



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

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# CONTENTS

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

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

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

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

	PREFACE	ii
	KEY MESSAGE	iv
	EXECUTIVE SUMMARY	vi
<b>1</b>	<b>INTRODUCTION</b>	<b>1</b>
1.1	THE REFORM IMPERATIVE	3
1.2	THE FEDERAL SYSTEM	4
<b>2</b>	<b>HOW WELL IS AUSTRALIA'S FEDERAL SYSTEM PERFORMING?</b>	<b>7</b>
2.1	INEFFICIENCIES AND WEAKNESSES	7
2.2	POOR COOPERATION	14
2.3	A RESURGENT COAG?	15
<b>3</b>	<b>REALITY CHECK</b>	<b>16</b>
3.1	REALITY 1: MORE THAN ONE TIER OF GOVERNMENT	17
3.2	REALITY 2: CENTRALISATION	17
3.3	REALITY 3: SHARED RESPONSIBILITIES	19
3.4	ONE MYTH	20
<b>4</b>	<b>AN ACTION PLAN FOR FEDERAL REFORM</b>	<b>21</b>
4.1	AN ACTION PLAN FOR FEDERAL REFORM	21
<b>5</b>	<b>PRINCIPLE 1: CLARIFY ROLES AND RESPONSIBILITIES</b>	<b>22</b>
5.1	PRINCIPLES FOR ALLOCATING FUNCTIONS	23
5.2	FEDERAL CONVENTION	24
5.3	AN AUSTRALIAN COMMON MARKET?	24
5.4	NATIONAL MARKETS	28
5.5	RATIONALISING FUNCTIONS	29
5.6	EXCLUSIVE AND SHARED RESPONSIBILITIES	30
5.7	MODELS FOR SHARED RESPONSIBILITIES	31
5.8	ENTRENCHING COOPERATION IN THE CONSTITUTION	32
5.9	PROPOSALS FOR CLARIFYING ROLES AND RESPONSIBILITIES	34
<b>6</b>	<b>PRINCIPLE 2: INSTITUTIONALISE COOPERATION</b>	<b>35</b>
6.1	STRENGTHENING COAG	35
6.2	STRENGTHENING MINISTERIAL COUNCILS	36
6.3	FEDERAL COMMISSION	36
6.4	PROPOSALS FOR INSTITUTIONALISING COOPERATION	39
<b>7</b>	<b>PRINCIPLE 3: FIX FISCAL ARRANGEMENTS</b>	<b>40</b>
7.1	VERTICAL FISCAL IMBALANCE	40
7.2	HORIZONTAL FISCAL EQUALISATION	42
7.3	PROPOSALS FOR FIXING FISCAL ARRANGEMENTS	42
<b>8</b>	<b>CONCLUSION</b>	<b>43</b>
	<b>APPENDIX 1 – INTERGOVERNMENTAL RELATIONS IN FEDERAL SYSTEMS</b>	
	<b>APPENDIX 2 – THE COSTS OF FEDERALISM</b>	



## PREFACE

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

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

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

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

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

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

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

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- + Mr Gary Banks
- + Ms Christine Bartlett
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- + The Hon. Michael Beahan
- + Mr Roger Beale AO
- + Mr Alec Brennan
- + Dr A.J. Brown
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- + Mr Guy Templeton
- + Mr Don Voelte
- + Dr Neil Warren
- + The Hon. Gough Whitlam AC
- + Mr Roger Wilkins
- + Professor George Williams
- + Mr Steve Wood
- + The Hon. Neville Wran AC QC
- + Ms Heidi Zwar



## KEY MESSAGE

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

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

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

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

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

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

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

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

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



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

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

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

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

The challenge is to strike the right balance.

