February 2008

Paper 4: How are the States faring?

Report by Access Economics Pty Limited for the

Business Council of Australia

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EXECUTIVE SUMMARY

The first of the reports in this series made the point that there are really only a few key aims for the Australian Budget: to help the nation achieve prosperity and fairness, while achieving both those aims simply (thereby avoiding undue costs of compliance and administration).

Yet there are three levels of government in Australia, and our federal system means that the States[1] are responsible for a very large share of public spending, whereas the Australian Government raises the lion's share of taxes. Moreover, although there is too much overlap in spending responsibilities and tax bases, these are relatively fixed.

That creates a structural problem, particularly as **the revenue surge of recent years has delivered money mostly to the Australian Government, whereas some of the key areas that need to be addressed in better delivering national prosperity and fairness (such as education, infrastructure and health) are mostly the preserve of the States**.

Or, in other words, the structure of our federal system has failed us:

- If governments are meant to work together to achieve prosperity and fairness, but
- different levels of government are responsible for different types of spending, while
- different levels of government receive funds from different types of taxes, and
- trends in tax bases diverge from trends in spending needs, then
- we have a problem, with needs more apparent among the States, yet funding capacity available more to the Feds.

That is not to say there have not been important advances in recent years. In particular, the GST is a much more efficient and stable source of revenue than the grab bag of taxes and fees it replaced, while recent COAG meetings have recognised the importance of reinvigorating a national reform agenda. And nor is it to say that some States and Territories have not seen their revenue bases also benefit from the resources boom.

Yet other problems have grown in magnitude in recent years:

- **The cost of inefficiencies is higher now**. It didn't matter as much in times past if unnecessary Federal/State duplication led to the employment of an extra worker than necessary, because the nation had spare capacity anyway. But now that we are at full capacity, each wasted worker and each wasted dollar is exactly that – wasted. That raises the relative return to reform of Federal/State relations. Similarly, the opportunity cost of Federal 'over-regulation' of Specific Purpose Payments is now higher, as the resources unnecessarily being burned up could now be more rather more beneficially used otherwise to boost national prosperity.
- **The GST might be a better option than the taxes it replaced, but it is still unnecessarily cyclical, and CGC misallocation of funding resources now has a rising opportunity cost**. The GST is levied on housing investment (construction) rather than housing consumption, and housing investment is highly cyclical. Moreover, the timing of GST cyclicality matches that in some other key State revenue bases, such

[1] The use of the word 'States' throughout this document refers to all of the Australian States and Territories.

as residential stamp duties. In addition, the shift to financing through the GST effectively gave added weight to the dollars distributed according to Commonwealth Grants Commission formulas. As those formulas are focussed on 'equity across State service delivery capacity' as opposed to either prosperity or fairness,[2] and more resources are being funnelled through these channels than ever before, then the opportunity cost of under-funding some States and over-funding others has risen.

- **Federal funding of the States has been squeezed in recent years**. As a share of national income, tied grants peaked in 2001-02, while GST revenues peaked in 2003-04. In part this trend in funding arose as the previous Australian Government was frustrated by what it saw as a lack of performance by the States. However, the squeeze on State funding has worsened the structural problems here: one level of government has more money than it needs to effectively tackle an agenda of prosperity and fairness, while the next tier of government is under-funded for similar challenges.
- **Policy failures have been pervasive**. Not only did the previous Australian Government achieve little in terms of prosperity or fairness from its revenue windfall of recent years, the same is true of the States, who similarly squandered their (admittedly smaller) revenue windfall from the housing price boom.

In short, prosperity has grown at the fastest rate in over a generation, but so too has the size of the Australian Government's footprint. And with this surge in prosperity, the pressures on one of the oldest federations in the world have become more acute, exposing inefficiencies in Commonwealth-State relations as a weakness.

There are few easy solutions to these ever more costly challenges. But 'ever more costly' they indeed are, and they make Federal/State funding reform ever more important.

Old battle lines need to give way to allow a new level of cooperation to come to the fore. Governments at all levels need to think seriously about how best to maximise the efficient use of the resources they command.

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[2] States are a means to an end. Fairness can ultimately only apply to people, and it is much more efficient to achieve that by focussing on people rather than on States.

1. INTRODUCTION

The first of the reports in this series made the point that there are really only a few key aims for the Australian Budget: to help the nation achieve prosperity and fairness, while achieving both those simply (avoiding undue costs of compliance and administration).

Yet there are three levels of government in Australia, and our federal system means that the States are responsible for a very large share of public spending, whereas the Australian Government raises the lion's share of taxes.

Moreover, although there is too much overlap in spending responsibilities and tax bases, these are relatively fixed.

That creates a structural problem, particularly as **the revenue surge of recent years has delivered money mostly to the Australian Government, whereas some of the key areas that need to be addressed in delivering national prosperity and fairness (such as education, infrastructure and health) are mostly the preserve of the States**. Or, in other words, the structure of our federal system has failed us:

- If governments are meant to work together to achieve prosperity and fairness, but
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… we have a problem, with needs more apparent among the States, yet funding capacity available more to the Feds.

- Chapter 2 of this report identifies who has what responsibilities in Australia's federation, focussing on the advantages and disadvantages of a federation versus more centralised forms of government.
- Chapter 3 discusses three State spending responsibilities of particular interest to the attainment of prosperity and fairness – education, health and infrastructure.
- Chapter 4 identifies who gets what in Australia's federation – which level of government has access to which tax bases.
- Chapter 5 notes the inefficiency of the States' tax bases, discusses the GST, and analyses unconditional ('block') grants made to the States by the Australian Government.
- Chapters 6 and 7 focus on related funding issues – Specific Purpose Payments ('tied' grants known as SPPs) and the split of Federal funding across the States under the operation of the Commonwealth Grants Commission formulas.
- Chapter 8 identifies recent relative shifts in tax capacity of the Australian Government versus the States, and discusses the structural problems arising from that.
- Chapter 9 reiterates earlier research done for the BCA in analysing the inefficiencies in the current operation of Australia's federation, and goes onto note how recent developments are raising the cost of those inefficiencies.

2. WHO DOES WHAT – THE FEDERATION AT A GLANCE

Australia's federation comprises three tiers:

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

The residual powers of the States are considerable, leaving them with most – if not all – control over the likes of education, health and publicly-provided infrastructure.

Australia's federation is one of the oldest in the world. It is characterised by significant vertical fiscal imbalances, as the majority of revenue raising powers have been concentrated within the Australian Government. Our federation also features an exceptional degree of 'shared responsibilities'.

Federal systems of governance are common across the world. Indeed, there are a great many advantages that underpin the principle of federalism:

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

Federal systems, while they come at the cost of increased complexity, do have a strong inherent potential for innovation and service improvement.

For example, the Australian federal system of government allows the States to develop their own approaches to achieving outcomes. This system has the potential to foster innovation, continuous learning, and competition within a broad national framework where the central government essentially focuses on national economic stability and economic growth while the States focus on delivering services.

2.1 AUSTRALIA'S FEDERATION

The division of powers under the Australian constitution provides the Federal Government with a small number of exclusive powers and a large number of areas where it shares powers with the States.

State Governments retain responsibility for all other matters.

The constitutional division of powers

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

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

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

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

The Federal Government can influence State policies and programs by granting financial assistance on terms and conditions that it specifies (Section 96).

And, over and above that, Federal powers have tended to grow over time, responding to globalisation and other trends which have raised the relative cost of imposing regulations on people and businesses at the 'Tasmania level' rather than the 'national level'. For example, while the constitution does not mention many specific functions (such as education, the environment and roads), the Federal Government can legislate in these areas under various powers (such as using its external affairs power in support of an international agreement covering the environment).

2.2 FEDERAL SYSTEMS HAVE BOTH ADVANTAGES AND DISADVANTAGES

There are advantages with federal systems:

1 Federal systems encourage governments to be more responsive by keeping power closer to the 'level' of the voters.

2 Not all groups of voters want the same thing. Some States may opt to spend more or less on education, or health, or to set particular taxes higher or lower. In a federal system, such diversity is possible.

3 And that diversity can help States learn from (and compete against) each other – if a policy works well in one State, it may well be adopted in others.

Yet there are also disadvantages with federal systems:

1 Governments have economies of scale – so there are higher costs from the overlap and duplication in a federation: the choice in favour of the 'diversity' offered by a federal structure also implies the deliberate foregoing of the greater economies of scale available to more centralised government.

2 And the relative size of such opportunity costs is growing as globalisation leads to increased commerce across State and national boundaries. That means the inefficiencies, higher transaction costs and uncertainties associated with being subject to rules and regulations set by more than one government are rising in relative terms.

3 Competition between governments can be bad as well as good – such as sweetheart deals via payroll tax exemptions.

4 The (constitutional) allocation of power between the Australian and State Governments can be badly designed, leading to governments having the 'wrong' responsibilities, or sharing too many responsibilities.

5 In addition, the benefits of competition can often be overstated. While one State may be better in some fields, chances are it will be worse in others. Given the very high costs (and risks) for businesses and families in moving between States, the latter is at best a weak discipline on State policies.

6 And there is a risk of a lack of scrutiny in smaller jurisdictions. After all, part of the judgement as to what is working well and what isn't comes to us via media, business and academic scrutiny, but there may be a lack of critical mass to achieve that in smaller jurisdictions. Worse still, that scrutiny may result in perverse judgements – with bad policies lauded, and good ones rubbished.

The literature also outlines the key theoretical advantages to the Federal system that relate to Australia's system of government.

By dispersing power across governments, a federal system adds to electoral competition, providing more opportunities for this discipline to be exercised by voters over time. In fact, federal systems offer two additional forms of competitive discipline on governments – 'horizontal' and 'vertical' competition.

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

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

3. STATE RESPONSIBILITIES ARE VITAL FOR PROSPERITY AND FAIRNESS

Our federal system therefore means that the States are responsible for a very large share of public spending, whereas the Australian Government raises the lion's share of taxes.

Moreover, although there is too much overlap in spending responsibilities and tax bases, these are relatively fixed.

Now that Australians are living in a supply constrained economy, the opportunity cost of not getting things right between the Feds and the States in terms of wasted dollars and workers is even more acute.

