water rights).
- ❑ In contrast, State Governments should levy taxes on immobile tax bases.

Moreover, there are potentially significant economies of scale available in centralising tax collection. These arise not only from economies in tax administration, but also because, for example, the potential evasion and avoidance associated with mobility of tax bases when taxes are imposed and administered at lower levels of government is reduced. That suggests State Governments should delegate tax collection on their behalf to the Federal Government.

In addition, when tax collection is centralised, there is also a tendency for State Governments to harmonise the requirements they place on businesses and families – that is, they agree to common definitions, common collection dates, and common reporting requirements. These all have the benefit of reducing the cost of compliance.

In brief then, State Governments should have access to all tax bases that are not mobile or unevenly distributed or for which there are significant economies of scale available in centralising tax collection, to the extent warranted by their own spending responsibilities.

## INTERGOVERNMENTAL TRANSFERS

The above discussion is a reminder that the longstanding consensus among economists is that:

- ❑ it makes sense for the States to have those responsibilities which allow them to tailor their policies to their voters (rather than a 'one size fits all' rule from Canberra), but that
- ❑ it also makes sense for most taxes to be raised at the Federal level.

In turn, that then means deciding whether (1) to let the States spend more than they tax, relying on Federal subsidies to make up the gap (risking overlap, duplication, finger-pointing and the like), or (2) to restrict State spending responsibilities to the level of tax they raise.

**Vertical fiscal imbalance (VFI)** arises where the first of these choices is made – where the revenue-raising powers of one level of government (usually the States) are insufficient to meet their spending responsibilities and, for the other level (usually the Federal Government), it is excessive, thus requiring a system of intergovernmental transfers or grants:

- ❑ If tax collections are centralised, then VFI exists by mutual agreement: the tax collecting government will raise more revenue than it spends on its own purposes and vice versa for the recipient governments.
- ❑ Moreover, the resultant revenue transfers ('grants') may be – again by mutual agreement – a mix of untied (unconditional) revenue sharing grants and tied (conditional, or specific purpose) grants.

Where vertical transfers are decided upon, State Governments as the recipients should face a **hard budget constraint** – that is, the grants should be fixed in dollar terms. Otherwise, the incentives could well be for them to spend too much, and overall fiscal discipline may be lost:

- ❑ State Governments should not be able to rely on transfers from the Federal Government to bail them out of fiscal difficulties; and
- ❑ at the margin, they should be required to fund their own spending fully through State taxes or by borrowings whose debt servicing they have to ensure themselves.

Ensuring State Governments face a hard budget constraint does not preclude the Federal Government from providing financial support for activities carried out by other levels of government.

For programs entirely the responsibility of State Governments, funding should be in the form of general purpose grants, allowing discretion to allocate spending across different programs. Likewise, **unconditional or 'block' grants** are typically the appropriate vehicle for the purposes of fiscal equalisation – that is, if there is a perceived need to 'equalise' across States (rather than across individuals), then these can be used to channel funds from relatively wealthy jurisdictions to poorer ones.

For programs where there is joint responsibility between levels of government, funding should go to pools that extend to all related programs, rather than being earmarked to specific programs. Again, this allows some discretion as to the allocation within funding pools.

Finally, there is the question of **specific purpose payments (SPPs)**. Where such funding is considered necessary, the Federal Government should focus on specifying policy objectives and establishing effective accountability frameworks, and give the State Governments greater freedom in designing program delivery.

Where local services generate benefits for residents of other jurisdictions, **conditional, or ‘matching’, grants** are best employed to fund the provision of services. It is important that these be structured with clear limits in order that they not turn into entitlements that undermine the hard budget constraint.

Where State Governments seek SPPs from the Federal Government by offering political benefits to the higher level government, there must be:

- ❑ a high level of visibility for the Federal Government’s contributions,
- ❑ a verifiably high level of demand for the goods and services among voters, and
- ❑ a verifiable set of implicit or explicit performance ‘benchmarks’ to be met to ensure that adequate political benefits flow to the grant-giving government.

On this reasoning, opportunities for tied grants are, in effect, as much supplied by lower level government as demanded by upper levels, and the conditions negotiated rather than imposed.

## 1.6 THE TYPES OF COSTS AND INEFFICIENCIES IN A POORLY-FUNCTIONING FEDERAL SYSTEM

Not surprisingly, Australia’s federal system operates in ways which fall short of the ideal described above. Indeed, all federal systems fall short of that ideal.

### Relative to other federations

Australia’s federal system has more shared responsibilities, not to mention ‘fuzzily shared’ responsibilities – and therefore more overlap and duplication, and hence a greater need to cooperate.

The gap between spending by Australia’s States and the revenues raised by them is high – thereby requiring large grants from the Federal Government to finance the States. The Federal Government finances about half the spending of the States. In turn, these large grants encourage the Australian Government to be overly prescriptive in how they want them to be spent. In combination with the overlap and duplication noted above, that then leads to blaming each other for any problems.

Those features tend to lie behind the shortfalls between the ‘ideal’ federal system and that Australia currently operates.

## EXPENDITURE-RELATED

The complex relationship between the Federal Government and the State Governments arises from constitutional arrangements which result in an unclear division of the respective roles and responsibilities of the two levels of government.

Moreover, the responsibilities of each level of government are continually changing – adding to the complexity.

### **Inefficient expenditure allocation**

Part of the reason why Australia's federation falls well short of the ideal is that our States have primary responsibility for some functions they shouldn't have – in particular, ones involving cross-border spillovers, such as the setting of regulations for mining, or food standards, as well as setting rules and regulations for transport, industrial relations, occupational health and safety.

That means they face the wrong incentives when they make decisions: they think of themselves, when they should be thinking of Australia as a whole. And their decisions typically result in diversity and fragmentation in rules and regulations, thereby leading to unnecessarily high transaction costs for businesses and families.

### **Cost (or risk) shifting**

Another type of inefficiency in this area is cost (or risk) shifting in its perverse forms.

Where State and Federal programs are close substitutes in terms of demand (and particularly where the States and the Federal Government share responsibilities), cost shifting is encouraged – for example, GPs are Federal-subsidised, while hospitals are State-funded, so the States encourage use of GPs, and the Australian Government encourage use of hospitals.

The end result is that programs aren't designed to provide the best services at the least cost. Rather, they are designed by the States to provide the best services at the least cost to the States, and by the Federal Government to provide the best services at the least cost to the Federal Government.

### **Inadequate governance/coordination arrangements**

Australia's federal model has many shared functions. These give rise to inefficiencies where:

- ☐ It allows governments to blame each other when things go wrong; or
- ☐ There is ineffective management of different parts of the overall service package; or
- ☐ Existing cooperative arrangements (such as committees involving all the States) fail to act to achieve reform because all of the States have individual veto power.

### **Excess intervention/coercion in the provision of State services**

Because the Federal Government pays such large grants to the States, it naturally wants to have a say in how that money is spent.

Hence it uses its 'grants power' to provide specific purpose (tied) payments to the States.

These 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.**

After all, one of the main justifications for having States in the first place is that different States can do things in different ways. However, 'tied' grants reduce such room to differentiate –

thereby leaving Australians paying the additional costs involved in running a federal system without getting many benefits from it.

## TAX-RELATED

Australia's federal model has a relatively high degree of vertical fiscal imbalance, with the taxation powers available to State Governments insufficient to meet their spending responsibilities even after other own-source revenue-raising is taken into account.

Indeed, about half of State spending is financed by Federal grants.

### Inefficient tax assignment

The Federal Government should be the one raising taxes on those tax bases which are mobile (can readily jump jurisdictions), or on those tax bases which are unevenly distributed (if one State sees a huge mineral find, should only its citizens benefit from the taxes on it, or should all Australians share?).

All tax bases are mobile to some extent, but the foregoing is why, for example, it makes sense for the States to levy land taxes.

*Property taxes have key advantages as [State] taxes. Most notably, the base is highly immobile, the tax is difficult to evade and efforts to improve local infrastructure are likely to be reflected in property values, thus increasing the yield for [State] governments. (Warren, 2006, p 61)*

It also makes sense for the States to levy payroll taxes – in part because, in practice, differences in payroll tax rates across the States are sufficiently small that they are unlikely to lead to businesses and workers moving States. However, whereas it makes sense for the States to be collecting these taxes, their competition should be in terms of tax rates (having a low rate of payroll tax) rather than tax bases (granting a particular company a payroll tax holiday if it sets up business in the State).

*... while a broad based payroll tax and land tax are theoretically efficient, in practice their economic efficiency is reduced by their selective application which narrows the potential tax base considerably, although harmonisation of payroll bases could address some of these inefficiencies. (Warren, 2006, p 62)*

However, it is less clear that the other taxes raised (and user charges levied) by the States should lie with them.

### 'Destructive' tax competition

The most undesirable form of horizontal competition is where State Governments 'bid' for major projects because of the perceived gain to them in terms of increased income and jobs.

That is because competition between the States sometimes makes them worse off – not better off. Examples include interstate bidding wars for major projects or events (*which State capital will be the HQ for Virgin Blue? Which will host the Grand Prix?*), and some forms of tax competition (*especially those where States compete on the tax base rather than the tax rate – that is, competition over who pays tax rather than on how much they pay*).

State Governments compete for major projects because they want the jobs that go with them. But such rivalry at best shuffles jobs between States, and at worst will make all States worse



off (because investments should be decided on the underlying economic strengths of a State rather than specific sweetheart deals).

Indeed, all the States and their Governments recognise just how pointless this posturing is, but it is hard for them not to join in – often the voters (and hence newspaper reports) assume that sweetheart deals can still benefit their State.

That is why cooperation to avoid destructive competition is so vital. All the Governments (except Queensland and the Federal Government) have signed an agreement to restrict the use of sweetheart deals.

That is great. But while one State stays out, the risks remain high.

### **Gaming of grants**

The Federal Government redirects revenue to the State Governments, with these grants accounting for about half their spending. The redirection of this revenue and the process of horizontal fiscal equalisation and specific purpose payments add another layer of interaction between Australia's governments. The associated processes also influence the behaviour of the participants.

The main form of inefficiency that arises in this area is that arising from the absence of a hard budget constraint. If governments getting grants can 'game' their funding levels, they effectively soften any budget constraint they face. For example, fiscal equalisation transfers can be subject to gaming depending upon the methodology adopted.

#### *Equalisation grants impeding changes in cost differentials and flows of resources*

More generally, depending upon the methodology employed, grants can cause inefficiencies to the extent that they impede changes in cost differentials and the flows of resources that regional adjustment requires.

#### *Inadequate accountability for SPP programs*

Inefficiencies can also arise because of inadequate accountability by the States to the (revenue-collecting) Federal Government. This arises mainly because of inadequate provision of information to the national authorities and poor financial reporting systems.

## 2. CASE STUDIES IN FLAWED FEDERALISM

### The task ahead is large

*“Competitive federalism may be contrasted with cooperative federalism. Looking back over the whole period since federation, one would have to conclude that cooperative federalism is much the weaker of the two.” (Ken Henry, Secretary of the Federal Treasury, 2006, at p 342)*

*“Educational qualifications do not translate across state borders; universities, though funded by the commonwealth, are regulated by half a dozen different bureaucracies; and Australia’s rail system is staggering under the weight of 22 different communication systems used on trains and seven different safety regulators. In any area where [there are] two levels of government, bureaucracy breeds. There are 15 occupational health and safety acts and 75 sets of environmental legislation. In the financial sphere, writing a simple mortgage requires reference to no less than 10 separate pieces of commonwealth legislation and regulation, as well as seven fair trading sets.” (Editorial, The Australian, 8 July 2006)*

*“We [need] a serious debate about ... the possibility of the States transferring their legislative responsibilities for universities holus-bolus to the Commonwealth, or about a hospital system or disability services being better managed by just a single level of government without all the perverse incentives for cost-shifting and finger-pointing that exist today.” (Carr, 2004, p. 6)*

This chapter considers a number of specific examples where we are currently falling short of best practice. It does so by looking at these examples under the different headings noted in the previous section – that is, it classifies the shortfalls in practice by ‘type’.

