

## THE ECONOMICS OF FEDERALISM AND FEDERAL REFORM

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### I INTRODUCTION

If I had been writing about the economics of federalism a couple of decades ago or earlier, I likely would have focused principally on federal *fiscal* issues: that is, about who should deliver what public sector services; what taxes they should use to do so; and what role intergovernmental grants should play. However, especially starting in the early 1990s with the Greiner–Goss–Bannon–Hawke-led new federalism initiative, economic issues – economic reforms – have become a, if not the, centrepiece of intergovernmental relations in Australia. That is to say, the focus has shifted to, for example, who should regulate what, by whom it should be regulated, and how essential infrastructure should be provided, in order to improve the international competitiveness of the Australian economy.

The genesis of this trend lay in recognition by key advisors to State Premiers (Gary Sturgess and Kevin Rudd especially, as the Heads of policy-focused Cabinet Offices in New South Wales ('NSW') and Queensland respectively) that the European Union 'single-market' initiatives were leading to a more integrated economy among sovereign nations than Australia, at that stage, had achieved among States in a single nation.<sup>1</sup> The new federalism initiative inspired by that recognition had modest, but important, initial objectives. Mutual recognition of occupational licensing and professional qualifications, mirroring what had already been achieved in Europe, was seen as a useful and not too ambitious first step towards tackling a much more ambitious agenda of national economic reforms to create a 'seamless' national economy. The importance of microeconomic reform of government trading enterprises, an extension of the

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1 There is some dispute about who really initiated the early 1990s reform initiative. A more or less contemporaneous account, and a critique of the principles underlying the initiative, can be found in Christine Fletcher and Cliff Walsh, 'Reform of Intergovernmental Relations in Australia: The Politics of Federalism and the Non-Politics of Managerialism' (1992) 70 *Public Administration* 591.

interstate electricity network, the establishment of what is now known as the Australian Rail Track Corporation, and a national heavy vehicle registration scheme were also promoted.

In a sense, this agenda was a logical next step to the national level structural economic reforms made by the Hawke–Keating national Government in the mid- to late-1980s, including floating the exchange rate, deregulating financial markets, eliminating import quotas, accelerating reductions in tariff barriers and privatisation or corporatisation of Commonwealth-owned public utilities. The early 1990s initiatives were not devoid of attempts to reform federal fiscal relationships, however. Indeed, some of the usual suspects were on the agenda, such as making roles and responsibilities neater and tidier and streamlining the system of tied grants or Specific Purpose Payments ('SPPs').<sup>2</sup> There was even talk of giving the States greater revenue raising ability, to reduce so-called Vertical Fiscal Imbalance ('VFI'), by allowing them (in a managed way) back into the income tax base. The fact that then Prime Minister Bob Hawke was even thinking about such a possibility contributed to his demise at the hands of Paul Keating, who scared the Labor caucus into believing that Hawke was preparing to cede substantial elements of Commonwealth powers to the States.

The Keating Prime Ministership pushed reforms to federal *fiscal* relationships firmly off the agenda and, the Howard Government's politically expedient Goods and Services Tax ('GST') deal being a notable exception, that is pretty much where they remained until the new Rudd Government, right from the outset in late 2007, put them equally firmly back on the table. What Keating did do, however, was to win cooperation from the States for a very ambitious program of economic reforms, at State as well as national level, embodied in the National Competition Policy ('NCP') agreement in the mid-1990s, and there have been further advances since then, albeit at a much reduced pace and of lesser scope, which I will discuss later.

The vehicle through which NCP was negotiated between the Commonwealth and the States (and much else since) – the Council of Australian Governments ('COAG') – also had its origins in the earlier 1990s initiatives. The then proposed cooperative economic and fiscal reforms were negotiated in a series of what were called Special Premiers' Conferences ('SPCs'), to distinguish them from regular Premiers' Conferences which had had a very long history of being highly conflictual, rancorous even, annual meetings at which the State Premiers and the Prime Minister fought about what was a reasonable level of untied (financial assistance) grants from the Commonwealth to the States. The SPCs proved to be a very successful cooperative forum in which Heads of Governments ('HOGs') formed agreements based on work jointly led by their most senior officials (reference to HOGs led to this group of officials calling themselves PIGLETS!). When he became Prime Minister, and needed a forum in

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2 This component of the agenda stemmed from an impassioned 1986 Garran Oration by then South Australian Premier John Bannon: see John C Bannon, 'Overcoming the Unintended Consequences of Federation' (1987) 46 *Australian Journal of Public Administration* 1.

which to get ‘cooperative’ agreements with the States, Paul Keating renamed the SPCs ‘Meetings of the Council of Australian Governments’ – a name that has stuck since then.

One consequence of the transformation of the principal focus of intergovernmental relations from essentially political and *fiscal* to substantially political and *economic* has been that a wider range of economists have become interested in intergovernmental relations. I should quickly say that most have become interested not because they are intellectually interested in economic (let alone political) theories of federalism but, rather, because the main game in economic reform nowadays is played out through COAG. Indeed, it would be fair to say that most economists (like the business community) see federalism as an anachronism, or at least an obstacle, to economic progress. While generally accepting that there is no way of getting rid of the States, they are on the lookout for ways to diminish the capacity of the States to act autonomously, especially in economic matters.

It will become obvious that I do not think about federalism in this way; I will make it clear why during the course of my discussion. What I attempt to do in the rest of my analysis is, first (Part II), to give a flavour of what those economists who are genuinely interested in federalism have developed as economic theories of federalism and, second, to explore what those theories have to say about future directions for federal fiscal reform (Part III) and for economic reform in the federal context (Part IV). In Part V, I offer a few concluding comments. I hope to demonstrate that from what initially was a rather mechanistic economic theory of federalism has flown a much more nuanced theory which challenges a number of orthodoxies in the way many political scientists, often governments, and certainly most economists, think and talk about federal reforms.

## II ECONOMIC THEORIES OF FEDERALISM

I refer to economic theories, plural, because, following the establishment of a basic economic theory of federalism, a number of divergences have emerged in ways of analysing and thinking about federalism among interested economists. I will address these after setting out the initial basic theory. Though somewhat dense, an explication of this theoretical basis will, I hope, be useful for the uninitiated in understanding what has been the predominant mindset of economists about federalism and the nature of their interest in it. (Those familiar with this theory, or uninterested in it, may want to refer directly to Part II B below.)

### A The Economic Theory of Functional Federalism

The first fully articulated economic theory of federalism was presented in a book by American economist Wallace Oates, published in 1972.<sup>3</sup> Reflecting the fact that economists’ increasing interest in federalism to that point had revolved

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3 Wallace E Oates, *Fiscal Federalism* (1972).

around fiscal issues, especially intergovernmental grants, Oates essentially presented a theory of *fiscal* federalism: that is, a theory about who should deliver what public sector services, what taxes they should use to do so, and when and why a system of intergovernmental grants would be an important accompaniment. Not surprisingly, this approach has subsequently become known as a theory of *functional* federalism.

The basis of the theory derived from a general approach to what were considered to be the appropriate roles of the public sector in the public economics literature, which drew a distinction between three functions: macroeconomic (demand) management (targeted at achieving stable prices and high levels of employment); promoting distributional equity (using a tax-transfer system to achieve an equitable distribution of income); and achieving allocative efficiency (addressing market failures that result in distorted patterns of outputs of goods and services).

The economic theory of functional federalism suggested that the macroeconomic management and distributional equity functions should rest primarily with the national government. They were argued to be almost inherently national objectives and there also are reasons why attempts by sub-national governments to stimulate their own economies or achieve distributional objectives would be of limited effectiveness and possibly counterproductive.<sup>4</sup> Those arguments do not need to be rehearsed here, save to say that later developments in the economic theory of federalism have called them somewhat into question. Nonetheless, they were taken to imply that if sub-national governments appropriately have a role it must primarily lie with the achievement of allocative efficiency by correcting market failures and that the strongest case was in the provision of what economists call ‘public goods’.

The term ‘public goods’ is best explained by reference to an example. A national defence system, unlike a slice of bread or a glass of wine, can be consumed simultaneously by many people: one person benefiting from it does not prevent others from also doing so to the same extent, making it ‘joint in consumption’. At the same time, no-one can be precluded from benefiting from it whether or not they offer to pay for consumption of its benefits: it is ‘non-excludable’. In fact, everyone has an incentive to try to ‘free-ride’ on others – to get the benefits without sharing in the costs. Since everyone has the same incentive, private-sector provision is not possible (or would at least result in under-provision). It requires public-sector provision, funded out of compulsory charges – taxes.