The need to boost prosperity and fairness through supply side policies becomes even more important. These policies at their most basic levels relate to broad spending responsibilities such as education, health and infrastructure.

Importantly, although responsibilities are shared across each of these three areas, they are mainly the responsibility of the States to provide or to regulate.

3.1 EDUCATION

Federal Treasury has been urging faster productivity growth and higher levels of participation, as the resultant increase in the size of the economy would directly address many of the risks associated with slowing growth and rising deficits – in essence, a larger pie will reduce the competition over the slices from it as Australia ages.

Federal Treasury researchers have also been making the point that one way to increase both productivity and participation is to have a higher skilled workforce. Productivity rises due to increased skills, and participation rises as those increased skills lead to higher wages, a reduced likelihood of unemployment and (typically) better working conditions.

These points have been made by Kennedy and Hedley of Treasury in a 2003 Working Paper, Gruen and Garbutt in a 2004 paper and Davis and Ewing in a 2005 paper. For example, Kennedy and Hedley note (at page 15) that: "For both males and females, those who had not completed year 12 schooling had noticeably lower participation rates than those who had completed year 12."

That places education centre stage in the fight for prosperity.

Of equal importance, however, is the role that education can play in fairness. International evidence makes it clear that rich nations have fairer distributions of income than poor nations, because their highly educated populations are rich in human capital (skills) for which they earn a good return (wages and salaries).

That makes education a particularly powerful weapon in the quest for both prosperity and fairness.

Education is the key to moving to higher levels of prosperity through time. Indeed, this will become even more of a key policy area over time given the shift in relative importance of supply side policymaking.

Well-crafted policies in areas such as child care and early childhood intervention and education eventually lead to significantly higher levels of attachment to the labour force. It is also recognised by economists that higher levels of education provide an economic payoff for the nation as well as for the individuals involved in increasing their skills.

There has long been a clear and well-established relationship between education and productivity. Workers with more education bring a higher level of skills to the workplace generally, and higher participation is also a key outcome of higher levels of education.

More recently, economists have also begun to emphasise the second and almost as well-established linkage – that those with higher levels of education also have higher rates of workforce participation, both during working age and as they approach traditional retirement age.

Therefore education and generalised training programs to increase work ready skills score well in terms of both prosperity and fairness.

Because higher levels of education are associated with increases in both productivity and participation, they have a long term impact on prosperity.

A less well-defined connection is that education also improves fairness at the same time.

International evidence makes it clear that rich nations have fairer distributions of income than poor nations, because their highly educated populations are rich in human capital (skills) for which they earn a good return (wages and salaries).

By increasing the educational prospects of the least well off in society we can significantly improve their lifelong wages and cut the risk of unemployment. There are therefore, for example, good reasons for further investment in education, especially in early childhood intervention which arguably has the highest returns per dollar invested in the economy than any other form of spending.

3.2 HEALTH

Health programs have the potential to lift prosperity by improving workforce participation. Indeed, this connection is becoming increasingly well understood, with a string of research reports from Access Economics and others in recent years detailing the potential benefits to participation of a healthier population – either through prevention (such as avoiding smoking or obesity) or through cost effective downstream interventions for acute or chronic conditions.

That said, health is probably more closely associated with fairness. We can all be struck down by ill-health, and a good health system pools those risks faced by individuals and families to provide a safety net for all of us.

However, and as is true of education, the lines of responsibility across the State/Federal divide are blurred and becoming more blurred, yet it is clear that the States still bear the brunt of this area of policy responsibility for service delivery.

Overall Australian health spending (that is, public and private together) has grown from around 3.8% of GDP in 1960-61 to nearly around 9% today. The Australian Government has financed most of this growth, with the private contribution hovering between 2-3% of GDP.

The reasons for that steady growth have changed over time. Early on it was mostly driven by increased access and lifting patient expectations. New health technologies have also played a hand, increasing possibilities and again, feeding patient expectations. In recent years, the ageing of the population has made a larger contribution.

In addition, health spending has grown over time because health goods and services are highly income-elastic.

- That is, as income grows, individuals want to consume proportionately more of their total 'consumption basket' on health goods and services.
- Indeed, health has one of the highest income-elasticities of all types of consumption, so unsurprisingly, our appetite for a healthy life has increased with higher income growth.
- That appetite for health care is all the greater given public sector subsidies – the cost to individual pockets of increasing demand is subsidised, because the cost falls on taxpayers in general more than it falls on the private pocket.

Thus far at least, health technologies have delivered in enabling the supply of greater longevity with a degree of greater mobility. As highlighted in the *Intergenerational Report* of April 2007, non-demographic growth (such as the listing of new medications on the Pharmaceutical Benefits Scheme and greater use of diagnostic procedures), rather than population growth or changes in the age structure of the population, is likely to be the key driver of health spending pressures:

- It is anticipated that this type of spending will contribute three-quarters of the projected increase in health spending over the next 40 years.
- Clearly, these new medications and new medical technologies are likely to be expensive, but no doubt people will expect 'governments to pay'.

In all, this is not surprising. Health is a key and fundamental building block for prosperity as well as fairness in society. After all, without our health we cannot work, and health programs have the potential to lift prosperity by improving participation. Indeed, this connection is becoming increasingly well understood, with a string of research reports from Access Economics and others in recent years detailing the potential benefits to participation of a healthier population – either through prevention (such as avoiding smoking or obesity) or cure (such as higher spending on some types of acute interventions).

Awareness of health issues has improved over time, in part with new technologies and research, but also in line with our higher incomes. Improved health outcomes have also led to higher participation rates in older age brackets, generating a significant payoff for society, especially with reference to preventative care.

Health will remain an extremely important issue well into the future. We are living longer, earning more and demanding a higher quality of health services.

3.3 ECONOMIC AND SOCIAL INFRASTRUCTURE

The States are left with 'residual powers'. That covers a plethora of areas, but one of importance is either the direct provision for much of the nation's infrastructure, or responsibility for the regulatory frameworks for infrastructure.

That is why the headline grabbing parts of capacity shortages of recent years were typically in areas of State responsibility – whether it was ships lined up off our ports, inadequate rail or road capacity, water infrastructure that was not up to the task during extended droughts, or stretched electrical generation and distribution capacity.

These matters go to the heart of the nation's productive capital stock, and hence to the productivity of our workforce (and therefore the prosperity of Australia as a whole).

Australia is running at full capacity. This means we are increasingly running up against bottlenecks and capacity constraints.

It therefore becomes increasingly important that we are able to boost our supply potential so as to secure our economic growth prospects.

Boosting supply can be done by increasing one or more of the '3Ps' – population, participation and productivity. In particular, productivity is a function of the quality of the machines, infrastructure and human capital (skills).

The States are now attempting to boost supply side capacity by investing in economic and social infrastructure. However, they are hamstrung by the money they have available to them. Although Public/Private Partnerships (PPPs) can get around the upfront cost to State Governments, PPPs can often result in appropriate incentives.

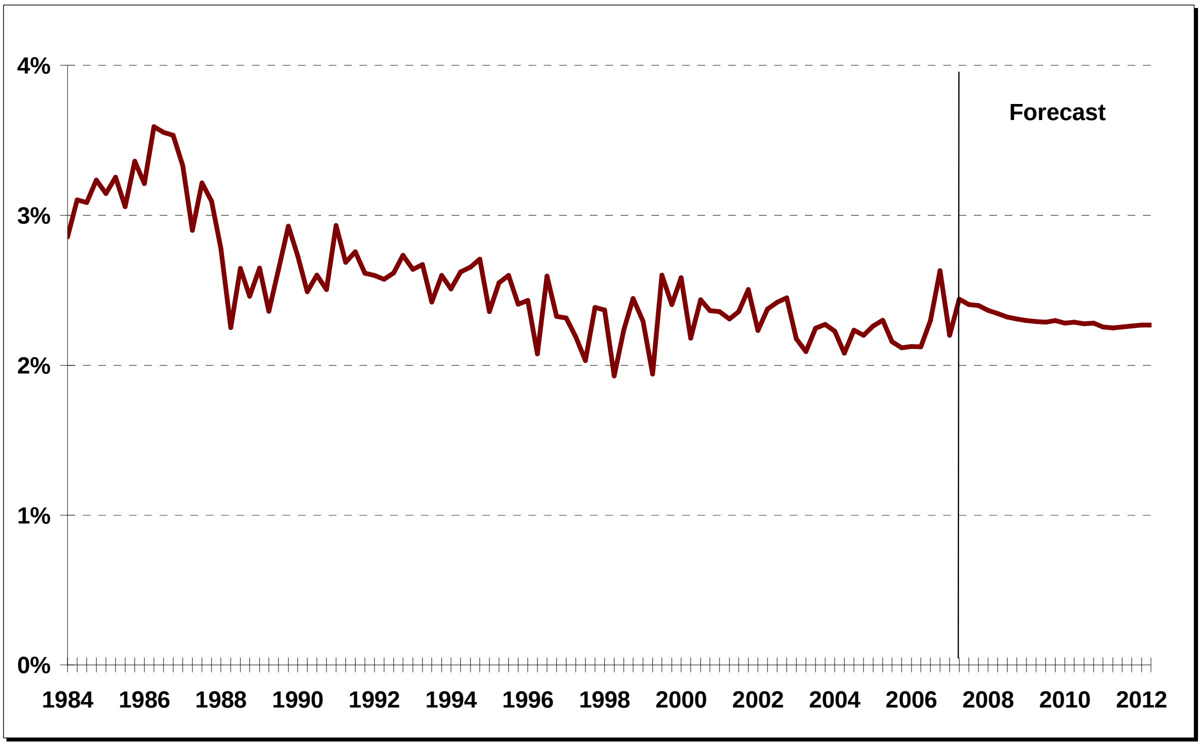
The end result of this mix of circumstances is that, taken as a whole, the States are running fiscal deficits at a time when the Federal coffers are bursting.

- In its 2007 Article IV report on Australia, the International Monetary Fund noted that "The States are collectively forecasting a fiscal deficit of around ½ percent of GDP in 2007-08."
- One of the reasons this is occurring is that the States are borrowing money to build infrastructure.
- Why do they need to do this when there is plenty of Federal money rolling in? Because our federal system starts to lead to inappropriate decisions being taken when different levels of government face changing circumstances on their funding and their spending responsibilities.
- That combination can thwart the attempts of the national public sector – the Australian, State and local governments taken together – to achieve the key national aims of prosperity and fairness.