In brief, we identify shortfalls:

- ❑ In the allocation of spending responsibilities (such as who should address global warming, or regulate interstate road and rail, electricity and water, the mining sector, or school starting age).
- ❑ Cost shifting:
  - Between State and Federal Governments (such as in the health field).
  - And across States (for example, the ACT has an incentive to release land for sale within its borders, even if it makes more sense for people to live in nearby areas in NSW).
- ❑ Coordination failures:
  - Between State and Federal Governments (such as in regulating user charges for heavy trucks).
  - And across States (such as recognising each others’ trade qualifications – allowing electricians and hairdressers to work in all States, not just one; or agreeing to regulate common food standards across jurisdictions).
- ❑ Federal micro-management of State responsibilities (in the likes of the Home and Community Care (HACC) program, or for TAFEs).

- ❑ In the allocation of taxing powers.
- ❑ Destructive tax competition (such as the 'race for the bottom' seen in death duties).
- ❑ The gaming of grants:
  - Between State and Federal Governments (such as in Supported Accommodation Assistance Program (SAAP) grants).
  - And across States (such as gaming the Grants Commission).

## 2.1 IN THE ALLOCATION OF POLICY RESPONSIBILITIES

### Global problems – local fumbling?

It is a mistake to put the States in charge of responsibilities whose outcomes 'spill over' into other States or whose outcomes need to be considered in a global context.

A classic example is global warming. That is obviously a global problem, yet the States are trying to impose a variety of inconsistent (and mostly inefficient) local approaches that have no capacity to solve that which requires a global response.

And often they are imposing these inconsistent local regulatory burdens on firms who operate in jurisdictions all around Australia (let alone around the world).

For example, the Victorian Government is committed to 10% of Victoria's electricity being provided by a range of renewable energy sources by 2010. Within that, there is also a commitment to the development of up to 1,000 MW of wind energy.

But what if other States don't follow that lead, meaning that it becomes relatively cheaper to do business there than in Victoria? Modelling by Access Economics suggests that Victoria would be \$88 million worse off by 'going it alone' rather than the same policy applying nationally (or if even better policies – using prices rather than targets – were applied nationally).

Or, in other words, inconsistencies – a lack of harmony – in State policies have costs. And those costs are all the greater when local policies are trying to address global problems.

### Railroaded

Similarly, rail freight traffic crosses borders – and so should logically be regulated at the national rather than the State level. But it isn't, and that has led to problems. Indeed, for many years the inconsistency of the rail gauges adopted by the different State rail systems was perhaps the best known example of Australia's dysfunctional federation. And problems still remain. As Treasury Secretary Ken Henry has noted (2006, at p 342):

*We do not have national markets in land transport — neither road nor rail. Instead, an operator of an interstate train in Australia may have to deal with six access regulators, seven rail safety regulators with nine different pieces of legislation, three transport accident investigators, 15 pieces of legislation covering occupational health and safety of rail operations, and 75 pieces of legislation with powers over environmental management.*

*Australia has seven rail safety regulators for a population of around 20 million people. In contrast, the United States, with a population of 285 million people, has one rail safety regulator.*

*A particularly farcical example of rail services fragmentation is in train communications. Currently, each State and Territory requires trains within its jurisdiction to have a particular type of radio — for good measure, NSW mandates two — meaning that a train cannot operate nationally without eight different radio systems. And even with a cabin full of eight radios, trains cannot ‘talk’ to each other.*

## Utilitarian

Power and water also span State borders – but lie in State control.

So Australia’s policy failures here (and the resultant loss in living standards for ordinary Australians) are all the more frustrating:

*We do not have a national electricity market, even though we launched something with that name in 1998. Instead, there is still a regional approach to many key regulatory and network planning decisions. In saying this, I do not want to understate the importance of reforms to date. But I do want to highlight the problem of disparate state-based regulation of energy distribution networks, retail businesses and retail pricing. State retail price regulations, in particular, distort price signals to both consumers and investors.*

*We do not have a national water market. In fact, we do not even have functioning State water markets. Instead, the majority of trade in water occurs within catchments and even then in insignificant volumes. For example, trade in permanent entitlements in the southern Murray Darling Basin involves, on average, only 1-2 per cent of total allocations, and water still cannot be traded interstate beyond a limited pilot area. Moreover, water is rarely traded between competing uses, being more likely to be traded between producers of similar commodities.*

*The National Water Initiative (NWI), agreed by CoAG in June 2004, sets out to establish a property rights framework for water and to create a national water market. The obstacles are considerable. For example, States have different water entitlement regimes, which create a practical barrier to the development of a national market. These barriers have proved difficult to overcome. But unless and until they are, NWI benchmarks will not be met. (Ken Henry, 2006, at page 339).*

## Will State regulations let Australian miners ride the China rocket – or not?

State regulation is getting in the way of national prosperity in mining too.

Half the world’s population is undergoing an Industrial Revolution. Not only is that pushing up living standards fast everywhere from China to Vietnam, but it also plays perfectly into Australia’s hands – we have long been the world’s best supplier of industrial inputs to developing Asia.

Yet Australia has failed to surf the strongest global growth in a generation, despite it occurring in our backyard, and among nations hungry for the commodities we produce.

And there are growing risks – Australia accounted for 22% of global mineral exploration in the 1990s, but fell below 15% in 2004-05, with indications that we’ll continue to fall.

In part that is because our federal system makes digging holes rather more complex than it need be.

- ❑ In Australia, State and local governments allocate mineral resources and ensure a return to the public from their utilisation.
- ❑ But land access for crown land and private land, heritage issues, uranium exploration, mining and export licensing, competition policy, taxes and foreign investment approvals are regulated by *both* the Commonwealth and the States.
- ❑ This sharing of powers creates confusion, duplication and waste if the requirements set by one Government are different from those set by another – as they all-too-often are.

Not surprisingly, the Minerals Council of Australia has argued for a ‘whole of government’ regulatory approach, with seamless cooperation between Federal and State Government agencies to simplify and streamline the regulatory hurdles that miners face.

### Just how different are the State-based mining regulatory regimes?

The Fraser Institute has conducted a survey of miners. The responses from the survey were used to construct ranks among jurisdictions. The Policy Potential Index is a composite index that measures the effects of, among other things, regulatory duplication and inconsistencies.

On this measure, the Australian States and Territories ranked between 11<sup>th</sup> and 29<sup>th</sup> of the 64 jurisdictions surveyed.

When asked the impact of regulatory duplication and inconsistencies on their investment, those ranging from *mildly deterred* to *decided not to pursue investment* accounted for 51% of respondents for Victoria, 43% for the NSW, 41% for Queensland, 34% for WA, 32% for South Australia and 10% for Tasmania.

### Whose fingers in which pies?

	Commonwealth	State/Territory	Local
Allocating mineral resources and ensuring a return to the public from their utilisation		X	X
Land access for crown land & private land	X	X	
Environmental protection		X	
Planning approval		X	X
Heritage issues	X	X	
Regional economic and social issues	X	X	X
Water access		X	
Occupational health and safety		X	
Uranium – exploration and/or mining	X for NT	X	
Uranium export	X		
Competition policy	X	X	
Taxation arrangements	X	X	
Foreign investment approvals	X	X	

Source: Minerals Council of Australia, *Taskforce on reducing the regulatory burden on business*

## **Education – the failure to have a common school starting age**

From a different angle, the States also set differential rules and regulations on early childhood education in a manner which discourages parents from switching States, and which artificially holds back the size of the Australian workforce.

Australians had a great ride on the sheep's back, and today we ride the prosperity of our mineral deposits. However, for future Australians to have high incomes, we will need to be highly skilled. That is why much of the research published by the Federal Treasury is focussing on the need for Australians to be better educated so as to raise both productivity and participation – the two key building blocks to a prosperous future.

So, how well are we doing? Because if the States trip over each other in providing Australians with the formal skills they need, then our future will fall short of its potential.

Sadly, the States do trip over each other, beginning right from when kids start school. And those problems keep going all the way through apprenticeships and university.

Take school starting age as an example. We all know just how dumb it was for the States to adopt different rail gauges – yet that is exactly what we do with starting school too.

Across the eight States and Territories there are five different minimum starting ages. NSW has the youngest, allowing kids to start school at 4 years and five months. In WA and Queensland it is four years and six months, Victoria and the ACT four years and eight months, and in Tasmania it is five years. South Australia has its own unique system of rolling enrolments.

Why is that a problem? Because the resultant patchwork is a major hurdle for kids and their parents, creating confusion and contributing to discontinuity in schooling and potential impacts on rates of school completion.

Kids who move from one State to another not only have to find new playmates and handle new teachers, they also have the added problem of a new education system. Some kids risk boredom by being re-taught material they already know. Others struggle as they attempt to catch up with material that they have not learnt.

This hurts the schooling prospects of the 80,000 or so students who shift States each year. Many families of these 80,000 kids don't have much choice about moving as one or both parents are in the military. And many other students don't cross borders as their families decide the costs are too high. Indeed, parents may decide against a highly paid job on the other side of Australia because of the education hurdles for their kids.

This has clear economic costs. In the short term all Australians are better off if fewer hurdles are put in the way of people moving to the best job opportunities. And, in the longer term, lower rates of school completion for the kids who do move ultimately mean lower wage earnings and lower productivity, while lower school completion rates also mean lower labour force participation as less educated workers retire younger.

In addition, a uniform minimum school starting age would provide a platform for building greater national consistency in Australian schooling, including the content of curricula and student assessment. There is the potential for standardised test data to be more validly compared between jurisdictions because, under grade-based testing, kids in all jurisdictions would have had the same length of exposure to formal schooling at the time of testing.

- ❑ The good news is that this is one area where the States have already recognised the costs to us all of a patchwork quilt of inconsistent starting ages.
- ❑ The bad news is that, in July, the nation's education ministers announced that they have put off making any decision to reform State-based policies on school starting ages.

## 2.2 COST SHIFTING

### BETWEEN STATE AND FEDERAL GOVERNMENTS

Where State and Federal Governments are in charge of different but related programs, there is an incentive for costs to be pushed onto the other government.

#### Health systems

Cost shifting is preventing Australia's health system from operating efficiently.

*The two major levels of government share the responsibility to ensure health expenditure is adequate, equitable and cost effective. The complex split in responsibilities for funding and provision of health care leads to poor coordination of planning and service delivery, barriers to efficient substitution of alternative types and sources of care, and scope for cost shifting. The funding arrangements do not encourage continuity of care, provision of multidisciplinary care, or provision of care in the most clinically appropriate setting. There is a lack of focus on prevention, health promotion and disease management. (Fitzgerald, 2006, at p 117)*

Three clear examples of cost-shifting include:

- ❑ public hospitals (funded by States) referring patients to GPs (funded by the Australian Government) for post-hospital care instead of providing those services at the hospital,
- ❑ conversely, an under-resourcing of GPs forcing people to attend hospital emergency departments when they fall ill, and
- ❑ shortages in the availability of Federal-funded aged care beds resulting in public hospital places being occupied by the aged.