Clearly, a system of defence is a national public good, as is a diplomatic service designed to keep amicable relations with neighbouring countries or to negotiate trade agreements and the like. But there are some public goods the benefits of which are more spatially limited. A local road system with multiple access points can be used by many and a system of toll-gates (or electronic tracking and charging) would be prohibitively expensive. But it benefits local

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4 Ibid 4–8.

residents much more substantially than others: it is a local public good. Similarly, a regional road network connecting towns is in the nature of a regional public good.

There are many other services that have similar characteristics. A local park, a metropolitan fire or police service, a protected forest or a wilderness area, offer essentially joint but non-excludable benefits to those who live nearer in proximity to them than those further away. And it seems natural to suggest that they might best be provided by governments that have a similar geographic span – local, regional and so on.

There are other services provided by, or at least subsidised by, the public sector (paid for by citizen-voters) because they have benefits over and above those directly captured by those who use them. For example, education not only benefits the educated by giving them skills that will provide them with employment and hence income earning opportunities, but also benefits communities by improving social functioning by those educated. Those ‘spillover’ benefits are also of a public goods nature – jointly consumed by many and non-excludable – and predominantly local for basic schooling and more regional and national for higher levels of education.

The geographic mapping of different types of services to different levels (or spheres) of government creates the basis of an economic theory of multi-level government. The mapping, however, would not always be perfect – or, at least, not unless one was prepared to contemplate *many* different levels of government, each tailor-made to the geographic span of different public goods. Mapping into just a few (usually three or four) will mean some of the benefits of public goods provided by, say, one local government area – such as its road system – will spill-out to residents of other local government areas around it who use the system for transit or access to shopping centres or friends.

This last fact, among others, gives rise to an economic theory of intergovernmental grants. Any benefits that one jurisdiction’s provision of public sector services provide to non-residents will not enter (at least not fully) into the benefits that residents recognise when they vote for levels of services to be provided by their government. So, for example, when jurisdiction A decides how much to spend on education, it has no incentive to take into account any benefits that might accrue to other jurisdictions if some people educated in jurisdiction A subsequently move to another jurisdiction. Since the same is true for all jurisdictions, under-investment in education everywhere will result. However, in principle, this can be corrected by the national government (or higher level sub-national government) providing grants to all jurisdictions, tied to increased expenditure by them on education.

Similar things could be said of expenditure on local and interstate roads, on health, on welfare programs, on law and order and so on. In some cases, the interdependencies can be ‘internalised’ by cooperation between sub-national jurisdictions (for example, in planning for inter-capital city highways), but in many cases corrective intergovernmental grants are the best and most feasible

way of ensuring that the interdependencies are reflected in the autonomous decisions made by sub-national jurisdictions.<sup>5</sup>

All in all, this economic theory of functional federalism provides a neat conceptualisation of a normatively desirable assignment of functions to different levels of government by trying to match service delivery functions against the geographic span of benefits they provide – local, regional or national – and mopping up the consequences of the inevitable lack of complete correspondence between jurisdictional boundaries and the geographic span of the benefits of services through a system of corrective, tied intergovernmental grants. And, of course, by having multiple multi-layered sub-national governments, differences in preferences for public sector services in different jurisdictions can be reflected in different patterns and levels of services in different jurisdictions (at sub-national levels at least).

However, while it might sound like a theory of federalism, the theory of functional federalism effectively sets aside a central ingredient of federal systems – politics. In fact, the theory in this basic form contains an important implicit assumption about political processes: that is, that governments in all jurisdictions can and will behave as if they are benevolent, omniscient ‘dictators’, providing more-or-less the right levels of public sector services to maximise the well-being of their jurisdiction’s citizen-voters. If that outcome could not be guaranteed, it throws open to question whether the proposed assignment is best. But if it *were* the case that governments are relatively omniscient, it would be hard to explain why sub-national governments could not be done away with in favour of an omniscient central government providing sub-national public goods at the varying levels desired by different sub-groups of the population.

Of course, no-one believes that governments are omniscient and the basic economic theory of federalism, somewhat incoherently, uses that fact to ‘explain’ why central governments cannot differentiate service delivery between sub-national regions – because they cannot obtain the necessary information about preferences, cost functions and other local circumstances to enable them to do so, and, as a consequence, will be limited to providing broadly similar service levels nationally. This is a convenient explanation because it corresponds with the standard presumption that governments closer to the people are better able to reflect their preferences in service delivery decisions.<sup>6</sup>

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5 The economic theory of federalism also provides an efficiency rationale for untied grants to (some) jurisdictions to achieve fiscal equalisation – essentially to prevent potential distortions in location decisions by individuals caused by differences in, for example, the capacities of jurisdictions to raise tax revenue, per capita, if they applied similar tax rates. Important as this is, it is not central to my discussion. For a simple exposition of the argument, and a critique of its current application in Australia, see Jonathan Pincus, ‘Six Myths of Federal–State Financial Relations’ in Committee for Economic Development of Australia, *Economic and Political Overview* (2008) <[http://ceda.com.au/public/research/federal/six\\_myths\\_federal\\_state.html](http://ceda.com.au/public/research/federal/six_myths_federal_state.html)> at 4 August 2008; Jonathan Pincus, *Submission to Senate Select Committee on State Government Financial Management* <[http://www.aph.gov.au/senate/committee/sgfm\\_ctte/submissions/sub07.pdf](http://www.aph.gov.au/senate/committee/sgfm_ctte/submissions/sub07.pdf)> at 4 August 2008.

6 See Wallace E Oates, ‘Toward a Second-Generation Theory of Fiscal Federalism’ (2005) 12 *International Tax and Public Finance* 349, 352–4.

While there is unquestionably *something* in this, it is not obvious why central governments could not tap into information about local preferences for local public goods – at some cost, of course. Here, the economic theory of functional federalism wheels in an alternative explanation for why central governments could not differentiate patterns and levels of service delivery between regions and localities. There is, it is suggested, a political constraint on governments that precludes them from providing different service levels to different regions (particularly more generous to some) funded out of uniformly applied taxes. There is, the argument goes, a sense in which people regard their ‘common citizenship’ in a political jurisdiction as entitling them to similar treatment to other citizens, regardless of location. Again, there probably is something in this suggestion; however, if there is such a constraint on governments, they often find ways around it to some extent. For example, governments often have grants schemes which support expenditure initiatives in some regions but not others on grounds that have little regard for economic rationality. They also make regionally salient decisions about where to locate facilities or award contracts and whether to support declining industries which have regionally-concentrated production facilities and so on that often appear to be at variance with what would be decided if economic criteria were applied.

The bottom line in all of this is that the economic theory of functional (fiscal) federalism’s unavoidable intersection with politics is handled in an ad hoc fashion, consisting principally of a search for reasons for why its theory of the appropriate assignment of functions between levels of government on economic grounds is not inconsistent with how functions are typically assigned within federal systems of government. This does not make the theory wholly irrelevant. At the very least, it provides a basis for understanding what is likely to shape the comparative advantages of different levels of government in delivering services to their constituents, relative both to the private sector and to other levels of government. However, it totally lacks the capacity to reflect the consequences of political motives, political institutions and the dynamics of political behaviour.

## **B Putting in Some Political Economy**

In more recent times, the initial economic theory of functional federalism has been enriched, and to a degree transformed, by recognising the weakness created by its lack of political context. Politics has been injected into the economic theory of federalism in two different ways – two different directions, in fact.

The first direction of enrichment of the economic theory, depicted by Wallace Oates as a Second Generation Theory of Fiscal Federalism,<sup>7</sup> attempts to build into the basic theory the reality that public sector players – politicians and bureaucrats especially – have their own motives rather than being mechanistic ‘servants of the people’ (or, in the case of bureaucrats, servants of the government) and that political institutions and processes have their own logic which shapes outcomes differently from economic institutions. This approach

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7 Ibid 356 ff.

builds on a branch of public sector economics that has come to be known as political economy, or public choice.<sup>8</sup>

One important thrust of the political economy literature is that voting as a preference revelation device has many deficiencies and this gives politicians some degree of discretion to promote their own objectives, even if not entirely consistent with voter preferences. A major direction in which the political economy of federalism literature has gone is to try to answer the question of what assignment of functions will most effectively constrain politicians' ability to act at variance with voter preferences. Although the precise way in which it is modelled differs substantially within the literature, the characteristic of this situation is what is known as a 'principal-agent' problem. Voters, as principals, are unable to completely monitor the behaviour of governments as their agents. The question then becomes one of what degree of centralisation or decentralisation serves the principals' (voters') interests best. Oates,<sup>9</sup> summarising a now fairly substantial literature, sees suggested in the models a trade-off between the capacity for centralisation to internalise the consequences of the interdependencies that result from the lack of complete correspondence between sub-national jurisdictional boundaries and the geographic span of sub-national public goods on the one hand, and the greater accountability to voters that comes with decentralisation of public sector decision-making on the other. This isn't entirely surprising. What is more interesting about the results compared to the older approach is that (at least in some models) the degree of decentralisation that maximises the interests of voters in constraining the degree of discretionary behaviour that politicians can exercise is independent of whether voter preferences for levels of local public services are different or not in different sub-national jurisdictions. Thus, a situation of identical preferences between jurisdictions, which in the older theory would have made centralised provision as good as decentralised provision and cut out the need for intergovernment tied grants, now does not make centralisation as 'good' as decentralisation.