Among other things, the volume of physical infrastructure projects currently undertaken and planned by the States indicates a serious commitment to freeing up the major veins and arteries of the Australian transport network to cope with significant projected increases in traffic volumes over the next 20 years.

General government investment continues to be boosted as State Governments rush to address infrastructure needs. 2006-07 saw the biggest increase in State funding for capital expenditure, which rose by a very large $10 billion. Moreover, 2007-08 sees another big instalment, with a further $6 billion added. Water and transport projects sit atop the State agenda.

FIGURE 3-1: GENERAL GOVERNMENT INVESTMENT AS A SHARE OF GDP



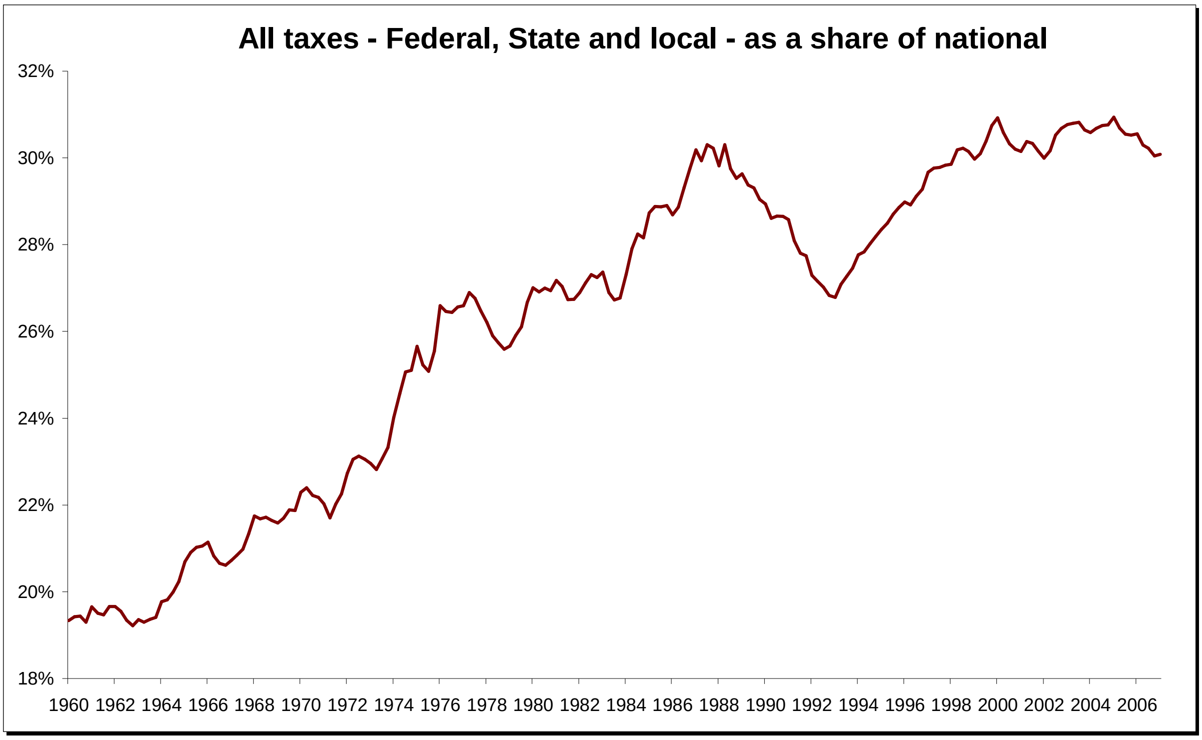
Yet, that said, and as Figure 3-1 shows, total general government investment as a share of national income may be a little higher now than it has averaged through this decade to date, but it remains all-too-low: a situation which may, in part, be attributable to the continuing squeeze on State funding from Federal sources.

4. WHO GETS WHAT – STATE REVENUE RAISING POWERS

> Ideally, each level of government should finance its assigned functions with funds that it raises itself (the principle of 'fiscal equivalence').
>
> Yet a gradual process of centralisation has increased the degree of 'vertical fiscal imbalance' in our federation – the Australian Government levies most taxes, and now raises more than $5 for each $1 raised by the States.
>
> That has left the States raising taxes on a relative narrow base, and using relatively inefficient taxes (such as stamp duties on commercial transactions).
>
> In turn, that requires a set of rules by which the Australian Government grants money to the States.

The total tax take – Federal, State and local – is around 30% of national output, having risen noticeably through the course of the twentieth century, but steadily more recently as the pace of growth of national income has itself sprinted.

FIGURE 4-1: THE TOTAL (FEDERAL, STATE AND LOCAL) TAX SHARE OF NATIONAL OUTPUT



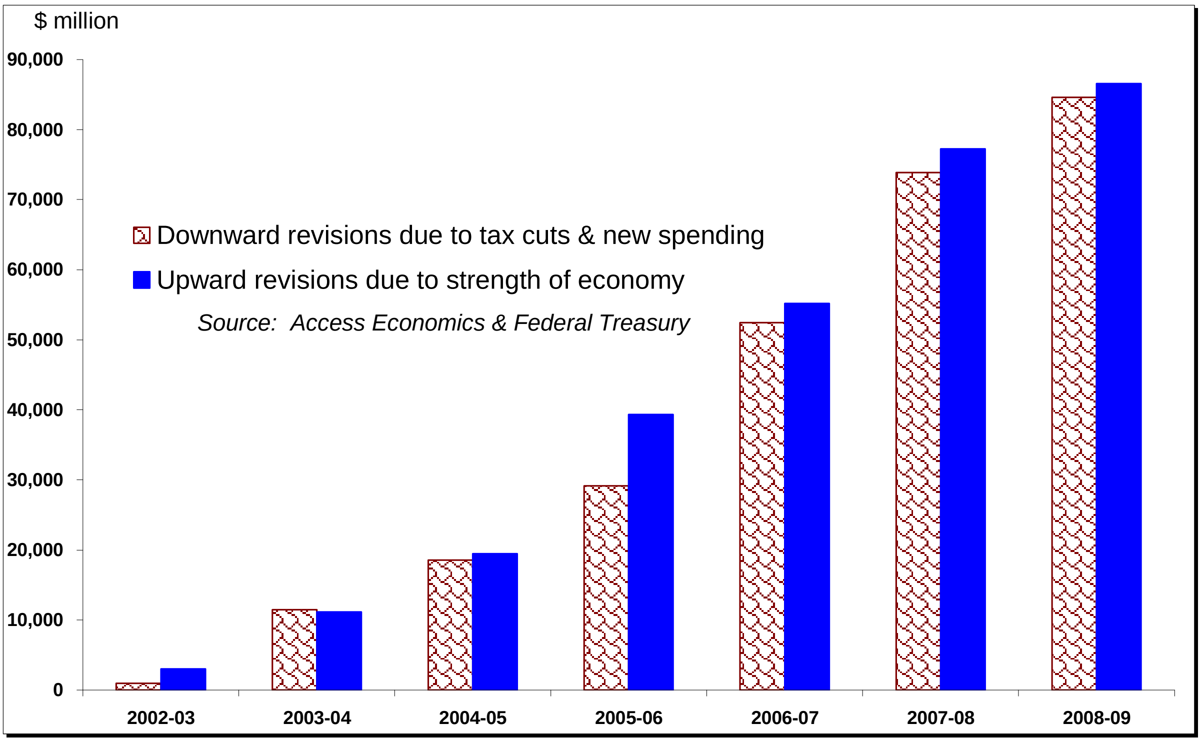
There is no meaningful sharing of tax bases between the Commonwealth and the States.

- **The Australian Government has sole access to the broadest and most lucrative tax bases – income taxes, corporate tax, customs and excises.**

- **The key areas of State taxation include property taxes and payroll tax**, which between them account for a major share of total State tax revenue. In addition the GST is levied by the Commonwealth on behalf of the States and forms a major share of State revenues.
- Local government revenue raising is largely accounted for by property taxes (or rates).

China's boom keeps getting stronger, and a key side-effect has been that the Federal taxman is reaping an ever larger dividend from it. That can be seen in Figure 4-2. It winds the clock back to the Australian Budget delivered in mid-2002. In the five and a bit years since then, Federal Treasury has steadily reacted to the growing China boom by revising up its estimates of strength in the revenue earning capacity of Australia's tax system.

FIGURE 4-2: ANNUAL COST OF NET NEW POLICIES ANNOUNCED SINCE THE 2002 BUDGET



That shows up as steady gains in the 'strength of economy' columns over the years. Compared to the estimates made some years ago, the earning capacity of the Australian Budget next financial year is now $85 billion better.

But the other columns show that, as fast as the boom in profits has generated a tax windfall, the Australian Government has parcelled it back out again as tax cuts (which account for a bit more than half of the big policy spend of recent years) and increased spending (notably the 'barbeque stopper' increases in family benefit payments and baby bonuses).

Moreover, even though Federal tax cuts have been substantial, Figure 4-3 shows that, while the States have also experienced increases in taxation revenues, they have not grown at the same pace as Federal tax revenues.