#### Problems with cost shifting and overlaps in the health system

- **Cost shifting:** For example, (State-funded) public hospitals refer patients being discharged to their (Federal-subsidised) GP. But if patients can't get into see GPs, they go to (State-funded) public hospital emergency departments. In turn, the (State-funded) departments sometimes recommend less urgent cases go to the (Federal-subsidised) clinic instead. That is why (Federal-subsidised) medical clinics are setting up close to many such (State-funded) emergency departments, with advertisements for the clinics plastered over the walls of the emergency department (as, for example, occurs in Canberra hospital). Meantime, shortages of (Federal-funded) aged care places leaving some frail aged in (State-funded) hospital beds.
- **Overlapping functions:** The care needed for a sick person is not the sole responsibility of one level of government – funding and delivery arrangements are split between the Australian Government and the States. That creates

artificial barriers to continuity of care and good planning, including the complex interface between the (State-funded) public hospital system and Australia's (Federal-funded) residential aged care sector.

## ACROSS STATES

### Cross-border cost shifting between NSW and the ACT

Access Economics has studied the economic and fiscal impacts of cross-border housing developments between the ACT and surrounding areas of New South Wales.

As a general principle, Australians will be better off if the existence of the ACT/NSW border does not artificially distort the location of land development. This implies that the ACT Government should not have a budgetary incentive to favour residential development in the ACT over that in adjacent NSW. This in turn means that inter-governmental financial arrangements (including those administered by the Commonwealth Grants Commission) should be locationally neutral.

Access Economics found that there are considerable financial advantages to the ACT Government from promoting residential development within the ACT's borders, rather than across the border in NSW. A large proportion of the advantage reflects the way that such developments would affect the Grants Commission's assessments of the ACT's fiscal needs.

We estimate that, for every 1,000 households, there is a \$4 million (or \$1,429 per capita) ongoing differential in favour of residential developments in the ACT ('in-border development') over comparable areas in adjacent NSW ('cross-border development').

There are three factors specific to the ACT, and within the Grants Commission's control, that more than account for the total differential.

- ❑ First, the ACT only recovers about 75% of additional hospital costs under the current externally arbitrated agreement with NSW. The Grants Commission's methodology makes no allowance for this.
- ❑ Second, the Grants Commission assesses the proportion of government services that NSW residents access from the ACT by applying 'population use weights' to adjacent NSW local government areas. Our analysis suggests that these 'population use weights' are too low, at least for a development in Queanbeyan.
- ❑ Third, revenues from ACT land sales reduce the ACT Government's net debt, and hence its ongoing net interest expense. Although access to land sales revenue is a continuing source of advantage to the ACT relative to other jurisdictions, the Grants Commission takes no account of that in its assessments.

## 2.3 COORDINATION FAILURES

Is competitive federalism working? When it doesn't work, that impedes the flow of resources by thwarting necessary cost differentials – in turn resulting in a loss of living standards for ordinary Australians.

*Competitive federalism asserts that there is a national interest in fostering [State-level] decision making in respect of things that are of national importance. The proposition is that while competition among [State] governments will initially produce a number of different policy models, that same competition will eventually*



*produce convergence on a model better than what any national government would likely be able to design and/or implement.*

*So, is competitive federalism the reason why nationally operated trains have to be equipped with eight different radios? Does competitive federalism explain why we have such a plethora of inconsistent state-based regulatory requirements for occupational licensing, occupational health and safety, road transport, water trading, and so on? Possibly. But there is a more likely explanation: a stubborn parochial interest in putting the welfare of the State or Territory ahead of that of the nation.*

*Parochialism is understandable. But a proper accounting of its national economic consequences would be weighted heavily in the negative. (Ken Henry, 2006, at p 342)*

## **BETWEEN STATE AND FEDERAL GOVERNMENTS**

### **Eight small economies: One economy – or eight?**

Here's a simple question: why do Americans have a higher standard of living than us?

It's not because they work more hours than we do.

Rather, US workers work more effectively – they have higher productivity.

And why is that? The evidence is that Australians are held back by our small markets and, in particular, by our 'remoteness' from world markets.

Our 'remoteness' – which may account for 40% of the productivity gap between Australian and US workers – limits our ability to trade.

As Federal Treasury Secretary, Ken Henry, has noted, "There is not much we can do about remoteness". But, as he went on to note, one obvious thing we can do is help to ensure that we don't make the problem of our remoteness any worse than it needs to be.

Indeed, Sawyer (2002) notes that a key reason behind the drafting of section 92 of Australia's constitution was the desire to develop a single free trade area within Australia – so that all Australians could concentrate on doing what they do best, and trading the resultant surpluses with each other.

Or, in other words, a goal of federation was to create one national economy from the disparate State economies.

However, more than a century after federation, our States and Territories (and often the Federal Government too) set rules and regulations which worsen our remoteness by treating the Australian economy as eight small economies – and thereby limiting the 'trade' which occurs across State borders in products and people.

And that problem is getting worse (that is, it penalises the living standards of ordinary Australians more) the more globalised the world economy becomes.

## Roadkill

The National Transport Commission (NTC) sets road user charges, but the NTC requires the agreement of a two-thirds majority of the Federal and State Transport Ministers.

This in itself is an impediment to efficiency as the body is more of a facilitator than a regulator.

For example, Ministers agreed to impose uniform heavy vehicle mass limits, but not all States have implemented the change. So, a vehicle with the maximum allowable mass travelling in Victoria is prohibited from travelling into NSW with the same load.

Similarly, after the careful crafting of a series of compromises, the State and Federal Governments had finally agreed on reforms of road transport, including increases in road user charges for heavy trucks – a much needed reform. However, the Australian Government junked that at the last moment in the 2006-07 Budget.

Nor is road planning well coordinated. The AusLink program goes some way towards integrating the planning and funding process for road and rail transport. However, particularly in roads investment, the joint funding provided by Commonwealth and State Governments leads to inefficiencies – the Commonwealth Government funds known State projects, but does so with hefty conditions attached.

For example, the Commonwealth used a promise of funding to force the Victorian Government's hand on tolls with the Eastlink freeway.

## ACROSS STATES

### Excessive equalisation in Grants Commission methodology

All the evidence is that the 'machinery' of our federation is rusty. For example, the current system for distributing GST grants among the States attempts to 'equalise' the fiscal capacities of the States. However, the primary test of whether arrangements are fair is whether they are progressive in redistributing income 'vertically' – that is, from high-income to low-income households. A detailed analysis commissioned by the Fitzgerald-Garnaut Review (2002) showed that the Grants Commission methods did not improve vertical equity and may actually worsen it slightly – mainly by transferring income from Australians in larger States to people with higher incomes in the smaller States (and Territories).

Equalising transfers also tend to shift resources to lower productivity locations. The Fitzgerald-Garnaut Review found that equalisation has put more resources into the two lowest productivity States, discouraging the flow of population to more productive regions. So these aims of federation are not being met and, more generally, flows from equalisation are not correlated with higher productivity.

Funding disability factors reduces the incentive for State Governments to reduce these disabilities. To maintain their share of GST revenue, States need to demonstrate the continuing relevance of these disabilities to the Grants Commission. The Grants Commission process effectively reduces the benefits States would receive from overcoming disabilities, because their grant share is reduced. This applies to cost factors such as scale, dispersion and congestion, and demand factors such as population age structure and socio-economic status.

The problem is more severe because disability factors are generally driven by States with the relevant disabilities – for example, scale assessments are based on the costs of the small States, and congestion costs are based on the costs of the large States. Likewise, indigenous service demands are driven disproportionately by the experience of States with large indigenous communities, and ageing demands are driven by the experience of States with older populations. This makes the Grants Commission a ‘race to the bottom’ – and a race away from much-needed reform.

The emphasis on disabilities in costs of delivering services in assessing a State’s share in the GST revenues, and the need for a State to demonstrate continuously that its costs are higher than those of other States, can be expected to reduce emphasis on cost reducing reform. These tendencies may be strengthened by the Grants Commission’s consistent use of delivery costs compared with State average practice – rather than costs under best practice in assessing disabilities. This conflicts with the general focus on best practice through the public sector over the past two decades of cost-reducing reform in Australia.

### **Retail regulation**

And there are many examples of differences in State regulations posing unnecessary problems for businesses who operate nationally. For example, legislation which determines the hours and days that retailers can operate differs across the States.

This causes particular tension at Christmas and New Year as national retailers need to alter their trading times and days according to each State’s law.

Additionally, State Governments can and do change these trading rules each year, resulting in discontinuity and disrupted leave for employees.

### **Trade qualifications**

It isn’t just doctors from other nations who end up driving Australian taxis.

Prime Minister John Howard says that “one of the ... federalism scandals of this country remains that qualifications in the trades area gained in some States don’t have full recognition in others.” (Australian Financial Review, 7 July 2006, p 5)

The States often stop the right person being in the right job – or, at least, make them go through duplicated regulatory hoops to do in one State something they have already qualified to practice in another State.

This is a big problem. Each State and Territory grants licences to practice in lots of occupations – everything from who can be a builder, plumber or electrician, to electrical mechanics, fitters and engineers, installing maintaining and servicing air conditioning and refrigeration, to who can be a security guard, do crowd control, be a locksmith or a bodyguard or own or use a gun, be an aircraft engineer, let foreign exchange contracts or manage investment products;

It is important to ensure that people have the necessary skills to practice particular occupations. But it is rather less clear that the licensing practices and procedures couldn’t be much better coordinated and harmonised than they are.

A 2002 report (*Licence to Skill*, Australian National Training Authority) noted that NSW alone then had 149 occupational licences, Victoria 136, Western Australia 87, the ACT 69 and the Commonwealth itself another 47 licences. That is ridiculously unnecessary duplication.

All too often, someone licensed in one State cannot readily practise in another. That is typically a triumph of bureaucracy over common sense. And while some progress has been made in individual sectors towards overcoming the impediments to a mobile workforce arising from such State-based licensing systems, no consistent approach to resolving the problems has been devised.

### **Why it is so hard to find an electrician ...**

Even where 'mutual recognition' arrangements have been made – where States agree to recognise each others qualifications – problems can still abound.

As Treasury Secretary Ken Henry has noted (2006, at p 340): "We do not have a national labour market ... Consider, for example, the case of electricians, where 'mutual recognition' legislation is in place.

If an electrician is licensed in one jurisdiction in Australia or New Zealand, they can then apply to become licensed in another jurisdiction, after making application and paying a suitable fee to the licensing body in that jurisdiction. But there is a problem: how does one jurisdiction know what an electrician from another jurisdiction looks like? It turns out that the word 'electrician' means different things in different jurisdictions. There are different categories, and numbers of categories, across jurisdictions that act as a substantial barrier to transferability.

Or consider hairdressers. The qualification, 'Certificate III Hairdressing WRH30100', is nationally recognised. But what does that mean? Well, it does *not* mean that somebody will be considered 'qualified to work' in a jurisdiction simply because he or she has a certificate. Different jurisdictions have different pathways — generally involving different work experience requirements — to progress from the certificate to being considered 'qualified to work'. As a consequence, we do not have a national market in hairdressing services.

Electricians and hairdressers are but two examples out of hundreds."

### **Food standards regulation**

We all eat – and we all eat food grown and manufactured in more than just our home State.

Or, in other words, the regulation of food standards is an area where national rather than State benchmarks should apply.

But they don't – food standards are the province of the States.

Recognising the 'spillover' effects across State borders, the States and Territories have combined with the Federal and New Zealand Governments to cooperate on food standards via committees – the first a committee of food experts called Food Standards Australia and New Zealand (FSANZ), and the second a committee of bureaucrats and politicians called the Food Regulation Ministerial Council (the Ministerial Council).

Needless to say, cooperation is easier professed than achieved.

When an application to amend food regulations is made, FSANZ undertakes a lengthy review process – an initial assessment, a draft assessment and a final assessment with two stages of

public consultation and a public information stage. If the proposal passes each of these hurdles, it is then recommended to the Ministerial Council that the regulations be amended.