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

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

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

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



## EXECUTIVE SUMMARY

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

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

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

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

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

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

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

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

## THE CURRENT SYSTEM IS FAILING AUSTRALIA





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

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

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

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

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

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

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

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

## A RESURGENT COAG?

### GREAT EXPECTATIONS VERSUS A HISTORY OF UNMET EXPECTATIONS

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

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

## FIXING FEDERALISM – THERE ARE SOLUTIONS

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

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

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

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

## A NEW CONTRACT FOR FEDERAL–STATE RELATIONS

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

### 1 CLARIFY ROLES AND RESPONSIBILITIES

### 2 INSTITUTIONALISE COOPERATION

### 3 FIX FISCAL ARRANGEMENTS

## PRINCIPLE 1: CLARIFY ROLES AND RESPONSIBILITIES

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

### ACTION 1

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

### ACTION 2

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

### ACTION 3

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

### ACTION 4

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

### ACTION 5

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

### ACTION 6

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

### ACTION 7

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

### ACTION 8

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



## PRINCIPLE 2: INSTITUTIONALISE COOPERATION

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

### ACTION 9

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

### ACTION 10

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

### ACTION 11

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

## PRINCIPLE 3: FIX FISCAL ARRANGEMENTS

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

### ACTION 12

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



## 1 | INTRODUCTION

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

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

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

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

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

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

### AUSTRALIA'S FEDERAL SYSTEM HAS GROWING WEAKNESSES AND INEFFICIENCIES

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

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

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

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

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

.....

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

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

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

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

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

## 1.1 | THE REFORM IMPERATIVE

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

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

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

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

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

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

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

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

## 1.2 | THE FEDERAL SYSTEM

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

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

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

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

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

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

### 1.2.1 | A FEDERAL SYSTEM – ADVANTAGES

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

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

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



## EXHIBIT 1

### STATE POLICY LEADERSHIP

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

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

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

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

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

### 1.2.2 | A FEDERAL SYSTEM – DISADVANTAGES

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

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

FEDERAL SYSTEMS HAVE INNATE WEAKNESSES THAT MUST BE COMBATED

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

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

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

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

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

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

## EXHIBIT 2

### ADVANTAGES AND DISADVANTAGES OF FEDERATIONS

#### Potential advantages:

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

#### Potential disadvantages:

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

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

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

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

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

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

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

### EXHIBIT 3

#### FEDERALISM AND HEALTH

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

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

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

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

## 2.1 | INEFFICIENCIES AND WEAKNESSES

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

## EXHIBIT 4

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

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

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

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



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

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

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

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

## EXHIBIT 5

### ONE NATION ... OR EIGHT

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

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

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

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

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

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

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## EXHIBIT 6

### RAIL GAUGES AND OTHER BARRIERS

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

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

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

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

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

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



## EXHIBIT 7

### NOT MY RESPONSIBILITY ...

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

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

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

**Queensland Premier Peter Beattie**

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

**Health Minister Tony Abbott**

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

**Queensland Premier Peter Beattie**

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

**Prime Minister John Howard**

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



## 2.2 | POOR COOPERATION

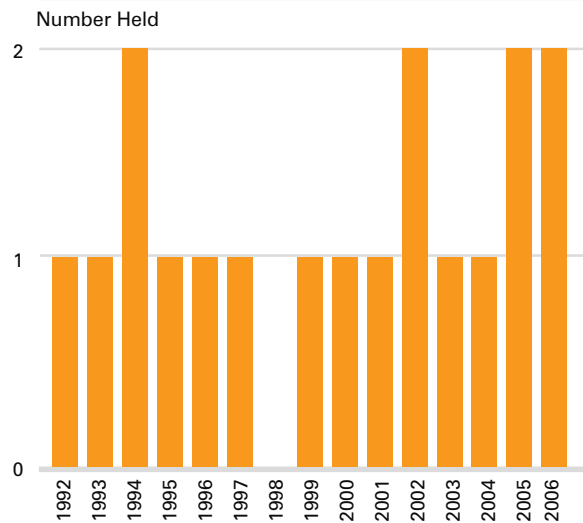
The weaknesses and inefficiencies in our federal system are costing Australians through higher taxes and poorer quality services than necessary. But they are only part of the problem.

