

THE EROSION OF THE ECONOMIC BENEFITS OF FEDERALISM

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I have been asked today to talk about the erosion of the economic benefits of federalism. I had to do some homework, to tell you the truth. And I concluded, after doing my homework, that — certainly at the academic level — the study of the federation is a dying field amongst economists. I spoke to my dear friend Jonathan Pincus this week and asked him whether he agreed with that proposition and he said that was right.

There was a halcyon time when economists were very interested in the federation and how it interacted with government spending and taxation and federal financial relations in general. The key economists in Australia interested in this area included Geoff Brennan, Jonathan Pincus, Glenn Withers, Brian Dollary, Cliff Walsh and Brian Galligan. But there is not much interest from younger academics today.

When thinking about why economists are interested in federalism, one of the absolute key issues is subsidiarity. It is a simple idea really: we want governments to be performing their task as close as possible to the locus of their activity, be it citizens or businesses. We want these things to be performed at the lowest possible level. The debate in this country has become extraordinarily confused and you hear all the time people saying: *'We need a national approach on homelessness, we need a national approach on pill testing, we need a national approach on lock-out laws.'* No, we do not. In fact, we do not need a national approach on a lot of things.

A national approach robs the nation of the potential benefits of competitive federalism. One state can experiment with a particular policy approach, or indeed do nothing, that also is an experiment, and see what happens, providing a yardstick for competition which is available to the other states. The Productivity Commission's Blue Book compares the performance of the states in providing government services, which essentially forms the basis for some very useful material when thinking about competitive federalism.

Subsidiarity is an absolute key idea based on the idea that sub-national governments have a much better idea of citizens and businesses in their jurisdiction. It is also about accountability, with much less blame shifting and buck passing. An important aspect to the system, however, is that there is free and unfettered movement of people within the country, with the potential for mobility of citizens therefore acting as a constraining force. For example, in the early 1990s in Victoria, things were getting sufficiently bad at that point, and there was scope for citizens to flee the jurisdiction. Of course, Victoria had an election and Jeff Kennett was elected.

When thinking about the economic issues of the federation, it really would be quite helpful if we had a better definition of the roles and responsibilities of the different levels of government. It was probably clearer in the past: the states had sole responsibility for school education, for example, and for hospitals, and so on. However, defining the roles and responsibilities of the different levels of government has now become a very blurry field. When Tony Abbott was the Prime Minister, he made the very useful suggestion that the Commonwealth Government should not be involved in urban transport; it being an area without any real interjurisdictional spill-overs. Interestingly, he was howled down at that point.

And now, of course, the Commonwealth is deeply involved in urban transport.

We also need to reform the specific purpose payments. These are a controlling mechanism whereby the Commonwealth provides grants to the States on tied terms, which has now become out of hand. I will return to this shortly.

And, of course, we have the complication of horizontal fiscal equalization. I have been in the news a lot over the past several years particularly with Western Australia doing so badly out of the allocation determined by the Commonwealth Grants Commission. This is an important economic issue, especially because of the lack of incentives for states to do sensible things. For example, in the case of royalties, they are distributed away to states that do not do anything.

Because this is a dying field, there is little recent evidence on the economic benefits of federalism. However, at a broad level, there are some international papers which demonstrate that federated states perform better economically than unitary states. Further, Anne Twomey and Glen Withers did a very interesting paper back in the mid-2000s, where they showed that the federal structure was adding about \$4,500 to per-capita income. And then they estimated that we could get an additional \$4,000 if we were to move to a better structure of federation. It was quite a compelling piece of work. But the big business community that operates over jurisdictional borders is not a big fan of federation. So the Business Council of Australia commissioned Access Economics to come up with what looked like, for them, compelling reasons to sort out the federation, suggesting that the cost of federation was about nine billion dollars because of overlaps and confused roles and responsibilities.

The 2000s was a bad time for federation in Australia in the sense that we had the *Work Choices Case* and the *Pape Case*, which confirmed the ability of the Commonwealth to override the states on various matters. (And I do not know whether anyone is talking about the *School Chaplains Case*, but it looks to me like the Commonwealth is violating that precedent all the time, but no one's bothering to challenge the Commonwealth because it is handing out money directly to local governments, and even handing out money directly to members of parliament to then allocate to their friends for community projects!)