As yet, however, no unified theory has come out of this political economy approach, and it has been very narrowly focused on the centralisation versus decentralisation issue. Among other things, it has little to say about some of the bigger issues about the design of intergovernmental arrangements that are the inevitable consequence of a federal structure. From this, and many other perspectives, a second new direction that the economic theory of federalism has taken has much the greater claim to provide a new unified approach, with politics at the front and centre of it.

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8 The literature on this branch of public sector economics is comprehensively covered in Dennis C Mueller, *Public Choice III* (3<sup>rd</sup> ed, 2003). A brief depiction of it can be found in Harvey S Rosen, *Public Finance* (7<sup>th</sup> ed, 2005) 111–42.

9 Oates, above n 6.



### C Competitive Federalism

What is likely to come to be seen as a defining moment in the development of economic theories of federalism occurred in 1996, with the publication of a book written by French-Canadian economist Albert Breton entitled *Competitive Governments: An Economic Theory of Politics and Public Finance*.<sup>10</sup> As yet, there is no definitive brief summary of his theory as it applies to federalism that I am aware of (though I have elsewhere made an attempt to encompass it in a discussion of whether political competition in federal systems is wasteful or welfare enhancing<sup>11</sup>). But, as its title suggests, it provides an economic theory of federalism in which politics now plays the pivotal role: it is an economic theory only in the sense that economists' ways of thinking shape how political processes are interpreted. Unlike in the economic theory of functional federalism which I outlined earlier, politics, not economic theories of public policy, drive interpretations of who should do what (or rather, who *will* do what) in the theory of competitive federalism.

A key component of Breton's analysis is his observation that, even in unitary systems of government, political competition is much richer than often is portrayed: inter-party (electoral) competition has typically been treated as if it is virtually the only form of competition in political systems. There are, he suggests, potentially large numbers of not only autonomous centres of power (political parties and final courts) but also semi- or quasi-autonomous centres of power (for example, courts at various levels, intelligence agencies, police, tribunals, commissions, public corporations, advisory councils, central banks and so on) within the public sector, all driven by the self-interested desire to influence public sector outcomes (policies and services provided). Since the relevance and legitimacy (and hence the capacity to have an effective influence on the supply of policies and services) of each and all of these power centres derive from them winning political consent, they are all driven by competition for that consent to attempt to reshape potential outcomes in ways that reflect the preferences of citizen-voters for policies and goods and services supplied by the public sector. As a consequence, Breton suggests, political competition (even in parliamentary systems of democratic government) drives outcomes more responsive to citizen-voter preferences than is usually assumed or derived from approaches which focus essentially on inter-party competition.

Breton argues that when the additional layers of political competition inherent in federal systems of government are added, the responsiveness of the political system to voter preferences is even further enhanced. Part of his argument is somewhat familiar: that is, federal systems promote *horizontal* inter-jurisdictional competition which, over time, drives all sub-national governments to deliver services at least as efficiently as the best performing of them and encourages the

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10 Albert Breton, *Competitive Governments: An Economic Theory of Politics and Public Finance* (1996).

11 Cliff Walsh, 'Competitive Federalism: Wasteful or Welfare Enhancing?' in Productivity Commission, *Productive Reform in a Federal System: Roundtable Proceedings* (2006).

development of policy innovations which, if successful, get diffused across jurisdictions to the benefit of the citizen-voters in them all.<sup>12</sup>

The usual explanation given for inter-jurisdictional competition of this sort is the potential for citizen-voters (and businesses) to vote with their feet: to move to other jurisdictions which will better (more effectively and efficiently) meet their needs and preferences. However, the mechanisms at work are more subtle than this explanation implies. The potential for mobility to influence the performance of sub-national governments must rest on the ability of people, business and political parties to engage in ‘yard-stick’ comparisons of outcomes (the performance of governments) in other sub-national jurisdictions. But if people can make these comparisons, so can political opposition parties; even if people were totally immobile, inter-party competition within sub-national jurisdictions would tend to drive outcomes similar to those that would result if people were, in fact, prepared to move to obtain better outcomes. In a manner of speaking, inter-jurisdictional competition and inter-party competition within jurisdictions are inextricably intertwined.

What Breton’s analysis of competitive federalism particularly adds to the analysis of political competition in federal systems, however, is an emphasis on *vertical* (intergovernmental) competition between national and sub-national governments. In most discussions of this sort of competition, the outcomes are assumed or asserted to be likely to be detrimental to sub-national governments – possibly more so than the risk that horizontal (inter-jurisdictional) competition might sometimes result in ‘beggar thy neighbour’ policies designed to attract business investment by offering special deals. The essence of these adverse reactions to vertical competition lies in a presumption that national governments will always ‘win’ because they are seen as being financially dominant and thus able to outbid sub-national governments essentially at will.<sup>13</sup>

There is no denying that, even in federations where sub-national governments have less circumscribed access to tax bases than do Australia’s State governments, national governments have potentially greater financial muscle-power than sub-national governments and are also often aided in their attempts to centralise power by constitutional decisions that do not apply, or apply weakly, ‘federal principles’ to decisions about the implied scope of national governments’ heads of power. But the flip-side of the coin is that exercising those powers comes at a cost that will influence whether they are, in fact, exercised. To outplay sub-national governments by using their potential financial muscle requires that national governments be willing to impose higher tax burdens on their constituents (or provide them with lower ‘own-purpose’ outlays) than otherwise; and to outplay them by appeal to the constitutional court requires that both national governments and the judicial arm be willing to put at risk the political consent they otherwise would enjoy. In short, there is an important difference

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12 Breton, above n 10, 181–95 provides an overview of this and related arguments.

13 Ibid 228–63.

between the *appearance* of dominance and the reality of the political consequences of trying to *exercise* it.

In Breton's analysis, the principal consequence of vertical competition between national and sub-national governments is in determining 'who does what'. The political reality is that the political constituents of national governments are also political constituents of (different) sub-national governments and the overlapping constituencies will judge between levels of government for service delivery according to how effective and efficient they prove to be in delivering services. On this account, vertical competition will result, in the long run, in governments at different levels sorting roles and functions among themselves according to which *activities* they have a comparative (competitive) advantage in undertaking. This will tend to be so whatever the constitutional divisions of powers, or functional theories of federalism, might appear to imply.

The almost inevitable outcome of vertical competition is a 'messiness' in how roles and responsibilities, as usually understood, ultimately become politically assigned: sub-national governments might prove to be more effective and efficient in planning and delivering some types of re-distributional activities or employment enhancing initiatives than national governments, even though normative 'best practice' policy principles might suggest otherwise. Conversely, national governments might prove to have a comparative advantage over sub-national governments in, for example, planning regional road systems to inter-link with inter-capital city highways or providing support for regional economic development. The general point, I hope, is fairly clear: vertical political competition will tend to result in governments at all levels being driven to take on activities in which they have a comparative political advantage. Those activities are to be seen as *activities* not functions; they might well appear to be, or actually be, at variance with what constitutions say, or imply, about appropriate roles of different 'levels' of government; and the activities that different governments take on will only sustainably cut across broad assignments of functions if governments that try to take them on prove to be the most efficient and effective in doing so. The outcomes for citizen-voters are that policies and programs will be more reflective of their preferences than otherwise and delivered at lower cost (lower taxes imposed) than otherwise.

The fact that political competition is the predominant characteristic of both intergovernmental and inter-jurisdictional relations does not mean that cooperation will not occur. It will do so when it has the capacity to enhance the political consent and support given to the cooperating governments, and sub-national governments might as easily be the initiators of cooperative initiatives as the national government. So, for example, the national government might agree to impose higher taxes than otherwise in order to more efficiently raise revenues from broad-based taxes on behalf of sub-national governments, but will require them, as a quid pro quo, to agree that part of the revenue be received as tied grants which promote the national government's objectives in policy areas that principally are occupied by the sub-national governments. Alternatively, the national government might offer 'incentive payments' to sub-national

governments to induce them to support policy changes that principally promote the national government's political objectives, thereby engendering associated political support.

That said, Breton's analysis suggests that it is most unlikely that cooperation will become the predominant means for 'organising' intergovernmental relations. As a general rule, competition rather than cooperation will best serve the political interests of governments. Cooperation will be considered on a case-by-case basis as an exception to the general rule.