FIGURE 4-3: LEVEL OF PER PERSON TAX, SPLIT BY LEVEL OF GOVERNMENT, 2005-06

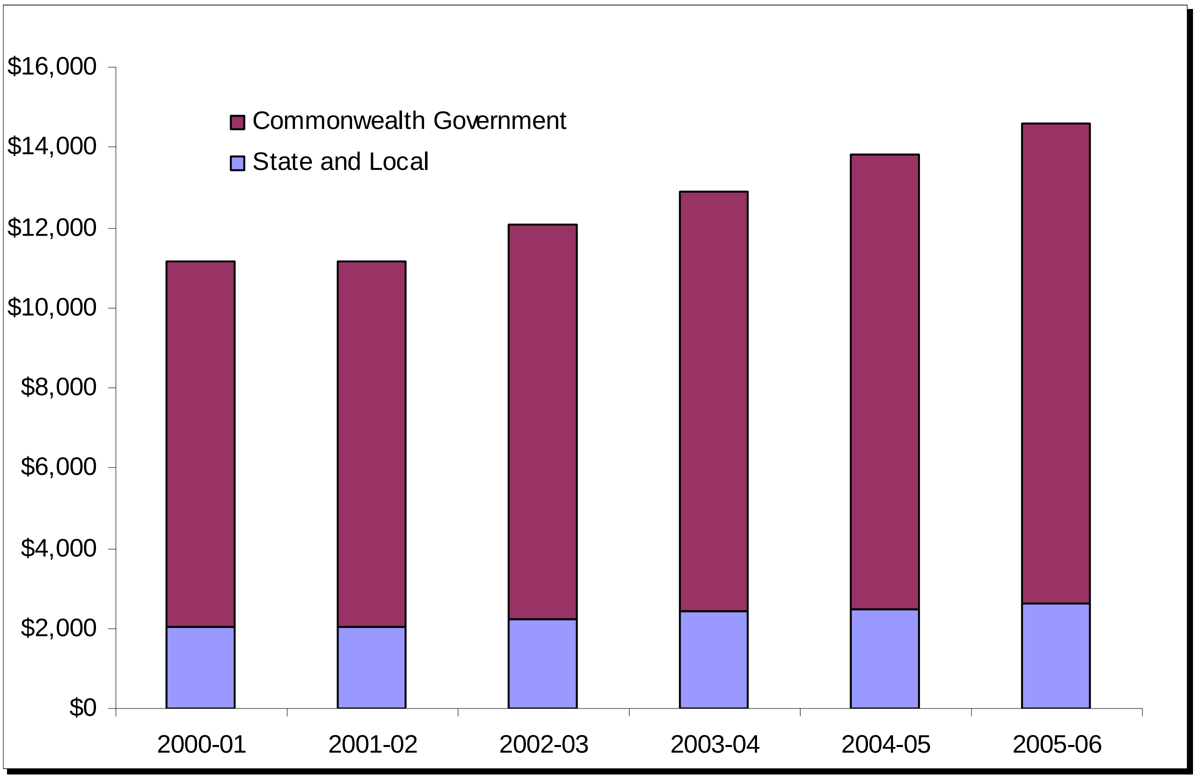
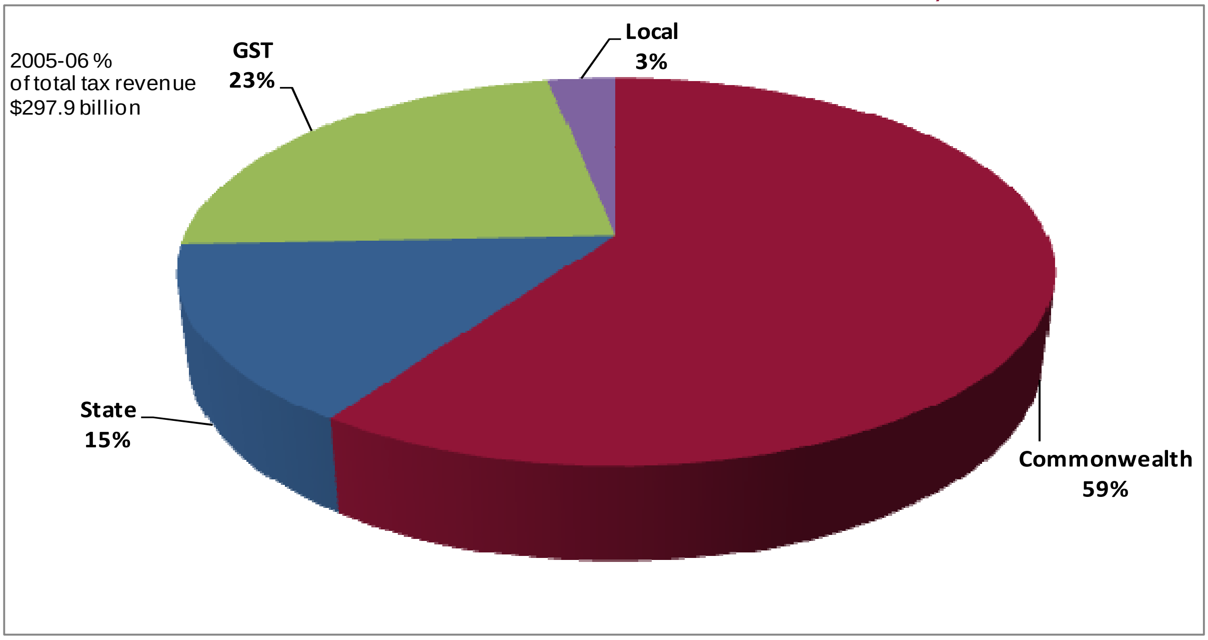


Figure 4-4 shows the relative shares of the revenue bases of the various levels of government. Once the GST is taken into account, the States receive almost 40% of the revenue raised. Of the revenue received directly by the States, nearly three-quarters comes from payroll, property and stamp duties on conveyances.

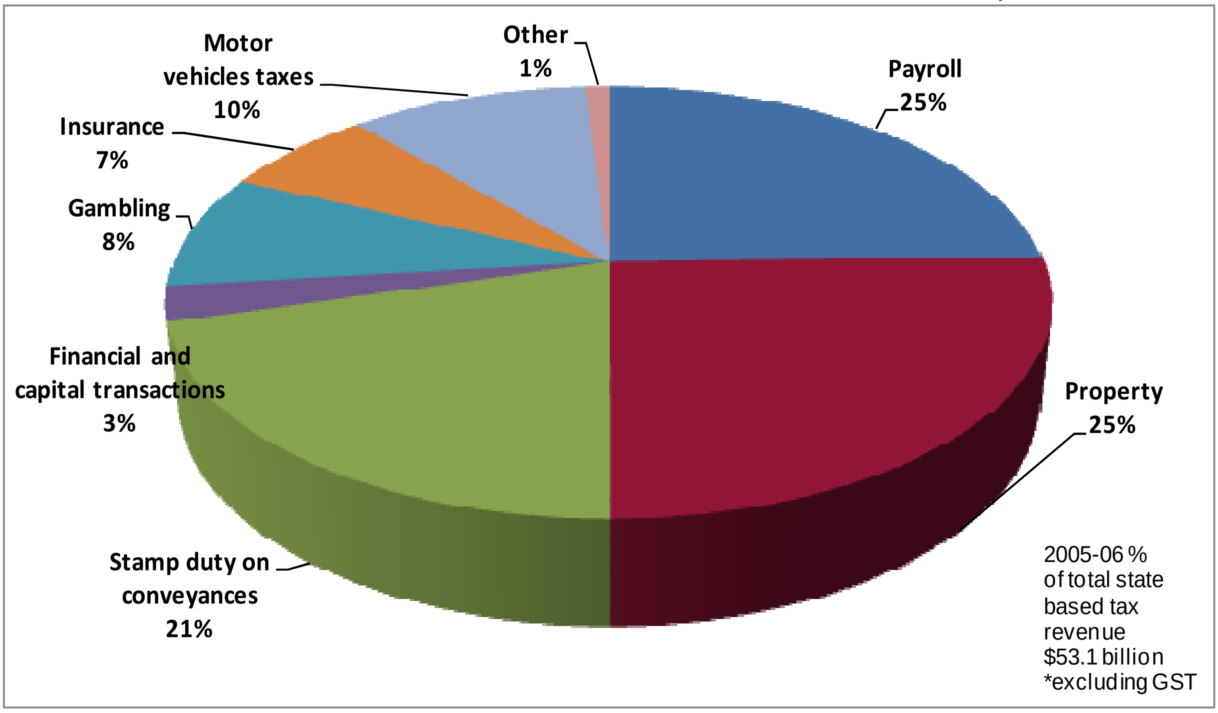
FIGURE 4-4: TAX REVENUE SHARES BY LEVEL OF GOVERNMENT, 2005-06



Source: ABS 5506.0

The gap between State spending responsibilities and their revenue raising powers is met by a combination of revenue sharing with the Commonwealth through grants and transfers.

FIGURE 4-5: STATE-BASED SOURCES OF REVENUE AS A SHARE OF TOTAL, 2005-06.



Source: ABS 5506.0

This gap is large. Indeed, Australia has significantly larger vertical fiscal imbalances than the US, Canada and Germany. This is not necessarily a problem, given Australia's geography and relatively small population base.

However, it does mean that the States may not have the levels of revenue required to match their expenditure responsibilities. Over half of the States' spending is on key health and education expenditures.

The issue here is one of choice – would society prefer to have seen spending on education, infrastructure and health care from the commodity boom windfall, rather than personal income tax cuts and family tax benefits? Or, more to the point, are we really maximising the gains to prosperity and fairness from future spending with the current mix of tax bases and grants as laid out in our federal structure?

5. STATE FUNDING

The funding responsibilities of the States have evolved over time rather than having been explicitly planned, with many powers being handed over or taken by the Commonwealth.

After WWII – during which the Federal Government look over taxes on income – the Feds decided that it made sense to keep this power to further national objectives. This was a key step in what has grown into a significant vertical fiscal imbalance that has forced the States to rely on narrower tax bases.

The States have been left with relatively inefficient taxes. In part that is their own fault, as they have pandered to political pressure and narrowed their tax bases even further, giving exemptions and the like. The States have also shied away from more efficient broad-based taxes for the same reason.

As a result they have left themselves reliant in large part on stamp duties on turnover of asset ownership. These are costing the Australian economy a significant amount in terms of deadweight loss.

5.1 THE EFFICIENCY OF STATE TAXATION ARRANGEMENTS

State and Territory level taxes are the least efficient in Australia.

Even where there are good tax bases for the States, there is often an unnecessary compliance and administration burden arising as the States use different definitions and different collection arrangements – payroll tax being a good example of this.

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

Among the most inefficient of these State taxes are:

- Stamp duties on non-residential conveyancing.
- Stamp duties on various financial instruments.
- Stamp duties on insurance.
- For some States, fire service levies.

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

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

As general rules of thumb:

- The greater the relative burden of a tax on an industry, the more resources are driven out of that industry, and so the greater the deadweight loss.
- Given a burden on a particular industry, the greater is the extent by which its labour productivity exceeds average labour productivity, the greater the loss to national income of diverting resources from that industry, and hence the greater the deadweight loss.
- The more price elastic (or sensitive) is consumption in a particular industry, the greater is the effect of a tax on consumption, and hence the larger is the deadweight loss.

