

APPENDIX 2
THE COSTS
OF FEDERALISM

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

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EXECUTIVE SUMMARY

AUSTRALIA'S FEDERAL SYSTEM – AND THE REFORM IMPERATIVE

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

THE FOUR MAIN PROBLEMS

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

We identify four main problems with achieving more reform.

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

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

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

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

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

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

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

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

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

WHAT IS THE COST OF THIS MESS?

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

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

How much does that cost?

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

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

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

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

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

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

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

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

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

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

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

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

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

That's a lot to waste.

Access Economics
September 2006

1. FRAMEWORK FOR THE ANALYSIS

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

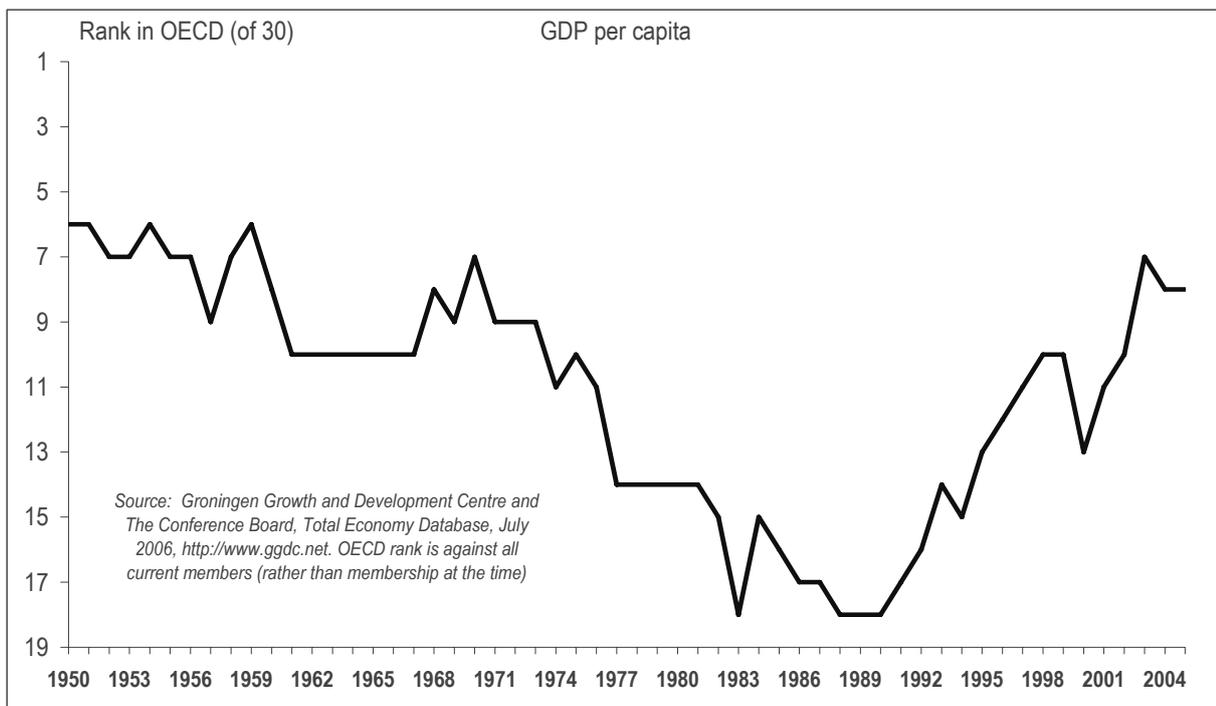
In brief, Australia’s federal system suffers from:

- (1) too much overlap,
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- (3) too heavy a Federal hand in areas of State responsibility,
- (4) too much ‘destructive competition’ across jurisdictions, and
- (5) too little cooperation across States and between the States and the Australian Government.

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

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

FIGURE 1: AUSTRALIAN LIVING STANDARDS – RANK WITHIN THE OECD



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

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

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

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

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

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

1.1 STRUCTURE OF THIS REPORT

Chapter 1 starts by:

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

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

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

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

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

- the indirect impact on other sectors.

1.2 WHAT IS A FEDERAL SYSTEM?

Federal systems of governance are common – they cover rich countries (such as the US, Canada and Germany) and poor ones (such as India). Together, federations account for about 40% of the world's population and about 50% of the global economy.

Essentially, federalism is a system of governance which provides for action by a national or central government for certain common functions together with independent actions by sub-national units of government, with each level of government accountable to its own electorate. (Pincus, 2006, p 26)

A citizen of a federation gets to vote for at least two governments, each of which operates over the same area and with separate powers of taxing, spending and regulation.

Australia's federation comprises three tiers:

- the Federal Government, with designated and delegated powers;
- six State Governments, with residual powers, and two Territory Governments, with State-type powers; and
- local government authorities with delegated powers and responsibilities.

The division of powers under the Australian constitution provides the Federal Government with a small number of exclusive powers and a large number of areas where it shares powers with the States. State Governments retain responsibility for all other matters.

The constitutional division of powers

The Australian constitution provides the Federal Government with some exclusive powers; primarily in respect of customs and excise duties, the coining of currency and holding of referendums for constitutional change.

This division of powers also provides the government with a large number of areas under Section 51 where it shares responsibilities in parallel with the States.

However, where State laws conflict with those of the Federal Government in these areas, the laws of the latter prevail (Section 109).

State Governments have retained (residual) responsibility for all other matters.

The Federal Government can influence State policies and programs by granting financial assistance on terms and conditions that it specifies (Section 96). And, over and above that, Federal powers have tended to grow over time. For example, while the constitution does not mention many specific functions (such as education, the environment and roads), the Federal Government can legislate in these areas under various powers (such as using its external affairs power in support of an international agreement covering the environment).

Presently, there remains considerable room for improvement in developing effective cooperation between the States and the Federal Government. While some cooperative arrangements are in place, they have proven less than robust to challenges in the High Court.

The BCA (2006) has noted that “there are major limitations on the ability of the Commonwealth and States to enter into such cooperative schemes”.

1.3 SCOPE OF THIS REPORT

This report explores the costs to Australian living standards of overlaps and inefficiencies in our federal system.

We focus on the first **two tiers** of government. Furthermore, our references to the States and to State Governments include reference to the Territories and to the Territory Governments.

Our focus also is on **practical** ideals and solutions, as significant improvements can be made to how the federal system works *without* major changes to the powers or responsibilities of different tiers of government and without significant Constitutional change.

The recent report by Neil Warren (2006) for the NSW Government concentrated (like the Garnaut-Fitzgerald Report (2002) before it) on evaluating federal financial relations.

In contrast, we are mainly concerned with analysing the consequences of the current allocation of **expenditure responsibilities and taxing powers** between the levels of government. While inefficiencies arising because of grants arrangements under our federal system are important, they are secondary to the inefficiencies that can arise from the allocation and operation of expenditure responsibilities and taxation powers by different governments within a federal system.

Furthermore, while the Warren report focused solely on **vertical** issues, we are also concerned with **horizontal** issues. Inefficiencies in policies and services can arise horizontally (across States) as well as vertically (between the Federal Government and the State Governments).

We therefore include an assessment of both State-State (horizontal, or inter-jurisdictional) and Federal-State (vertical, or intergovernmental) relationships.

1.4 THE BENEFITS OF A FEDERAL SYSTEM

Federal systems have both advantages and disadvantages

There are advantages with federal systems:

- 1) Federal systems encourage governments to be more responsive by keeping power closer to the ‘level’ of the voters.
- 2) Not all groups of voters want the same thing. Some States may opt to spend more or less on education, or health, or to set particular taxes higher or lower. In a federal system, such diversity is possible.
- 3) And that diversity can help States learn from (and compete against) each other – if a policy works well in one State, it may well be adopted in others.

Yet there are also disadvantages with federal systems:

- 1) Governments have economies of scale – so there are higher costs from the overlap and duplication in a federation: the choice in favour of the ‘diversity’ offered by a federal structure also implies the deliberate foregoing of the greater economies of scale available to more centralised government.
- 2) And the relative size of such opportunity costs is growing as globalisation leads to increased commerce across State and national boundaries. That means the inefficiencies, higher transaction costs and uncertainties associated with being subject to rules and regulations set by more than one government are rising in relative terms.
- 3) Competition between governments can be bad as well as good – such as sweetheart deals via payroll tax exemptions.
- 4) The (constitutional) allocation of power between the Federal and State Governments can be badly designed, leading to governments having the ‘wrong’ responsibilities, or sharing too many responsibilities.
- 5) In addition, the benefits of competition can often be overstated. While one State may be better in some fields, chances are it will be worse in others. Given the very high costs (and risks) for businesses and families in moving between States, the latter is at best a weak discipline on State policies.
- 6) And there is a risk of a lack of scrutiny in smaller jurisdictions. After all, part of the judgement as to what is working well and what isn’t comes to us via media, business and academic scrutiny, but there may be a lack of critical mass to achieve that in smaller jurisdictions. Worse still, that scrutiny may result in perverse judgements – with bad policies lauded, and good ones rubbished.

By dispersing power across governments, a federal system adds to electoral competition, providing more opportunities for this discipline to be exercised by voters over time.

In fact, federal systems offer two additional forms of competitive discipline on governments – ‘horizontal’ and ‘vertical’ competition.

Horizontal competition refers to the discipline imposed on governments by the possibility of citizens (and businesses) exercising their right to relocate from one State or nation to another (‘voting with their feet’) in response to fiscal and regulatory differences. Some States may differentiate themselves by taxing less and spending less, or taxing more or spending more, while others may choose to emphasise education over health spending, or vice versa. While the option of migration opens up the possibility of horizontal competition between Australian States and other nations as well as among the States themselves, federal systems make this form of competition stronger, since it is normally much easier to move within a nation than between nations.

Vertical competition arises where either the Federal or State Governments enter a specific area of responsibility (spending or taxing) in direct competition with the other level of government. Such ‘vertical’ competition is unique to federations. Federations provide their governments and citizens with an important opportunity for comparing performance and learning from what other jurisdictions are doing and how they are doing it.

1.5 WHAT CONSTITUTES AN IDEALLY-FUNCTIONING FEDERAL SYSTEM?

How should a federal system operate if its potential benefits are to be maximised while the potential costs are minimised?

Or, in other words, **who should do what?**

- Should it be the Federal or State Governments in charge of particular responsibilities (and the spending programs that go with them)?
- Who should raise what taxes?
- And should States only spend as much as they raise through taxes – or should there be subsidies from one level of Government to another?

These questions go to the heart of the issue of what is an ideal Federal structure.

The longstanding consensus among economists is that it makes sense for the States to have a range of responsibilities to allow them to tailor their policies to their voters (rather than a 'one size fits all' rule from Canberra), but that it also makes sense for most taxes to be raised at the federal level.

In turn, that then means deciding whether:

- to let the States spend more than they tax, relying on federal subsidies to make up the gap (risking overlap, duplication, finger-pointing and the like), or
- to restrict State spending responsibilities to the level of tax they raise.

Again, in turn, that leads to the next question – if the latter, or if there are moves to reduce the amount of transfers from the Australian Government to the States, should that shift occur by taking spending responsibilities away from the States, or by giving the States greater taxing powers?

That is a vital issue. In times past, economists and politicians mostly thought it made sense to give the States more taxing powers – for example, Malcolm Fraser mused about doing so.

But the pendulum is swinging, because the economy is changing. In particular, globalisation is resulting in a relative increase in transactions across borders – there is greater mobility among people, business operations, the sourcing of business inputs, and capital.

That means there is a steadily improving case for taxes to be raised at the Federal level – and hence there is a steadily building case for taking spending responsibilities away from the States. The debate on the latter revs up from time to time. For example, ex-NSW Premier Bob Carr has called for a reduction in the overlap of responsibilities via a swap of functions.

WHO SHOULD BE RESPONSIBLE FOR WHICH 'SPENDING PROGRAMS'?

The 'subsidiarity principle' – and the caveats to it

Economists see advantages in responsibility for a particular function resting, where practicable, with the *lowest* level of government that can do it well. This rests on three main considerations:

1. State Governments are more likely to understand the needs of their voters – the argument is that decisions specifically affecting far north Queensland are better made in Brisbane than in Canberra.
2. In turn, voters in far north Queensland can have their voices heard more readily in Brisbane than in Canberra, and can more readily lobby to have policies aimed at their particular needs and concerns.
3. And if their voices are not heard, then – if the problem they have is with a decision or policy made in Brisbane, they can always move to another State (“vote with their feet”). In contrast, if the problem they have is with a decision or policy made in Canberra, they have to move to another nation to avoid it.

