

NEW FISCAL POSSIBILITIES

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It's not uncommon to hear business leaders bemoaning the costs imposed by Australia's federal system of government. A study for the Business Council of Australia by Access Economics put it at 'nearly \$9bn a year' (BCA, 2006). Business leaders and others, including most recently the Minister for Defence (Fitzgibbon 2007) routinely decry Australia's federal system as making us 'the most over-governed country in the world'. There is even an 'Abolish the States Collective' which holds that 'state governments are ... an enormous cost burden generally which Australians can ill afford in an increasingly competitive world' (ASC 2001).

Such views are, not surprisingly, more commonplace in Sydney or Melbourne than in other parts of Australia. It's pretty easy, if you live in either of those cities, as most business leaders do, to imagine everything being decided in one of them – as it almost inevitably would be if the States were abolished. However if you live in, say, Perth or Hobart, the idea that staffing levels at your local hospital or the opening hours of your local police station might be decided in Sydney is distinctly less appealing.

More generally, there is no *democracy* in the world covering at least as much land area as Australia which is *not* governed by some form of Federal system – to say nothing of many smaller countries which are.

In fact, as Twomey and Withers (2007: 20) show, Australia is not especially 'over-governed' by comparison with other federal systems:

- Canada, whose system of government Australia's resembles more closely than any other, has 57% more people than Australia, has 50% more Provinces (States) and Territories (12 vs 8) but has nearly five times as many local governments (3,160 vs 673, a figure which predates the most recent local government amalgamations in Queensland);
- the United States, with a population more than 14 times larger than Australia's, has 'only' 6½ times as many State governments (counting our Territories as States for this purpose) but has nearly 88,000 local governments, or 130 times as many as Australia – and they generally have greater powers than Australia's local governments;
- Germany, with about four times as many people as Australia, has 'only' twice as many *Länder* (or States) as Australia but has 439 district authorities and 12,320 *gemeinden* or local authorities, 19 times as many in total as Australia.

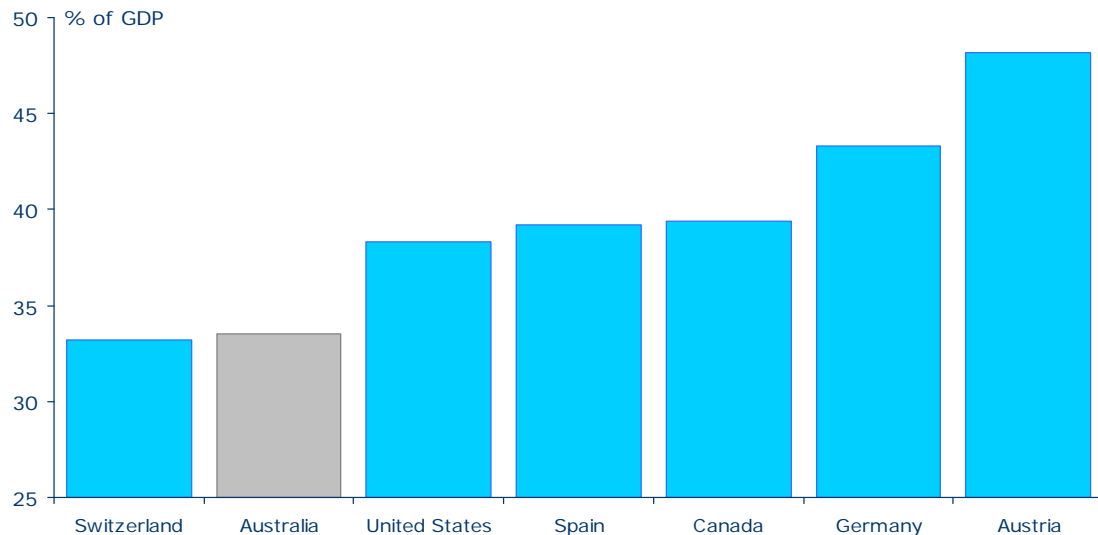
Table 1: Number of governments in selected Federal systems

Country	Population (mn, 2008)	Number of governments			
		National	'State' (a)	Local	Total
Australia	21.2	1	8	673	682
United States	305.0	1	51	87,849	87,901
Canada	33.4	1	12	3,160	3,173
Germany	82.1	1	16	12,320	12,337
Spain	45.6	1	17	8,097	8,115
Switzerland	7.3	1	26	2,867	2,894
Austria	8.3	1	9	2,359	2,369
Mexico	106.5	1	32	2,378	2,411
South Africa	48.3	1	9	284	294

(a) Provinces, Länder, cantons etc. Includes 'mainland' territories and capital territories or districts.
Sources: Twomey and Withers (2006); IMF *World Economic Outlook* database; ANZ

And that is measuring 'over-government' rather simplistically by the *number* of governments, without taking any account of the relative size of their revenue-raising or expenditures. Measured by expenditure as a proportion of GDP, Australia's 'government' is the third-smallest of 28 OECD countries for which data are available, although it is somewhat larger than in most Asian and other developing economies (Australian Treasury, 2008: 202-3).