All tax bases are mobile to some extent, but the less mobile, the better they are as tax bases for the States. That is why for example, it makes sense for the States to levy land taxes.

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

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

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

There are a number of ways the States can optimise the revenue raising functions they have. There is substantial scope for the States to raise the efficiency of the State based tax system, especially given that narrowly based stamp duties on business are one of the least efficient forms of taxes. Now that the Australian economy is facing a supply constrained future, decisions on resource allocation or allocative efficiency in all of the nation's tax bases are increasingly crucial.

Simplicity, equity and allocative efficiency are the key principles at the heart of tax policy design. All State-based taxes need to be tested against their impact on the decisions of business and individuals using these principles as the key yardsticks.

- The design of the tax should be simple:
  - easy to enforce (with a minimalist approach to the ongoing regulatory burden),
  - easy to police compliance, and
  - easy for payees to understanding its application and purpose.
- The design should be fair:
  - Those people with higher incomes should pay relatively more tax
- The design should not hinder allocative efficiency:
  - The tax should not influence the allocation of resources within the economy. It should apply equally across its base, and not encourage the allocation of resources away from areas of competitive advantage to areas of lower return simply because of the existence of the tax.

A useful policy rule of thumb might be to work towards harmonising tax bases, tax rates and tax administration across States, while moving to abolish or reduce the remaining stamp duties on businesses.

Over the longer term, and despite the political difficulties of doing so, it would make considerable economic sense to replace some of the more inefficient taxes with a higher rate of GST.

5.2 GST

The Australian Government implemented *The New Tax System* from 1 July 2000. This introduced the Goods and Services Tax (GST) in conjunction to significant reforms to Australia's system of Federal financial arrangements through the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations* of June 1999.

There were three objectives underpinning the Intergovernmental Agreement:

- the achievement of a new national tax system, including the elimination of inefficient indirect taxes;
- the provision to the States of a more robust tax base that will grow over time; and
- an improvement in the financial position of all States.

The underlying tax base for the GST consists of all consumer spending (less that on health, education and fresh food), plus housing construction (although such spending is investment, the GST treats it as consumption) and tourism exports.

Because housing construction was riding high and consumers responded to gains in their housing wealth by spending up, growth in GST receipts averaged 12.7% growth a year in its first three years of operation. Indeed, GST revenues rose so fast that all States switched to full GST financing sooner rather than later, with Budget Balancing Assistance no longer required. As the 2007-08 Budget points out:

> *"The Australian Government has implemented all of its Intergovernmental Agreement commitments. It abolished the inefficient Commonwealth tax listed in the agreement (wholesale sales tax) and implemented the goods and services tax. It also ensured, through legislative provision, that the States receive every dollar of GST revenue. As was anticipated at the time, GST revenues have proved to be a robust source of state revenue that has been growing over time.*

> ***Furthermore, every State now receives more revenue under the current Federal financial arrangements than it would have if the previous arrangements had continued."***

Once they receive the GST revenue, the States are then free to spend it as they wish – that is, without strings attached.

In the *Intergovernmental Agreement*, the States agreed to abolish a range of inefficient indirect taxes that were impeding economic activity.

Yet while the GST might be a better option than the taxes it replaced, it is still cyclical. The GST is levied on housing investment (construction) rather than housing consumption, and housing investment is highly cyclical. Moreover, the timing of GST cyclicality matches that in some other key State revenue bases, such as residential stamp duties making the key planks of State taxation bases more volatile than they need be.

5.2.1 Is the GST a good tax?

The GST is not necessarily the simplest of taxes – thanks in part to the changes adopted at the insistence of the Democrats.

- Yet the GST does stack up as a theoretically sound tax base for the States to draw an important revenue source.
- Indeed, value added taxes like the GST are generally viewed in the literature as good candidates for State based taxes.
- Importantly, the GST is flexible. It has the capacity to be increased and replace a number of inefficient taxes.

Moreover, the GST base broadly grows in line with the economy.

That is important for a number of reasons. One relevant reason here is that the retirement of the baby boomers means coming decades will see faster growth in Australia's 'consumers' (our total population) than in our 'producers' (those employed).

Indirect taxes tend to fall on consumers and direct taxes to fall on producers, meaning that the move to the GST was a move towards greater reliance on indirect taxes, and towards a revenue base that will grow in line with the consumption base of the economy.

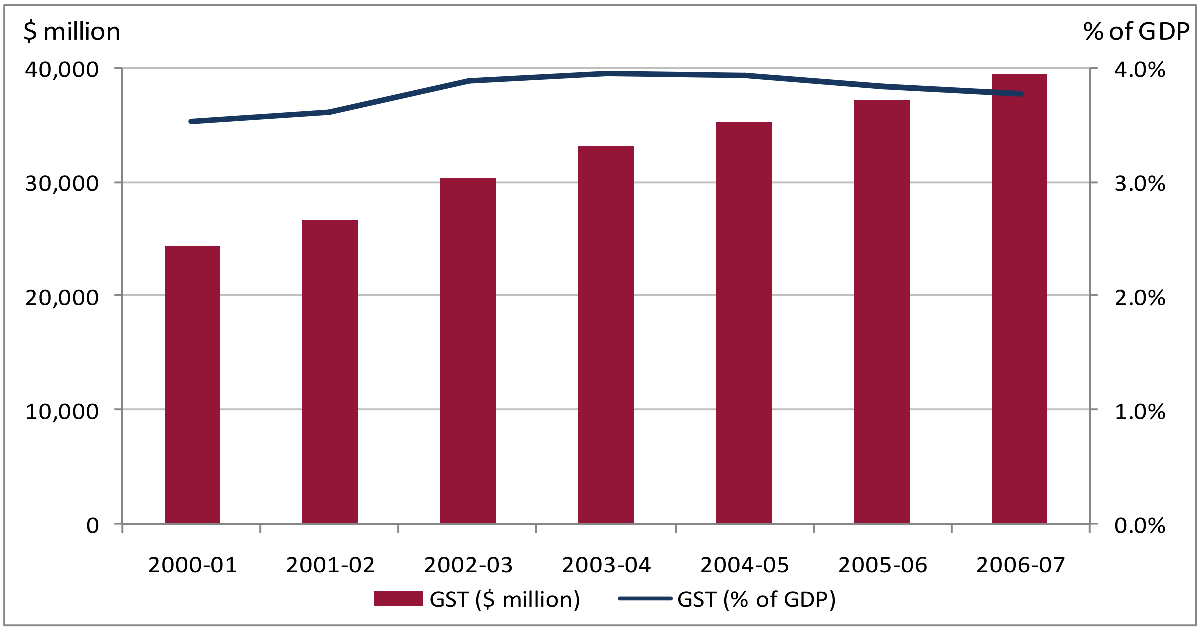
The move to a GST instead of a raft of less efficient stamp duty style taxes was a key reform that will serve the States well in the decades ahead given the ageing of the population.

The switch to the GST was from a sales tax base heavily reliant on goods to a rather wider tax base, including services. In times past the sales tax base fell as a share of total consumer spending. That means that the July 2000 switch was from a less robust tax base to a more robust tax base.

GST revenue paid to the States has grown in nominal terms since its introduction – the average annual increase since between 2000-01 and 2006-07 has been around 8%.

As a result, GST revenue to the States has remained relatively *constant* as a proportion of GDP – at around 3½ to 4% of GDP. Figure 5-1 below shows the story.

FIGURE 5-1: GST REVENUE TO THE STATES



Source: ABS (Cat no. 5506.0) and the 2007-08 Mid-Year Economic and Fiscal Outlook.

5.3 UNTIED GRANTS

Untied grants are those grants provided to States without any specific conditions attached regarding the exact allocation of the funds. While they may be directed to general areas of spending they are not tied to a specific set of conditions.

Where programs are entirely the responsibility of State Governments, funding should be in the form of general purpose grants, thereby allowing discretion to allocate spending across different programs. For programs where there is joint responsibility between levels of government, funding should go to pools that extend to all related programs, rather than being earmarked to specific programs. Again, this allows some discretion as to the allocation within funding pools.

- That is why **unconditional or 'block' grants** are typically the appropriate vehicle for the purposes of fiscal equalisation – that is, if there is a perceived need to 'equalise' across States (rather than across individuals), then these can be used to channel funds from relatively wealthy jurisdictions to poorer ones.
- This doesn't mean that the Australian Government cannot or should not provide financial support for activities carried out by other levels of government. However, where transfers from the Australian Government are decided upon, State Governments as the recipients should face a **hard budget constraint.** Outcomes and outputs should be the focus.

This implies that untied grants should be fixed in dollar terms. This limits the incentive to spend too much and then to ask for funding to make up the resultant gap, a habit which leads to an overall loss of fiscal discipline:

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

6. SPECIFIC PURPOSE PAYMENTS – WE SHOULDN'T GET TOO TIED UP

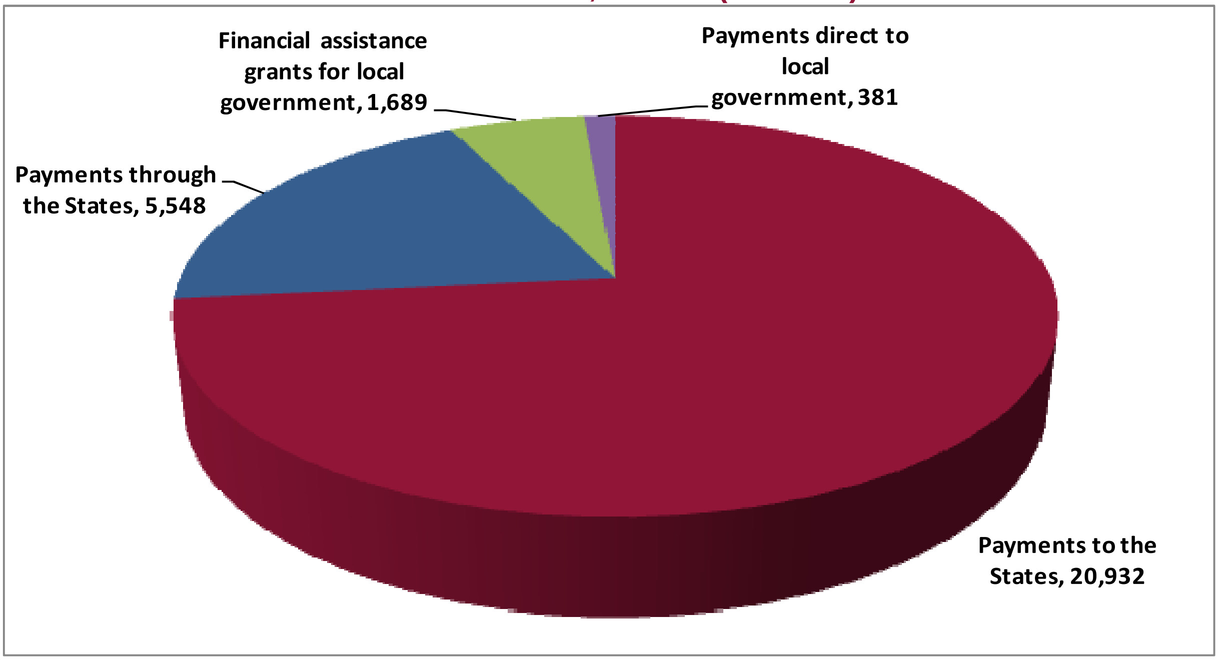
Specific purpose payments (SPPs) are funding for a State responsibility paid for by Australian taxpayers.