In contrast, economists prefer the Federal Government to have charge where:

1. The implications of policies ‘spill over’ State borders (for example, policies affecting the likes of business operations, or long distance trucking, or water flows).
2. There are big economies of scale and scope with centralising policies (for example, macroeconomic policymaking, defence and foreign affairs).
3. Having State-by-State differences in rules and regulations is a burden on those who regularly trade across State boundaries (for example, in regulating banks and companies).
4. There are big differences in capacity across States – for example, if only one State has huge oil deposits, it makes sense for resource taxes to lie with the Federal Government rather than with individual State Governments.
5. Where capital and people can readily move to avoid State-level policies that affect them. For example, and as history has shown, you can’t have only some States levying death duties, as retirees will move. Similarly, you couldn’t try to levy taxes on personal or company income or capital gains at the State level, or have notably different welfare entitlements by State, as those policy differences would be undermined over time by people moving. **Hence the ideal federal system would promote national markets for people and for business inputs.**

The above discussion does indeed suggest some spending responsibilities are better in the hands of State Governments than the Federal Government. But what proportion of the total might that be? There is no clear cut answer to that in the international practice, although the spending share of Australia’s States ranks highly in the international league ladder:

There is no consistent pattern in the size of State governments – they range from less than a fifth of total government expenditures (Austria 17 per cent) to almost half (Canada 45 per cent), with Australian, German and Swiss State governments approximately 40 per cent, 22 per cent and 33 per cent, respectively. (Warren, 2006, at p 54)

Partly Australia’s States rank highly on this measure because the degree of shared responsibilities is high here. In turn, that leads to another key question – if even the ideal federal structure has shared responsibilities, then how should then be managed?

Overlap, duplication and inconsistency in ‘shared’ responsibilities can arise vertically (between the Federal Government and State Governments) or horizontally (across State Governments).

- ❑ **‘Sharing’ works best** where there is a clear delineation of the respective roles of the different levels of government in a manner which enhances accountability and minimises duplication and overlap, and where there are clear and appropriate coordination mechanisms in place. Coordination needs to establish clear policy strategies and set priorities, assign responsibility for implementation, resolve funding issues, and ensure effective performance monitoring is in place – the BCA’s proposed Federal Commission would address these issues. These arrangements should include mutual recognition regimes, the harmonisation of regulation, the adoption of national standards, better governance arrangements to promote effective coordination in areas of shared responsibility, and the use of integrated inter-jurisdictional frameworks to develop and oversee the implementation of various reform measures.
- ❑ **But ‘sharing’ works worst** where the demand for particular programs is closely related, such as where State Governments fund the emergency departments of hospitals, while the Australian Government subsidise the medical centre next door to the hospital emergency department.
- ❑ However, for many areas of shared responsibility, it may be neither practical nor appropriate to cede responsibility entirely to one level of government. Furthermore, shared functions aren’t always inefficient. In some cases, overlapping responsibilities – and the resultant political competition – could drive better outcomes for voters (Walsh (2006)). That is, sharing leads to additional costs and inefficiencies, but the competition resulting from the sharing of responsibilities has the potential to result in offsetting cost savings.

TAX ASSIGNMENT

Ideally, each level of government should finance its assigned functions with funds that it raises itself (the principle of **‘fiscal equivalence’**).

However, there is a tension here with broader economic efficiency considerations which require:

- ❑ The Federal Government to levy taxes on highly-mobile tax bases (to help avoid businesses and families moving between States due to tax considerations).
- ❑ The Federal Government to levy taxes on tax bases which are very uneven across States so as to ensure fairness.
- ❑ The Federal Government to levy taxes on tax bases with cross-border externalities (such as pollution or greenhouse taxes or user charges for water rights).
- ❑ In contrast, State Governments should levy taxes on immobile tax bases.

Moreover, there are potentially significant economies of scale available in centralising tax collection. These arise not only from economies in tax administration, but also because, for example, the potential evasion and avoidance associated with mobility of tax bases when taxes are imposed and administered at lower levels of government is reduced. That suggests State Governments should delegate tax collection on their behalf to the Federal Government.

In addition, when tax collection is centralised, there is also a tendency for State Governments to harmonise the requirements they place on businesses and families – that is, they agree to common definitions, common collection dates, and common reporting requirements. These all have the benefit of reducing the cost of compliance.

In brief then, State Governments should have access to all tax bases that are not mobile or unevenly distributed or for which there are significant economies of scale available in centralising tax collection, to the extent warranted by their own spending responsibilities.

INTERGOVERNMENTAL TRANSFERS

The above discussion is a reminder that the longstanding consensus among economists is that:

- ❑ it makes sense for the States to have those responsibilities which allow them to tailor their policies to their voters (rather than a 'one size fits all' rule from Canberra), but that
- ❑ it also makes sense for most taxes to be raised at the Federal level.

In turn, that then means deciding whether (1) to let the States spend more than they tax, relying on Federal subsidies to make up the gap (risking overlap, duplication, finger-pointing and the like), or (2) to restrict State spending responsibilities to the level of tax they raise.

Vertical fiscal imbalance (VFI) arises where the first of these choices is made – where the revenue-raising powers of one level of government (usually the States) are insufficient to meet their spending responsibilities and, for the other level (usually the Federal Government), it is excessive, thus requiring a system of intergovernmental transfers or grants:

- ❑ If tax collections are centralised, then VFI exists by mutual agreement: the tax collecting government will raise more revenue than it spends on its own purposes and vice versa for the recipient governments.
- ❑ Moreover, the resultant revenue transfers ('grants') may be – again by mutual agreement – a mix of untied (unconditional) revenue sharing grants and tied (conditional, or specific purpose) grants.

Where vertical transfers are decided upon, State Governments as the recipients should face a **hard budget constraint** – that is, the grants should be fixed in dollar terms. Otherwise, the incentives could well be for them to spend too much, and overall fiscal discipline may be lost:

- ❑ State Governments should not be able to rely on transfers from the Federal Government to bail them out of fiscal difficulties; and
- ❑ at the margin, they should be required to fund their own spending fully through State taxes or by borrowings whose debt servicing they have to ensure themselves.

Ensuring State Governments face a hard budget constraint does not preclude the Federal Government from providing financial support for activities carried out by other levels of government.

For programs entirely the responsibility of State Governments, funding should be in the form of general purpose grants, allowing discretion to allocate spending across different programs. Likewise, **unconditional or 'block' grants** are typically the appropriate vehicle for the purposes of fiscal equalisation – that is, if there is a perceived need to 'equalise' across States (rather than across individuals), then these can be used to channel funds from relatively wealthy jurisdictions to poorer ones.

For programs where there is joint responsibility between levels of government, funding should go to pools that extend to all related programs, rather than being earmarked to specific programs. Again, this allows some discretion as to the allocation within funding pools.

Finally, there is the question of **specific purpose payments (SPPs)**. Where such funding is considered necessary, the Federal Government should focus on specifying policy objectives and establishing effective accountability frameworks, and give the State Governments greater freedom in designing program delivery.

Where local services generate benefits for residents of other jurisdictions, **conditional, or 'matching', grants** are best employed to fund the provision of services. It is important that these be structured with clear limits in order that they not turn into entitlements that undermine the hard budget constraint.

Where State Governments seek SPPs from the Federal Government by offering political benefits to the higher level government, there must be:

- ❑ a high level of visibility for the Federal Government's contributions,
- ❑ a verifiably high level of demand for the goods and services among voters, and
- ❑ a verifiable set of implicit or explicit performance 'benchmarks' to be met to ensure that adequate political benefits flow to the grant-giving government.

On this reasoning, opportunities for tied grants are, in effect, as much supplied by lower level government as demanded by upper levels, and the conditions negotiated rather than imposed.

1.6 THE TYPES OF COSTS AND INEFFICIENCIES IN A POORLY-FUNCTIONING FEDERAL SYSTEM

Not surprisingly, Australia's federal system operates in ways which fall short of the ideal described above. Indeed, all federal systems fall short of that ideal.

Relative to other federations

Australia's federal system has more shared responsibilities, not to mention 'fuzzily shared' responsibilities – and therefore more overlap and duplication, and hence a greater need to cooperate.

The gap between spending by Australia's States and the revenues raised by them is high – thereby requiring large grants from the Federal Government to finance the States. The Federal Government finances about half the spending of the States. In turn, these large grants encourage the Australian Government to be overly prescriptive in how they want them to be spent. In combination with the overlap and duplication noted above, that then leads to blaming each other for any problems.

Those features tend to lie behind the shortfalls between the 'ideal' federal system and that Australia currently operates.

EXPENDITURE-RELATED

The complex relationship between the Federal Government and the State Governments arises from constitutional arrangements which result in an unclear division of the respective roles and responsibilities of the two levels of government.

Moreover, the responsibilities of each level of government are continually changing – adding to the complexity.

Inefficient expenditure allocation

Part of the reason why Australia's federation falls well short of the ideal is that our States have primary responsibility for some functions they shouldn't have – in particular, ones involving cross-border spillovers, such as the setting of regulations for mining, or food standards, as well as setting rules and regulations for transport, industrial relations, occupational health and safety.

That means they face the wrong incentives when they make decisions: they think of themselves, when they should be thinking of Australia as a whole. And their decisions typically result in diversity and fragmentation in rules and regulations, thereby leading to unnecessarily high transaction costs for businesses and families.

Cost (or risk) shifting

Another type of inefficiency in this area is cost (or risk) shifting in its perverse forms.

Where State and Federal programs are close substitutes in terms of demand (and particularly where the States and the Federal Government share responsibilities), cost shifting is encouraged – for example, GPs are Federal-subsidised, while hospitals are State-funded, so the States encourage use of GPs, and the Australian Government encourage use of hospitals.

The end result is that programs aren't designed to provide the best services at the least cost. Rather, they are designed by the States to provide the best services at the least cost to the States, and by the Federal Government to provide the best services at the least cost to the Federal Government.

Inadequate governance/coordination arrangements

Australia's federal model has many shared functions. These give rise to inefficiencies where:

- It allows governments to blame each other when things go wrong; or
- There is ineffective management of different parts of the overall service package; or
- Existing cooperative arrangements (such as committees involving all the States) fail to act to achieve reform because all of the States have individual veto power.

Excess intervention/coercion in the provision of State services

Because the Federal Government pays such large grants to the States, it naturally wants to have a say in how that money is spent.

Hence it uses its 'grants power' to provide specific purpose (tied) payments to the States.

These often impose excessively detailed and distorting conditions on how the States exercise even their (constitutionally) exclusive functions. As a result, **tied grants can be costly intrusions into State functions and responsibilities, resulting in overlap, duplication and other inefficiencies.**

After all, one of the main justifications for having States in the first place is that different States can do things in different ways. However, 'tied' grants reduce such room to differentiate –

thereby leaving Australians paying the additional costs involved in running a federal system without getting many benefits from it.

TAX-RELATED

Australia's federal model has a relatively high degree of vertical fiscal imbalance, with the taxation powers available to State Governments insufficient to meet their spending responsibilities even after other own-source revenue-raising is taken into account.

Indeed, about half of State spending is financed by Federal grants.

Inefficient tax assignment

The Federal Government should be the one raising taxes on those tax bases which are mobile (can readily jump jurisdictions), or on those tax bases which are unevenly distributed (if one State sees a huge mineral find, should only its citizens benefit from the taxes on it, or should all Australians share?).

All tax bases are mobile to some extent, but the foregoing is why, for example, it makes sense for the States to levy land taxes.

Property taxes have key advantages as [State] taxes. Most notably, the base is highly immobile, the tax is difficult to evade and efforts to improve local infrastructure are likely to be reflected in property values, thus increasing the yield for [State] governments. (Warren, 2006, p 61)

It also makes sense for the States to levy payroll taxes – in part because, in practice, differences in payroll tax rates across the States are sufficiently small that they are unlikely to lead to businesses and workers moving States. However, whereas it makes sense for the States to be collecting these taxes, their competition should be in terms of tax rates (having a low rate of payroll tax) rather than tax bases (granting a particular company a payroll tax holiday if it sets up business in the State).

... while a broad based payroll tax and land tax are theoretically efficient, in practice their economic efficiency is reduced by their selective application which narrows the potential tax base considerably, although harmonisation of payroll bases could address some of these inefficiencies. (Warren, 2006, p 62)

However, it is less clear that the other taxes raised (and user charges levied) by the States should lie with them.

'Destructive' tax competition

The most undesirable form of horizontal competition is where State Governments 'bid' for major projects because of the perceived gain to them in terms of increased income and jobs.

That is because competition between the States sometimes makes them worse off – not better off. Examples include interstate bidding wars for major projects or events (*which State capital will be the HQ for Virgin Blue? Which will host the Grand Prix?*), and some forms of tax competition (*especially those where States compete on the tax base rather than the tax rate – that is, competition over who pays tax rather than on how much they pay*).

State Governments compete for major projects because they want the jobs that go with them. But such rivalry at best shuffles jobs between States, and at worst will make all States worse

off (because investments should be decided on the underlying economic strengths of a State rather than specific sweetheart deals).

Indeed, all the States and their Governments recognise just how pointless this posturing is, but it is hard for them not to join in – often the voters (and hence newspaper reports) assume that sweetheart deals can still benefit their State.

That is why cooperation to avoid destructive competition is so vital. All the Governments (except Queensland and the Federal Government) have signed an agreement to restrict the use of sweetheart deals.

That is great. But while one State stays out, the risks remain high.