Clearly, the economic theory of competitive federalism puts politics at the centre, unlike the older economic theory of functional (fiscal) federalism. As a result, many of the features of the predicted outcomes differ substantially. For example, in Breton's analysis, competition for political support might (and likely will) take governments into policies and programs that involve them interfering with what otherwise would be efficient market outcomes, rather than merely correcting market failures as the functional federalism model *assumes* will be the case. Moreover, it is entirely unlikely that competition between governments in a federal system will lead to the rather neat and tidy occupation of functions by different levels of government that the functional federalism model assumes, rather than demonstrates, will arise: indeed, governments at sub-national level will be likely to implement, for example, demand management and income redistribution policies that functional federalism argued they should not. Additionally, Breton's analysis provides an explanation for intergovernmental cooperation of a sort that is hard to squeeze out of the older line of thought.

Against this background, I now turn, first, to consider the ramifications of this theory for federal reform in general and, second, for economic reform in particular, in contemporary circumstances in Australia.

### III FEDERAL FISCAL REFORM

Calls for, and attempts at, reforming how intergovernmental relations work are a recurring theme in political (and academic) discourse about Australia's federal system. The Rudd Government put the achievement of what it calls 'Modern Federalism' at the centre of its political agenda from the moment it took office. This is so not only because the Government's election commitments included ending the so-called 'blame game' but also because many more of its election commitments require cooperation from the States if they are to be delivered. These include efforts to address climate change, water reform initiatives and reforms in the areas of health and hospitals, economic infrastructure, education, housing, competition and business regulation, as well as reforms targeted at indigenous Australians. The State Premiers have been co-opted into delivering the Rudd Government's commitments through promises of compensation for costs to their States of meeting those commitments and a broader range of National Partnership Payments ('NPPs') dependent on them making progress on meeting other 'mutually agreed' objectives.

There are two central themes in the Government's presentation of its reform initiatives: an emphasis on cooperation, and an end to overlap and duplication

(which is said to be responsible for the ‘blame game’). I will discuss these in turn, applying aspects of the economic theories of federalism that I have already laid out.

### A Cooperative Federalism

Calls for a more cooperative federalism have long been a catch-cry of political science students of federal systems of government. Australian political scientists borrowed heavily from a substantial American literature, led especially by Daniel Elazar.<sup>14</sup> Interestingly, in the American context, the call for cooperative federalism was a response to what was perceived to be a *lack* of desirable intergovernmental interaction between the federal and State governments, whereas in the Australian context, it has been a response to perceptions that there has been too much intergovernmental competition and that the Commonwealth, it is said, has used its financial dominance to an undesirable extent.<sup>15</sup>

In recent years, the business community has joined the cooperative federalism fan club, arguing that greater cooperation is required to secure ongoing economic and regulatory reform. The Business Council of Australia has even gone so far as to propose a model for institutionalising intergovernmental cooperation, including by giving COAG a permanent secretariat and staff.<sup>16</sup>

Clearly, intergovernmental cooperation sometimes will be highly beneficial, as it has been in achieving major economic reforms, beginning with NCP in the mid-1990s and now being extended through the new National Reform Agenda (‘NRA’). The establishment and continuation of COAG as a forum for cooperatively promoting reform has been a pivotal element in that.

As I observed earlier, even in a context in which intergovernmental relations are generally highly competitive, cooperation can be expected to occur when it is in the mutual interests of national and sub-national governments, because it will enhance their political support. This must mean that there are more benefits to their various political constituencies than continuing to operate independently. However, to borrow a term frequently used in relation to the decision-making processes of the European Union, there is a potentially significant ‘democratic

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14 An encapsulation of Elazar’s views can be found in Daniel J Elazar, ‘Cooperative Federalism’ in Daphne A Kenyon and John Kincaid (eds), *Competition Among States and Local Governments: Efficiency and Equity in American Federalism* (1991) 65. This edited volume, incidentally, contains a number of contributions which signal an increasing comfort among political scientists in America with the idea that competitive federalism might have substantial virtues.

15 See, eg, Kenneth Wiltshire, ‘Barriers to Rationalising Commonwealth/State Overlap’ in Economic Planning Advisory Council, *Towards a More Cooperative Federalism?* (Discussion Paper 90/4, 1990).

16 A brief encapsulation of their proposal is contained in Business Council of Australia, *A Charter for New Federalism* (2007). The ideas presented there come from a much more substantial BCA report: Business Council of Australia, *Reshaping Australia’s Federation: A New Contract for Federal–State Relations* (2006).

deficit' involved in the development of intergovernmental agreements.<sup>17</sup> There is limited transparency in the processes used to form agreements: they are deals done behind closed doors, with much of the shape and content driven by bureaucrats; the outcomes are invariably determined by the lowest (highest-achievable) common denominator among first ministers; and their subsequent implementation again is essentially in the hands of bureaucrats (intergovernmental managers, in a manner of speaking).

If there are 'stakeholder consultations' along the way, the stakeholders principally consulted are lobby (interest) groups. The average citizen-voter is dealt out of the process; so too are other State or Commonwealth parliamentary members, even ministers, and especially backbench members of the governing party. Such agreements are presented essentially as a *fait accompli*.

The general point is that intergovernmental cooperation, while sometimes highly desirable and productive, is not invariably 'a good thing' from the perspective of applying democratic principles. The fact that inter-jurisdictional competition often makes intergovernmental relationships appear combative, disharmonious and sometimes rancorous, does not mean that they are not productive, especially from the viewpoint of 'the people' – the citizen-voters whose consent and support governments compete for. Nor does it mean that intergovernmental cooperation is likely to be a rare event.<sup>18</sup>

Cooperative federalism, while often desirable, should be viewed with caution. It is potentially productive but also potentially 'anti-democratic'. Certainly, as an overarching organising principle for intergovernmental relations, it has no appeal: it facilitates governments behaving like private sector cartels, deflecting citizen-voter preferences, and denying them the use of their governments, at all levels, to pursue their perceived needs. It is an odd fact that business groups, of all people, do not recognise the dangers in the formation of a political cartel. The case for cooperation needs to be made on an issue-by-issue basis: competition should be the default option, in the interests of 'the people'.

## B Overlap and Duplication

The other familiar theme in discussions about federal reform is the claim that there is excessive overlap and duplication between the Commonwealth and the States, at substantial expense to the taxpayer. An estimate by Mark Drummond<sup>19</sup> of the savings that could be made by removing the State tier of government and

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17 George Tsebelis, 'Maastricht and the Democratic Deficit' (1997) 52 *Aussenwirtschaft* 29. See also Cheryl Saunders, 'Democracy, Transparency and the Apparent Demise of the Treaty Establishing a Constitution for Europe' in John Bell and Claire Kilpatrick (eds), *Cambridge Yearbook of International Legal Studies* (2006) 9.

18 See Albert Breton, 'Towards a Theory of Competitive Federalism' (1987) 3 *European Journal of Political Economy* 263.

19 Mark Drummond, 'Costing Constitutional Change: Estimating the Cost of Five Variations on Australia's Federal System' (2002) 61(4) *Australian Journal of Public Administration* 43. Cf Anne Twomey and Glenn Withers, *Federalist Paper 1 – Australia's Federal Future*, Report for the Council for the Australian Federation (2007).

replacing it with either regional governments *or* local governments (but not both) puts the cost of overlap and duplication at around \$20 billion a year. What Drummond does not estimate is what the costs would be to citizen-voters of losing one of their access points for influencing public policy – one with autonomous powers, at that. Nor is it self-evident that any new system of government would, in fact, be any less expensive than the present one. In any event, getting rid of the States is unlikely to happen. The real issue is whether there really is so-called overlap and duplication that can be eliminated without damaging the interests of citizen-voters.

It is certainly the case that the Rudd Government's reforms include a claimed need to end what Treasurer Wayne Swan has described as 'waste and duplication'.<sup>20</sup> He has also stated that 'the new financial architecture will make roles and responsibilities unambiguous'.

If the Treasurer literally meant 'unambiguous', he presumably was suggesting that there would be a neater and tidier delineation of roles and responsibilities between the Commonwealth and the States. Joint tasks, by definition, require joint inputs and joint activities, and the boundaries of responsibility and accountability for outcomes are, at best, blurred. At the same time, however, the Rudd Government extols the virtues of cooperation, which blends resources and comparative advantages in delivering desired policy outcomes. But cooperation blurs lines of accountability and responsibility – ultimately to citizen-voters. It is not obvious at what point neatness and tidiness – a structured, so-called rational, allocation of roles and responsibilities between spheres of government – ideally should give way to cooperatively promoting objectives in the Rudd Government's view of 'well-functioning federalism'. Taken at face value, the Government's position is logically incoherent. This sort of incoherence, repeated widely among critics of Australia's federal fiscal arrangements, gets in the way of clear thinking about what should be the intent, and content, of federal fiscal reform.