Typically, this funding comes with strings attached and the States need to fulfil specified conditions in order to receive these payments, which cover most functional areas of State and local government activity, including education, health, social security, housing and transport.

Specific purpose payments fall into two broad conceptual categories.

- First, there are a number of programs which are essentially Australian Government programs but which, for constitutional reasons, the Commonwealth must fund via the States. In other words, the States essentially act as agents for the Commonwealth. Such SPPs have been designated as 'payments through the States'. These payments can include funding for research at universities, higher education, non-government schools, and general revenue assistance to local government.
- Second, where the Commonwealth provides funding to the States for programs which are substantially administered at the State level, such payments are referred to as 'payments to the States'. These payments encompass a wide range of programs, but are significantly weighted to education and health. They also include aged and disability services, housing, highways and legal aid.

FIGURE 6-1: SPPS, 2006-07 ($ MILLION)



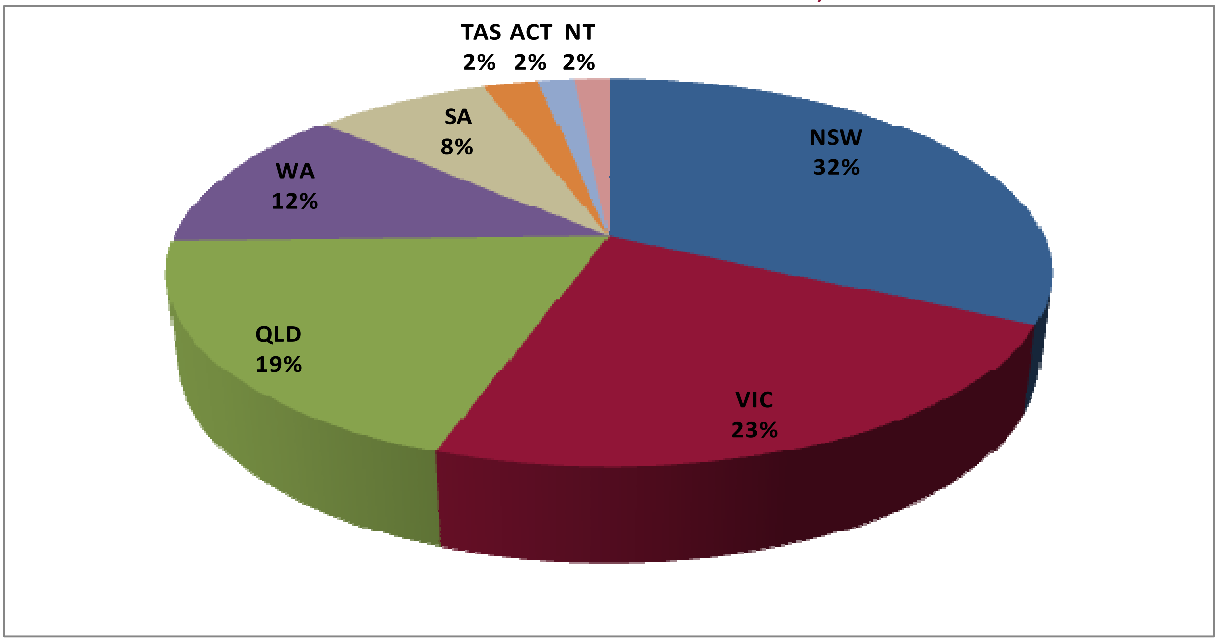
Source: Australian Government, 2006-07 Final Budget Outcome.

SPPs account for a significant proportion of Australian Government revenues and a large proportion of the assistance provided to the States.

The Australian Government provided a commitment in the *Intergovernmental Agreement* that they would maintain SPPs in aggregate. The commitment was consistent with the objective of the States being financially better off under the new arrangements.

- SPPs are largely distributed based on population and need. Figure 6-2 shows that the largest share goes to NSW – the most populous State.

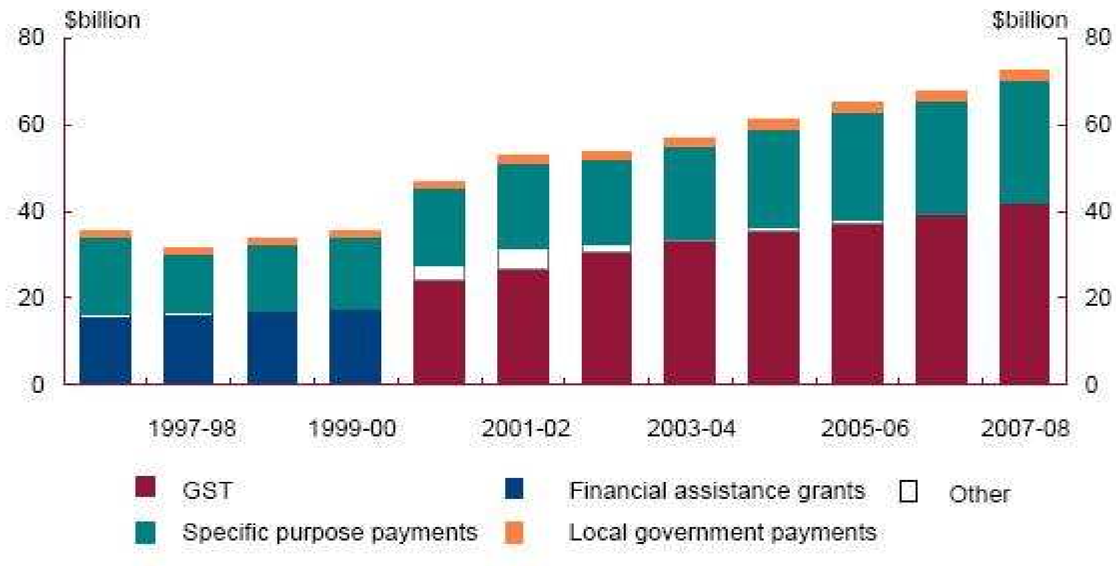
FIGURE 6-2: STATE DISTRIBUTION OF SPPS, 2006-07



Source: Australian Government, 2006-07 Final Budget Outcome.

In the 2007-08 MYEFO Budget update, total SPPs were estimated to be $30.9 billion, an increase of 8.1% over 2006-07 (a faster rate than nominal GDP growth).

FIGURE 6-3: TOTAL PAYMENTS TO THE STATES SINCE 1996-97



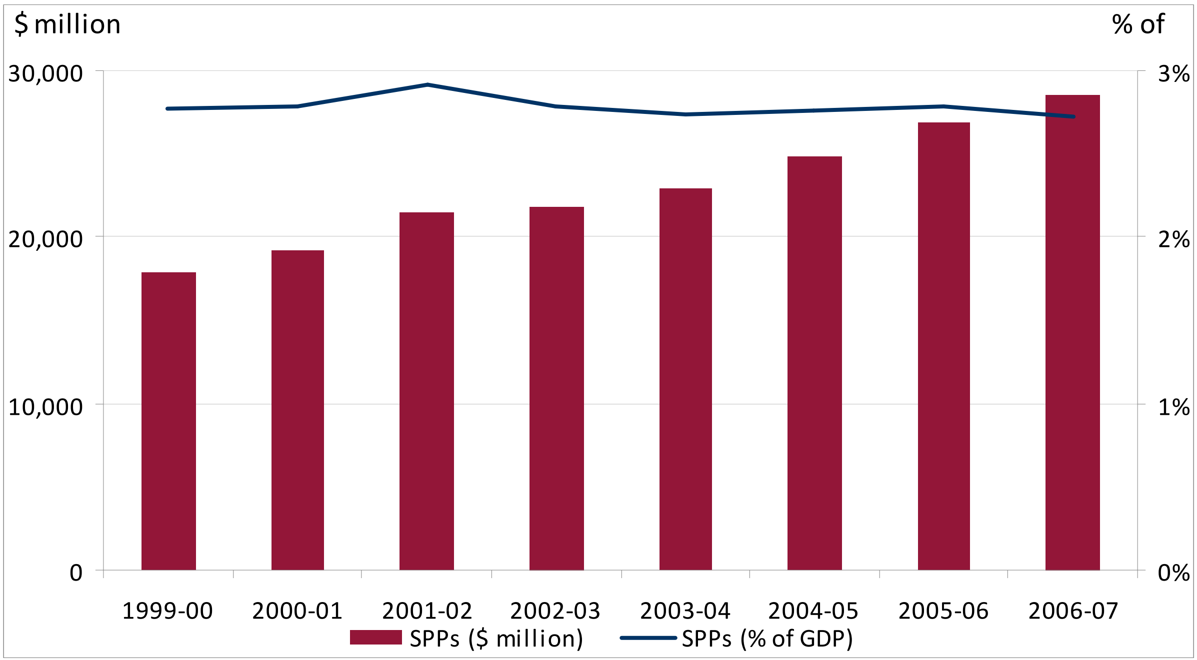
Source: Australian Government, 2007-08 Budget Paper No.3.