Gaming of grants

The Federal Government redirects revenue to the State Governments, with these grants accounting for about half their spending. The redirection of this revenue and the process of horizontal fiscal equalisation and specific purpose payments add another layer of interaction between Australia's governments. The associated processes also influence the behaviour of the participants.

The main form of inefficiency that arises in this area is that arising from the absence of a hard budget constraint. If governments getting grants can 'game' their funding levels, they effectively soften any budget constraint they face. For example, fiscal equalisation transfers can be subject to gaming depending upon the methodology adopted.

Equalisation grants impeding changes in cost differentials and flows of resources

More generally, depending upon the methodology employed, grants can cause inefficiencies to the extent that they impede changes in cost differentials and the flows of resources that regional adjustment requires.

Inadequate accountability for SPP programs

Inefficiencies can also arise because of inadequate accountability by the States to the (revenue-collecting) Federal Government. This arises mainly because of inadequate provision of information to the national authorities and poor financial reporting systems.

2. CASE STUDIES IN FLAWED FEDERALISM

The task ahead is large

“Competitive federalism may be contrasted with cooperative federalism. Looking back over the whole period since federation, one would have to conclude that cooperative federalism is much the weaker of the two.” (Ken Henry, Secretary of the Federal Treasury, 2006, at p 342)

“Educational qualifications do not translate across state borders; universities, though funded by the commonwealth, are regulated by half a dozen different bureaucracies; and Australia’s rail system is staggering under the weight of 22 different communication systems used on trains and seven different safety regulators. In any area where [there are] two levels of government, bureaucracy breeds. There are 15 occupational health and safety acts and 75 sets of environmental legislation. In the financial sphere, writing a simple mortgage requires reference to no less than 10 separate pieces of commonwealth legislation and regulation, as well as seven fair trading sets.” (Editorial, The Australian, 8 July 2006)

“We [need] a serious debate about ... the possibility of the States transferring their legislative responsibilities for universities holus-bolus to the Commonwealth, or about a hospital system or disability services being better managed by just a single level of government without all the perverse incentives for cost-shifting and finger-pointing that exist today.” (Carr, 2004, p. 6)

This chapter considers a number of specific examples where we are currently falling short of best practice. It does so by looking at these examples under the different headings noted in the previous section – that is, it classifies the shortfalls in practice by ‘type’.

In brief, we identify shortfalls:

- ❑ In the allocation of spending responsibilities (such as who should address global warming, or regulate interstate road and rail, electricity and water, the mining sector, or school starting age).
- ❑ Cost shifting:
 - Between State and Federal Governments (such as in the health field).
 - And across States (for example, the ACT has an incentive to release land for sale within its borders, even if it makes more sense for people to live in nearby areas in NSW).
- ❑ Coordination failures:
 - Between State and Federal Governments (such as in regulating user charges for heavy trucks).
 - And across States (such as recognising each others’ trade qualifications – allowing electricians and hairdressers to work in all States, not just one; or agreeing to regulate common food standards across jurisdictions).
- ❑ Federal micro-management of State responsibilities (in the likes of the Home and Community Care (HACC) program, or for TAFEs).

- ❑ In the allocation of taxing powers.
- ❑ Destructive tax competition (such as the ‘race for the bottom’ seen in death duties).
- ❑ The gaming of grants:
 - Between State and Federal Governments (such as in Supported Accommodation Assistance Program (SAAP) grants).
 - And across States (such as gaming the Grants Commission).

2.1 IN THE ALLOCATION OF POLICY RESPONSIBILITIES

Global problems – local fumbling?

It is a mistake to put the States in charge of responsibilities whose outcomes ‘spill over’ into other States or whose outcomes need to be considered in a global context.

A classic example is global warming. That is obviously a global problem, yet the States are trying to impose a variety of inconsistent (and mostly inefficient) local approaches that have no capacity to solve that which requires a global response.

And often they are imposing these inconsistent local regulatory burdens on firms who operate in jurisdictions all around Australia (let alone around the world).

For example, the Victorian Government is committed to 10% of Victoria’s electricity being provided by a range of renewable energy sources by 2010. Within that, there is also a commitment to the development of up to 1,000 MW of wind energy.

But what if other States don’t follow that lead, meaning that it becomes relatively cheaper to do business there than in Victoria? Modelling by Access Economics suggests that Victoria would be \$88 million worse off by ‘going it alone’ rather than the same policy applying nationally (or if even better policies – using prices rather than targets – were applied nationally).

Or, in other words, inconsistencies – a lack of harmony – in State policies have costs. And those costs are all the greater when local policies are trying to address global problems.

Railroaded

Similarly, rail freight traffic crosses borders – and so should logically be regulated at the national rather than the State level. But it isn’t, and that has led to problems. Indeed, for many years the inconsistency of the rail gauges adopted by the different State rail systems was perhaps the best known example of Australia’s dysfunctional federation. And problems still remain. As Treasury Secretary Ken Henry has noted (2006, at p 342):

We do not have national markets in land transport — neither road nor rail. Instead, an operator of an interstate train in Australia may have to deal with six access regulators, seven rail safety regulators with nine different pieces of legislation, three transport accident investigators, 15 pieces of legislation covering occupational health and safety of rail operations, and 75 pieces of legislation with powers over environmental management.

Australia has seven rail safety regulators for a population of around 20 million people. In contrast, the United States, with a population of 285 million people, has one rail safety regulator.

A particularly farcical example of rail services fragmentation is in train communications. Currently, each State and Territory requires trains within its jurisdiction to have a particular type of radio — for good measure, NSW mandates two — meaning that a train cannot operate nationally without eight different radio systems. And even with a cabin full of eight radios, trains cannot ‘talk’ to each other.

Utilitarian

Power and water also span State borders – but lie in State control.

So Australia’s policy failures here (and the resultant loss in living standards for ordinary Australians) are all the more frustrating:

We do not have a national electricity market, even though we launched something with that name in 1998. Instead, there is still a regional approach to many key regulatory and network planning decisions. In saying this, I do not want to understate the importance of reforms to date. But I do want to highlight the problem of disparate state-based regulation of energy distribution networks, retail businesses and retail pricing. State retail price regulations, in particular, distort price signals to both consumers and investors.

We do not have a national water market. In fact, we do not even have functioning State water markets. Instead, the majority of trade in water occurs within catchments and even then in insignificant volumes. For example, trade in permanent entitlements in the southern Murray Darling Basin involves, on average, only 1-2 per cent of total allocations, and water still cannot be traded interstate beyond a limited pilot area. Moreover, water is rarely traded between competing uses, being more likely to be traded between producers of similar commodities.

The National Water Initiative (NWI), agreed by CoAG in June 2004, sets out to establish a property rights framework for water and to create a national water market. The obstacles are considerable. For example, States have different water entitlement regimes, which create a practical barrier to the development of a national market. These barriers have proved difficult to overcome. But unless and until they are, NWI benchmarks will not be met. (Ken Henry, 2006, at page 339).

Will State regulations let Australian miners ride the China rocket – or not?

State regulation is getting in the way of national prosperity in mining too.

Half the world’s population is undergoing an Industrial Revolution. Not only is that pushing up living standards fast everywhere from China to Vietnam, but it also plays perfectly into Australia’s hands – we have long been the world’s best supplier of industrial inputs to developing Asia.

Yet Australia has failed to surf the strongest global growth in a generation, despite it occurring in our backyard, and among nations hungry for the commodities we produce.

And there are growing risks – Australia accounted for 22% of global mineral exploration in the 1990s, but fell below 15% in 2004-05, with indications that we’ll continue to fall.

In part that is because our federal system makes digging holes rather more complex than it need be.

- ❑ In Australia, State and local governments allocate mineral resources and ensure a return to the public from their utilisation.
- ❑ But land access for crown land and private land, heritage issues, uranium exploration, mining and export licensing, competition policy, taxes and foreign investment approvals are regulated by *both* the Commonwealth and the States.
- ❑ This sharing of powers creates confusion, duplication and waste if the requirements set by one Government are different from those set by another – as they all-too-often are.

Not surprisingly, the Minerals Council of Australia has argued for a ‘whole of government’ regulatory approach, with seamless cooperation between Federal and State Government agencies to simplify and streamline the regulatory hurdles that miners face.

Just how different are the State-based mining regulatory regimes?

The Fraser Institute has conducted a survey of miners. The responses from the survey were used to construct ranks among jurisdictions. The Policy Potential Index is a composite index that measures the effects of, among other things, regulatory duplication and inconsistencies.

On this measure, the Australian States and Territories ranked between 11th and 29th of the 64 jurisdictions surveyed.

When asked the impact of regulatory duplication and inconsistencies on their investment, those ranging from *mildly deterred* to *decided not to pursue investment* accounted for 51% of respondents for Victoria, 43% for the NSW, 41% for Queensland, 34% for WA, 32% for South Australia and 10% for Tasmania.

Whose fingers in which pies?

	Commonwealth	State/Territory	Local
Allocating mineral resources and ensuring a return to the public from their utilisation		X	X
Land access for crown land & private land	X	X	
Environmental protection		X	
Planning approval		X	X
Heritage issues	X	X	
Regional economic and social issues	X	X	X
Water access		X	
Occupational health and safety		X	
Uranium – exploration and/or mining	X for NT	X	
Uranium export	X		
Competition policy	X	X	
Taxation arrangements	X	X	
Foreign investment approvals	X	X	

Source: Minerals Council of Australia, *Taskforce on reducing the regulatory burden on business*

Education – the failure to have a common school starting age

From a different angle, the States also set differential rules and regulations on early childhood education in a manner which discourages parents from switching States, and which artificially holds back the size of the Australian workforce.

Australians had a great ride on the sheep's back, and today we ride the prosperity of our mineral deposits. However, for future Australians to have high incomes, we will need to be highly skilled. That is why much of the research published by the Federal Treasury is focussing on the need for Australians to be better educated so as to raise both productivity and participation – the two key building blocks to a prosperous future.

So, how well are we doing? Because if the States trip over each other in providing Australians with the formal skills they need, then our future will fall short of its potential.

Sadly, the States do trip over each other, beginning right from when kids start school. And those problems keep going all the way through apprenticeships and university.

Take school starting age as an example. We all know just how dumb it was for the States to adopt different rail gauges – yet that is exactly what we do with starting school too.

Across the eight States and Territories there are five different minimum starting ages. NSW has the youngest, allowing kids to start school at 4 years and five months. In WA and Queensland it is four years and six months, Victoria and the ACT four years and eight months, and in Tasmania it is five years. South Australia has its own unique system of rolling enrolments.

Why is that a problem? Because the resultant patchwork is a major hurdle for kids and their parents, creating confusion and contributing to discontinuity in schooling and potential impacts on rates of school completion.

Kids who move from one State to another not only have to find new playmates and handle new teachers, they also have the added problem of a new education system. Some kids risk boredom by being re-taught material they already know. Others struggle as they attempt to catch up with material that they have not learnt.

This hurts the schooling prospects of the 80,000 or so students who shift States each year. Many families of these 80,000 kids don't have much choice about moving as one or both parents are in the military. And many other students don't cross borders as their families decide the costs are too high. Indeed, parents may decide against a highly paid job on the other side of Australia because of the education hurdles for their kids.

This has clear economic costs. In the short term all Australians are better off if fewer hurdles are put in the way of people moving to the best job opportunities. And, in the longer term, lower rates of school completion for the kids who do move ultimately mean lower wage earnings and lower productivity, while lower school completion rates also mean lower labour force participation as less educated workers retire younger.

In addition, a uniform minimum school starting age would provide a platform for building greater national consistency in Australian schooling, including the content of curricula and student assessment. There is the potential for standardised test data to be more validly compared between jurisdictions because, under grade-based testing, kids in all jurisdictions would have had the same length of exposure to formal schooling at the time of testing.

- ❑ The good news is that this is one area where the States have already recognised the costs to us all of a patchwork quilt of inconsistent starting ages.
- ❑ The bad news is that, in July, the nation's education ministers announced that they have put off making any decision to reform State-based policies on school starting ages.

2.2 COST SHIFTING

BETWEEN STATE AND FEDERAL GOVERNMENTS

Where State and Federal Governments are in charge of different but related programs, there is an incentive for costs to be pushed onto the other government.

Health systems

Cost shifting is preventing Australia's health system from operating efficiently.

The two major levels of government share the responsibility to ensure health expenditure is adequate, equitable and cost effective. The complex split in responsibilities for funding and provision of health care leads to poor coordination of planning and service delivery, barriers to efficient substitution of alternative types and sources of care, and scope for cost shifting. The funding arrangements do not encourage continuity of care, provision of multidisciplinary care, or provision of care in the most clinically appropriate setting. There is a lack of focus on prevention, health promotion and disease management. (Fitzgerald, 2006, at p 117)

Three clear examples of cost-shifting include:

- ❑ public hospitals (funded by States) referring patients to GPs (funded by the Australian Government) for post-hospital care instead of providing those services at the hospital,
- ❑ conversely, an under-resourcing of GPs forcing people to attend hospital emergency departments when they fall ill, and
- ❑ shortages in the availability of Federal-funded aged care beds resulting in public hospital places being occupied by the aged.