Chart 1: General government outlays as a pc of GDP in selected OECD federal systems



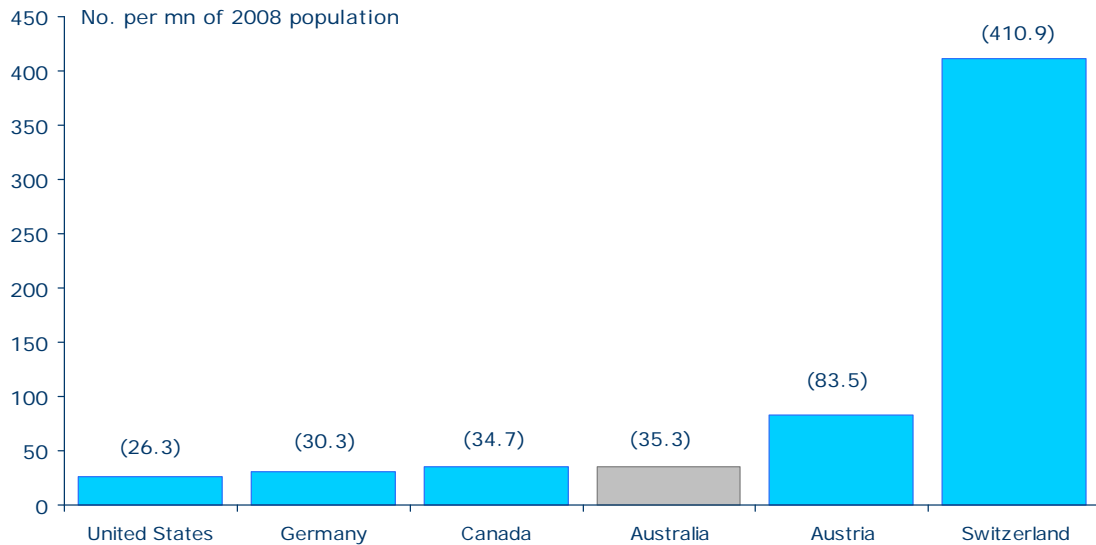
Source: OECD *Economic Outlook* 83 (June 2008), Annex Table 25.

Incidentally, there is no clear relationship, at least among federal systems, between the *number of politicians* and the 'amount' of government:

- Australia has 824 Federal, State and Territory politicians, or about 39 per million people;
- that's more than the United States, with about 26.3 politicians per million people (although that excludes the tens of thousands of elected local officials whose positions are usually full-time, in contrast to local councillors in Australia);
- it's also more than Canada, with 35 politicians per million people, and Germany, with 30 politicians per million people – although in both of these countries taxation and government spending are considerably higher as a proportion of GDP than in Australia;
- by contrast, Switzerland – one of the few OECD countries in which both taxation and government spending are lower as a percentage of GDP than in Australia – has 411 politicians per million people.

As an aside, the larger number of politicians per head in Australia than in either Canada or Germany is largely attributable to the fact that Canadian Provinces and German *Länder* have unicameral legislatures, whereas Australian States (other than Queensland and the Territories) have bicameral parliaments.

Chart 2: National and State/provincial politicians per million of population in selected federal systems



Source: ANZ.