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

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

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

FIGURE 1 NUMBER OF COAG MEETINGS HELD, 1992–2006



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

Australia therefore faces two challenges with its federal system:

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



## 2.3 | A RESURGENT COAG?

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

The reform agenda mapped out by COAG broadly covers:

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

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

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

## EXHIBIT 8

### THE EBB AND FLOW OF WATER REFORM

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

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

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

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

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

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

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



### 3 | REALITY CHECK

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

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

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

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

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

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

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

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



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

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

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

Assumptions that removing the states will somehow fundamentally improve the operation of government in Australia also need to be tested more rigorously. There are many potential benefits for Australia from a federal system of government (see 1.2.1). With its dispersed population and large geographic distances, some form of regional government seems inevitable in Australia, whether it is through semi-autonomous state governments, or through Commonwealth-controlled regional governments.

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

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

### 3.2 | REALITY 2: CENTRALISATION

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

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

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

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

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

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

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

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

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

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

THERE ARE NOW FEW LIMITS ON THE POWER OF THE COMMONWEALTH

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

### 3.3 | REALITY 3: SHARED RESPONSIBILITIES

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

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

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

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

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

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

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

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

### 3.4 | ONE MYTH

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

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

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

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

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

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

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

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



## 4 | AN ACTION PLAN FOR FEDERAL REFORM

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

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

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

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

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

### 4.1 | AN ACTION PLAN FOR FEDERAL REFORM

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

### PRINCIPLE 1: CLARIFY ROLES AND RESPONSIBILITIES

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

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

### PRINCIPLE 2: INSTITUTIONALISE COOPERATION

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

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

### PRINCIPLE 3: FIX FISCAL ARRANGEMENTS

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

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

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## 5 | PRINCIPLE 1: CLARIFY ROLES AND RESPONSIBILITIES

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

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

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

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

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

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

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

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

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

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

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

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

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

## 5.1 | PRINCIPLES FOR ALLOCATING FUNCTIONS

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

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

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

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

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

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

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



## 5.2 | FEDERAL CONVENTION

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

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

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

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

## 5.3 | AN AUSTRALIAN COMMON MARKET?

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

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

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

## AUSTRALIA IS NOT YET A COMMON MARKET



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

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

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

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

## EXHIBIT 9

### A NATIONAL CORPORATIONS LAW FOR A COMMON MARKET

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

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

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

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

## EXHIBIT 9 (CONTINUED)

Another worrying development is the decision of a number of states to unilaterally veto changes to the Corporations Act. Under the agreement by which states have referred their powers, the states may veto amendments to the Commonwealth's Corporations Act, even if those changes would pass Federal Parliament. The states have recently exercised that veto in connection to changes to the Act that currently allow just 100 shareholders to force a corporation to hold an extra ordinary general meeting of all shareholders.

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

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

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

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

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

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

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

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

## A TIME LIMIT SHOULD BE PLACED ON COAG PROCESSES

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

## EXHIBIT 10

### NATIONAL BUSINESS SCHEMES

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

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

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

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

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

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

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

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

## 5.4 | NATIONAL MARKETS

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

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

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

## EXHIBIT 11

### WHAT NATIONAL ELECTRICITY MARKET?

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

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

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

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



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

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

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

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

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

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

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

## 5.5 | RATIONALISING FUNCTIONS

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

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

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



## 5.6 | EXCLUSIVE AND SHARED RESPONSIBILITIES

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

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

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

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

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

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

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



## 5.7 | MODELS FOR SHARED RESPONSIBILITIES

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

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

### INCREASED STATE RESPONSIBILITY

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

### NATIONAL JOINT MANAGEMENT

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

### REGIONAL JOINT MANAGEMENT

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

### SEGMENTED JOINT MANAGEMENT

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

Other models for managing shared responsibilities include:

### INCREASED COMMONWEALTH RESPONSIBILITY

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

### COMPETITIVE TENDERING

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

### PUBLIC CHOICE

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

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## EXHIBIT 12

### MANAGING SHARED FUNCTIONS LIKE JOINT VENTURES

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

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

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

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

## 5.8 | ENTRENCHING COOPERATION IN THE CONSTITUTION

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

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

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

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

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



## 5.9 | PROPOSALS FOR CLARIFYING ROLES AND RESPONSIBILITIES

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

### **ACTION 1**

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

### **ACTION 2**

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

### **ACTION 3**

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

### **ACTION 4**

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

### **ACTION 5**

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

### **ACTION 6**

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

### **ACTION 7**

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

### **ACTION 8**

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



## 6 | PRINCIPLE 2: INSTITUTIONALISE COOPERATION

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

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

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

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

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

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

### 6.1 | STRENGTHENING COAG

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

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

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

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

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

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



## 6.2 | STRENGTHENING MINISTERIAL COUNCILS

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

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

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

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

## 6.3 | FEDERAL COMMISSION

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

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





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

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

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

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



## EXHIBIT 13

### THE FEDERAL COMMISSION

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

#### ROLE

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

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

#### GOVERNANCE

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

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

#### STRUCTURE

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

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

#### INITIAL ACTIVITIES

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

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

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

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

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

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

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

## 6.4 | PROPOSALS FOR INSTITUTIONALISING COOPERATION

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

### **ACTION 9**

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

### **ACTION 10**

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

### **ACTION 11**

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



## 7 | PRINCIPLE 3: FIX FISCAL ARRANGEMENTS

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

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

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

### 7.1 | VERTICAL FISCAL IMBALANCE

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

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

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

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

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

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

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



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

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

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

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

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

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

## 7.2 | HORIZONTAL FISCAL EQUALISATION

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

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

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

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

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

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

## 7.3 | PROPOSALS FOR FIXING FISCAL ARRANGEMENTS

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

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

### ACTION 12

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

## 8 | CONCLUSION

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

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

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

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

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

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

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

### 1 CLARIFY ROLES AND RESPONSIBILITIES

### 2 INSTITUTIONALISE COOPERATION

### 3 FIX FISCAL ARRANGEMENTS

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

## NOTES

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- 17 A Deakin, Morning Post, 1 April 1902, London, in *Federated Australia: Selections from the Letters to the Morning Post, 1900–1910*, Melbourne University Press, Melbourne, 1968.
- 18 J Pincus, 'Productive Reform in a Federal system', in Productivity Commission, *Productive Reform in a Federal System*, Roundtable Proceedings, Canberra, 2006.
- 19 The 1946 referendum gave the Commonwealth Parliament power to make laws to provide a wider range of social services, including 'maternity allowances, widows' pensions, child endowment, unemployment, pharmaceutical, sickness and hospital benefits, medical and dental services ... benefits to students and family allowances'. Other significant amendments include the 1928 amendment validating the Loan Council and the 1967 amendment giving the Commonwealth power to make special laws with respect to Indigenous people and to include them in the national census.
- 20 A recent survey, for example, found that more than 50 per cent of respondents with a view favoured replacing Australia's current three-tiered system with a two-tiered system consisting of a national government and regional governments. See Griffith University & Charles Sturt University, *Constitutional Values Survey*, May 2006.
- 21 Section 87 of the Constitution.
- 22 The goods and services tax (GST) is included in this figure as revenue raised by the Commonwealth as it is raised under Commonwealth legislation and, although politically committed, the Commonwealth is not constitutionally bound to pass the GST revenue to the states.
- 23 Based on own-purpose expenditure and excluding subsidies and grants, including to the states.
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- 25 Section 96 of the Constitution.
- 26 A Deakin, *Second Reading Speech*, Judiciary Bill, Commonwealth Parliament, 18 March 1902.
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- 30 Section 51(xxix) of the Constitution.
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- 46 T Wilson & B Moore, 'Regulatory Reform in Land Transport', in Productivity Commission, *Productive Reform in a Federal System*, p. 293.
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- 48 These are discussed more fully in Wilkins.
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- 51 While the major casualty of the High Court cases was the cooperative scheme for corporations regulation, the BCA does not support a return to a cooperative scheme in this area. The consequence of the High Court case has been the referral of state powers to the Commonwealth to overcome the limitations in the Commonwealth's otherwise extensive powers to legislate for corporations. For purely policy and practical reasons, the BCA supports the regulation of corporations being a Commonwealth function and believes the current referral of powers was appropriate even without the High Court cases and should be made permanent.
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- 60 OECD, Fig. 3.4, p. 78.
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