Problems with cost shifting and overlaps in the health system

- **Cost shifting:** For example, (State-funded) public hospitals refer patients being discharged to their (Federal-subsidised) GP. But if patients can't get into see GPs, they go to (State-funded) public hospital emergency departments. In turn, the (State-funded) departments sometimes recommend less urgent cases go to the (Federal-subsidised) clinic instead. That is why (Federal-subsidised) medical clinics are setting up close to many such (State-funded) emergency departments, with advertisements for the clinics plastered over the walls of the emergency department (as, for example, occurs in Canberra hospital). Meantime, shortages of (Federal-funded) aged care places leaving some frail aged in (State-funded) hospital beds.
- **Overlapping functions:** The care needed for a sick person is not the sole responsibility of one level of government – funding and delivery arrangements are split between the Australian Government and the States. That creates

artificial barriers to continuity of care and good planning, including the complex interface between the (State-funded) public hospital system and Australia's (Federal-funded) residential aged care sector.

ACROSS STATES

Cross-border cost shifting between NSW and the ACT

Access Economics has studied the economic and fiscal impacts of cross-border housing developments between the ACT and surrounding areas of New South Wales.

As a general principle, Australians will be better off if the existence of the ACT/NSW border does not artificially distort the location of land development. This implies that the ACT Government should not have a budgetary incentive to favour residential development in the ACT over that in adjacent NSW. This in turn means that inter-governmental financial arrangements (including those administered by the Commonwealth Grants Commission) should be locationally neutral.

Access Economics found that there are considerable financial advantages to the ACT Government from promoting residential development within the ACT's borders, rather than across the border in NSW. A large proportion of the advantage reflects the way that such developments would affect the Grants Commission's assessments of the ACT's fiscal needs.

We estimate that, for every 1,000 households, there is a \$4 million (or \$1,429 per capita) ongoing differential in favour of residential developments in the ACT ('in-border development') over comparable areas in adjacent NSW ('cross-border development').

There are three factors specific to the ACT, and within the Grants Commission's control, that more than account for the total differential.

- ❑ First, the ACT only recovers about 75% of additional hospital costs under the current externally arbitrated agreement with NSW. The Grants Commission's methodology makes no allowance for this.
- ❑ Second, the Grants Commission assesses the proportion of government services that NSW residents access from the ACT by applying 'population use weights' to adjacent NSW local government areas. Our analysis suggests that these 'population use weights' are too low, at least for a development in Queanbeyan.
- ❑ Third, revenues from ACT land sales reduce the ACT Government's net debt, and hence its ongoing net interest expense. Although access to land sales revenue is a continuing source of advantage to the ACT relative to other jurisdictions, the Grants Commission takes no account of that in its assessments.

2.3 COORDINATION FAILURES

Is competitive federalism working? When it doesn't work, that impedes the flow of resources by thwarting necessary cost differentials – in turn resulting in a loss of living standards for ordinary Australians.

Competitive federalism asserts that there is a national interest in fostering [State-level] decision making in respect of things that are of national importance. The proposition is that while competition among [State] governments will initially produce a number of different policy models, that same competition will eventually

produce convergence on a model better than what any national government would likely be able to design and/or implement.

So, is competitive federalism the reason why nationally operated trains have to be equipped with eight different radios? Does competitive federalism explain why we have such a plethora of inconsistent state-based regulatory requirements for occupational licensing, occupational health and safety, road transport, water trading, and so on? Possibly. But there is a more likely explanation: a stubborn parochial interest in putting the welfare of the State or Territory ahead of that of the nation.

Parochialism is understandable. But a proper accounting of its national economic consequences would be weighted heavily in the negative. (Ken Henry, 2006, at p 342)

BETWEEN STATE AND FEDERAL GOVERNMENTS

Eight small economies: One economy – or eight?

Here's a simple question: why do Americans have a higher standard of living than us?

It's not because they work more hours than we do.

Rather, US workers work more effectively – they have higher productivity.

And why is that? The evidence is that Australians are held back by our small markets and, in particular, by our 'remoteness' from world markets.

Our 'remoteness' – which may account for 40% of the productivity gap between Australian and US workers – limits our ability to trade.

As Federal Treasury Secretary, Ken Henry, has noted, "There is not much we can do about remoteness". But, as he went on to note, one obvious thing we can do is help to ensure that we don't make the problem of our remoteness any worse than it needs to be.

Indeed, Sawyer (2002) notes that a key reason behind the drafting of section 92 of Australia's constitution was the desire to develop a single free trade area within Australia – so that all Australians could concentrate on doing what they do best, and trading the resultant surpluses with each other.

Or, in other words, a goal of federation was to create one national economy from the disparate State economies.

However, more than a century after federation, our States and Territories (and often the Federal Government too) set rules and regulations which worsen our remoteness by treating the Australian economy as eight small economies – and thereby limiting the 'trade' which occurs across State borders in products and people.

And that problem is getting worse (that is, it penalises the living standards of ordinary Australians more) the more globalised the world economy becomes.

Roadkill

The National Transport Commission (NTC) sets road user charges, but the NTC requires the agreement of a two-thirds majority of the Federal and State Transport Ministers.

This in itself is an impediment to efficiency as the body is more of a facilitator than a regulator.

For example, Ministers agreed to impose uniform heavy vehicle mass limits, but not all States have implemented the change. So, a vehicle with the maximum allowable mass travelling in Victoria is prohibited from travelling into NSW with the same load.

Similarly, after the careful crafting of a series of compromises, the State and Federal Governments had finally agreed on reforms of road transport, including increases in road user charges for heavy trucks – a much needed reform. However, the Australian Government junked that at the last moment in the 2006-07 Budget.

Nor is road planning well coordinated. The AusLink program goes some way towards integrating the planning and funding process for road and rail transport. However, particularly in roads investment, the joint funding provided by Commonwealth and State Governments leads to inefficiencies – the Commonwealth Government funds known State projects, but does so with hefty conditions attached.

For example, the Commonwealth used a promise of funding to force the Victorian Government's hand on tolls with the Eastlink freeway.

ACROSS STATES

Excessive equalisation in Grants Commission methodology

All the evidence is that the 'machinery' of our federation is rusty. For example, the current system for distributing GST grants among the States attempts to 'equalise' the fiscal capacities of the States. However, the primary test of whether arrangements are fair is whether they are progressive in redistributing income 'vertically' – that is, from high-income to low-income households. A detailed analysis commissioned by the Fitzgerald-Garnaut Review (2002) showed that the Grants Commission methods did not improve vertical equity and may actually worsen it slightly – mainly by transferring income from Australians in larger States to people with higher incomes in the smaller States (and Territories).

Equalising transfers also tend to shift resources to lower productivity locations. The Fitzgerald-Garnaut Review found that equalisation has put more resources into the two lowest productivity States, discouraging the flow of population to more productive regions. So these aims of federation are not being met and, more generally, flows from equalisation are not correlated with higher productivity.

Funding disability factors reduces the incentive for State Governments to reduce these disabilities. To maintain their share of GST revenue, States need to demonstrate the continuing relevance of these disabilities to the Grants Commission. The Grants Commission process effectively reduces the benefits States would receive from overcoming disabilities, because their grant share is reduced. This applies to cost factors such as scale, dispersion and congestion, and demand factors such as population age structure and socio-economic status.

The problem is more severe because disability factors are generally driven by States with the relevant disabilities – for example, scale assessments are based on the costs of the small States, and congestion costs are based on the costs of the large States. Likewise, indigenous service demands are driven disproportionately by the experience of States with large indigenous communities, and ageing demands are driven by the experience of States with older populations. This makes the Grants Commission a ‘race to the bottom’ – and a race away from much-needed reform.

The emphasis on disabilities in costs of delivering services in assessing a State’s share in the GST revenues, and the need for a State to demonstrate continuously that its costs are higher than those of other States, can be expected to reduce emphasis on cost reducing reform. These tendencies may be strengthened by the Grants Commission’s consistent use of delivery costs compared with State average practice – rather than costs under best practice in assessing disabilities. This conflicts with the general focus on best practice through the public sector over the past two decades of cost-reducing reform in Australia.

Retail regulation

And there are many examples of differences in State regulations posing unnecessary problems for businesses who operate nationally. For example, legislation which determines the hours and days that retailers can operate differs across the States.

This causes particular tension at Christmas and New Year as national retailers need to alter their trading times and days according to each State’s law.

Additionally, State Governments can and do change these trading rules each year, resulting in discontinuity and disrupted leave for employees.

Trade qualifications

It isn’t just doctors from other nations who end up driving Australian taxis.

Prime Minister John Howard says that “one of the ... federalism scandals of this country remains that qualifications in the trades area gained in some States don’t have full recognition in others.” (Australian Financial Review, 7 July 2006, p 5)

The States often stop the right person being in the right job – or, at least, make them go through duplicated regulatory hoops to do in one State something they have already qualified to practice in another State.

This is a big problem. Each State and Territory grants licences to practice in lots of occupations – everything from who can be a builder, plumber or electrician, to electrical mechanics, fitters and engineers, installing maintaining and servicing air conditioning and refrigeration, to who can be a security guard, do crowd control, be a locksmith or a bodyguard or own or use a gun, be an aircraft engineer, let foreign exchange contracts or manage investment products;

It is important to ensure that people have the necessary skills to practice particular occupations. But it is rather less clear that the licensing practices and procedures couldn’t be much better coordinated and harmonised than they are.

A 2002 report (*Licence to Skill*, Australian National Training Authority) noted that NSW alone then had 149 occupational licences, Victoria 136, Western Australia 87, the ACT 69 and the Commonwealth itself another 47 licences. That is ridiculously unnecessary duplication.

All too often, someone licensed in one State cannot readily practise in another. That is typically a triumph of bureaucracy over common sense. And while some progress has been made in individual sectors towards overcoming the impediments to a mobile workforce arising from such State-based licensing systems, no consistent approach to resolving the problems has been devised.

Why it is so hard to find an electrician ...

Even where 'mutual recognition' arrangements have been made – where States agree to recognise each others qualifications – problems can still abound.

As Treasury Secretary Ken Henry has noted (2006, at p 340): “We do not have a national labour market ... Consider, for example, the case of electricians, where 'mutual recognition' legislation is in place.

If an electrician is licensed in one jurisdiction in Australia or New Zealand, they can then apply to become licensed in another jurisdiction, after making application and paying a suitable fee to the licensing body in that jurisdiction. But there is a problem: how does one jurisdiction know what an electrician from another jurisdiction looks like? It turns out that the word 'electrician' means different things in different jurisdictions. There are different categories, and numbers of categories, across jurisdictions that act as a substantial barrier to transferability.

Or consider hairdressers. The qualification, 'Certificate III Hairdressing WRH30100', is nationally recognised. But what does that mean? Well, it does *not* mean that somebody will be considered 'qualified to work' in a jurisdiction simply because he or she has a certificate. Different jurisdictions have different pathways — generally involving different work experience requirements — to progress from the certificate to being considered 'qualified to work'. As a consequence, we do not have a national market in hairdressing services.

Electricians and hairdressers are but two examples out of hundreds.”

Food standards regulation

We all eat – and we all eat food grown and manufactured in more than just our home State.

Or, in other words, the regulation of food standards is an area where national rather than State benchmarks should apply.

But they don't – food standards are the province of the States.

Recognising the 'spillover' effects across State borders, the States and Territories have combined with the Federal and New Zealand Governments to cooperate on food standards via committees – the first a committee of food experts called Food Standards Australia and New Zealand (FSANZ), and the second a committee of bureaucrats and politicians called the Food Regulation Ministerial Council (the Ministerial Council).

Needless to say, cooperation is easier professed than achieved.

When an application to amend food regulations is made, FSANZ undertakes a lengthy review process – an initial assessment, a draft assessment and a final assessment with two stages of

public consultation and a public information stage. If the proposal passes each of these hurdles, it is then recommended to the Ministerial Council that the regulations be amended.

But each member of the Ministerial Council is given veto power in the first stage (so the representative from New Zealand has the same voting rights at that from the ACT). Dissent from just one member is enough to result in a further review by FSANZ. And, without majority support of the Council at the second stage, the proposal can again be returned to FSANZ for a second review.

This convoluted and overly prescriptive process can significantly delay much needed reforms to legislation from taking effect, not to mention the additional cost burden that up to five reviews of a single amendment carries.

Naturally, those opposed to reforms simply gang up on the weakest government – typically focussing their lobbying efforts on the government closest to an election.

The end result is that:

- ❑ This is an area where the Australian Government should be in charge, but the States are.
- ❑ That then requires cooperation in order to ensure good policy outcomes are achieved.
- ❑ But that cooperation is typically not forthcoming – instead, delays dominate, and Australian consumers miss out.

The bones of a good idea

A good example of the delays comes from a proposal by Arnotts and Nutrinova to allow juices, drinks, soups and savoury biscuits to be fortified with calcium – a proposal backed up by research on Australians' inadequate calcium intake.