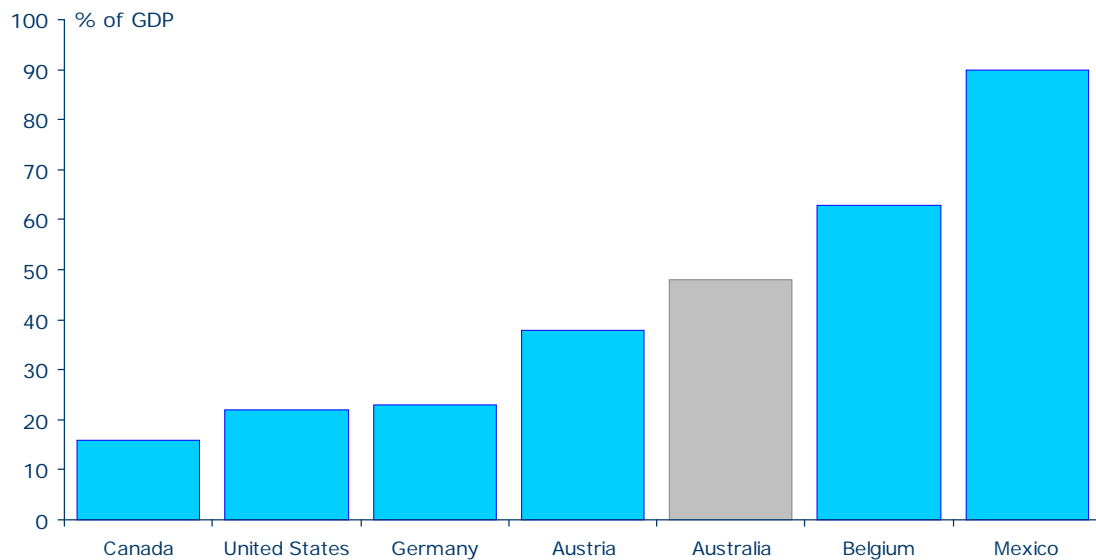
If it were really thought to be important to reduce the number of politicians, then the existence of State Upper Houses would be a useful place to start – although personally I think this is a second- or third-order issue. More generally, I would observe that Tasmania's experience since reducing its number of State politicians by one-quarter a decade ago demonstrates that there are costs as well as benefits in doing so.

There are other aspects of Australia's federal system which warrant greater attention from would-be reformers than the number of politicians.

As Neil Warren noted in his 'benchmarking' exercise undertaken for the New South Wales Government (Warren, 2006), Australia's federal system is characterized by a very high level of 'vertical fiscal imbalance', with the Commonwealth collecting over 80% of all taxation revenues whilst having direct responsibility for only about 54% of all outlays, compared with the States having responsibility for about 40% of all 'own-purpose' outlays yet collecting only 16% of total taxation revenues.

As a result, transfers from the Commonwealth account for about 45% of total State and Territory revenue. By contrast, only around 16% of the revenue of Canadian Provinces and Territories, and just over 20% of the revenue of US States and German Länder, come from transfers from their respective national governments. Among OECD countries with Federal systems, only Belgium and Mexico have a greater degree of vertical fiscal imbalance than Australia (Australian Treasury, 2008: 301).

Unlike most other federal systems, in Australia there is no 'sharing' of revenue bases among levels of government (other than States and local government sharing land tax); whereas, as Warren (2006: xxx-xxxi and 36-41) points out, 'Australia has a relatively high and increasing degree of shared [expenditure] functions between different levels of government', with 'unusually high levels of federal/State overlap in the areas of health and education'.

Chart 3: Vertical fiscal imbalance in selected federal systems

Note: Chart shows ratio of federal payments to total sub-national government revenue. Data are for 2003, except for Australia which is 2005-06.

Sources: Australian Treasury (2008: 301); OECD (2006: 78)

The internationally distinctive restrictions on the revenue-raising powers of the Australian States are largely the product of specific provisions of Australia's Constitution and of the way they have been interpreted by the High Court, in particular sections 90 and 92 precluding the States from imposing customs or excise duties (and, as interpreted by the High Court, from imposing almost any kind of indirect tax) and section 96 granting the Commonwealth the power to make grants to the States on such terms and conditions as it thinks fit (and which has been interpreted by the High Court as allowing the Commonwealth to preclude the States from levying income tax as a valid condition, as well as to enter the fields of education and health).

By contrast, although the Constitution of the United States also has a provision (section 10, subsection 2) prohibiting the States from laying 'any imposts or duties on imports or exports', that has not precluded States from levying sales taxes.

However policy decisions taken by State Governments themselves over many years have also contributed to the relatively high degree of vertical fiscal imbalance in the Australian federal system. The States have unilaterally 'given away' some tax bases over which there was no constitutional question – most notably death duties, beginning in 1977. And they have consciously narrowed the base of the revenue sources which are available to them by granting concessions, for example on payroll tax to small business, on land taxes for principal places of residence, and on stamp duties to first-time purchasers (Freebairn 2002).