But each member of the Ministerial Council is given veto power in the first stage (so the representative from New Zealand has the same voting rights at that from the ACT). Dissent from just one member is enough to result in a further review by FSANZ. And, without majority support of the Council at the second stage, the proposal can again be returned to FSANZ for a second review.

This convoluted and overly prescriptive process can significantly delay much needed reforms to legislation from taking effect, not to mention the additional cost burden that up to five reviews of a single amendment carries.

Naturally, those opposed to reforms simply gang up on the weakest government – typically focussing their lobbying efforts on the government closest to an election.

The end result is that:

- ❑ This is an area where the Australian Government should be in charge, but the States are.
- ❑ That then requires cooperation in order to ensure good policy outcomes are achieved.
- ❑ But that cooperation is typically not forthcoming – instead, delays dominate, and Australian consumers miss out.

#### **The bones of a good idea**

A good example of the delays comes from a proposal by Arnotts and Nutrinova to allow juices, drinks, soups and savoury biscuits to be fortified with calcium – a proposal backed up by research on Australians' inadequate calcium intake.

The proposal was made in 2001. It passed each stage of FSANZ assessment and public consultation and was recommended to the Ministerial Council in 2003. The politicians on the Ministerial Council returned the proposal to the experts on FSANZ for reassessment, asking numerous questions, many of which had been addressed thoroughly in the first stages of assessment. A second recommendation went to the Ministerial Council in 2005, but the issue was again returned to FSANZ later that year. A subsequent review finally 'addressed Ministerial Council concerns' and the application was gazetted in late 2005.

It took four years for this proposal to become part of the food standards code: a delay that costs the industry dearly. And such delays are occurring more frequently – in just the last couple of years the proportion of proposals approved by FSANZ but vetoed by the Ministerial Council has gone from a tenth to a quarter.

The current system needs to be fixed.

The duplication of review responsibilities given to both FSANZ and the Ministerial Council creates inefficiencies and an additional cost burden to Australian businesses – and hence to Australian consumers.

The veto powers of each member of the Ministerial Council, without regard to the number of constituents that that minister represents, allows Australia's smallest State to stand in the way of a proposal supported by its largest State.

## 2.4 FEDERAL MICRO-MANAGEMENT OF STATE RESPONSIBILITIES

There are numerous examples of Commonwealth funding of SPPs carrying with it conditions and requirements which do little to improve service provision.

### **Commonwealth requirements attached to SPPs are often not focussed on outcomes**

The Commonwealth/State agreement on *Skilling Australia's Workforce* provides a good example of where funding – ostensibly targeted at supporting documented national goals for Vocational Education and Training – in fact provides perverse incentives and opens the way for the imposition of overly prescriptive requirements on the States (such as the courses to be offered at individual TAFEs). The agreement:

- does not provide incentives or rewards for improving quality of training,
- imposes maintenance of effort requirements in both activity and spending which are disincentives to efficiency (so it rewards the more inefficient States), and,
- imposes highly prescriptive requirements at provider level which have nothing to do with training outcomes.

### **Heavy administrative burdens attached to some SPPs diminish service delivery**

Other examples abound. For example, in the Home and Community Care (HACC) program the Commonwealth demands detailed plans and reporting across a range of service types (such as 'meals on wheels') by regions within States. (And almost the exact same problems of the Commonwealth demanding detailed plans and reporting across a range of service types occur in the Australian Health Care Agreement SPPs.)

The subsequent Commonwealth process whereby these plans are approved often takes several months and has at times resulted in notable delays in the release of funds to providers when relatively small amounts of money are queried. Equally important is that the requirement to plan and report at this detail inhibits the State's ability to innovate in service delivery.

## 2.5 IN THE ALLOCATION OF TAXING POWERS (AVOIDING DESTRUCTIVE TAX COMPETITION)

### **BETWEEN STATE AND FEDERAL GOVERNMENTS**

As the discussion below notes, the States have lost a few of the mobile tax bases they once had (such as death duties) as competition between them drove tax rates to zero.

Also as noted below, even where there are good tax bases for the States, there is often an unnecessary compliance and administration burden arising because the States use different definitions and different collection arrangements – payroll tax being a good example.

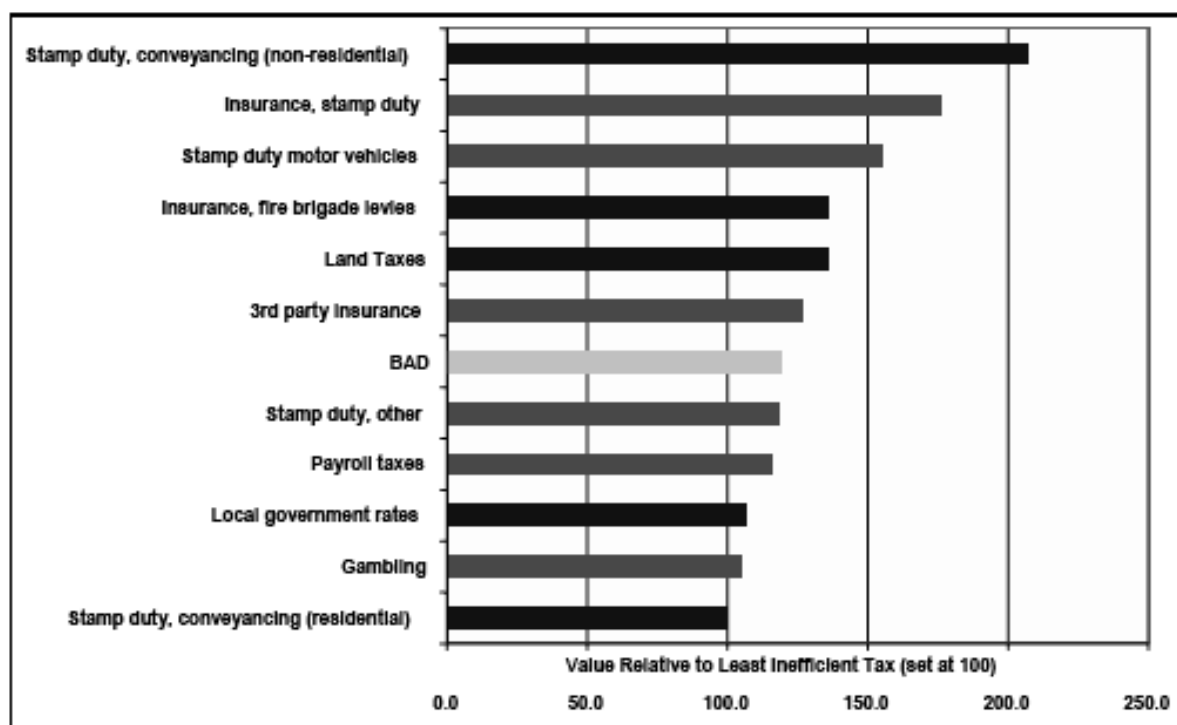
However, arguably the biggest problem of all arises because, relative to their spending responsibilities, the States have a relatively narrow tax base on which to raise revenue. That leaves them raising revenue from a bunch of very inefficient turnover-type taxes – meaning that a dollar of tax raised by a State typically hurts the economy more (results in a larger 'deadweight loss') than the matching dollar of tax raised by the Federal Government.

Among the most inefficient of these State taxes<sup>3</sup> are:

- ❑ Stamp duties on non-residential conveyancing,
- ❑ Stamp duties on various financial instruments,
- ❑ Stamp duties on insurance, and
- ❑ For NSW, Victoria and Tasmania, fire service levies.

The first two groups of taxes are on their way out, while most States have already abolished their fire services levies and moved to more efficient ways of financing fire and emergency services.

**FIGURE 2: WELFARE GAIN FROM A \$100 MILLION REDUCTION IN STATE TAXES  
(SOME LABOUR SUPPLY RESPONSIVENESS)**



To the extent that State taxes have been piled onto relatively narrow fields of activity, there are associated efficiency and welfare losses. To use an extreme example for illustrative purposes, say the States tried to raise all of their revenue from non-residential stamp duties alone – the obvious impact would be the closure of a number of small businesses, to the detriment of the Australian economy.

As general rules of thumb:

<sup>3</sup> See the analysis in Access Economics (2004), *Axing the Alcabala: A program for a 21<sup>st</sup> Century state tax system*, for the Business Coalition for Tax Reform.

- The greater the relative burden of a tax on a specific industry, the more resources are driven out of that industry, and so the greater the deadweight loss.
- Given a burden on a particular industry, the greater is the extent by which its labour productivity exceeds average labour productivity, the greater the loss to national income of diverting resources from that industry, and hence the greater the deadweight loss. (It is possible however to realise a net welfare gain by diverting resources from a low productivity to high productivity industry, raising income sufficiently to exceed the loss through distortion of consumption.)
- The more price elastic (or sensitive) is consumption in a particular industry, the greater is the effect of a tax on consumption, and hence the larger is the deadweight loss.

## ACROSS STATES

### Tax rivalry/concessions

It is all too easy for the States to drive each other 'out of business' on the tax front.

The loss of death duties as a tax base is a classic example. Retirees are often happy to move, so Queensland's abolition of death duties started a downward spiral.

*... the migration of more affluent elderly people to Queensland, following the abolition of death duties by that State, induced other States to do the same. Consequently, all States lost access to a source of revenue, with knock-on effects of higher rates of other taxes and charges or a reduced capacity to provide government services (see, for example, New South Wales Tax Task Force 1988). ... death duties certainly proved politically unpopular, and the Australian Government did not fill the gap. (Pincus, 2006, at p 39).*

### Payroll tax harmonisation

Similarly, it is all-too-easy for the States to impose unnecessarily high compliance costs on business through a failure to harmonise their regulations, including tax regulations.

Payroll tax is a good example. Economists are happy to see States compete on payroll tax rates. They are less comfortable seeing competition between States on payroll tax thresholds (that is, over who is inside and outside the tax base). And they are unhappy to see the granting of payroll tax holidays (the most extreme form of competition over the tax base). But they are downright grumpy when States insist on running very different systems for taxes – and hence generate completely unnecessary compliance costs.

*State and territorial treasury officials have been working on finding ways to remove anomalies in administrative arrangements and definitions of payroll tax.*

*... Among the areas of reform that will be considered are: the timing of payroll tax payments; the treatment of fringe benefits; employee share acquisition schemes; and superannuation contributions.*



*National employers, already furious over a failure by state governments to properly co-ordinate their plans to abolish \$4.4 billion in nuisance taxes, are demanding greater consistency in payroll tax, as well as further reductions in rates.*

*... "There's no reason for there to be these differences in definitions and payment procedures and timing arrangements from state to state," [WA Treasurer] Mr Ripper said. "We can deliver a benefit to business at no cost to us in terms of revenue with a harmonised arrangement." ... National employers want standard administrative arrangements for payroll tax. States believe they could reduce the compliance cost for business by reducing unnecessary differences in the administrative arrangements.*

*... The payroll tax regime has become increasingly inconsistent since the states and territories took over the administration of payroll tax in 1971. Not only is the headline rate and threshold different in each state and territory but other aspects – such as the definitions of wages used in calculating the tax and the monthly payment date – also vary. The Australian Financial Review, 17 July 2006, page 1*

## **2.6 THE GAMING OF GRANTS**

### **BETWEEN STATE AND FEDERAL GOVERNMENTS**

#### **Inadequate SPP accountability**

It is sometimes easy to pull the wool over the Commonwealth's eyes – a game the States know how to play well. The Supported Accommodation Assistance Program (SAAP) involves the Commonwealth contributing to the funding of transitional accommodation and a range of related support services for the homeless.

The Commonwealth contributes 60% and the States contribute 40%. Outcomes and performance indicators form part of the reporting framework in bilateral agreements between the Commonwealth and each State.

Access Economics examined published State reports to assess the extent to which the reporting of SAAP and homelessness spending generally was consistent with these intentions.