In my view, it is simply a reality of federal systems that they will *not* result in, or sustain, a neat and tidy (unambiguous) allocation of roles and responsibilities, as usually interpreted. As suggested by the theory of competitive federalism, national governments and State governments compete with one another to occupy policy spaces in order to win political support. Who wins depends on who is best – most efficient and effective – in delivering the desired policy and service-delivery outcomes. The result is a win for the people (and businesses as intermediaries): they get the outcomes at least cost, or more effective outcomes for any given cost. But the outcomes are likely to involve governments sorting themselves by activities, not functions, *per se*. The upshot of all this is likely to look very messy seen through the prism used by those who want separation of roles by functional area and I would be surprised if anyone in the political sphere thought it really could, or would, be otherwise. Politics is a messy business. It is

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20 Wayne Swan, 'Modern Federalism and Our National Future' (Speech delivered at the Economic and Social Outlook Conference, Melbourne, 27 March 2008).

more so when jurisdictions overlap, but that is a consequence of having a political system more responsive to citizen-voter needs and demands.

### C Intergovernmental Grants

The major cause of so-called overlap and duplication is the fact that the Commonwealth government makes tied, conditional, grants (SPPs in Australian parlance) to the States, as it is able to do under section 96 of the *Australian Constitution*. These are used to promote Commonwealth objectives in service-delivery areas that are exclusively the States', including in relation to public hospitals, State schools, universities, roads, housing and local government. They beget overlap and duplication because a substantial number of Commonwealth officials, in effect, 'shadow' counterparts in State agencies in order to acquire the capacity to monitor whether the States are using the grants as required under agreements between the Commonwealth and the States, and to develop policies, or policy changes, for renegotiation of the agreements from time to time. The provision of SPPs and the terms on which they are provided is a *potentially* important item in promoting federal reform. However, its position on the Rudd Government's reform agenda is not unique: the early 1990s reform initiative, among other things, had reform of the ways in which SPPs were designed as an important agenda item. However, it went roughly nowhere. To understand why attempts to reform (and especially reduce) tied grants have proved ineffective, if not futile, requires that SPPs be seen in the broader context of the totality of the grants provided by the Commonwealth to the States.

Figure 1 provides a summary of State governments' revenue sources, indicating the significance of Commonwealth grants. Those grants – tied (SPPs) and untied (general purpose, nowadays consisting of fully hypothecated GST revenues) – provide over 40 per cent of State government revenues (\$64 billion out of \$148 billion of State revenues projected for the 2007–08 financial year). Untied grants are the largest component: \$42 billion estimated for 2007–08, or around 28 per cent of States' revenues and 65 per cent of Commonwealth grants to the States. By contrast, tied grants (SPPs) are a more modest 15 per cent of State government revenues, or about one-third of Commonwealth grants to the States.



Figure 1: Estimated State Revenue by Source 2007-08

Revenue Source	\$ billion	Per cent of Total
<i>Own-Source Revenue:</i>		
Tax	49	33
Other	35	24
Sub-Total	84	57
<i>Commonwealth Grants</i>		
GST Revenue (untied)	42	28
SPPs (tied)	22	15
Sub-Total	64	43
Total States' Revenue	148	100

Source: Australian Bureau of Statistics, *Government Financial Estimates 2007-08* (Cat No 5501).

## 1 Vertical Fiscal Imbalance

The seemingly high level of dependence of the States on grants from the Commonwealth to fund the public services for which they are responsible is often referred to as reflecting VFI. As the term VFI suggests, the inference drawn from the *essentially statistical* observation that grants from the Commonwealth fund a substantial proportion of States' expenditures is that the States' own revenue sources are inadequate to meet their expenditure needs. The Commonwealth's takeover of the income tax during World War II<sup>21</sup> and its subsequent 'refusal' to let the States back into this field,<sup>22</sup> together with 'irrational' decisions by the High Court, in effect interpreting the States' preclusion from imposing duties of excise as precluding them from imposing any sort of tax on the sale of goods,<sup>23</sup> are said to be to blame for VFI.

A number of general responses might be made about this representation of the causes of VFI. The first is simply that some degree of 'dependence' on grants from national governments – untied as well as tied – is characteristic of all mature federations with which Australia compares itself, even where sub-national governments have access to a wide range of buoyant revenue sources on their own account. That is, national governments seemingly have motives of their own to make intergovernmental grants, even where sub-national governments appear to have adequate revenue sources to meet their own expenditure needs.

The second point to be made is that, to some degree, the States are exercising a choice about how dependent they are – about the degree of VFI as statistically

21 The validity of this change was upheld by the High Court in *South Australia v Commonwealth* (1942) 65 CLR 373 ('*First Uniform Tax Case*') and subsequently re-affirmed in *Victoria v Commonwealth* (1957) 99 CLR 575 ('*Second Uniform Tax Case*').

22 Legally and technically, of course, there is nothing to prevent the States from unilaterally re-entering the income tax field. However, the Commonwealth has made its untied general revenue payments to the States conditional on the States not doing so: any State that did try to impose an income tax would almost certainly have its general revenue grants cut and have to impose its income tax rate on top of an unchanged Commonwealth income tax rate structure.

23 See especially *Ha v New South Wales* (1997) 189 CLR 465.

measured. As I have had reason to point out elsewhere,<sup>24</sup> land tax is one of the most efficient taxes available to governments because its base is immobile and its ownership readily identified; yet, the States choose to apply it to a narrow base. Similarly with payroll tax: it is no less efficient than an income tax and, indeed, it looks like a PAYE income tax but with employers being legally liable to pay it. Again, however, the States exempt a large part of its potential base (small, and increasingly medium size, businesses as measured by payroll size) and have been competing the tax rate downward on those businesses that are required to pay it.

The third point is that there are efficiency benefits from having collection of some revenue sources centralised and others decentralised, to reduce the overall economic cost of raising tax revenue.<sup>25</sup> Funding State government spending partly out of taxes imposed by national governments has a rationale in normative economics.

Finally, and perhaps most importantly, to return to the ramifications of competitive federalism, there are reasons why national and sub-national governments, otherwise competing vertically and horizontally, might form a collective agreement to have the national government collect some revenue on all their behalves.<sup>26</sup>

The explanation starts from the simple observation that there are potentially significant economies of scale available in centralising tax collection. This is not only because there are 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 sub-national levels of government is reduced. Tax rates could be lower for any given required total revenue with centralisation, generating potential mutual benefits to both the national and sub-national governments. As a consequence, there is an incentive for sub-national governments to delegate tax collection on their behalf to the national government, and for the national government to accept that delegation, where the scale and nature of the tax base warrant it.

However, centralisation of tax collection, and the degree of harmonisation of definitions of bases, tax rate structures and so on that it requires, involves costs. Some are associated with coordination *per se*. Others involve, for example, a loss of capacity for sub-national governments to compete with one another, which will be greater for jurisdictions which see themselves as having a comparative revenue-raising advantage. So, on grounds of costs associated with centralisation, this form of negotiated centralisation may not occur at all (for example, if the

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24 Cliff Walsh, 'Fixing Fiscal Federalism' in Robert Carling (ed), *Fixing Federalism* (2008) (forthcoming). See also Pincus, 'Six Myths of Federal-State Financial Relations', above n 5.

25 Anyone interested in the technical argument should see Geoffrey Brennan and Jonathan Pincus, 'A minimalist model of federal grants and fly-paper effects' (1996) 61 *Journal of Public Economics* 229.

26 A fuller analysis than I can offer here can be found in Breton, above n 10, ch 8. The exposition of the arguments here follows closely the relevant part of my previous article attempting to provide a comprehensive analysis of all the consequences of competitive federalism: see Walsh, 'Competitive Federalism: Wasteful or Welfare Enhancing?', above n 11.

numbers of sub-national jurisdictions that need to agree are large) or may not be complete (some jurisdictions may choose not to participate while others do).

If tax collection arrangements of this sort do arise, so-called VFI will exist 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, and importantly, the revenue transfers ('grants') from national to sub-national governments may be – again by mutual agreement – a mixture of untied (unconditional) revenue sharing grants and tied (conditional, specific purpose) grants.

To ensure that the tax collecting government (the agent) does not allow the benefits of centralised collection to be eroded through inefficient tax collection – the presence or absence of which is costly to monitor by the recipient governments (the principals) – there must be a clear and continuing stream of benefits to the collecting agent from minimising inefficiency. Some of those benefits will flow to the collecting (national) government from its share of the economies of scale from centralised tax collection that create the potential for mutual benefits in the first place and, to that extent, untied revenue sharing will be mutually beneficial and acceptable. But once, for a given joint tax rate schedule, the revenue 'needs' of the tax collecting governments are met, any further tax revenue collection on behalf of sub-national governments would have to be purchased by them by offering altogether other political benefits to the tax-collecting government.