Overall assistance to the States is also rising in nominal terms, as Figure 6-3 shows. However, the States' share of assistance in terms of nominal GDP has remained relatively flat in recent years despite surging Commonwealth revenues.

Most of total payments to the States are made up of GST revenue – which is provided with no strings attached – rather than via conditional SPPs.

- The level of SPPs has grown to record levels. However, the economy has kept pace and SPPs have remained relatively constant in recent years.
- The tied proportion of total Federal payments has been falling over time and is now around 40% of the total assistance provided by the Feds. This proportion has fallen from over 60% in tied payments to the States in 1996-97.
- So while the level of SPPs has grown in nominal terms over the last decade, the growth in the GST/untied proportion of payments has outstripped this growth.

FIGURE 6-4: HISTORY OF SPPS, $ MILLION VS. % OF GDP



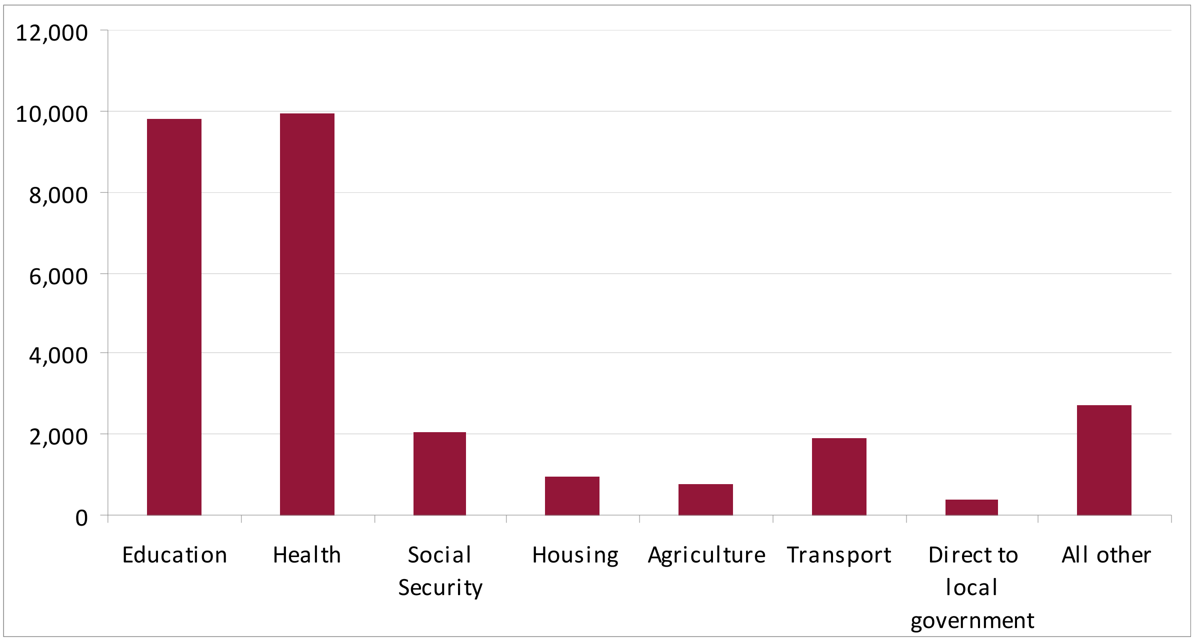
Source: Australian Government, 2006-07 Final Budget Outcome.

Given that these payments are used by the Australian Government for the purposes of "pursuing important national policy objectives" in areas administered by the States, this implies that "important policy objectives" are growing at a clip roughly equal to that of the economy as a whole.

SPPs have also grown in number over the years to around 90[3] distinct programs. The majority of SPPs are in the health and education fields.

[3] Allen Consulting Group, (2006) *Governments Working Together? Assessing Specific Purpose Payment Arrangements*, Melbourne.

FIGURE 6-5: COMPOSITION OF SPPS, 2006-07 ($ MILLION)



Source: Australian Government, 2006-07 *Final Budget Outcome*.

A report by Allen Consulting Group (2006) into SPPs in health and education argues that:

- instead of being focused on achieving agreed outcomes, in many cases SPPs in these areas centre on inputs and bureaucratic processes and controls;
- SPPs are typically burdensome and impede efficiency;
- SPPs have tended to create tension between governments rather than promoting collaboration or partnership; and
- SPPs lack incentives or frameworks for pursuing improvement.

Indeed, there are a number of instances where SPPs are being used in ways that appear to have little to do with core national policy objectives.

To the extent that this occurs, then SPPs can be broad-banded (with funds provided for broad functions rather than more specific activities). This would allow for a better focus on outcomes, and allow the States to decide what means they will employ to meet required Commonwealth objectives rather than being instructed by the Commonwealth exactly how Federal funding should be used.

There is evidence that SPPs have become a convenient form of assistance, which may well have led to them being overused at present. It is hard to imagine how a $50,000 program is of critical national importance, yet this is the level of detail that some SPPs can get down to.

Typically the States are required to meet specific conditions within the agreements reached under particular SPPs. It is clear that in some instances SPPs are not efficient or effective, include allocation rigidities and increase the administrative burden and create grey areas around issues and policy objectives that should have clear responsibilities, accountability and guidelines.

So what is the ideal?

Economists see advantages in responsibility for a particular function resting, where practicable, with the *lowest* level of government that can do it well, as this increases accountability and efficiency. This idea rests on three broad considerations:

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

This is an important question, as economic theory suggests spending responsibilities should be clearly defined and aligned with revenue bases at the lowest level of government competent with the task of delivering the service: 'the subsidiarity principle'.

- The Commonwealth should be engaged in State areas of spending responsibility only when there are genuine national interests at stake, and the Commonwealth involvement should be limited to that extent.
- Otherwise the subsidiarity principle should be applied, and the States receive assistance in the form of untied or at the very least pooled grants by broad categories.
- It would no doubt be in the national interest if SPPs were used in a framework more akin to co-operative federalism, with the aim of meeting shared goals outcomes and national objectives. They should not be used to control outcomes in small and disparate program areas that overlap with existing program responsibilities.

What are the issues from the viewpoint of the Australian Government?

There are a number of reasons that the Australian Government uses SPPs rather than adhering to the subsidiarity principle:

- to pursue policy objectives outside of the Commonwealth's constitutional power,
- to promote harmonisation and convergence towards national standards,
- to comply with international obligations, and
- to pay for the delivery of Commonwealth programs administered by the States.

More broadly, it is probably fair to say the Australian Government has been frustrated by what they see as a lack of performance by the States. Denis James (1997) argues that:

> "Even though the States have often argued for the 'untying' of Commonwealth specific purpose assistance, the degree to which tied assistance actually reduces State budgetary flexibility is difficult to assess."

A more pertinent issue is the extra administrative cost and duplication that can be associated with poorly crafted SPPs. Certainly it is argued by Scherini (2006) from the WA Treasury that SPPs have tended to become more onerous over time:

- In some instances, minimum growth requirements for State contributions (roads, hospitals and disability services) have been added as conditions to SPPs.
- In addition, there have been expanded reporting requirements on States; penalties for non-provision of data or failing to adhere to requirements; and more Commonwealth policy requirements (such as school flagpoles, national schools reporting standards, private sector involvement in public sector, offering Australian Workplace Agreements in TAFEs and a requirement for major construction projects that receive Commonwealth assistance to adhere to its National Building Code Implementation Guidelines).

If SPPs are to succeed into the future and limit the waste of resources commonly associated with SPPs at present, then these agreements need to return to being used for the purposes achieving their legitimate goals of what are genuinely national objectives.

Most of the problems with SPPs relate to these agreements not complying with a basic set of standards.

The1996 National Commission of Audit recommended that:

- Duplication and overlap should be eliminated, and that where possible, one level of government should take full responsibility for related programs to minimise avenues for cost shifting between governments. Otherwise, resource pooling across levels of government, with agreements concerning program risk sharing, should be pursued.
- If the Commonwealth retains a broad standard setting role, then it should confine its activity to that role, and monitoring of such standards.
- As far as possible, service delivery should be devolved to the level of government closest to the ultimate clients to allow for diversity, unless national considerations are critical. The Commission recommended that:
  - For programs which become the sole responsibility of the States, Commonwealth funding support should be through general purpose payments.
  - For joint Commonwealth/State programs, Commonwealth funding should go to pools financing all related programs.

It is unlikely that SPPs can be eliminated, as they have been a significant feature of our Federal system since as early as 1942. It is also the case that there are a number of examples of SPPs that work well and are efficient and benefit society broadly. Rather, it is more a case that poorly designed SPPs have negative externalities associated with them.

It is clear that by following a simple set of principles – about when to use SPPs and how best to design them – will avoid:

- the possibility for overlap,
- duplication,
- blame and cost shifting, and
- overly tiresome administrative burdens.

7. SHARING ACROSS STATES OF FEDERAL GRANTS

GST revenue and general purpose grants are broadly redistributed to the States in accordance with the principle of 'horizontal fiscal equalisation' administered by the Commonwealth Grants Commission (CGC).

Yet the merit and complexity of this process is questionable given that horizontal fiscal imbalances are relatively minor in Australia compared with other federations, while the CGC processes are also too complex and resource-intensive, and open to gaming. The formulas used falsely exude precision whereas in fact they are very approximate. Moreover, the results are lagged and backward-looking, so they don't achieve the (limited) objectives set in a forward-looking sense except under very static conditions.

Even more importantly, efficiency takes a back seat to 'equity across State service delivery capacity', in that equality of tax rates across States is considered an end in itself, whereas differences in tax prices across different regions may have a role to play in signalling where resources should move to or from – particularly in a supply-constrained environment.

All up, the current tax sharing distribution arrangements need to be swept aside, to be replaced by much simpler arrangements that either give the same grants per person or, at most, give a set above-average per capita share only to the lower-income States such as Tasmania and South Australia.

As Access Economics has noted elsewhere[4], the 'machinery' of our federation is rusty. For example, the current system for distributing GST grants among the States attempts to 'equalise' their fiscal capacities by focussing on 'equity across State service delivery capacity'.

Why? What are we doing? And why are we doing it? The answer is less than clear here. After all, although 'fairness' is one of the two main aims of public policy, 'fairness' makes most sense when it is applied to individuals – rather than to States.