What we found was highly aggregated output groups and changing internal administrative which made it hard to track SAAP. In terms of administrative changes, there was a general failure to reconcile successive arrangements whenever a change in administrative arrangements occurs.

While States acknowledged the Commonwealth funding effort, finding 'State only' spending was difficult. The figure usually had to be 'derived' and the result treated with caution.

That is because high level program or output group consolidation made it (1) difficult to identify SAAP, (2) difficult to identify the level of State spending, and (3) hard to identify other homelessness spending and the boundaries with SAAP.

## **ACROSS STATES**

### **States' gaming of HFE and Grants Commission methodology**

The overhead and transaction costs of administering SPPs are one issue. However, also of concern is duplication, imperfect coordination and game playing to assert control by both Commonwealth and State officials engaged in funding closely related services in areas where the States have constitutional responsibility through SPPs and directly through State budgets. This is a potential source of large inefficiencies.

These inefficiencies may involve cost shifting and re-labelling, exploitation of weaknesses in criteria, and matching requirements and reporting arrangements. As well as causing inefficiency, accountability is diminished.

### 3. QUANTIFYING THE COSTS

The costs which a less-than-optimal operation of our federal system imposes on Australians are often subtle and hidden. They show up as:

1. **Higher than necessary costs of government** (and hence as higher taxes and less government services for a given amount of government spending).
2. **Higher than necessary costs of doing business** (due to higher compliance costs arising from overlap and duplication – and the higher taxes too).
3. And, as a result of the above two factors, **lower than necessary purchasing power for ordinary Australians** (as the first two factors show up as higher prices and taxes, and as less government services and lower wages).

Most analyses of ‘the costs of federalism’ focus on the first factor – indeed, on a subset of (1): the costs of inefficiencies in spending (often called ‘overlap and duplication’), rather than also adding in the costs of the inefficiency of State taxes relative to Federal taxes.

Our own estimates in this chapter allow for both inefficiencies in spending and the inefficiency of State taxes. Even so, that means they are just an estimate of (1) – we do not attempt to estimate (2), and so our cost estimate of almost \$9 billion a year is just a subset of the costs of a federal system that falls short of an efficient (‘ideal’) federal system.

#### 3.1 DO THE STATES COST AUSTRALIANS \$20 BILLION A YEAR?

The findings by Drummond are often cited. He estimated duplication and coordination costs in Australia’s federation amounted to more than \$20 billion a year in 2000-01.<sup>4</sup> At 9% of total general government expenses and 3% of GDP, this estimate may not be out of the ballpark. Box 1 below summarises Drummond’s method and findings.

His argument is that the States provide many public goods and services less efficiently than could be achieved through the Federal Government. His estimates indicate the gains that might be available from moving to a national/regional government system of federalism.

<sup>4</sup> M.L. Drummond, *Costing Constitutional Change: Estimating the Costs of Five Variations on Australia’s Federal System*, Australian Journal of Public Administration, December 2002, pp. 43-56.

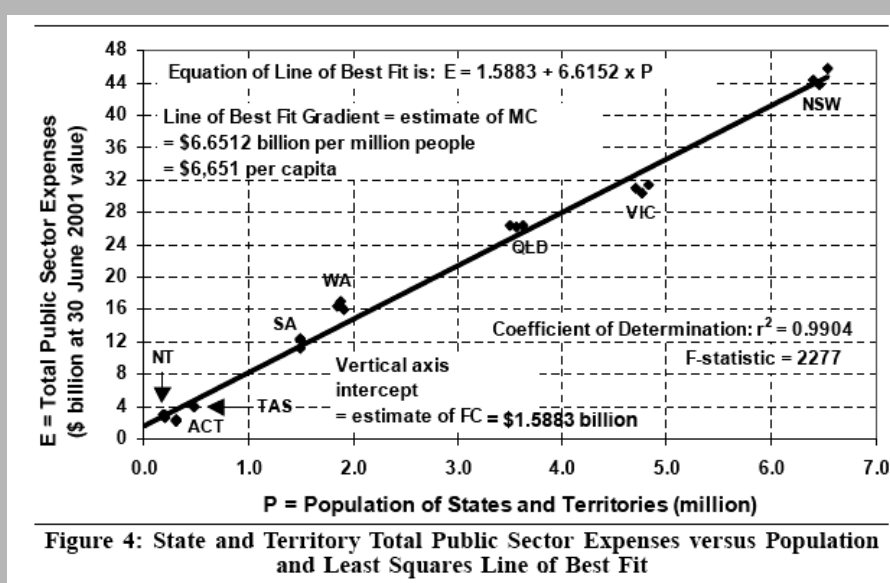
### BOX 1: DRUMMOND'S \$20 BILLION SAVINGS ESTIMATE

Drummond's estimates assume that all State governments host:

- equal fixed or overhead costs (FC); and
- equal marginal per capita costs (MC),

... so each amalgamation of two States into one should liberate cost savings equal to one quantum of FC.

He used least squares regression methods to test the validity of this linear cost model, based on the plot of total public sector expenses versus population for the eight States and Territories, for each of the three years from 1998–99 to 2000–01. This plot is shown in Drummond's Figure 4, copied below:



The coefficient of determination ( $r^2$ ) value of 0.9904 indicates that the plot fits the State public sector expenses versus population relationship very closely.

While the estimate implied in Figure 4 of FC is \$1.5883 billion and of MC is \$6,615 per head of population (which in turn suggests savings in expenses through the elimination of horizontally duplicated fixed or overhead costs among State governments to be \$11.12 billion (= 7 x FC) in 2000-01 dollars), Drummond assumed that the departures from the regression line apparent in Figure 4 were accounted for by higher or lower FC values rather than relatively low or high marginal per capita costs (MC). Drummond reasoned that

*"...whereas marginal per capita costs – of schools, hospitals, teachers, nurses and so on – could be expected to accrue at more or less equal levels in both larger and smaller federal units, fixed or overhead costs can be expected to be higher in centralised political units which govern larger areas and hence need to exercise functional command, control and communication more remotely from communities, through more levels of delegation and with greater coordination burdens."*

By effectively adding such a variable to his equation and re-estimating, Drummond managed to almost double his aggregated estimate of FC. As a consequence, Drummond estimated the savings in expenses achievable at the State level through the elimination of horizontally duplicated fixed or overhead costs among State governments to be \$20.22 billion in 2000-01 dollars.

Drummond's analysis provides limited insight into the gains that might be possible from variations at the margin in roles and responsibilities between levels of government, let alone the coordination cost savings that might be possible if overlap and duplication between levels of government were to be tackled.

The costs which a less-than-optimal operation of our federal system imposes on Australians are often subtle and hidden. They show up as:

- (1) **Higher than necessary costs of government** (and hence as higher taxes and less government services for a given amount of government spending).
- (2) **Higher than necessary costs of doing business** (due to higher compliance costs arising from overlap and duplication – and the higher taxes too).
- (3) And, as a result of the above two factors, **lower than necessary purchasing power for ordinary Australians** (as the first two factors show up as higher prices and taxes, and as less government services and lower wages).

Analyses of 'the costs of federalism' such as that by Drummond focus on (1) above – indeed, on a subset of (1): the costs of inefficiencies in spending (often characterised as 'overlap and duplication'), rather than also adding in the costs of the inefficiency of State taxes relative to Federal taxes.

Our own estimates in this chapter allow for both overlap and the inefficiency of State taxes. Even so, that means they are just an estimate of (1) – we do not attempt to estimate (2), and so our cost estimates are just a subset of the actual costs of a federal system that falls short of the efficient 'ideal' federal system.

We initially focus on estimating the likely fiscal costs of spending inefficiencies in our federal system. We do so by putting figures on the excessive tax effort likely to result from expenses being above efficient levels on a function-by-function basis.

In particular:

- ❑ for those functional areas where the Federal Government pays SPPs to the States, general government expenses at the national level are likely to be higher than necessary because of a certain amount of overlap and duplication likely to be involved in administering these programs involved and any cost shifting from the States;
- ❑ for those functional areas where the States receive SPPs from the Federal Government, general government expenses at the State level are also likely to be above efficient levels on account of inadequacies in Federal oversight and accountabilities; and
- ❑ for the remaining functional areas where there is significant involvement by both levels of government, general government expenses at the State level are also likely to be above levels that could be achieved were there more effective coordination between the different levels of government.

## 3.2 EXPENDITURE-RELATED COSTS AND INEFFICIENCIES

In 2004-05 (the latest year for which data on actual expenses are available), the following functional areas are mainly provided nationally:<sup>5,6</sup>

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<sup>5</sup> Based upon the general purpose classification (GPC) of general government expenses published by the ABS in its *Government Finance Statistics, Australia* (Cat. No. 5512.0) publication.

**TABLE 3-1: GENERAL GOVERNMENT EXPENSES BY PURPOSE, 2004-05**  
**NATIONALLY-PROVIDED FUNCTIONS**

	States' share <sup>(a)</sup> (%)	Commonwealth share <sup>(b)</sup> (%)	% of total general government expenses
Defence	0%	100%	5%
Universities	0%	100%	4%
Pharmaceutical	0%	100%	2%
Social security	0%	100%	23%
Broadcasting and film production	1%	99%	0.4%
Air transport	7%	93%	0.05%

<sup>(a)</sup> Includes local government.

<sup>(b)</sup> Includes multi-jurisdictional sector, which contains units where jurisdiction is shared between two or more governments, or classification of a unit to a jurisdiction is otherwise unclear. The main types of units currently falling into this category are the public universities.

Together, these functions involved one-third of all general government expenses in 2004-05.

For the purposes of this study, we take it that there are no costs and inefficiencies due to federalism in these functional areas.

The following functional areas involving a further 12% of all general government expenses may appropriately be the responsibility of both the Commonwealth and the States:

**TABLE 3-2: GENERAL GOVERNMENT EXPENSES BY PURPOSE, 2004-05**  
**JURISDICTION-SPECIFIC FUNCTIONS**

	States' share <sup>(a)</sup> (%)	Commonwealth share <sup>(b)</sup> (%)	% of total general government expenses
General public services	42%	58%	7%
Public debt transactions	36%	64%	2%
Nominal interest on superannuation	40%	60%	3%

<sup>(a)</sup> Includes local government.

<sup>(b)</sup> Includes the multi-jurisdictional sector.

- ☐ General public services involve legislative and executive affairs, financial and fiscal affairs, external affairs and research and services not connected to a particular function.
- ☐ Public debt transactions are the costs of floating government loans and the associated interest payments.
- ☐ Nominal interest on unfunded superannuation liabilities is the direct result of public sector employment practices.

We consider the expenses associated with all these functions to be inherent in a federal system – we would have something similar to those same costs in an 'ideal' federal system, and so these do not involve any costs due to inefficient federalism. The sharing across the levels of government in these areas approximates that in all other functions, namely 36% by the States and 64% by the Commonwealth.

<sup>6</sup> Throughout this chapter, we take any function that involves one level of government being responsible for 90% or more of general government expenses in that function to be primarily the responsibility of that level of government.

It is the remaining 55% of all general government expenses that are likely to be the source of the majority of costs due to inefficiencies in our federal system.

Of this amount, just three percentage points of all general government expenses in 2004-05 arose in the functional areas which are primarily the responsibility of the States:

**TABLE 3-3: GENERAL GOVERNMENT EXPENSES BY PURPOSE, 2004-05**  
**STATE-DOMINATED FUNCTIONS**

	States' share <sup>(a)</sup> (%)	Commonwealth share <sup>(b)</sup> (%)	% of total general government expenses
Recreational facilities and services	90.1%	9.9%	1%
Rail transport	95%	5%	1%
Other tertiary education	100%	0%	0.02%
Other community amenities	100%	0%	0.6%
Other health institutions	100%	0%	0.2%

<sup>(a)</sup> Includes local government.