The proposal was made in 2001. It passed each stage of FSANZ assessment and public consultation and was recommended to the Ministerial Council in 2003. The politicians on the Ministerial Council returned the proposal to the experts on FSANZ for reassessment, asking numerous questions, many of which had been addressed thoroughly in the first stages of assessment. A second recommendation went to the Ministerial Council in 2005, but the issue was again returned to FSANZ later that year. A subsequent review finally 'addressed Ministerial Council concerns' and the application was gazetted in late 2005.

It took four years for this proposal to become part of the food standards code: a delay that costs the industry dearly. And such delays are occurring more frequently – in just the last couple of years the proportion of proposals approved by FSANZ but vetoed by the Ministerial Council has gone from a tenth to a quarter.

The current system needs to be fixed.

The duplication of review responsibilities given to both FSANZ and the Ministerial Council creates inefficiencies and an additional cost burden to Australian businesses – and hence to Australian consumers.

The veto powers of each member of the Ministerial Council, without regard to the number of constituents that that minister represents, allows Australia's smallest State to stand in the way of a proposal supported by its largest State.

2.4 FEDERAL MICRO-MANAGEMENT OF STATE RESPONSIBILITIES

There are numerous examples of Commonwealth funding of SPPs carrying with it conditions and requirements which do little to improve service provision.

Commonwealth requirements attached to SPPs are often not focussed on outcomes

The Commonwealth/State agreement on *Skilling Australia's Workforce* provides a good example of where funding – ostensibly targeted at supporting documented national goals for Vocational Education and Training – in fact provides perverse incentives and opens the way for the imposition of overly prescriptive requirements on the States (such as the courses to be offered at individual TAFEs). The agreement:

- does not provide incentives or rewards for improving quality of training,
- imposes maintenance of effort requirements in both activity and spending which are disincentives to efficiency (so it rewards the more inefficient States), and,
- imposes highly prescriptive requirements at provider level which have nothing to do with training outcomes.

Heavy administrative burdens attached to some SPPs diminish service delivery

Other examples abound. For example, in the Home and Community Care (HACC) program the Commonwealth demands detailed plans and reporting across a range of service types (such as 'meals on wheels') by regions within States. (And almost the exact same problems of the Commonwealth demanding detailed plans and reporting across a range of service types occur in the Australian Health Care Agreement SPPs.)

The subsequent Commonwealth process whereby these plans are approved often takes several months and has at times resulted in notable delays in the release of funds to providers when relatively small amounts of money are queried. Equally important is that the requirement to plan and report at this detail inhibits the State's ability to innovate in service delivery.

2.5 IN THE ALLOCATION OF TAXING POWERS (AVOIDING DESTRUCTIVE TAX COMPETITION)

BETWEEN STATE AND FEDERAL GOVERNMENTS

As the discussion below notes, the States have lost a few of the mobile tax bases they once had (such as death duties) as competition between them drove tax rates to zero.

Also as noted below, even where there are good tax bases for the States, there is often an unnecessary compliance and administration burden arising because the States use different definitions and different collection arrangements – payroll tax being a good example.

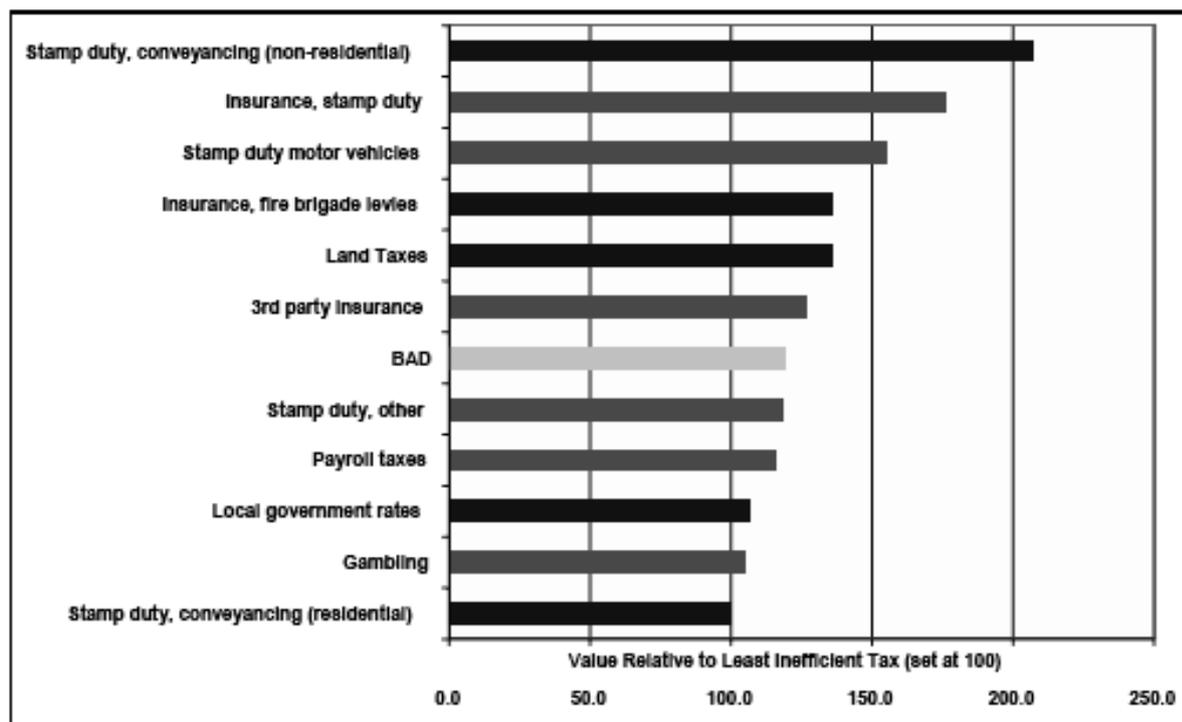
However, arguably the biggest problem of all arises because, relative to their spending responsibilities, the States have a relatively narrow tax base on which to raise revenue. That leaves them raising revenue from a bunch of very inefficient turnover-type taxes – meaning that a dollar of tax raised by a State typically hurts the economy more (results in a larger 'deadweight loss') than the matching dollar of tax raised by the Federal Government.

Among the most inefficient of these State taxes³ are:

- Stamp duties on non-residential conveyancing,
- Stamp duties on various financial instruments,
- Stamp duties on insurance, and
- For NSW, Victoria and Tasmania, fire service levies.

The first two groups of taxes are on their way out, while most States have already abolished their fire services levies and moved to more efficient ways of financing fire and emergency services.

FIGURE 2: WELFARE GAIN FROM A \$100 MILLION REDUCTION IN STATE TAXES (SOME LABOUR SUPPLY RESPONSIVENESS)



To the extent that State taxes have been piled onto relatively narrow fields of activity, there are associated efficiency and welfare losses. To use an extreme example for illustrative purposes, say the States tried to raise all of their revenue from non-residential stamp duties alone – the obvious impact would be the closure of a number of small businesses, to the detriment of the Australian economy.

As general rules of thumb:

³ See the analysis in Access Economics (2004), *Axing the Alcabala: A program for a 21st Century state tax system*, for the Business Coalition for Tax Reform.

- The greater the relative burden of a tax on a specific industry, the more resources are driven out of that industry, and so the greater the deadweight loss.
- Given a burden on a particular industry, the greater is the extent by which its labour productivity exceeds average labour productivity, the greater the loss to national income of diverting resources from that industry, and hence the greater the deadweight loss. (It is possible however to realise a net welfare gain by diverting resources from a low productivity to high productivity industry, raising income sufficiently to exceed the loss through distortion of consumption.)
- The more price elastic (or sensitive) is consumption in a particular industry, the greater is the effect of a tax on consumption, and hence the larger is the deadweight loss.

ACROSS STATES

Tax rivalry/concessions

It is all too easy for the States to drive each other 'out of business' on the tax front.

The loss of death duties as a tax base is a classic example. Retirees are often happy to move, so Queensland's abolition of death duties started a downward spiral.

... the migration of more affluent elderly people to Queensland, following the abolition of death duties by that State, induced other States to do the same. Consequently, all States lost access to a source of revenue, with knock-on effects of higher rates of other taxes and charges or a reduced capacity to provide government services (see, for example, New South Wales Tax Task Force 1988). ... death duties certainly proved politically unpopular, and the Australian Government did not fill the gap. (Pincus, 2006, at p 39).

Payroll tax harmonisation

Similarly, it is all-too-easy for the States to impose unnecessarily high compliance costs on business through a failure to harmonise their regulations, including tax regulations.

Payroll tax is a good example. Economists are happy to see States compete on payroll tax rates. They are less comfortable seeing competition between States on payroll tax thresholds (that is, over who is inside and outside the tax base). And they are unhappy to see the granting of payroll tax holidays (the most extreme form of competition over the tax base). But they are downright grumpy when States insist on running very different systems for taxes – and hence generate completely unnecessary compliance costs.

State and territorial treasury officials have been working on finding ways to remove anomalies in administrative arrangements and definitions of payroll tax.

... Among the areas of reform that will be considered are: the timing of payroll tax payments; the treatment of fringe benefits; employee share acquisition schemes; and superannuation contributions.

National employers, already furious over a failure by state governments to properly co-ordinate their plans to abolish \$4.4 billion in nuisance taxes, are demanding greater consistency in payroll tax, as well as further reductions in rates.

... "There's no reason for there to be these differences in definitions and payment procedures and timing arrangements from state to state," [WA Treasurer] Mr Ripper said. "We can deliver a benefit to business at no cost to us in terms of revenue with a harmonised arrangement." ... National employers want standard administrative arrangements for payroll tax. States believe they could reduce the compliance cost for business by reducing unnecessary differences in the administrative arrangements.

... The payroll tax regime has become increasingly inconsistent since the states and territories took over the administration of payroll tax in 1971. Not only is the headline rate and threshold different in each state and territory but other aspects – such as the definitions of wages used in calculating the tax and the monthly payment date – also vary. The Australian Financial Review, 17 July 2006, page 1

2.6 THE GAMING OF GRANTS BETWEEN STATE AND FEDERAL GOVERNMENTS

Inadequate SPP accountability

It is sometimes easy to pull the wool over the Commonwealth's eyes – a game the States know how to play well. The Supported Accommodation Assistance Program (SAAP) involves the Commonwealth contributing to the funding of transitional accommodation and a range of related support services for the homeless.

The Commonwealth contributes 60% and the States contribute 40%. Outcomes and performance indicators form part of the reporting framework in bilateral agreements between the Commonwealth and each State.

Access Economics examined published State reports to assess the extent to which the reporting of SAAP and homelessness spending generally was consistent with these intentions.

What we found was highly aggregated output groups and changing internal administrative which made it hard to track SAAP. In terms of administrative changes, there was a general failure to reconcile successive arrangements whenever a change in administrative arrangements occurs.

While States acknowledged the Commonwealth funding effort, finding 'State only' spending was difficult. The figure usually had to be 'derived' and the result treated with caution.

That is because high level program or output group consolidation made it (1) difficult to identify SAAP, (2) difficult to identify the level of State spending, and (3) hard to identify other homelessness spending and the boundaries with SAAP.

ACROSS STATES

States' gaming of HFE and Grants Commission methodology

The overhead and transaction costs of administering SPPs are one issue. However, also of concern is duplication, imperfect coordination and game playing to assert control by both Commonwealth and State officials engaged in funding closely related services in areas where the States have constitutional responsibility through SPPs and directly through State budgets. This is a potential source of large inefficiencies.

These inefficiencies may involve cost shifting and re-labelling, exploitation of weaknesses in criteria, and matching requirements and reporting arrangements. As well as causing inefficiency, accountability is diminished.

3. QUANTIFYING THE COSTS

The costs which a less-than-optimal operation of our federal system imposes on Australians are often subtle and hidden. They show up as:

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

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

Our own estimates in this chapter allow for both inefficiencies in spending and the inefficiency of State taxes. Even so, that means they are just an estimate of (1) – we do not attempt to estimate (2), and so our cost estimate of almost \$9 billion a year is just a subset of the costs of a federal system that falls short of an efficient (‘ideal’) federal system.

3.1 DO THE STATES COST AUSTRALIANS \$20 BILLION A YEAR?

The findings by Drummond are often cited. He estimated duplication and coordination costs in Australia’s federation amounted to more than \$20 billion a year in 2000-01.⁴ At 9% of total general government expenses and 3% of GDP, this estimate may not be out of the ballpark. Box 1 below summarises Drummond’s method and findings.

His argument is that the States provide many public goods and services less efficiently than could be achieved through the Federal Government. His estimates indicate the gains that might be available from moving to a national/regional government system of federalism.

⁴ M.L. Drummond, *Costing Constitutional Change: Estimating the Costs of Five Variations on Australia’s Federal System*, Australian Journal of Public Administration, December 2002, pp. 43-56.