A fortiori, the additional revenue transfers would have to be 'tied', and tied to the delivery of goods and services in the supply of which the sub-national governments have a competitive advantage (otherwise the national government could be better off by spending on them – supplying them – on its own account). There also must be a high level of visibility for the national government's contributions, a verifiably high level of demand for the goods and services among citizen-voters and a verifiable set of implicit or explicit performance 'benchmarks' to be met by sub-national governments, to ensure that adequate political benefits flow to the grant-giving government. What functional areas, and activities in them, might meet these requirements is likely to change over time, although it seems a priori obvious that education, health, roads and transport, training, local government and the like would qualify in current circumstances. Importantly, moreover, on this account, opportunities for there to be tied grants of benefit to national governments are likely to be as much *supplied* by sub-national governments as *demand*ed by national governments, and the conditions *negotiated* rather than imposed. Nonetheless, tensions would be likely to arise when, for example, perceptions about pay-offs from established grant patterns and conditions change.

This line of reasoning is highly suggestive and, in a number of respects, leaves significant parts of the literature on VFI and intergovernmental grants looking at

least questionable.<sup>27</sup> However, its potential explanatory power in various federal systems on the face of it might seem highly variable. For example, it fits well with Canada's Tax Collection Agreements and Established Programs grants – including the partial and total opt-outs by some provinces – and also with the relatively much more autarkic United States federal fiscal system, with a much larger number of state and local governments, making cooperative arrangements more difficult to achieve. In Germany, and more so Australia, one would have to rely on a more supply-side driven story, and enrichments driven by, for example, constitutional arrangements and judicial interpretations. Indeed, one would expect history and culture, as well as constitutions and their interpretations, to restrain or redirect what emerges and how.

## 2 Tied Grants

This depiction of VFI brings us back to the issue of tied grants – SPPs. The explanation of SPPs in the theory of competitive federalism as a quid pro quo for the national government undertaking at least some revenue collection on behalf of sub-national governments makes substantial sense. Their provision, on this account, is less a manifestation of coercive federalism than one of cooperative federalism: in the Australian context, the Commonwealth is to be seen as, in effect, purchasing policy influence over policy and program areas in which it has a political interest but no competitive advantage in service delivery, and being willing to bear the political costs of raising additional revenue from its political constituents in order to do so. Seen in this light, the logic of what fiscal reforms the Rudd Government is proposing might be seen in a somewhat different way from how they are being seen by some.<sup>28</sup>

The current Treasurer<sup>29</sup> has stated that there currently are over 90 different SPPs, each with a separate agreement. He has also said that the Rudd Government, as part of a 'new financial architecture', will collapse the 90 existing agreements to just five block grants – in health, early childhood and schools, vocational education, disabilities and housing.

Might this mean that, contrary to my earlier suggestions about national governments' interests in SPPs, the Commonwealth will be reducing its influence over State government spending programs? In my view, it does not. The new block grants are going to remove *input* controls and replace them with a set of required *outcomes* against which the performance of the States will be monitored. This process *might* lead to fewer Commonwealth bureaucrats being needed to

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27 See, eg, Neil Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements: Final Report* (2006); Robert Carling, *State Taxation and Fiscal Federalism: A Blueprint for Further Reform* (2006) CIS Policy Monograph 73. I have to concede that I, in earlier times, was a member of this 'club': see, eg, Cliff Walsh, 'The Distribution of Taxing Powers between Governments: The Possibility of a State Income Tax Reconsidered' in Geoffrey Brennan (ed), *Constitutional Reform and Fiscal Federalism* (1987) 1.

28 See, eg, Robert Carling, 'Fixing Australian Federalism' (2008) 24 *Policy* 30. See further Robert Carling (ed), *Fixing Federalism* (2008) (forthcoming).

29 Swan, above n 20.

shadow State counterparts, but it is unlikely that the Commonwealth will give up using the grants to achieve *its* objectives. The specification of objectives, and what will be set as measures of progress towards them, will ultimately be determined by the Commonwealth. In most of the relevant policy areas there are specific election commitments of the Rudd Government that it will insist must be delivered and it will have wider objectives that it will want to be seen to be achieving for its own political purposes. If not explicitly, at least implicitly, the Commonwealth will want its way as a quid pro quo for the political costs to it of raising revenue beyond its own-purpose needs to support State governments' spending programs.

As a matter of fact, one of the first acts of the new Government was to add two new SPPs – funding to reduce waiting lists in States' public hospitals and funding to provide computers in all schools, State schools included. Moreover, a new set of what are, in effect, SPPs – so-called NPPs – are to be made available, conditional on the States delivering new, mutually-agreed, reform initiatives. Useful as such payments can be in getting the States to participate in what can sometimes be politically difficult reforms, and ensuring that they really do implement the reforms, they amount to the Commonwealth paying the States to deliver on Commonwealth commitments and future objectives.

### **3 Untied Grants and Horizontal Fiscal Equalisation**

Unlike on earlier occasions, the issue of the magnitude of Commonwealth government *untied* (general purpose or financial assistance) grants to the States appears not to be an issue on the State governments' agenda in their dealings with the Rudd Government in relation to reform of federal fiscal arrangements. This almost certainly reflects the fact that the Howard Government's 1999 Intergovernmental Agreement on Reform of Commonwealth–State Financial Relations with the States to completely hypothecate GST revenue to them (partly in exchange for elimination of some of the most inefficient of State taxes) has given the States an assured, relatively buoyant, revenue stream compared to the former Financial Assistance Grants, the quantum of which was entirely at the discretion of the Commonwealth government. The States know that they are onto a good deal and currently have no incentive to 'rock the boat'.

The fact of the matter, of course, is that the GST revenues received by the States are, and must remain, a Commonwealth grant to them: High Court interpretations of the Commonwealth's exclusive power to impose 'duties of excise' preclude the States from imposing any form of direct tax on goods (though not on services).<sup>30</sup> The 'fiction' that the GST is a source of State revenue is a convenient one for both the Commonwealth and the States, but it is just that – a fiction.

What does remain a source of friction – though not yet one that has raised its head in recent COAG Meetings – is the issue of how GST revenues are distributed between the States. In current practice, this is determined by

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

recommendations of the Commonwealth Grants Commission ('CGC'), based on a methodology for achieving what is known as Horizontal Fiscal Equalisation ('HFE'). This results in 'shares' of GST revenue received by different States not being determined by reference to where (from which State) the revenue is raised, nor from an equal per capita share of what total GST revenue is raised. Rather, the distribution is determined by reference to a formula which adjusts the distribution of GST revenues between States to attempt to ensure that each State would have the capacity to provide similar levels of public sector services to all others, per capita, if they applied similar tax-raising effort, per capita.<sup>31</sup>

The consequence of this 'fiscal capacity equalisation' is that the 'richer' States (NSW and Victoria traditionally, but now including Western Australia and, from 2008–09, Queensland) receive less in GST funded grants than they would if an equal per-capita distribution was applied, and the other States receive a greater share. Currently, the 'donor' States, in aggregate, receive about \$3.6 billion less in untied, GST-funded, grants than they would if the GST revenue was distributed on an equal per capita basis.<sup>32</sup> Needless to say, they often express resentment about the outcomes.

The conventional, normative, fiscal federalism literature offers support to the *principles* underlying this horizontal fiscal equalisation ('HFE') as ensuring that people's location decisions are not distorted by differences in the fiscal capacities of different States and by reference to notions of equity in treatment of people nationally. It has been increasingly argued, however, that how the principle of equalising fiscal capacity is applied in Australia lacks transparency and may itself be distorting State decision-making.<sup>33</sup>

The theory of competitive federalism sees fiscal equalisation in a different light – that is, as part of a package of measures by which national governments seek to achieve stability in the federation.

One adverse potential consequence of horizontal competition (between sub-national governments) in federal systems is that 'bidding wars' can break out, where sub-national governments compete with one another, by offering subsidies or tax concessions to attract new business investment or by reducing the base and driving down rates on what are relatively efficient taxes on businesses (in Australia's case, especially payroll tax). This can have a destabilising effect on intergovernmental relations and reduce the wellbeing of citizen-voters, as States reduce their capacity to provide services.

There are a number of ways in which national governments can win political support by developing policies and programs that help to offset, to some degree, the causes of bidding wars. One form in which they clearly do so is through specific or general support for 'regional development'. A recent specific example

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31 The CGC's recent report, in early chapters, provides an easy to read discussion of why these adjustments are made, and how: Commonwealth Grants Commission, *Relative Fiscal Capacities of the States* (2008). A simple exposition of how the adjustment factors are calculated can be found in Peter Groenewegen, *Public Finance in Australia* (2<sup>nd</sup> ed, 1984) 252–8.