<sup>(b)</sup> Includes the multi-jurisdictional sector.

With the exception of rail freight, these functions are appropriately undertaken by the States. However, spending on these functions is relatively inconsequential.

**Where the main costs and inefficiencies are likely to arise are in the one-half of all general government expenses that are in functional areas that are 'shared' by the Commonwealth and the States** (as summarised in Table 3-4).

**TABLE 3-4: GENERAL GOVERNMENT EXPENSES BY PURPOSE, 2004-05**  
**SHARED FUNCTIONS**

	States' share <sup>(a)</sup> (%)	Commonwealth share <sup>(b)</sup> (%)	% of total general government expenses
Primary and secondary schooling	71%	29%	8%
Acute care institutions	59%	41%	7%
Community health services	28%	72%	6%
Public order and safety	84%	16%	5%
Welfare services	49%	51%	4%
Road transport	83%	17%	3%
Other economic affairs	41%	59%	3%
Other health	27%	73%	2%
Fuel and energy	18%	82%	2%
Housing and community development	65%	35%	1.5%
Technical and further education	70%	30%	1.5%
Other education	84%	16%	1.2%
Agriculture, forestry and fishing	49%	51%	1.1%
Other social security and welfare	22%	78%	0.9%
Environment protection	83%	17%	0.9%
Cultural facilities and services	75%	25%	0.9%
Mining, manufacturing and construction	31%	69%	0.8%
Communications and other transport	75%	25%	0.8%
Water supply	47%	53%	0.4%
Other functions n.e.i.	64%	36%	0.4%
Water transport	53%	47%	0.1%
Other recreation and culture	81%	19%	0.02%

Annual expenses in these functional areas totalled \$162 billion in 2004-05.

These functional areas can be classified into three groupings:

- ☐ those where specific purpose payments (SPPs) from the Commonwealth to the States are significant;
- ☐ those not involving significant SPPs but which directly affect markets for business inputs; and
- ☐ all other shared functional areas.

The shared functional areas where significant SPPs are involved are listed in Table 3-5.



**TABLE 3-5: GENERAL GOVERNMENT EXPENSES BY PURPOSE, 2004-05**  
**SHARED FUNCTIONS WITH SIGNIFICANT SPPs**

	State own- purpose \$m	SPPs \$m	Commonwealth own-purpose \$m
Primary and secondary	18,754	7,478	0
Acute care institutions	13,844	8,877	768
Road transport	6,435	1,894	1,647
Other health	1,986	252	5,115
Housing and community development	3,028	720	877
Technical and further education	3,223	1,164	213
Agriculture, forestry and fishing	1,732	333	1,464
Other social security and welfare	647	806	1,540
Communications and other transport	1,159	711	632
Water supply	660	715	25
Other recreation and culture	45	11	0

Together, in 2004-05, these functions saw \$51.5 billion in State own-purpose expenses, \$12.3 billion in Commonwealth own-purpose expenses and \$23.0 billion in SPPs paid by the Commonwealth to the States.

The likely fiscal costs of federalism in these functional areas include:

- ❑ General government expenses at the national level being higher than necessary because of **overlap and duplication** involved in administering the programs involved. *That is, the costs to the Federal Government of administering grants to the States (SPPs) over and above cost of either the States or the Federal Government directly funding and running the programs themselves.*
- ❑ General government expenses at the national level being higher than necessary because of any **cost shifting** from the States. *That is, where it would be more efficient for States to provide services such as public hospitals, but those services are inefficiently provided via (Federal-subsidised) pharmaceuticals or GPs or aged care homes instead. (Note other such sources of inefficiency have not been counted.)*
- ❑ General government expenses at the State level being **above efficient levels** on account of inadequacies in Commonwealth oversight and accountabilities. *That is, overlap and duplication in areas where both States and Federal Government are operating at the same time – too many cooks spoiling the broth in areas such as welfare, community health and policing.*

### Overlap and duplication

If the general government expenses at the national level involved in administering the SPP programs involved were in the order of 5% of the amount of SPPs paid by the Commonwealth to the States and 75% of these expenses could be eliminated if the Commonwealth instead undertook such functions or the States had sufficient revenue powers to fully fund all the expenses they incur, then **Commonwealth general government expenses may be \$861 million higher than necessary because of overlap and duplication.**

## Cost shifting

If 5% of Commonwealth expenses in the Pharmaceutical area and in public hospital grants paid to the States is the result of cost shifting by the States from more efficient (less costly) own-purpose expenses by the States on the acute care and aged care sectors, then **Commonwealth general government expenses could be a further \$836 million higher than necessary because of the cost shifting involved.**

## Above efficient levels

The consensus among analysts is that this category of the 'government' costs of flawed federalism is the largest on the spending side (see Productivity Commission, 2006) – both in terms of absolute dollars, and as a share of the spending involved.

If the amount of SPPs paid by the Commonwealth and spent by the States in these functional areas is 10% 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 shared functional areas where States are active in regulating or taxing markets for business inputs are listed in Table 3-6.

**TABLE 3-6: GENERAL GOVERNMENT EXPENSES BY PURPOSE, 2004-05**  
**FUNCTIONS INVOLVING MARKETS FOR BUSINESS INPUTS**

	State own-purpose \$m	SPPs \$m	Commonwealth own-purpose \$m
Other economic affairs	3,448	86	4,809
Fuel and energy	965	60	4,422
Rail transport	3,345	28	159
Environment protection	1,884	0	509
Mining, manufacturing and construction	813	4	1,774
Water transport	219	0	194

Together, in 2004-05, these functions involved \$10.7 billion in State own-purpose expenses and \$11.9 billion in Commonwealth own-purpose expenses.

The costs of federalism in these functions are mainly non-fiscal in nature.

That is, the costs of an inefficient federation in these areas usually falls on business as higher costs of compliance with, for example, eight regulatory regimes instead of one.

The other shared functional areas are listed in the Table 3-7.

**TABLE 3-7: GENERAL GOVERNMENT EXPENSES BY PURPOSE, 2004-05**  
**OTHER SHARED FUNCTIONS**

	State own- purpose \$m	SPPs \$m	Commonwealth own-purpose \$m
Community health services	5,236	261	13,248
Public order and safety	12,223	153	2,192
Welfare services	6,821	499	6,728
Other education	3,263	0	635
Cultural facilities and services	2,071	122	564
Other functions n.e.i.	835	0	474

Together, in 2004-05, these functions involved \$30.4 billion in State own-purpose expenses, \$23.8 billion in Commonwealth own-purpose expenses and only \$1.0 billion in SPPs paid by the Commonwealth to the States.

### Overlap and duplication

That raises a separate issue of 'overlap and duplication'. If the general government expenses at the State level involved a degree of overlap and duplication with Commonwealth activities that was in the order of 3% of the amount spent by the States, then **State general government expenses could be \$910 million higher than necessary because of overlap and duplication.**

In total, this report therefore conservatively estimates that some **\$5.1 billion** a year of taxpayers' money is being wasted – used to no effect.

### 3.3 TAX-RELATED COSTS AND INEFFICIENCIES

In 2004-05, tax collections were shared between the levels of government as shown in Table 3-8:<sup>7</sup>

**TABLE 3-8: GENERAL GOVERNMENT TAXES BY TYPE, 2004-05**

	States' share <sup>(a)</sup> (%)	Commonwealth share (%)	% of total general government tax revenue
Taxes on income	0%	100%	59%
GST and other sales taxes	0%	100%	13%
Taxes on international trade	0%	100%	2%
Excises and levies	0.2%	99.8%	8%
Other taxes n.e.i.	33%	67%	0.4%
Government borrowing guarantee levies	94%	6%	0.1%
Employers payroll taxes	100%	0%	4%
Stamp duties on conveyances	100%	0%	3%
Municipal rates	100%	0%	3%
Motor vehicle taxes	100%	0%	2%
Taxes on gambling	100%	0%	2%
Land taxes	100%	0%	1%
Taxes on insurance	100%	0%	1%
Other stamp duties	100%	0%	0.4%
Other taxes on immovable property	100%	0%	0.3%
Financial institutions transactions taxes	100%	0%	0.2%

<sup>(a)</sup> Includes local government.

The States (which here include the local government sector) collect 18% of the overall tax take in Australia. The Commonwealth collects 14% of the national tax take for on-passing to the States through tax-sharing grants (mainly GST) and the remaining 68% for its own purposes.

The Commonwealth has exclusive powers in the taxation of income, sales and international trade, which altogether account for 74% of the total tax take in 2004-05.

The States collect taxes exclusively in the tax types:

- ☐ Payroll taxes,
- ☐ Stamp duties on conveyances
- ☐ Motor vehicle taxes
- ☐ Taxes on gambling
- ☐ Land taxes
- ☐ Taxes on insurance
- ☐ Other stamp duties

<sup>7</sup> Based upon the general purpose classification (GPC) of general government expenses published by the ABS in its *Taxation Revenue* (Cat. No. 5506.0) publication.

- ❑ Other taxes on immovable property
- ❑ Financial institutions transactions taxes.

Altogether (and adding in municipal rates), these taxes accounted for 18% of the total tax take in Australia in 2004-05.

The only areas of overlapping collection are Excises and levies, Government borrowing guarantee levies and Other taxes n.e.i. These taxes accounted for the remaining 9% of the total tax take.

### 3.3.1 INEFFICIENT TAX ASSIGNMENT

Of the 10 types of taxes collected exclusively by the States, we would classify those listed in Table 3-8 as inefficient taxes.

**TABLE 3-8: INEFFICIENT STATE TAXES, 2004-05**

	States' share %	Commonwealth share %	% of total general government tax revenue
Motor vehicle taxes	100%	0%	1.9%
Land taxes	100%	0%	1.3%
Taxes on insurance	100%	0%	1.3%
Stamp duties on commercial conveyances	100%	0%	0.7%
Other stamp duties	100%	0%	0.4%
Other taxes on immovable property	100%	0%	0.3%
Financial institutions transactions taxes	100%	0%	0.2%

These taxes amount to 6% of the total tax take, or \$16.9 billion in 2004-05.

Clearly the economy would be better off without these taxes – as seen in Figure 2 above.

From a federalism point of view, at issue is whether there would be efficiencies if the States exited these taxes and the Commonwealth compensated the States for the revenue foregone from the proceeds of its increased collection of more efficient taxes.

Or, alternatively, the costs to taxpayers and the wider economy of Australia's federation would be rather lower if the States exited these taxes and made up the difference by raising one or both of their two efficient taxes – the GST and/or payroll taxes.

**Access Economics has estimated the welfare gains arising from the efficiency savings implied in a swap of these inefficient taxes for more efficient ones as a saving of \$2.8 billion.**

This estimate has been developed using the relative efficiency rankings developed in Access Economics' 2004 report, *Axing the Alcabala: A program for a 21<sup>st</sup> century State tax system*, prepared for the Business Coalition for Tax Reform. Those rankings are as shown in Figure 2 above.

The saving represents the difference in efficiency losses ('deadweight' losses) between actual State taxes in 2004-05 and a system of State taxation under which the revenues collected in 2004-05 from the taxes listed in Table 3-8 are replaced by taxes collected from the GST and payroll taxes (with these latter two taxes each making up half the shortfall).

### 3.3.2 THE TAX-RELATED DEADWEIGHT COSTS OF EXCESS SPENDING

We noted above that this report conservatively estimates some \$5.1 billion a year as the spending-related inefficiencies of flawed federalism.

But the net cost of that is more than just the \$5.1 billion a year. When taxes are used to raise that amount, they result in additional efficiency costs to the economy.

We have (again conservatively) costed the latter effect by assuming these are paid for out of GST and/or payroll tax receipts (that is, from efficient rather than inefficient taxes).