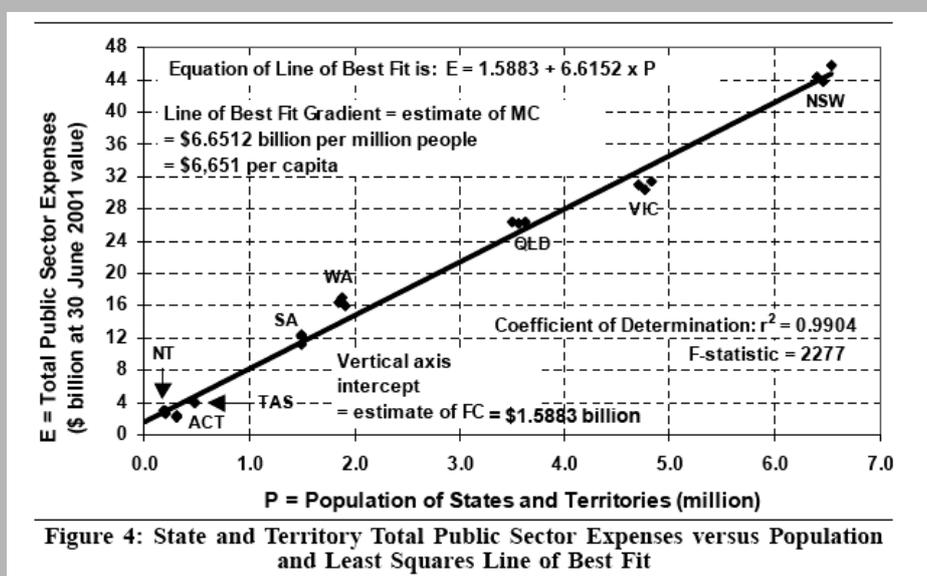
BOX 1: DRUMMOND'S \$20 BILLION SAVINGS ESTIMATE

Drummond's estimates assume that all State governments host:

- equal fixed or overhead costs (FC); and
- equal marginal per capita costs (MC),

... so each amalgamation of two States into one should liberate cost savings equal to one quantum of FC.

He used least squares regression methods to test the validity of this linear cost model, based on the plot of total public sector expenses versus population for the eight States and Territories, for each of the three years from 1998–99 to 2000–01. This plot is shown in Drummond's Figure 4, copied below:



The coefficient of determination (r^2) value of 0.9904 indicates that the plot fits the State public sector expenses versus population relationship very closely.

While the estimate implied in Figure 4 of FC is \$1.5883 billion and of MC is \$6,615 per head of population (which in turn suggests savings in expenses through the elimination of horizontally duplicated fixed or overhead costs among State governments to be \$11.12 billion (= 7 x FC) in 2000-01 dollars), Drummond assumed that the departures from the regression line apparent in Figure 4 were accounted for by higher or lower FC values rather than relatively low or high marginal per capita costs (MC). Drummond reasoned that

"...whereas marginal per capita costs – of schools, hospitals, teachers, nurses and so on – could be expected to accrue at more or less equal levels in both larger and smaller federal units, fixed or overhead costs can be expected to be higher in centralised political units which govern larger areas and hence need to exercise functional command, control and communication more remotely from communities, through more levels of delegation and with greater coordination burdens."

By effectively adding such a variable to his equation and re-estimating, Drummond managed to almost double his aggregated estimate of FC. As a consequence, Drummond estimated the savings in expenses achievable at the State level through the elimination of horizontally duplicated fixed or overhead costs among State governments to be \$20.22 billion in 2000-01 dollars.

Drummond's analysis provides limited insight into the gains that might be possible from variations at the margin in roles and responsibilities between levels of government, let alone the coordination cost savings that might be possible if overlap and duplication between levels of government were to be tackled.

The costs which a less-than-optimal operation of our federal system imposes on Australians are often subtle and hidden. They show up as:

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

Analyses of 'the costs of federalism' such as that by Drummond focus on (1) above – indeed, on a subset of (1): the costs of inefficiencies in spending (often characterised as 'overlap and duplication'), rather than also adding in the costs of the inefficiency of State taxes relative to Federal taxes.

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

We initially focus on estimating the likely fiscal costs of spending inefficiencies in our federal system. We do so by putting figures on the excessive tax effort likely to result from expenses being above efficient levels on a function-by-function basis.

In particular:

- ❑ for those functional areas where the Federal Government pays SPPs to the States, general government expenses at the national level are likely to be higher than necessary because of a certain amount of overlap and duplication likely to be involved in administering these programs involved and any cost shifting from the States;
- ❑ for those functional areas where the States receive SPPs from the Federal Government, general government expenses at the State level are also likely to be above efficient levels on account of inadequacies in Federal oversight and accountabilities; and
- ❑ for the remaining functional areas where there is significant involvement by both levels of government, general government expenses at the State level are also likely to be above levels that could be achieved were there more effective coordination between the different levels of government.

3.2 EXPENDITURE-RELATED COSTS AND INEFFICIENCIES

In 2004-05 (the latest year for which data on actual expenses are available), the following functional areas are mainly provided nationally:^{5,6}

⁵ Based upon the general purpose classification (GPC) of general government expenses published by the ABS in its *Government Finance Statistics, Australia* (Cat. No. 5512.0) publication.

TABLE 3-1: GENERAL GOVERNMENT EXPENSES BY PURPOSE, 2004-05
NATIONALLY-PROVIDED FUNCTIONS

	States' share ^(a) (%)	Commonwealth share ^(b) (%)	% of total general government expenses
Defence	0%	100%	5%
Universities	0%	100%	4%
Pharmaceutical	0%	100%	2%
Social security	0%	100%	23%
Broadcasting and film production	1%	99%	0.4%
Air transport	7%	93%	0.05%

^(a) Includes local government.

^(b) Includes multi-jurisdictional sector, which contains units where jurisdiction is shared between two or more governments, or classification of a unit to a jurisdiction is otherwise unclear. The main types of units currently falling into this category are the public universities.

Together, these functions involved one-third of all general government expenses in 2004-05.

For the purposes of this study, we take it that there are no costs and inefficiencies due to federalism in these functional areas.

The following functional areas involving a further 12% of all general government expenses may appropriately be the responsibility of both the Commonwealth and the States:

TABLE 3-2: GENERAL GOVERNMENT EXPENSES BY PURPOSE, 2004-05
JURISDICTION-SPECIFIC FUNCTIONS

	States' share ^(a) (%)	Commonwealth share ^(b) (%)	% of total general government expenses
General public services	42%	58%	7%
Public debt transactions	36%	64%	2%
Nominal interest on superannuation	40%	60%	3%

^(a) Includes local government.

^(b) Includes the multi-jurisdictional sector.

- General public services involve legislative and executive affairs, financial and fiscal affairs, external affairs and research and services not connected to a particular function.
- Public debt transactions are the costs of floating government loans and the associated interest payments.
- Nominal interest on unfunded superannuation liabilities is the direct result of public sector employment practices.

We consider the expenses associated with all these functions to be inherent in a federal system – we would have something similar to those same costs in an 'ideal' federal system, and so these do not involve any costs due to inefficient federalism. The sharing across the levels of government in these areas approximates that in all other functions, namely 36% by the States and 64% by the Commonwealth.

⁶ Throughout this chapter, we take any function that involves one level of government being responsible for 90% or more of general government expenses in that function to be primarily the responsibility of that level of government.

It is the remaining 55% of all general government expenses that are likely to be the source of the majority of costs due to inefficiencies in our federal system.

Of this amount, just three percentage points of all general government expenses in 2004-05 arose in the functional areas which are primarily the responsibility of the States:

**TABLE 3-3: GENERAL GOVERNMENT EXPENSES BY PURPOSE, 2004-05
STATE-DOMINATED FUNCTIONS**

	States' share ^(a) (%)	Commonwealth share ^(b) (%)	% of total general government expenses
Recreational facilities and services	90.1%	9.9%	1%
Rail transport	95%	5%	1%
Other tertiary education	100%	0%	0.02%
Other community amenities	100%	0%	0.6%
Other health institutions	100%	0%	0.2%

^(a) Includes local government.

^(b) Includes the multi-jurisdictional sector.

With the exception of rail freight, these functions are appropriately undertaken by the States. However, spending on these functions is relatively inconsequential.

Where the main costs and inefficiencies are likely to arise are in the one-half of all general government expenses that are in functional areas that are 'shared' by the Commonwealth and the States (as summarised in Table 3-4).

TABLE 3-4: GENERAL GOVERNMENT EXPENSES BY PURPOSE, 2004-05
SHARED FUNCTIONS

	States' share ^(a) (%)	Commonwealth share ^(b) (%)	% of total general government expenses
Primary and secondary schooling	71%	29%	8%
Acute care institutions	59%	41%	7%
Community health services	28%	72%	6%
Public order and safety	84%	16%	5%
Welfare services	49%	51%	4%
Road transport	83%	17%	3%
Other economic affairs	41%	59%	3%
Other health	27%	73%	2%
Fuel and energy	18%	82%	2%
Housing and community development	65%	35%	1.5%
Technical and further education	70%	30%	1.5%
Other education	84%	16%	1.2%
Agriculture, forestry and fishing	49%	51%	1.1%
Other social security and welfare	22%	78%	0.9%
Environment protection	83%	17%	0.9%
Cultural facilities and services	75%	25%	0.9%
Mining, manufacturing and construction	31%	69%	0.8%
Communications and other transport	75%	25%	0.8%
Water supply	47%	53%	0.4%
Other functions n.e.i.	64%	36%	0.4%
Water transport	53%	47%	0.1%
Other recreation and culture	81%	19%	0.02%

Annual expenses in these functional areas totalled \$162 billion in 2004-05.

These functional areas can be classified into three groupings:

- those where specific purpose payments (SPPs) from the Commonwealth to the States are significant;
- those not involving significant SPPs but which directly affect markets for business inputs; and
- all other shared functional areas.

The shared functional areas where significant SPPs are involved are listed in Table 3-5.

**TABLE 3-5: GENERAL GOVERNMENT EXPENSES BY PURPOSE, 2004-05
SHARED FUNCTIONS WITH SIGNIFICANT SPPs**

	State own- purpose \$m	SPPs \$m	Commonwealth own-purpose \$m
Primary and secondary	18,754	7,478	0
Acute care institutions	13,844	8,877	768
Road transport	6,435	1,894	1,647
Other health	1,986	252	5,115
Housing and community development	3,028	720	877
Technical and further education	3,223	1,164	213
Agriculture, forestry and fishing	1,732	333	1,464
Other social security and welfare	647	806	1,540
Communications and other transport	1,159	711	632
Water supply	660	715	25
Other recreation and culture	45	11	0

Together, in 2004-05, these functions saw \$51.5 billion in State own-purpose expenses, \$12.3 billion in Commonwealth own-purpose expenses and \$23.0 billion in SPPs paid by the Commonwealth to the States.

The likely fiscal costs of federalism in these functional areas include:

- ❑ General government expenses at the national level being higher than necessary because of **overlap and duplication** involved in administering the programs involved. *That is, the costs to the Federal Government of administering grants to the States (SPPs) over and above cost of either the States or the Federal Government directly funding and running the programs themselves.*
- ❑ General government expenses at the national level being higher than necessary because of any **cost shifting** from the States. *That is, where it would be more efficient for States to provide services such as public hospitals, but those services are inefficiently provided via (Federal-subsidised) pharmaceuticals or GPs or aged care homes instead. (Note other such sources of inefficiency have not been counted.)*
- ❑ General government expenses at the State level being **above efficient levels** on account of inadequacies in Commonwealth oversight and accountabilities. *That is, overlap and duplication in areas where both States and Federal Government are operating at the same time – too many cooks spoiling the broth in areas such as welfare, community health and policing.*

Overlap and duplication

If the general government expenses at the national level involved in administering the SPP programs involved were in the order of 5% of the amount of SPPs paid by the Commonwealth to the States and 75% of these expenses could be eliminated if the Commonwealth instead undertook such functions or the States had sufficient revenue powers to fully fund all the expenses they incur, then **Commonwealth general government expenses may be \$861 million higher than necessary because of overlap and duplication.**

Cost shifting

If 5% of Commonwealth expenses in the Pharmaceutical area and in public hospital grants paid to the States is the result of cost shifting by the States from more efficient (less costly) own-purpose expenses by the States on the acute care and aged care sectors, then **Commonwealth general government expenses could be a further \$836 million higher than necessary because of the cost shifting involved.**

Above efficient levels

The consensus among analysts is that this category of the 'government' costs of flawed federalism is the largest on the spending side (see Productivity Commission, 2006) – both in terms of absolute dollars, and as a share of the spending involved.

If the amount of SPPs paid by the Commonwealth and spent by the States in these functional areas is 10% above efficient levels on account of inadequacies in Commonwealth oversight and accountability mechanisms, then **SPPs paid by the Commonwealth to the States in these functional areas could be \$2.3 billion higher than necessary.**

The shared functional areas where States are active in regulating or taxing markets for business inputs are listed in Table 3-6.