For a time there in the 2000s, it looked a little favourable because when Kevin Rudd became Prime Minister (and my guess is that it was Ken Henry), he recommended that they call a quick COAG meeting in December 2007 and at that time there was a real push to try to sort out roles and responsibilities and the specific purpose payments. It fell apart, but it was quite an interesting development. Then we had Prime Minister Tony Abbott, who had really been a very devoted centralist. He had said early in the 2000s that he thought the federation was “feral” and when he was the Minister for Health he thought it might be a good idea if the Commonwealth took over all health responsibilities from the states and territories, which was actually quite a lunatic idea that even the Commonwealth bureaucrats did not like. The Commonwealth did run one hospital down in Burnie incredibly badly for quite a long time and has now, at great expense, handed it back to the Tasmanian government.

When Rudd came to power there were 70 ongoing specific purpose payments and 30 one-off payments. They moved to six national agreements, which was a positive development, but it was incredibly short-lived. They panicked during the Global Financial Crisis and they wanted to tell the states what to be

doing. By 2010, we had 51 national partnership agreements and 230 implementation plans. The mind boggles when you think about it. Can you imagine the number of meetings? Can you imagine the number of reports? Can you imagine the number of words? Can you imagine the number of public servants that were involved in that activity? And then, by 2016, when the Abbott reforms had been killed off by Malcolm Turnbull after the green paper, we had seven national agreements, 30 national partnership and 50 project agreements. And the more general point is that the tied grant represents around 45% of all state grants, bearing in mind that GST grants are not tied grants, and there were only about 20% of such grants in the 1950s and 1960s. So, it really is a picture of encroaching and inefficient Commonwealth controlled spending. There is a really high degree of process and measurement and outcomes that are required in these specific purpose payments: in other words, the compliance costs are extremely high.

Turning then to the issue of vertical fiscal imbalance. The Commonwealth is absolutely dominant in terms of raising revenue. The Commonwealth raises 82% of total tax revenue, the states and territories raise about 15% and local government the remaining 3%. And it really does contrast quite markedly with Canada, where the provinces are very active in raising their own revenue, and the central government there raises only 45%. The sub-national governments of Germany, the United States and Switzerland also raise very high proportions of revenue. Thus, Australia has a very high degree of vertical fiscal imbalance. The only one that seems to be higher is Austria.

It also is quite true, and it partly arises because of the horizontal fiscal equalization issue, that this degree of vertical fiscal imbalance also varies across the states. Victoria, New South Wales and Western Australia raise a higher proportion of

their own revenue, than, for example the Northern Territory, which raises pretty much nothing. Jonathan Pincus was telling me that he had done a ‘back of the envelope’ calculation about the rate of growth of taxes that the states and territories would have to impose to get Australia into a level of vertical fiscal imbalance at around 20% like it is in Canada: and the answer was 90%. In other words, the states and territories would have to increase taxes and other charges by 90% in order to remedy the vertical fiscal imbalance. I guess you can conclude that that is not going to happen, which means we are going to continue to live with a very high degree of vertical fiscal imbalance and its consequences.

How do I see the future? The mess will continue, and the confusion will continue, and the Commonwealth will continue to dominate. All the levels of government are to blame and I think the blame shifting and the buck passing suits everyone up to a point; it certainly suits some of the states — in Queensland and Western Australia, particularly, they press the Canberra button and they might get some more votes. And I am not sure the states and the territories are particularly keen to raise their own revenue.

I think it was extremely badly handled but Prime Minister Malcolm Turnbull raised the issue of the states imposing an income tax surcharge. The sprint out the door was particularly unedifying. None of them were interested in that at all and you just have to come to the conclusion that, in a sense, they might complain but they are unlikely to do anything about the current system. I think the sad thing is that we will continue to exact a high economic price for this. I was quite excited about the green and white paper process that Tony Abbott put in train. He set up a very good expert panel with my friend Doug McTaggart. He was part of the team and the feedback he gave me was that it

was a very productive process. They had some very good meetings and, particularly, the Premiers – Labor and Liberal – were on board. The trouble was that, for reasons that I am not entirely sure about, it did not suit Malcolm Turnbull to proceed with the process and so it died. But there is a lot of good material in the green paper that was prepared on the reform of the federation, even though there was never a white paper.

Henry Bolte said that the time will come when the federal government will be blamed for everything – an unmade road, the lack of an ambulance, a leaky school tap, at which point the Commonwealth would come to the states and say “take it back”. I do not think so. My take is that the states will not take it back. Maybe the Samuel Griffith Society is a group that can think strategically about how we can restart the process of the reform of federation including the absolutely central issue of federal financial relations.