Rather, the key test of whether these arrangements are fair is whether they are progressive in redistributing income 'vertically' – that is, from high-income to low-income households.

For example, were Australia's Antarctic territory to be declared a State tomorrow, then the Commonwealth Grants Commission formulas would pay enormous amounts per individual living in the new State given the relative cost of providing bus stops and hospitals in the Antarctic. Yet such a policy would not contribute to either prosperity or fairness for Australians. Or, in other words, the extant Commonwealth Grants Commission formulas seem to lack much to recommend them.

A detailed analysis commissioned by the Fitzgerald-Garnaut Review (2002) showed that the Grants Commission methods did not improve vertical equity and may actually worsen it

[4] *The Costs of Federalism*, report prepared for the Business Council of Australia, 2006.

slightly – mainly by transferring income from Australians in larger States to people with higher incomes in the smaller States (and Territories).

That's not a good outcome.

Equalising transfers also tend to shift resources to lower productivity locations. The Fitzgerald-Garnaut Review found that equalisation has put more resources into the two lowest productivity States, discouraging the flow of population to more productive regions. So the aim of prosperity for our federation is not being met in part because our policy processes are deliberately heading in the other direction – or, more generally, **flows from equalisation are not correlated with higher productivity and hence with higher prosperity**.

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

The problem is more severe because disability factors are generally driven by States with the relevant disabilities – for example, scale assessments are based on the costs of the small States, and congestion costs are based on the costs of the large States. Likewise, indigenous service demands are driven disproportionately by the experience of States with large indigenous communities, and ageing demands are driven by the experience of States with older populations. **This makes the Grants Commission a 'race to the bottom' – and a race away from much-needed reform aimed at boosting prosperity and fairness (where the latter is correctly understood to reside with individuals rather than States).**

- As a result, it is clear that some of the monies raised by the Commonwealth and on-passed to the States is likely to be wasted via the misallocation of resources that goes with successful gaming by less efficient States of the Commonwealth Grants Commission (CGC) horizontal fiscal equalisation (HFE) process used to determine the distribution of GST grants among the States.
- In addition, not merely does this process result in grants going to less efficient States, but a percentage is also consumed by the administration of the Commonwealth Grants Commission (CGC) horizontal fiscal equalisation (HFE) process itself. This comprises a portion of the cost of the CGC itself, and the related State Treasury costs. These costs were estimated by Fitzgerald and Garnaut to be in the order of $150-280 million a year.
- Moreover, not only is Australia largely alone in the world in attempting to fully equalise (horizontally) revenue raising capacity and expenditure needs, Australia also stands out as having some of the lowest pre-equalisation fiscal disparities.
- Finally, the weight of dollars being shunted around is rather higher now than it used to be. The shift to financing through the GST effectively gave added weight to the dollars distributed according to Commonwealth Grants Commission formulas.
- As those formulas are focussed on 'equity across State service delivery capacity' as opposed to either prosperity or fairness, and more resources are being funnelled through these channels than ever before, then resultant the opportunity cost of under-funding some States and over-funding others has risen.

8. HOW HAS RELATIVE FUNDING FARED: FEDS VS THE STATES?

Policy failures have been pervasive at both the Federal and State levels.

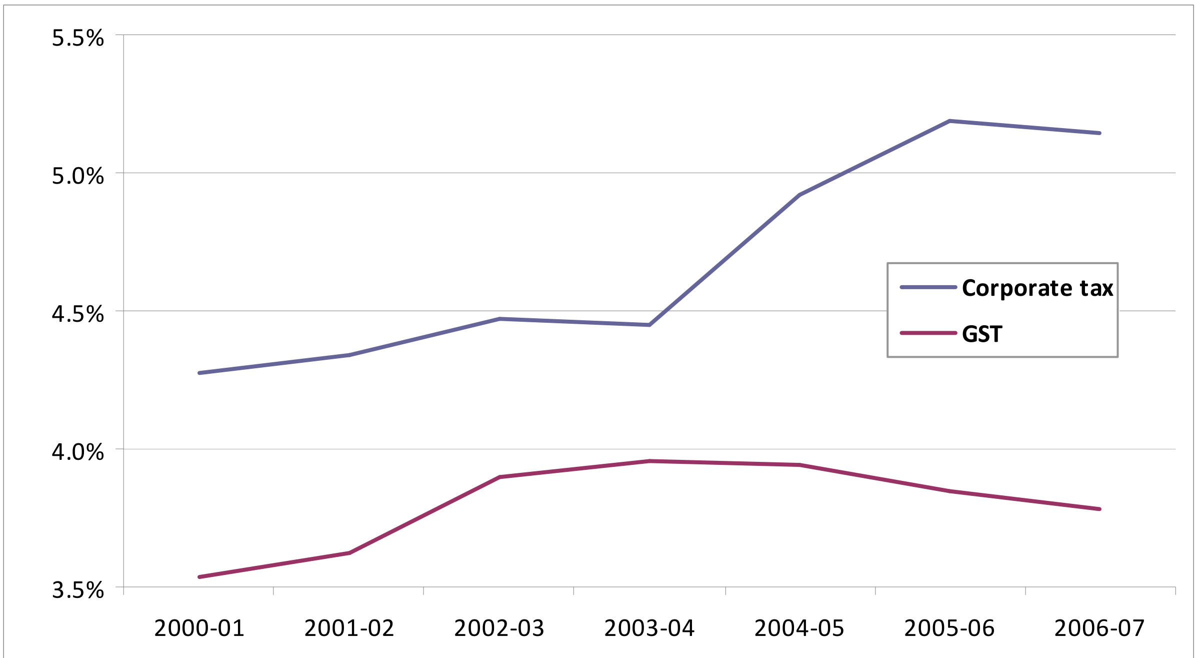
Not only did the previous Australian Government achieve little in terms of prosperity or fairness from its revenue windfall of recent years, the same is true of the States, who similarly squandered their (admittedly smaller) revenue windfall from the housing price boom.

Federal funding of the States has been squeezed in recent years. As a share of national income, tied grants peaked in 2001-02, while GST revenues peaked in 2003 04. In part this trend in funding arose as the previous Australian Government was frustrated by what it saw as a lack of performance by the States. However, the squeeze on State funding has worsened the structural problems here: one level of government has more money than it needs to effectively tackle an agenda of prosperity and fairness, while the next tier of government is under-funded for similar challenges.

The picture below tells a powerful story. Spurred on by the terms of trade boom, revenue from company taxes has been rising in recent years. On the other hand, GST revenue paid to the States has remained relatively constant as a share of national income.

- **This implies that the States have benefited less than the Feds from the revenue boom of recent years – though they did better on other taxes when house prices and the rate of turnover in housing markets were rising fast in most States through to end-2003.**

FIGURE 8-1: GST REVENUE (TO THE STATES) VS. COMPANY TAX (% OF GDP)



Source: ABS (Cat no. 5506.0) and 2007-08 MYEFO.

- There has been a surge in Federal tax revenues in recent years – mostly in the profit taxes, and particularly in company taxes. And the windfall is still getting larger rather than smaller.
- The policy response from the previous Australian Government was to spend this windfall largely on Federal matters.
- That may have been the right thing to do. However, just because the current revenue surge is particularly benefiting the Australian Government doesn't mean that furthering the aims of prosperity and fairness comes down solely to matters that are the responsibility of the Australian Government.
- Rather, the aim of improving prosperity and fairness might have seen part of the windfall being used at the State level.
  - In its 2007 Article IV report on Australia, the IMF noted that *"The States are collectively forecasting a fiscal deficit of around ½ percent of GDP in 2007-08."*
  - One of the reasons this is occurring is that the States are borrowing money to build infrastructure. Why do they need to do this when there is plenty of Federal money rolling in? We should set aside politics and get taxpayers' money to where it is most needed in order to better achieve prosperity and fairness.
  - This situation in the States is likely to get worse if their revenue base is not shored up for the long-term.

9. THE COST OF INEFFICIENCIES

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

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

As the Secretary of the Federal Treasury has argued, it is time for our federal system to 'embrace the logic of markets'. In brief, Australia's federal system suffers from:

(1) too much overlap,

(2) too big a mismatch between what the States get via taxes and their spending,

(3) too heavy a Federal hand in areas of State responsibility,

(4) too much 'destructive competition' across jurisdictions, and

(5) too little cooperation across States and between States and the Australian Government.

A simple rule of economics is that **somebody pays**. If our federal structures and operation fall short of the ideal or efficient federal structure and operation, then that shows up as:

(1) Higher than necessary costs of government (and hence as higher taxes and less government services for a given amount of government spending).

(2) Higher than necessary costs of doing business (due to higher compliance costs arising from overlap and duplication – and the higher taxes too).

(3) And, as a result of the above two factors, **lower than necessary living standards for ordinary Australians** (as the first two factors show up as higher prices and taxes than necessary, as well as less government services and lower wages than necessary).

How much? A 2006 Access Economics study for the Business Council estimated that the fiscal costs in Australia's current federalism system – the higher than necessary costs of government compared with an efficient federation were almost $9 billion in 2004-05.

And that estimate only covered the 'government' costs of inefficient federalism in Australia.

Yet as depressing as that figure is, **the cost of such inefficiencies is rising**. It didn't matter as much in times past if unnecessary Federal/State duplication led to the employment of an extra worker than necessary, because the nation had spare capacity anyway.

But now that Australia's economy is at full capacity, each wasted worker and each wasted dollar is exactly that – wasted.

That raises the relative return to reform of Federal/State relations.

Similarly, the opportunity cost of Federal 'over-regulation' of Specific Purpose Payments is also rising, as the resources unnecessarily being burned up could now be rather more beneficially used to boost national prosperity.

As a recent OECD working paper (No.541), *Fiscal relations across levels of government in Australia*, points out:

> "*Key areas of public service provision in Australia are subject to complex patterns of joint government involvement that can lead to inefficiencies."*
>
> As a result "*Clarifying government roles and responsibilities is likely to have a significant potential for improving public sector efficiency".*
>
> Currently the *"Fragmentation of decision making and funding arrangements, particularly in the areas of hospital services and old–age care, creates incentives of cost and blame shifting between government levels*."

So many of the existing frameworks used for intergovernmental relationships are causing inefficiencies at best and cost and blame shifting at worst.

We can do better.

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