32 Commonwealth, *Budget Paper No 3: Australia's Federal Relations 2008–09*, Pt 4, Box 4.1 Table A.

33 Pincus, 'Six Myths of Federal–State Financial Relations', above n 5.

in Australia is in South Australia, where the Australian Government voluntarily entered into an agreement with the South Australian Government to support absorption of the ‘shock’ caused by the announcement by Mitsubishi that it was closing down its manufacturing operations in Adelaide (and Australia as a whole). The agreement involves support for relocation and retraining of displaced workers as well as a coordinated strategy to attract new businesses, especially if they would utilise sunk investments in a no longer needed factory. As a consequence, the South Australian Government will feel less of a need to try to attract new business investment away from other States through subsidies or payroll tax concessions.

More generally, Australian governments of all persuasions have instituted programs supporting regional development agencies, including through subsidising the organisations per se and making grants available, often on a competitive basis, for specific activities, including training programs.

Of course, some of this Commonwealth activity may reflect elements of pork-barrel politics. However, it is plausible to argue that at least some of it is implicitly or explicitly about restraining incentives for more overt or aggressive interstate rivalry.

It might be argued that the Australian Government also seeks to moderate inefficient interstate competition through HFE – reducing the disadvantages some economically and fiscally weaker States face that potentially lead to instability in the federal system, including sometimes more aggressive strategies by the weaker States to improve their positions. It is clear in Australia that the constitutional founders hoped that federation would lead to convergence in the economic fortunes and capacities of the States, but they also put in place mechanisms by which this could be aided, including that the Commonwealth could, if it saw fit, discriminate among the States through grant-giving (but not taxation). The history of what we now call fiscal equalisation in Australia in fact revolves around stresses created by the relative economic and fiscal incapacities, at various stages, of some States vis-à-vis others. This, in turn, eventually led to the establishment of the Commonwealth Grants Commission in the 1930s,<sup>34</sup> to provide a mechanism for assessing the needs of ‘claimant States’ from time to time, in the wake of West Australia’s attempt to secede.

Although in the mainstream literature the case for fiscal equalisation has been made on grounds of equity and efficiency (limiting inefficient migration), the practice in Australia (and elsewhere) precedes the development of that literature. It is hard not to see fiscal equalisation as it is practised, in fact, reflecting essentially political motives – including there being broad acceptance by ‘donor’ States (to some extent) that equalising transfers are necessary for the stability of the federation.

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34 With the passage of the *Commonwealth Grants Commission Act 1933* (Cth) (now the *Commonwealth Grants Commission Act 1973* (Cth)).

## IV FEDERAL ECONOMIC REFORM

I turn now from *fiscal* reform to *economic* reform. As I began by saying, for almost two decades now, the central – almost exclusive – focus of intergovernmental relations and reform has been on economic reform, not fiscal reform. This has secured unprecedented achievements on an unprecedented scale, especially through the NCP agreement made in 1995. A review in 2005 of the achievements of NCP, undertaken by the Productivity Commission,<sup>35</sup> declared it to have been a great success, which had contributed to a substantial productivity surge begun by the Hawke–Keating reforms of the mid- to late-1980s and would ultimately add more than two per cent to GDP, and possibly much more. The principal components of the NCP agenda are set out in Figure 2.

Figure 2: An overview of the NCP reforms

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### General reforms

- Extension of the anti-competitive conduct provisions in the TPA to unincorporated enterprises and government businesses.
- Reforms to public monopolies and other government businesses:
  - structural reforms — including separating regulatory from commercial functions; and reviewing the merits of separating natural monopoly from potentially contestable service elements; and/or separating contestable elements into smaller independent businesses; competitive neutrality requirements involving the adoption of corporatised governance structures for significant government enterprises; the imposition of similar commercial and regulatory obligations to those faced by competing private businesses; and the establishment of independent mechanisms for handling complaints that these requirements have been breached.
- The creation of independent authorities to set, administer or oversee prices for monopoly service providers.
- The introduction of a national regime to provide third-party access on reasonable terms and conditions to essential infrastructure services with natural monopoly characteristics.
- The introduction of a Legislation Review Program to assess whether regulatory restrictions on competition are in the public interest and, if not, what changes are required. The legislation covered by the program spans a wide range of areas, including: the professions and occupations; statutory marketing of agricultural products; fishing and forestry; retail trading; transport; communications; insurance and superannuation; child care; gambling; and planning and development services.

### Sector-specific reforms

- *Electricity*: Various structural, governance, regulatory and pricing reforms to introduce greater competition into electricity generation and retailing and to establish a National Electricity Market in the eastern states.

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35 Productivity Commission, *Review of National Competition Policy Reforms*, Productivity Commission Inquiry Report No 33 (2005).



- *Gas*: A similar suite of reforms to facilitate more competitive supply arrangements and to promote greater competition at the retail level.
- *Road transport*: Implementation of heavy vehicle charges and a uniform approach to regulating heavy vehicles to improve the efficiency of the road freight sector, enhance road safety and reduce the transactions costs of regulation.
- *Water*: Various reforms to achieve a more efficient and sustainable water sector including institutional, pricing and investment measures, and the implementation of arrangements that allow for the permanent trading of water allocations.

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Source: Productivity Commission, *Review of National Competition Policy Reforms*, Productivity Commission Inquiry Report No 33 (2005) xv.

Although the Rudd Government has now put intergovernmental fiscal arrangements back on the COAG agenda, it also is promoting the new NRA<sup>36</sup> initially adopted by COAG prior to the new government taking office. This has additional economic and regulation reform streams which the Productivity Commission has tentatively projected might add another two per cent to GDP. It also has human capital streams in health, education and training and workforce participation incentives. Those, among many other things, will also add to national productivity – probably much more so than the new economic and regulation reform streams. In fact, the Productivity Commission has tentatively estimated that the workforce participation reforms alone might ultimately add up to six per cent to GDP. A brief summary of the contents of the NRA is set out in Figure 3.

Figure 3: The NRA at a glance

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The National Reform Agenda comprises three streams — competition reform, regulatory reform and improvements to human capital.

- The *competition* stream involves reforms in the areas of energy, transport, infrastructure and planning, and climate change.
- The *regulatory reform* stream comprises two distinct sets of initiatives. The first is designed to promote best-practice regulation making and review. The second focuses on reducing the regulatory burden in 'hot spots' where overlapping and inconsistent regulatory regimes are impeding economic activity.
- The *human capital* stream covers three areas — health, education and training, and work incentives.
  - The health element comprises two distinct parts. The first seeks to improve the delivery of health services and to modify specific purpose health payments where they cause perverse outcomes. The second is aimed at improving workforce participation and productivity by reducing the incidence of illness, injury and disability and chronic disease in the population.

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36 Productivity Commission, *Potential Benefits of the National Reform Agenda*, Report to the Council of Australian Governments (2006).

- The education and training element seeks to equip more people with the skills needed to increase workforce participation and productivity. Four areas have been targeted: early childhood development; literacy and numeracy; transitions from school to further education or work; and adult learning.
- The workforce incentives element is designed to increase workforce participation by improving incentives for those groups with the greatest potential to raise their participation rates: people on welfare, the mature aged and women.

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Source: Productivity Commission, *Potential Benefits of the National Reform Agenda*, Report to the Australian Council of Governments (2006) xxx.

Important as the new NRA might be, it is being dwarfed by two other reform initiatives, both related to climate change – the National Water Initiative and an Emissions Trading Scheme ('ETS') to be introduced in 2010. Both of these involve the Commonwealth and the States facing political stress. Indeed, in the case of the ETS, it has the (unusual) known consequence of (at least in early decades) reducing future economic activity and real incomes compared to what they otherwise would be. It also will have the essentially unintended, but unavoidable, consequence of there being large negative impacts in some regions, particularly those disproportionately represented in coal-fired electricity generation and coal mining. Comparing the Government's recent Green Paper on its proposed Carbon Pollution Reduction Scheme with the Garnaut Climate Change Review's *Draft Report* suggests that the Government is being very cautious, seemingly for fear of badly losing political consent.<sup>37</sup>

In the context of my earlier discussion, the question I now want to address is what economic theories of federalism have to say about the economic reforms so far achieved, or on the way, and about what more might be achieved in future.

Surprising as it might seem, the theories have not had anything much to say directly about economic reform, or even about the allocation of responsibilities for economic policy. This, in large measure, reflects their origins as theories about the assignment of *fiscal* responsibilities. In the case of the theory of functional federalism, its development long preceded the focus on globalisation and its implication for national economies. I suspect that, if asked, the progenitors of the theory would say that they would take it as an essentially obvious presumption that responsibility for the national economy should rest with the national government.