**TABLE 3-6: GENERAL GOVERNMENT EXPENSES BY PURPOSE, 2004-05
FUNCTIONS INVOLVING MARKETS FOR BUSINESS INPUTS**

	State own- purpose \$m	SPPs \$m	Commonwealth own-purpose \$m
Other economic affairs	3,448	86	4,809
Fuel and energy	965	60	4,422
Rail transport	3,345	28	159
Environment protection	1,884	0	509
Mining, manufacturing and construction	813	4	1,774
Water transport	219	0	194

Together, in 2004-05, these functions involved \$10.7 billion in State own-purpose expenses and \$11.9 billion in Commonwealth own-purpose expenses.

The costs of federalism in these functions are mainly non-fiscal in nature.

That is, the costs of an inefficient federation in these areas usually falls on business as higher costs of compliance with, for example, eight regulatory regimes instead of one.

The other shared functional areas are listed in the Table 3-7.

**TABLE 3-7: GENERAL GOVERNMENT EXPENSES BY PURPOSE, 2004-05
OTHER SHARED FUNCTIONS**

	State own- purpose \$m	SPPs \$m	Commonwealth own-purpose \$m
Community health services	5,236	261	13,248
Public order and safety	12,223	153	2,192
Welfare services	6,821	499	6,728
Other education	3,263	0	635
Cultural facilities and services	2,071	122	564
Other functions n.e.i.	835	0	474

Together, in 2004-05, these functions involved \$30.4 billion in State own-purpose expenses, \$23.8 billion in Commonwealth own-purpose expenses and only \$1.0 billion in SPPs paid by the Commonwealth to the States.

Overlap and duplication

That raises a separate issue of ‘overlap and duplication’. If the general government expenses at the State level involved a degree of overlap and duplication with Commonwealth activities that was in the order of 3% of the amount spent by the States, then **State general government expenses could be \$910 million higher than necessary because of overlap and duplication.**

In total, this report therefore conservatively estimates that some **\$5.1 billion** a year of taxpayers’ money is being wasted – used to no effect.

3.3 TAX-RELATED COSTS AND INEFFICIENCIES

In 2004-05, tax collections were shared between the levels of government as shown in Table 3-8:⁷

TABLE 3-8: GENERAL GOVERNMENT TAXES BY TYPE, 2004-05

	States' share ^(a) (%)	Commonwealth share (%)	% of total general government tax revenue
Taxes on income	0%	100%	59%
GST and other sales taxes	0%	100%	13%
Taxes on international trade	0%	100%	2%
Excises and levies	0.2%	99.8%	8%
Other taxes n.e.i.	33%	67%	0.4%
Government borrowing guarantee levies	94%	6%	0.1%
Employers payroll taxes	100%	0%	4%
Stamp duties on conveyances	100%	0%	3%
Municipal rates	100%	0%	3%
Motor vehicle taxes	100%	0%	2%
Taxes on gambling	100%	0%	2%
Land taxes	100%	0%	1%
Taxes on insurance	100%	0%	1%
Other stamp duties	100%	0%	0.4%
Other taxes on immovable property	100%	0%	0.3%
Financial institutions transactions taxes	100%	0%	0.2%

^(a) Includes local government.

The States (which here include the local government sector) collect 18% of the overall tax take in Australia. The Commonwealth collects 14% of the national tax take for on-passing to the States through tax-sharing grants (mainly GST) and the remaining 68% for its own purposes.

The Commonwealth has exclusive powers in the taxation of income, sales and international trade, which altogether account for 74% of the total tax take in 2004-05.

The States collect taxes exclusively in the tax types:

- Payroll taxes,
- Stamp duties on conveyances
- Motor vehicle taxes
- Taxes on gambling
- Land taxes
- Taxes on insurance
- Other stamp duties

⁷ Based upon the general purpose classification (GPC) of general government expenses published by the ABS in its *Taxation Revenue* (Cat. No. 5506.0) publication.

- ❑ Other taxes on immovable property
- ❑ Financial institutions transactions taxes.

Altogether (and adding in municipal rates), these taxes accounted for 18% of the total tax take in Australia in 2004-05.

The only areas of overlapping collection are Excises and levies, Government borrowing guarantee levies and Other taxes n.e.i. These taxes accounted for the remaining 9% of the total tax take.

3.3.1 INEFFICIENT TAX ASSIGNMENT

Of the 10 types of taxes collected exclusively by the States, we would classify those listed in Table 3-8 as inefficient taxes.

TABLE 3-8: INEFFICIENT STATE TAXES, 2004-05

	States' share %	Commonwealth share %	% of total general government tax revenue
Motor vehicle taxes	100%	0%	1.9%
Land taxes	100%	0%	1.3%
Taxes on insurance	100%	0%	1.3%
Stamp duties on commercial conveyances	100%	0%	0.7%
Other stamp duties	100%	0%	0.4%
Other taxes on immovable property	100%	0%	0.3%
Financial institutions transactions taxes	100%	0%	0.2%

These taxes amount to 6% of the total tax take, or \$16.9 billion in 2004-05.

Clearly the economy would be better off without these taxes – as seen in Figure 2 above.

From a federalism point of view, at issue is whether there would be efficiencies if the States exited these taxes and the Commonwealth compensated the States for the revenue foregone from the proceeds of its increased collection of more efficient taxes.

Or, alternatively, the costs to taxpayers and the wider economy of Australia's federation would be rather lower if the States exited these taxes and made up the difference by raising one or both of their two efficient taxes – the GST and/or payroll taxes.

Access Economics has estimated the welfare gains arising from the efficiency savings implied in a swap of these inefficient taxes for more efficient ones as a saving of \$2.8 billion.

This estimate has been developed using the relative efficiency rankings developed in Access Economics' 2004 report, *Axing the Alcabala: A program for a 21st century State tax system*, prepared for the Business Coalition for Tax Reform. Those rankings are as shown in Figure 2 above.

The saving represents the difference in efficiency losses ('deadweight' losses) between actual State taxes in 2004-05 and a system of State taxation under which the revenues collected in 2004-05 from the taxes listed in Table 3-8 are replaced by taxes collected from the GST and payroll taxes (with these latter two taxes each making up half the shortfall).

3.3.2 THE TAX-RELATED DEADWEIGHT COSTS OF EXCESS SPENDING

We noted above that this report conservatively estimates some \$5.1 billion a year as the spending-related inefficiencies of flawed federalism.

But the net cost of that is more than just the \$5.1 billion a year. When taxes are used to raise that amount, they result in additional efficiency costs to the economy.

We have (again conservatively) costed the latter effect by assuming these are paid for out of GST and/or payroll tax receipts (that is, from efficient rather than inefficient taxes).

That adds to the estimate of the efficiency costs involved here – adding another **\$866 million a year** to the total.

Or, in other words, to pay for \$5.1 billion of wasted spending actually costs taxpayers almost \$6 billion, because the taxes raised to pay for the wasted spending themselves destroy further value in the economy.

3.3.3 INSUFFICIENT CENTRALISATION OF TAX COLLECTIONS

In 2004-05, as shown in Table 3-9, taxes accounting for 80% of tax collections were the subject of some form of central collection, although only 17% of these collections were on-passed to the States.

TABLE 3-9: CENTRALLY-COLLECTED TAXES, 2004-05

	State direct collection \$m	Commonwealth collection on behalf of States \$m	Commonwealth direct collection \$m
GST and other sales taxes	0	35,473	1,164
Taxes on income	0	2,541	160,433
Excises and levies	50	600	22,211

It is in the types of 'efficient' taxes listed in Table 3-10 that are exclusively collected by the States where the question is whether there would be greater efficiencies if more of these taxes were collected centrally.

TABLE 3-10: STATE-EXCLUSIVE TAXES, 2004-05

	States' share %	Commonwealth share %	% of total general government tax revenue
Payroll taxes	100%	0%	4.4%
Taxes on gambling	100%	0%	1.5%
Municipal rates	100%	0%	0.0%

These taxes amounted to \$16.4 billion in 2004-05, or 6% of the total tax take in Australia.

Again, as noted above, although we do not estimate 'government' inefficiencies with respect to this latter group of taxes, there are important non-fiscal costs associated with eight different State tax systems in Australia. The latter costs weigh on business rather than government, and are less easily estimated, but both these types of costs lower living standards for all Australians.

The fiscal costs of this degree of decentralisation in tax collection may not be quite as significant, and could be proxied by (say) 50% of the summed cost of State revenue collection agencies. This amounted to **around \$150 million in 2004-05**.

3.3.4 GAMING OF GRANTS

Finally, some part of the \$35½ billion in GST and other sales taxes collected by the Commonwealth and on-passed to the States is likely to be wasted via the misallocation of resources that goes with successful gaming by less efficient States of the Commonwealth Grants Commission (CGC) horizontal fiscal equalisation (HFE) process used to determine the distribution of GST grants among the States. In addition, not merely does this process result in grants going to less efficient States, but a percentage is also consumed by the administration of the Commonwealth Grants Commission (CGC) horizontal fiscal equalisation (HFE) process itself. This comprises a portion of the cost of the CGC itself, and the related State Treasury costs.

These costs were estimated by Fitzgerald and Garnaut to be in the order of **\$150-280 million** a year.⁸

3.4 OVERALL COST ESTIMATE

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

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

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

As noted above, there are also likely to be broader 'private' costs of inefficient federalism – where costs fall on to businesses and families due to overlapping and excessive State regulations. How high might these 'private' costs be? Appendix A deals with that issue, but it is not unreasonable to assume that these costs would be higher than the 'government' costs – perhaps substantially higher.

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

That's a lot to waste.

⁸ Fitzgerald, V. and Garnaut, R. (2002), Review of Commonwealth-State Funding, Final Report.

TABLE 3.1: THE 'GOVERNMENT' COSTS OF FLAWED FEDERALISM, 2004-05

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

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APPENDIX A: THE COSTS OF EXCESSIVE REGULATION

This report has concentrated on the ‘government’ costs of a less-than-optimal federal system.

However, as noted, the ‘business’ costs arising from dealing with multiple and overlapping regulatory requirements may be rather higher than the ‘government’ costs estimated here.

This Appendix concentrates upon the latter, drawing on *The Benefits and Costs of Business Regulation*, a report prepared by Access Economics for the Business Council of Australia in 2005.

Productivity Commission Chairman Gary Banks has drawn particular attention to the danger of ‘regulatory cocktails’ creating adverse and unintended interactions. In Australia overlapping or conflicting regulation can occur:

- ❑ **Between different regulatory bodies at the same level of government.** For example, Federal agencies APRA, ASIC, the Reserve Bank and the ACCC share regulatory oversight of banking and financial markets. And these different regulatory bodies can have conflicting objectives. For example, Australian Government agencies appear to have conflicting goals and attitudes toward foreign investment – *InvestAustralia* aims to attract and facilitate foreign investment, while the *Foreign Investment Review Board* adds a regulatory process, stops some foreign investment from proceeding, and by its mere presence may discourage other investment.
- ❑ **Between levels of government.** For example, new developments may need to comply with planning laws at the Federal, State and local level. A review of Australia’s building regulations found “Local Governments usually do not conduct an adequate level of impact analysis of their regulations. New regulations may be introduced that contain extra requirements on business, with increased costs, for uncertain benefit”.⁹
- ❑ **Between jurisdictions.** For example, workers compensation or OH&S laws differ between States, despite almost identical objectives. This generates extra compliance costs for national firms with no benefits to the community. The Productivity Commission has consistently found benefit in mutual recognition regimes (both domestically and internationally) to harmonise standards and reduce the potential for duplication or inconsistency (see box below).

Many firms have to navigate the compliance nightmare that overlapping regulation creates. Imposing additional costs on business without a commensurate benefit to consumers and society is bad policy and bad regulation, as the Productivity Commission’s inquiry in into National Workers’ Compensation and Occupational Health & Safety Frameworks showed.

⁹ Productivity Commission (2004) *Reform of Building Regulation* Research Report, Productivity Commission, Canberra, November 2004, p.xxxvii.

Same Policy, Multiple Versions, Zero Benefit – Australia’s overlapping OH&S and Workers Compensation Schemes

There are ten principal Occupational Health & Safety (OH&S) statutes across Australia – one for each State and Territory and two Federal laws dealing with employees in the Federal Government and the maritime industry, respectively.

There are even more workers’ compensation schemes, as some States have industry-specific as well as State-wide schemes.

Industry surveys identify the lack of nationally consistent Workers’ Compensation and OH&S regulations as a key concern of business. In 2003-04 the Productivity Commission’s inquiry into National Workers’ Compensation and Occupational Health & Safety Frameworks attracted many submissions from firms and industry associations canvassing the inefficient effects of nationally inconsistent regimes.

The objectives which underlie OH&S and workers’ compensation regimes in each jurisdiction are essentially identical. Differences arise in how each jurisdiction implements these policies. The Productivity Commission found these differences to be substantial, and not merely superficial drafting differences.¹⁰ As well as what is written in the detailed regulations and codes which set out the scheme, there are also differences in how the responsible body exercises its discretion, particularly in relation to enforcement.