That adds to the estimate of the efficiency costs involved here – adding another **\$866 million a year** to the total.

Or, in other words, to pay for \$5.1 billion of wasted spending actually costs taxpayers almost \$6 billion, because the taxes raised to pay for the wasted spending themselves destroy further value in the economy.

### 3.3.3 INSUFFICIENT CENTRALISATION OF TAX COLLECTIONS

In 2004-05, as shown in Table 3-9, taxes accounting for 80% of tax collections were the subject of some form of central collection, although only 17% of these collections were on-passed to the States.

**TABLE 3-9: CENTRALLY-COLLECTED TAXES, 2004-05**

	State direct collection \$m	Commonwealth collection on behalf of States \$m	Commonwealth direct collection \$m
GST and other sales taxes	0	35,473	1,164
Taxes on income	0	2,541	160,433
Excises and levies	50	600	22,211

It is in the types of 'efficient' taxes listed in Table 3-10 that are exclusively collected by the States where the question is whether there would be greater efficiencies if more of these taxes were collected centrally.

**TABLE 3-10: STATE-EXCLUSIVE TAXES, 2004-05**

	States' share %	Commonwealth share %	% of total general government tax revenue
Payroll taxes	100%	0%	4.4%
Taxes on gambling	100%	0%	1.5%
Municipal rates	100%	0%	0.0%

These taxes amounted to \$16.4 billion in 2004-05, or 6% of the total tax take in Australia.

Again, as noted above, although we do not estimate 'government' inefficiencies with respect to this latter group of taxes, there are important non-fiscal costs associated with eight different State tax systems in Australia. The latter costs weigh on business rather than government, and are less easily estimated, but both these types of costs lower living standards for all Australians.

The fiscal costs of this degree of decentralisation in tax collection may not be quite as significant, and could be proxied by (say) 50% of the summed cost of State revenue collection agencies. This amounted to **around \$150 million in 2004-05**.

### 3.3.4 GAMING OF GRANTS

Finally, some part of the \$35½ billion in GST and other sales taxes collected by the Commonwealth and on-passed to the States is likely to be wasted via the misallocation of resources that goes with successful gaming by less efficient States of the Commonwealth Grants Commission (CGC) horizontal fiscal equalisation (HFE) process used to determine the distribution of GST grants among the States. In addition, not merely does this process result in grants going to less efficient States, but a percentage is also consumed by the administration of the Commonwealth Grants Commission (CGC) horizontal fiscal equalisation (HFE) process itself. This comprises a portion of the cost of the CGC itself, and the related State Treasury costs.

These costs were estimated by Fitzgerald and Garnaut to be in the order of **\$150-280 million** a year.<sup>8</sup>

## 3.4 OVERALL COST ESTIMATE

Altogether, based upon conservative assumptions, Access Economics estimates that the *fiscal* costs in Australia's current federalism system – the higher than necessary costs of government compared with an efficient ('ideal') federation could be almost \$9 billion per annum in 2004-05. (The details are as spelt out in the table over the page.)

This represents an estimate of spending from which ordinary Australians are getting zero benefit, and hence having to pay the tax to finance that spending – all for nothing.

And this estimate only covers the 'government' costs of inefficient federalism in Australia.

As noted above, there are also likely to be broader 'private' costs of inefficient federalism – where costs fall on to businesses and families due to overlapping and excessive State regulations. How high might these 'private' costs be? Appendix A deals with that issue, but it is not unreasonable to assume that these costs would be higher than the 'government' costs – perhaps substantially higher.

Yet even without allowance for the latter costs, the almost \$9 billion estimate of 'government' costs of flawed federalism identified in this report implies a cost of **almost \$450 a year for every Australian, or over \$1,100 a year for every household**.

**That's a lot to waste.**

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<sup>8</sup> Fitzgerald, V. and Garnaut, R. (2002), Review of Commonwealth-State Funding, Final Report.

**TABLE 3.1: THE 'GOVERNMENT' COSTS OF FLAWED FEDERALISM, 2004-05**

Type	Category	Cost (\$m, 2004-05)	Source of inefficiency
Spending-related inefficiencies	<b>Overlap and duplication</b> due to the need to administer grants between jurisdictions (ie, a cost of one level of government taxing less than it spends)	\$861	The costs to the Federal Government of administering grants to the States (SPPs) over and above cost of either the States or the Federal Government directly funding and running the programs themselves
	<b>Cost shifting</b> by the States that results in inefficient spending by the Commonwealth on pharmaceuticals and in public hospital grants	\$836	Where it would be more efficient for States to provide services such as public hospitals, but services are instead inefficiently provided via (Federal-subsidised) pharmaceuticals or GPs or aged care homes. <i>(Note similar other such sources of inefficiency not counted.)</i>
	<b>Spending above efficient levels</b> by the States due to lack of coordination and/or inadequacies in Commonwealth oversight and accountabilities	\$2,296	Where State spending is inefficient in achieving program aims because Federal interference means State spending is misdirected, or because State 'gaming' of Federal grants sees them overspend in some areas and underspend in others with the aim of maximising grants received from the Commonwealth, or because the two levels of government fail to coordinate their efforts
	<b>Overlap and duplication</b> in areas where both States and Federal Government are operating at the same time	\$913	Too many cooks spoiling the broth in areas such as welfare, community health and policing
	Inefficiencies due to operation of <b>'horizontal fiscal equalisation'</b>	\$215	Grants directed to inefficient States
Spending sub-total		\$5,122	
Tax-related inefficiencies	<b>Unnecessarily inefficient State taxes</b> (such as taxes on insurance, land tax, stamp duties on commercial conveyances, other stamp duties etc)	\$2,782	Saving in efficiency costs if these were replaced by more efficient taxes such as the GST or payroll tax
	<b>The efficiency (deadweight) costs of raising taxes to pay for the higher-than-necessary level of spending</b> identified in the spending sub-total above	\$866	Conservatively costed assuming these are paid for out of GST and/or payroll tax receipts (ie, from efficient rather than inefficient taxes)
	<b>Failure to centralise tax collection</b> nationally for payroll taxes and taxes on gambling	\$150	It is inefficient to collect these taxes using State-based bureaucracies
Tax sub-total		\$3,797	
Total 'higher than necessary costs of government'		\$8,919	



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## APPENDIX A: THE COSTS OF EXCESSIVE REGULATION

This report has concentrated on the ‘government’ costs of a less-than-optimal federal system.

However, as noted, the ‘business’ costs arising from dealing with multiple and overlapping regulatory requirements may be rather higher than the ‘government’ costs estimated here.

This Appendix concentrates upon the latter, drawing on *The Benefits and Costs of Business Regulation*, a report prepared by Access Economics for the Business Council of Australia in 2005.

Productivity Commission Chairman Gary Banks has drawn particular attention to the danger of ‘regulatory cocktails’ creating adverse and unintended interactions. In Australia overlapping or conflicting regulation can occur:

- ❑ **Between different regulatory bodies at the same level of government.** For example, Federal agencies APRA, ASIC, the Reserve Bank and the ACCC share regulatory oversight of banking and financial markets. And these different regulatory bodies can have conflicting objectives. For example, Australian Government agencies appear to have conflicting goals and attitudes toward foreign investment – *InvestAustralia* aims to attract and facilitate foreign investment, while the *Foreign Investment Review Board* adds a regulatory process, stops some foreign investment from proceeding, and by its mere presence may discourage other investment.
- ❑ **Between levels of government.** For example, new developments may need to comply with planning laws at the Federal, State and local level. A review of Australia’s building regulations found “Local Governments usually do not conduct an adequate level of impact analysis of their regulations. New regulations may be introduced that contain extra requirements on business, with increased costs, for uncertain benefit”.<sup>9</sup>
- ❑ **Between jurisdictions.** For example, workers compensation or OH&S laws differ between States, despite almost identical objectives. This generates extra compliance costs for national firms with no benefits to the community. The Productivity Commission has consistently found benefit in mutual recognition regimes (both domestically and internationally) to harmonise standards and reduce the potential for duplication or inconsistency (see box below).

Many firms have to navigate the compliance nightmare that overlapping regulation creates. Imposing additional costs on business without a commensurate benefit to consumers and society is bad policy and bad regulation, as the Productivity Commission’s inquiry in into National Workers’ Compensation and Occupational Health & Safety Frameworks showed.

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<sup>9</sup> Productivity Commission (2004) *Reform of Building Regulation* Research Report, Productivity Commission, Canberra, November 2004, p.xxxvii.

### **Same Policy, Multiple Versions, Zero Benefit – Australia’s overlapping OH&S and Workers Compensation Schemes**

There are ten principal Occupational Health & Safety (OH&S) statutes across Australia – one for each State and Territory and two Federal laws dealing with employees in the Federal Government and the maritime industry, respectively.

There are even more workers’ compensation schemes, as some States have industry-specific as well as State-wide schemes.

**Industry surveys identify the lack of nationally consistent Workers’ Compensation and OH&S regulations as a key concern of business.** In 2003-04 the Productivity Commission’s inquiry into National Workers’ Compensation and Occupational Health & Safety Frameworks attracted many submissions from firms and industry associations canvassing the inefficient effects of nationally inconsistent regimes.

**The objectives which underlie OH&S and workers’ compensation regimes in each jurisdiction are essentially identical.** Differences arise in how each jurisdiction implements these policies. The Productivity Commission found these differences to be substantial, and not merely superficial drafting differences.<sup>10</sup> As well as what is written in the detailed regulations and codes which set out the scheme, there are also differences in how the responsible body exercises its discretion, particularly in relation to enforcement.

Even where principles and policies are consistent, multiple arrangements create extra premium and reporting requirements for national firms, which in itself raises business compliance costs. CSR, a national firm eligible to self-insure for workers’ compensation, still needs to obtain a licence to do so in each of the five States and Territories which it operates. It estimated that the ongoing cost of renewing these licences would fall by \$500,000 a year (from \$700,000 to \$200,000) if it had to only maintain and review one ‘national’ licence. These savings would come from a reduction in administration staff, administration fees and reporting costs. The requirement to report to five different regulators at different times of the year and in different formats was estimated to add \$60,000 alone to CSR’s total reporting costs.

<sup>11</sup>

Other organisations provided estimates of potential cost savings from a national scheme ranging from 5 to 15% of their annual compliance costs. They also identified areas of lost efficiency to the economy, the value of which could not be quantified in dollar terms.

While there are potential benefits from multiple arrangements, including tailoring arrangements to local preferences, or competing and learning between jurisdictions, the Productivity Commission does not appear to have found these benefits to be notable, or that they could only be obtained through the current fragmented system.

<sup>10</sup> The Productivity Commission, at p16.

<sup>11</sup> The Productivity Commission, at p20.

In brief, the costs of regulation over and above efficient levels of regulation include:

- ❑ costs to taxpayers (*administration* – covered in ‘government’ costs above);
- ❑ costs to business (*compliance*); and
- ❑ costs to the economy (*efficiency* or *deadweight losses* – only the tax-driven component of which is covered in ‘government’ costs above, not the regulatory-driven component).

Economists expect the magnitude of costs to increase down that list, so that administration costs are just the tip of the regulatory cost iceberg. However, as we move down those categories it also becomes ever harder to accurately quantify the amount of costs involved.

#### 4.1.1 COSTS TO TAXPAYERS – ADMINISTRATIVE

It is generally not possible to isolate the total of government resources devoted to a particular piece of legislation. Table 4.1 shows the budgets of State competition and taxation bodies, compared with their Federal counterparts; the ACCC and the ATO.