In the case of the theory of competitive federalism, however, its focus on governmental systems and political processes makes it possible to deduce at least some things about what it might say about industry policy, infrastructure provision and economic regulation. The starting point is the general observation that *vertical* intergovernmental competition will result in governments tending to specialise in areas of infrastructure provision and economic regulation according

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37 See Department of Climate Change, *Carbon Pollution Reduction Scheme Green Paper* (2008); Garnaut Climate Change Review, *Draft Report* (2008).

to where they have a comparative advantage, and will only give up control of parts of them when there are obvious mutual benefits, in the form of increased capacity to win political support, from doing so. The comparative advantage that State governments have is in knowledge about their community's preferences and other relevant local circumstances. They will retain control of those areas of infrastructure provision and economic regulation where there are no, or no politically salient, inter-jurisdictional interdependencies, while being willing to at least consider more uniform or consistent approaches – or transferring power to the Commonwealth – where their constituents will benefit from them doing so. So, for example, while having ceded the provision and management of (most of) the interstate rail network to the Commonwealth-owned Australian Rail Track Corporation, the States retain control of their intrastate rail systems, providing urban and regional passenger services and intrastate freight transport (such as grain lines). And, while agreeing to subject themselves to legislative review under NCP, the States have retained, for example, control over regulation of shopping hours, persons who can own and operate a pharmacy, liquor licensing, waste management, and so on. They have, to date, also retained control of Workers Compensation schemes and Occupational Health and Safety legislation, where some States see substantial political costs in surrendering control to national uniform approaches.

There are substantial advantages in States retaining control of infrastructure and regulations where interstate interdependencies are not particularly large, arising from inter-jurisdictional competition which will tend, over time, to pressure each State into providing least cost solutions and learning from policy experiments that some of their number might undertake from time to time.

One area in which the Commonwealth arguably has a competitive advantage over the States is where there are high costs associated with designing, and monitoring compliance with, regulations requiring complex expert assessment. This is so, for example, with regulation of corporations and financial regulation, and also for testing pharmaceuticals, motor vehicles and food products against approved standards, or for evaluating possible variations in the standards. In these cases, even if there were differences in preferences across States concerning standards, there are clear advantages in applying uniform standards and from concentrating expertise in the design and monitoring application of the standards at a national (coordinated) level. The Commonwealth can win political benefits by being seen to be doing the right thing by consumers, and the States can gain benefits – even if they had reason to want different standards to some extent – not least by being relieved of the cost of designing the regulations and monitoring compliance.

Clearly, however, the Commonwealth's comparative advantage is greatest where there are very substantial inter-jurisdictional spillovers. This has become particularly salient in recent times in relation to the Murray–Darling Basin, where the effects of upstream land use and irrigation practices have had increasing downstream consequences, and particularly so in the context of a severe drought. This has led to the Commonwealth-led National Water Initiative. The consequences of global warming – relevant to the water initiative and to much

more – involves international as well as national spillover costs that ultimately only a global initiative can successfully address. The Commonwealth has an unambiguous comparative advantage in representing Australia's interests in global forums as well as in designing and applying means of reducing greenhouse gas emissions in Australia as a whole.

Where there are substantial economic benefits that can flow from nationally consistent regulatory regimes, the States have an incentive to cooperate to achieve them, provided the political pay-offs are substantial enough to make it worthwhile. The Commonwealth generally can be a facilitator, and gain political credit for playing this role. The establishment of national markets in electricity, gas, telecommunications and freight-rail, with oversight of compliance with national access regulations by the Australian Competition and Consumer Commission to counteract the potential anti-competitive behaviour by natural monopolist infrastructure owners, has been a large part of the NCP agenda, and further progress is to be made under the new NRA.

An interesting development in some areas where the States have been reluctant to make regulatory regimes more consistent has been the Commonwealth's provision for corporations to choose, if they wish, to opt-in to a national scheme. This was first applied to Workers Compensation and was being developed for Occupational Health and Safety regulations, but that issue has now been taken on board as a COAG agenda item. It is an example of vertical intergovernmental competition where the Commonwealth has judged that it gains political benefits from offering a competing alternative; that it has a comparative advantage in the design of regulations in these areas. However, it will 'win' only if its scheme(s) prove(s) to be superior to the State-based alternatives for corporations that can choose to opt in or out.

Importantly, however, where there are potential economic, and associated political benefits to be made from achieving greater consistency or uniformity, it is not invariably the case that the Commonwealth will initiate the development of a cooperative approach. As noted in the Introduction, the proposed economic reforms in the early 1990s new federalism initiative were initially identified by the States. More recently, Victoria took the lead on the development of the new NRA in the face of initial reluctance by the then Commonwealth Government to engage with the States on at least some of the items on that Agenda. Indeed, the Commonwealth's reluctance, and its prevarication over a number of issues that the States considered to be nationally significant, led to their establishing the Council for the Australian Federation ('CAF') in 2006 as an inter-jurisdictional forum comprised of State and Territory leaders through which they could cooperate in various ways, including promoting engagement with Commonwealth on matters of national significance. Through this forum, the States made a decision that they cooperatively would do what, at that stage, the Commonwealth would not – develop the basis for a national ETS. It was the States that established the Garnaut Climate Change Review and the design of an ETS. The change of government in late 2007 has seen the Commonwealth become a partner in the Garnaut Climate Change Review and, indeed, to

effectively take over policy development since a nationally uniform scheme, calibrated to evolve as global agreements are made, is the only viable option.

The establishment of CAF, it should be said, provides another vehicle for vertical competition – this one with the States being the initiators – where there are potential collective advantages to initiating competition of that nature, if only to try to get the Commonwealth on board with them.

There are, of course, likely to be contexts in which there is ambiguity about the best approach – areas of regulation that matter significantly both intra- and inter-jurisdictionally where preferences and economic interests might differ. A topical case might be labour market regulation and related acceptable wage-setting processes. For businesses with activities in two or more States, differences in prescribed terms and conditions of employment and in acceptable wage-setting processes can be much more than an irritant to their operations. But it is not always the case that businesses have more to gain from national uniformity than from State-specific diversity in labour market regulations. For example, mining companies with operations concentrated in Western Australia and Queensland might benefit more from flexible, but different, labour market regulations in those States than from a uniform but less flexible national set of labour market regulations. Moreover, at least some State governments are likely to prefer to retain their power over labour market regulation rather than cede it to the Commonwealth, for example, because it provides a means by which States can ‘compete’ for business attraction or retention. If so, cooperation to achieve nationally uniform labour market regulations would be unlikely. In addition, the imposition of a national set of regulations would not be unambiguously beneficial.

Given what is already on the national agenda for fiscal and economic reform over the next few years, it seems (very) unlikely that either the Commonwealth or the States will consider that there are new areas of substantial reform that will bring them *net* additional political support. This is not because there are not potential reforms that would win them enhanced political support, but rather because to take them on board, while the current reform agenda is being developed and implemented, would require diverting more resources from the everyday business of ensuring that public sector services are being efficiently and effectively delivered. Governments would, as a result, risk losing political support for a possibly poorer performance in delivering existing services. If I am right about this, doubtless the business community and other supporters of further national reforms will accuse them of ‘reform fatigue’. This, however, would be a complete misunderstanding of political reality.

## V CONCLUDING COMMENTS

The development by economists of economic theories of federalism arguably hit a high point with the emergence of a fairly comprehensive economic theory of competitive federalism – one which suggests that, on the whole, federal systems work particularly well in promoting the interests of citizen-voters, whose interests should be front and centre in consideration of the likely consequences of

proposed federal reforms. This may be an inconvenient conclusion for those frustrated by what they usually see as obstinate resistance by the States to ‘obviously needed’ national uniformity, if not an outright Commonwealth takeover in more policy areas. It is, however, the appropriate conclusion to be drawn from the analysis. Governments are interested in ‘good ideas’ about reform only to the extent that their adoption has the capacity to win them additional political consent: only reform proposals designed with an eye to that fact – and to the fact that national reforms ultimately need the consent of all governments to be successful – stand a realistic chance of being implemented.

The important role in the theory of competitive federalism for *vertical* competition between national and sub-national governments appears to cause discomfort to some students of federalism, apparently because they see it as likely that the Commonwealth will always dominate the outcomes, aided and abetted by a High Court that refuses to apply ‘federal principles’ to its interpretations of the Commonwealth’s constitutional powers. I see it somewhat differently. The Commonwealth’s apparent dominance in fiscal matters comes at a political cost to it – it has to be willing to wear the consequences of raising more revenue than it spends for its own purposes in order to make both general purpose and specific purpose grants. If it wants to increase SPPs in order to extend its influence on State policies, it has to raise more revenue from its constituents, or cut expenditures of benefit to them, and there are political limits to exercising either of those options. Trying to extend the Commonwealth’s use of its constitutional heads of power can also come at the expense of threats to its political mandate, as the Howard Government most recently discovered, to its cost, with the *Workplace Relations Amendment (Work Choices) Act 2005* (Cth).