Even where principles and policies are consistent, multiple arrangements create extra premium and reporting requirements for national firms, which in itself raises business compliance costs. CSR, a national firm eligible to self-insure for workers’ compensation, still needs to obtain a licence to do so in each of the five States and Territories which it operates. It estimated that the ongoing cost of renewing these licences would fall by \$500,000 a year (from \$700,000 to \$200,000) if it had to only maintain and review one ‘national’ licence. These savings would come from a reduction in administration staff, administration fees and reporting costs. The requirement to report to five different regulators at different times of the year and in different formats was estimated to add \$60,000 alone to CSR’s total reporting costs.

¹¹

Other organisations provided estimates of potential cost savings from a national scheme ranging from 5 to 15% of their annual compliance costs. They also identified areas of lost efficiency to the economy, the value of which could not be quantified in dollar terms.

While there are potential benefits from multiple arrangements, including tailoring arrangements to local preferences, or competing and learning between jurisdictions, the Productivity Commission does not appear to have found these benefits to be notable, or that they could only be obtained through the current fragmented system.

¹⁰ The Productivity Commission, at p16.

¹¹ The Productivity Commission, at p20.

In brief, the costs of regulation over and above efficient levels of regulation include:

- ❑ costs to taxpayers (*administration* – covered in ‘government’ costs above);
- ❑ costs to business (*compliance*); and
- ❑ costs to the economy (*efficiency* or *deadweight losses* – only the tax-driven component of which is covered in ‘government’ costs above, not the regulatory-driven component).

Economists expect the magnitude of costs to increase down that list, so that administration costs are just the tip of the regulatory cost iceberg. However, as we move down those categories it also becomes ever harder to accurately quantify the amount of costs involved.

4.1.1 COSTS TO TAXPAYERS – ADMINISTRATIVE

It is generally not possible to isolate the total of government resources devoted to a particular piece of legislation. Table 4.1 shows the budgets of State competition and taxation bodies, compared with their Federal counterparts; the ACCC and the ATO.

TABLE 4.1: OPERATING EXPENSES OF STATE COMPETITION/TAX REGULATORS, 2002-03

JURISDICTION	COMPETITION REGULATOR	2002-03 \$M	TAXATION REGULATOR	2002-03 \$M
NSW	Independent Pricing & Regulatory Tribunal	11.4	Office of State Revenue	79.3*
VIC	Essential Services Commission Victorian Competition & Efficiency Commission#	11.7	State Revenue Office	56.2
QLD	Queensland Competition Authority	5.6	Office of State Revenue	37.2
SA	Essential Services Commission of SA	4.3	RevenueSA	24.8^
WA	Economic Regulation Authority**	n/a	Office of State Revenue	31.3^^
TAS	Government Prices Oversight Commission Office of the Tasmanian Energy Regulator	0.2 1.5	State Revenue Office	6.2
ACT	Independent Competition & Regulatory Commission	2.1	ACT Revenue Office	n/a
NT	Utilities Commission	0.6	Territory Revenue	5.2*
State Total		37.5		240.1
<i>Federal Govt</i>	<i>Australian Competition & Consumer Commission</i>	<i>73.0</i>	<i>Australian Taxation Office</i>	<i>2,133.0</i>
Australian Total		110.5		2373.1

* Excludes First Home Owner Grants # Not established until July 2004 ^Based on cost allocated to sub-program 2.1: Revenue Collection and Management ** Not established until January 2004 to replace the Office of Gas Access Regulation, Office of the Rail Access Regulator, Office of Water Regulation ^^Based on cost allocated to Land Tax, Payroll Tax, Stamp Duties and Grants & Subsidies

4.1.2 COSTS TO BUSINESS – COMPLIANCE

The direct costs of regulation include the costs incurred by businesses in complying, such as:

- (1) staff time needed to comply with regulations;
- (2) hiring of any additional staff required to meet the additional administration burden;
- (3) maintaining and developing new and up-to-date reporting systems;
- (4) obtaining advice (lawyers, accountants, architects etc);
- (5) educating staff about the new requirements; and
- (6) any associated costs of advertising, travel or the like.

These costs also indirectly affect the broader community by increasing prices and sometimes by delaying the introduction of new products and services.

That said, business compliance costs are that proportion of a firm's administrative processes and resources which are devoted to activities *they would not do if the regulation did not exist*.

Some compliance procedures, such as accurate record keeping, would likely occur even without regulatory stipulation. That makes it very difficult to make judgements about what activities would occur without regulation.

The leading example of this incremental cost approach to compliance costing is the MISTRAL model used in the Netherlands. A Dutch study using the MISTRAL model found that **around one fifth of all administration costs borne by business were caused solely by compliance responsibilities.**¹²

Moreover, some activities may still be undertaken, but they would be structured in a more efficient or less costly manner than that required to meet particular regulatory requirements. The MISTRAL model cannot calculate the latter costs. While caution is required when extrapolating from the Dutch experience to Australian regulation, a figure of around 20% would support Australian survey data that regulatory compliance costs are significant.

As noted above, most Australian research is generated by surveys which ask business respondents to estimate time spent complying with a particular or a range of regulations, such as ACCI and AIG industry surveys (see the comments in the box). These focus on particular types of regulation, such as tax or environmental regulation. There have been no major studies on the overall costs of regulation to Australian businesses in recent years.

¹² Chittenden, F, Kauser, S & Poutziouris, P (2001) *Regulatory Burdens of Small Business: A Literature Review* Manchester Business School, p.3. This result is obviously applicable to the Dutch context. However, it is indicative of the scale of regulatory compliance costs in a modern developed economy.

What are Australian businesses saying about compliance costs?

- In dealing with government regulation, the greatest concern to business is the complexity of regulation, followed by the costs of compliance.¹³
- 91% of small businesses and 76% of large firms surveyed prior to the 2004 election described the frequency of changes to tax laws and rules as a major or moderate concern for their business.¹⁴
- Firms, regardless of size, expressed more concern over labour regulations and on-costs than labour costs themselves. In ACCI's pre-election survey the greatest concern was over workers' compensation costs, unfair dismissal legislation and termination, change and redundancy regulations.¹⁵
- Regulations have varying impacts depending on firm size. Larger firms report greater concern with environmental and OH&S regulations.¹⁶
- The Australian Industry Group estimated that each Australian manufacturer spends 102 hours a month of staff time managing compliance, equivalent to 1.8 hours per employee. At average manufacturing wage costs, this totals over \$680 million per year for the Australian manufacturing sector.¹⁷

- ❑ A US analyst suggests paperwork-related compliance burdens amount to around one third of the aggregate regulatory burden in the United States. If this same multiplier applied in Australia, total compliance costs would amount to as much as 7% of GDP.¹⁸
- ❑ The Productivity Commission found that, in 1994-95, the administrative burden resulting from regulation amounted to some \$11 billion for businesses.¹⁹ A more recent OECD study estimated that the direct compliance costs of taxation, employment and environmental regulations totalled more than \$17 billion in 1998 for small and medium sized Australian businesses alone.²⁰
- ❑ While such surveys occur regularly enough to identify current trends in compliance activity, there will be a potential upward bias in the results due to a lack of common understanding about what constitutes a compliance cost; an inclination for business people to overestimate their compliance burden; and an inability accurately to estimate and allocate the costs of compliance activities to particular forms of regulation, especially if the survey respondent is being asked to give an immediate answer.

¹³ ACCI (2004), *ACCI Review*, June 2004, p.8

¹⁴ ACCI (2004), *ACCI Review*, June 2004, p.4

¹⁵ ACCI (2004), *ACCI Review*, June 2004, p.7

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¹⁷ Australian Industry Group (2004), *Compliance Costs Time and Money*, Sydney, November 2004.

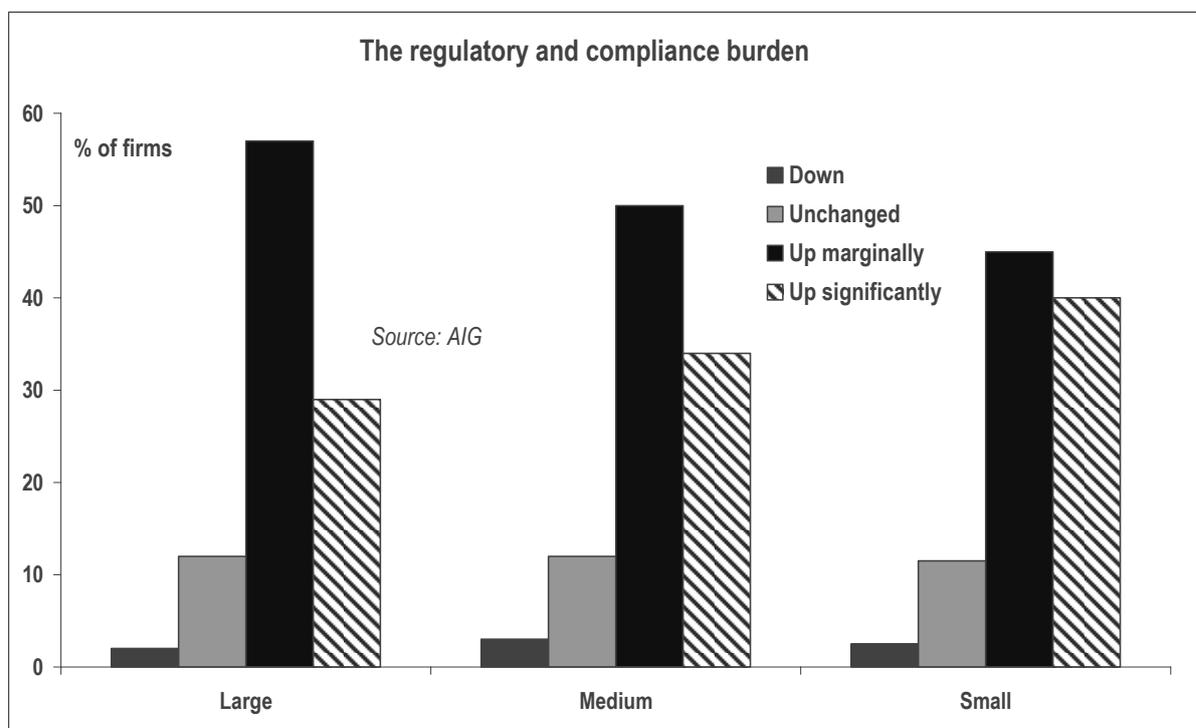
¹⁸ Banks (2003), *The good, the bad and the ugly: economic perspectives on regulation in Australia*, Address to the Conference of Economists, Business Symposium, October, p6.

¹⁹ Banks (2003), *The good, the bad and the ugly*, p5.

²⁰ OECD (2001), *Business' views on red tape: administrative and regulatory burdens on SMEs*, October.

- An alternative way to use business surveys is to focus on business perceptions about changes to the overall level of compliance required, rather than resources spent on a particular regulation. For example, AIG found 85% of manufacturers thought the time spent complying with Federal regulation had increased over the three years to 2004 (see Figure 3).

FIGURE 3: PERCEPTIONS OF CHANGES IN THE COMPLIANCE BURDEN 2001-04



Source: AIG (2004) *A Survey of Business Priorities in the lead up to the Budget*

Concern about the rising costs of compliance is not limited to manufacturers. Government business liaison programs have detected a more general concern that the costs of meeting regulatory requirements have risen significantly.²¹

For example, business representatives from the financial services sector indicate that the cost of meeting financial sector regulatory requirements had increased '3 or 4 times over the past 5 years'.²² And, according to some estimates, the combined annual costs to the top 50 listed companies of compliance with CLERP 9, the Financial Services Reform Act and the Australian Stock Exchange's corporate governance guidelines is as high as \$375 million.²³

4.1.3 COSTS TO THE ECONOMY – EFFICIENCY

The economy-wide costs stem from an allocation of resources which is different to that which would otherwise have prevailed in the absence of regulation. Its impact shows up as:

²¹ Treasury (2004) *Key themes from the Treasury Business Liaison Program – April 2004*, Canberra, April.

²² Treasury (2004) *Key themes*.

²³ Nicholas, N & Buffini, F (2004) 'Backlash against regulation costs' *Australian Financial Review*, 5 July, p.1, 60.

- ❑ **Higher prices** for consumers and other businesses and **lower wages** to employees (to finance compliance costs, and because less efficiently allocated resources mean productivity is lower than it would have been), and
- ❑ **Higher taxes** paid to governments (to finance administration costs).

These are typically the largest costs and most well-hidden costs of regulation. Moreover, they are often incurred by policymakers with the best intentions, but with less than perfect information, and less than adequate assessment, so that regulators end up enforcing less than optimal outcomes.

It should also be noted that efficiency costs are not merely static. **There are dynamic efficiency costs to the economy as well because regulation can discourage risk-taking and reduce accountability.** In particular, bad regulation can breed a culture of unaccountability among individuals and corporations and – at greater still potential cost – it can reduce the return to risk. That discourages entrepreneurs and others from the innovation that leads to growth in national income.

But how big are they? These costs are not counted in business compliance cost surveys or in regulation impact statements.

Nevertheless, the available indicators do suggest a strong link between greater regulation and poorer economic outcomes – lower GDP, higher unemployment, and a less equitable distribution of wealth.