**TABLE 4.1: OPERATING EXPENSES OF STATE COMPETITION/TAX REGULATORS, 2002-03**

JURISDICTION	COMPETITION REGULATOR	2002-03 \$M	TAXATION REGULATOR	2002-03 \$M
NSW	Independent Pricing & Regulatory Tribunal	11.4	Office of State Revenue	79.3*
VIC	Essential Services Commission	11.7	State Revenue Office	56.2
	Victorian Competition & Efficiency Commission#			
QLD	Queensland Competition Authority	5.6	Office of State Revenue	37.2
SA	Essential Services Commission of SA	4.3	RevenueSA	24.8^
WA	Economic Regulation Authority**	n/a	Office of State Revenue	31.3^^
TAS	Government Prices Oversight Commission	0.2	State Revenue Office	6.2
	Office of the Tasmanian Energy Regulator	1.5		
ACT	Independent Competition & Regulatory Commission	2.1	ACT Revenue Office	n/a
NT	Utilities Commission	0.6	Territory Revenue	5.2*
<b>State Total</b>		<b>37.5</b>		<b>240.1</b>
<b>Federal Govt</b>	<b>Australian Competition &amp; Consumer Commission</b>	<b>73.0</b>	<b>Australian Taxation Office</b>	<b>2,133.0</b>
<b>Australian Total</b>		<b>110.5</b>		<b>2373.1</b>

\* Excludes First Home Owner Grants # Not established until July 2004 ^Based on cost allocated to sub-program 2.1: Revenue Collection and Management \*\* Not established until January 2004 to replace the Office of Gas Access Regulation, Office of the Rail Access Regulator, Office of Water Regulation ^^Based on cost allocated to Land Tax, Payroll Tax, Stamp Duties and Grants & Subsidies

#### 4.1.2 COSTS TO BUSINESS – COMPLIANCE

The direct costs of regulation include the costs incurred by businesses in complying, such as:

- (1) staff time needed to comply with regulations;
- (2) hiring of any additional staff required to meet the additional administration burden;
- (3) maintaining and developing new and up-to-date reporting systems;
- (4) obtaining advice (lawyers, accountants, architects etc);
- (5) educating staff about the new requirements; and
- (6) any associated costs of advertising, travel or the like.

These costs also indirectly affect the broader community by increasing prices and sometimes by delaying the introduction of new products and services.

That said, business compliance costs are that proportion of a firm's administrative processes and resources which are devoted to activities *they would not do if the regulation did not exist*.

Some compliance procedures, such as accurate record keeping, would likely occur even without regulatory stipulation. That makes it very difficult to make judgements about what activities would occur without regulation.

The leading example of this incremental cost approach to compliance costing is the MISTRAL model used in the Netherlands. A Dutch study using the MISTRAL model found that **around one fifth of all administration costs borne by business were caused solely by compliance responsibilities**.<sup>12</sup>

Moreover, some activities may still be undertaken, but they would be structured in a more efficient or less costly manner than that required to meet particular regulatory requirements. The MISTRAL model cannot calculate the latter costs. While caution is required when extrapolating from the Dutch experience to Australian regulation, a figure of around 20% would support Australian survey data that regulatory compliance costs are significant.

As noted above, most Australian research is generated by surveys which ask business respondents to estimate time spent complying with a particular or a range of regulations, such as ACCI and AIG industry surveys (see the comments in the box). These focus on particular types of regulation, such as tax or environmental regulation. There have been no major studies on the overall costs of regulation to Australian businesses in recent years.

<sup>12</sup> Chittenden, F, Kauser, S & Poutziouris, P (2001) *Regulatory Burdens of Small Business: A Literature Review* Manchester Business School, p.3. This result is obviously applicable to the Dutch context. However, it is indicative of the scale of regulatory compliance costs in a modern developed economy.

**What are Australian businesses saying about compliance costs?**

- In dealing with government regulation, the greatest concern to business is the complexity of regulation, followed by the costs of compliance.<sup>13</sup>
- 91% of small businesses and 76% of large firms surveyed prior to the 2004 election described the frequency of changes to tax laws and rules as a major or moderate concern for their business.<sup>14</sup>
- Firms, regardless of size, expressed more concern over labour regulations and on-costs than labour costs themselves. In ACCI's pre-election survey the greatest concern was over workers' compensation costs, unfair dismissal legislation and termination, change and redundancy regulations.<sup>15</sup>
- Regulations have varying impacts depending on firm size. Larger firms report greater concern with environmental and OH&S regulations.<sup>16</sup>
- The Australian Industry Group estimated that each Australian manufacturer spends 102 hours a month of staff time managing compliance, equivalent to 1.8 hours per employee. At average manufacturing wage costs, this totals over \$680 million per year for the Australian manufacturing sector.<sup>17</sup>

- ❑ A US analyst suggests paperwork-related compliance burdens amount to around one third of the aggregate regulatory burden in the United States. If this same multiplier applied in Australia, total compliance costs would amount to as much as 7% of GDP.<sup>18</sup>
- ❑ The Productivity Commission found that, in 1994-95, the administrative burden resulting from regulation amounted to some \$11 billion for businesses.<sup>19</sup> A more recent OECD study estimated that the direct compliance costs of taxation, employment and environmental regulations totalled more than \$17 billion in 1998 for small and medium sized Australian businesses alone.<sup>20</sup>
- ❑ While such surveys occur regularly enough to identify current trends in compliance activity, there will be a potential upward bias in the results due to a lack of common understanding about what constitutes a compliance cost; an inclination for business people to overestimate their compliance burden; and an inability accurately to estimate and allocate the costs of compliance activities to particular forms of regulation, especially if the survey respondent is being asked to give an immediate answer.

<sup>13</sup> ACCI (2004), *ACCI Review*, June 2004, p.8

<sup>14</sup> ACCI (2004), *ACCI Review*, June 2004, p.4

<sup>15</sup> ACCI (2004), *ACCI Review*, June 2004, p.7

<sup>16</sup> ACCI (2004), *ACCI Review*, June 2004, p.9

<sup>17</sup> Australian Industry Group (2004), *Compliance Costs Time and Money*, Sydney, November 2004.

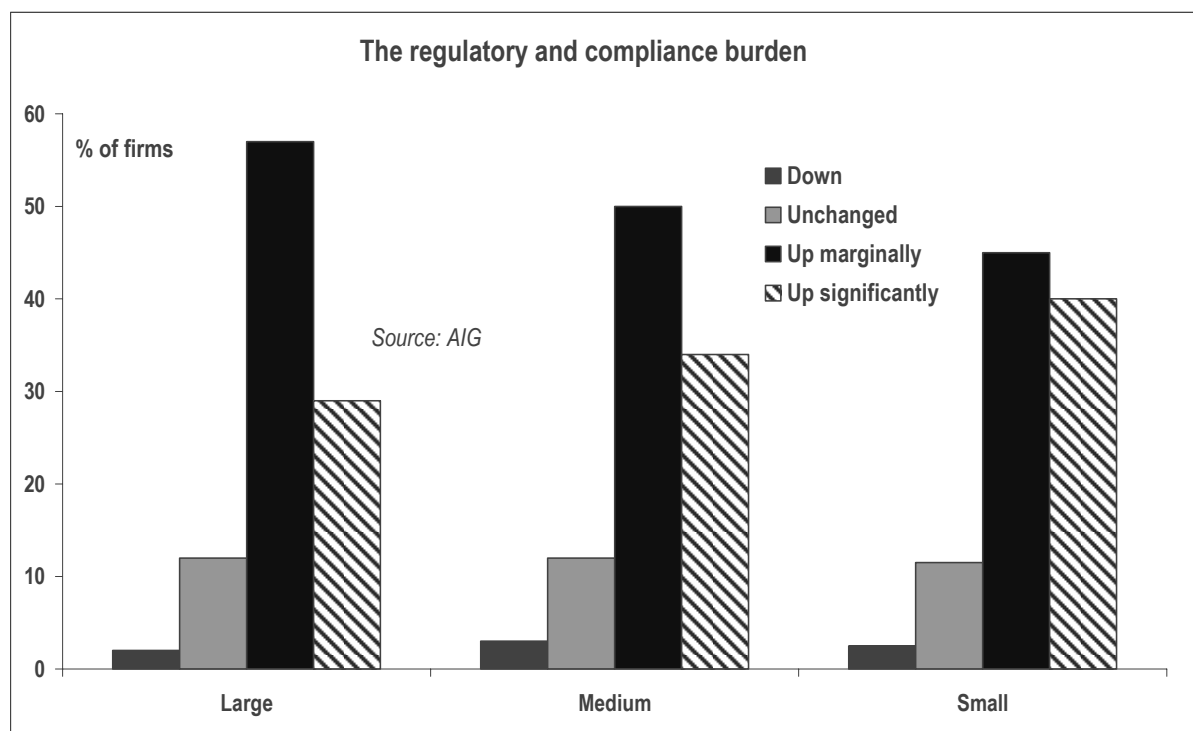
<sup>18</sup> Banks (2003), *The good, the bad and the ugly: economic perspectives on regulation in Australia*, Address to the Conference of Economists, Business Symposium, October, p6.

<sup>19</sup> Banks (2003), *The good, the bad and the ugly*, p5.

<sup>20</sup> OECD (2001), *Business' views on red tape: administrative and regulatory burdens on SMEs*, October.

- An alternative way to use business surveys is to focus on business perceptions about changes to the overall level of compliance required, rather than resources spent on a particular regulation. For example, AIG found 85% of manufacturers thought the time spent complying with Federal regulation had increased over the three years to 2004 (see Figure 3).

**FIGURE 3: PERCEPTIONS OF CHANGES IN THE COMPLIANCE BURDEN 2001-04**



Source: AIG (2004) *A Survey of Business Priorities in the lead up to the Budget*

Concern about the rising costs of compliance is not limited to manufacturers. Government business liaison programs have detected a more general concern that the costs of meeting regulatory requirements have risen significantly.<sup>21</sup>

For example, business representatives from the financial services sector indicate that the cost of meeting financial sector regulatory requirements had increased '3 or 4 times over the past 5 years'.<sup>22</sup> And, according to some estimates, the combined annual costs to the top 50 listed companies of compliance with CLERP 9, the Financial Services Reform Act and the Australian Stock Exchange's corporate governance guidelines is as high as \$375 million.<sup>23</sup>

#### 4.1.3 COSTS TO THE ECONOMY – EFFICIENCY

The economy-wide costs stem from an allocation of resources which is different to that which would otherwise have prevailed in the absence of regulation. Its impact shows up as:

<sup>21</sup> Treasury (2004) *Key themes from the Treasury Business Liaison Program – April 2004*, Canberra, April.

<sup>22</sup> Treasury (2004) *Key themes*.

<sup>23</sup> Nicholas, N & Buffini, F (2004) 'Backlash against regulation costs' *Australian Financial Review*, 5 July, p.1, 60.



- ❑ **Higher prices** for consumers and other businesses and **lower wages** to employees (to finance compliance costs, and because less efficiently allocated resources mean productivity is lower than it would have been), and
- ❑ **Higher taxes** paid to governments (to finance administration costs).

**These are typically the largest costs and most well-hidden costs of regulation.** Moreover, they are often incurred by policymakers with the best intentions, but with less than perfect information, and less than adequate assessment, so that regulators end up enforcing less than optimal outcomes.

It should also be noted that efficiency costs are not merely static. **There are dynamic efficiency costs to the economy as well because regulation can discourage risk-taking and reduce accountability.** In particular, bad regulation can breed a culture of unaccountability among individuals and corporations and – at greater still potential cost – it can reduce the return to risk. That discourages entrepreneurs and others from the innovation that leads to growth in national income.

**But how big are they? These costs are not counted in business compliance cost surveys or in regulation impact statements.**

Nevertheless, the available indicators do suggest a strong link between greater regulation and poorer economic outcomes – lower GDP, higher unemployment, and a less equitable distribution of wealth.

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