The total cost of State 'tax expenditures' has been estimated at \$10.4bn in 2006-07 (Australian Treasury, 2008: 35), equivalent to 17.5% of the revenue which States would have been collected in the absence of these 'tax expenditures'. (For comparison, Commonwealth 'tax expenditures' cost just over \$50bn in 2006-07, equivalent to 16% of the revenue which would have been collected in their absence).

Demographic change is likely to exacerbate the degree of vertical fiscal imbalance in the Australian federal system given the States' and Territories' reliance on specific purpose payments from the Commonwealth to meet their acute health care expenditure responsibilities (Productivity Commission, 2005: 306-312).

A high level of vertical fiscal imbalance is usually argued to result in a lack of accountability for spending decisions, to either over- or under-provision of services, to 'cost-' and/or 'blame-shifting' between governments, and additional administrative costs (see, eg Australian Treasury, 2008: 302-3; and Warren, 2006: 40-43). To the extent that these problems are considered to be significant enough to warrant major change, there are options which could be considered on both the revenue and expenditure sides.

On the revenue side, States could easily strengthen their revenue positions unilaterally by reducing or removing the large exemptions and concessions which they provide through their payroll and land tax or stamp duty systems. Although I personally think stamp duties are very bad taxes, offending nearly all of the traditional 'canons' of taxation except, perhaps, simplicity, there is no reason (beyond the objections which can be made to any tax increase) why State governments could not collect substantially more from payroll or land taxes than they do currently, if they really wanted to, and use the additional revenue to abolish other State taxes, or to reduce their dependence on the Commonwealth.

Although the GST is a Commonwealth tax – and is now properly recorded as such in the Commonwealth Budget Papers – the fact that its entire proceeds are distributed among the States and Territories means that the latter would benefit from any increase in the rate of GST or any broadening in its base. While the legislation establishing the GST was intentionally crafted in such a way as to make any such changes very difficult – requiring the agreement not only of each House of the Commonwealth Parliament but also each State and Territory Parliament – it could be argued that (subject to the uncertainty surrounding the outcome of last week's Western Australian election) the current conjuncture of Labor Governments at the Commonwealth level and in every State and Territory provides an unparalleled opportunity for such changes to be accomplished.

Alternatively, it may be possible for States and Territories to levy different rates of GST (although it would be desirable, I think, to maintain a common base). This would obviously require the co-operation of the Commonwealth, and it may be necessary (in order to get around section 51 (ii) of the Constitution which precludes the Commonwealth from discriminating between States or parts of States) to incorporate arrangements to 'compensate' States choosing to have lower rates of GST on transactions within their borders similar to those which apply to Queensland in respect of petrol taxes. It would also of course entail an additional layer of complexity for businesses operating in more than one State or Territory (as, increasingly, they do) – although no more so than in the United States or Canada where different rates of and bases for indirect taxes are quite common. Ultimately, whether this additional complexity is considered acceptable depends on how serious the problem of vertical fiscal imbalance is seen as being.

A third alternative on the revenue side would be for the Commonwealth to share the income tax field with the States and Territories, allowing the latter to impose their own income taxes if they choose – preferably by 'piggy-backing' on the same tax base as the Commonwealth, as US States and Canadian Provinces do. There would appear to be fewer constitutional obstacles to this approach, although the objections in terms of complexity are at least as valid (and there may be more avenues for shifting income to low-tax jurisdictions than for shifting expenditures).

Moreover this has been tried before, most recently by the Fraser Government, without inducing any conspicuous enthusiasm on the part of the States. The ditty recorded by Sir Robert Garran (1958: 208) which has State officials saying, 'you keep the cows and do the milking for us' comes to mind.

Given the seemingly unpalatable nature of the revenue-side options for reducing the degree of vertical fiscal imbalance, the transfer of some expenditure responsibilities to the Commonwealth may be more feasible. The most obvious candidate would be public hospitals, and indeed Tony Abbott, as Health Minister in the Howard Government, was an occasional advocate of precisely such a step (Abbott 2008). The mooted takeover of the Mersey General Hospital at Latrobe in Tasmania, in the lead-up to last year's election, provided a possible model for how the Commonwealth might run a public hospital although in the end this came to naught. And the Commonwealth already has full responsibility for public and private health insurance (and hence for the funding of GP visits and private hospitals) and pharmaceutical benefits, and for the bulk of the public sector's responsibility for aged care facilities.

Although there would seem to be no Constitutional obstacle to the Commonwealth assuming the entire responsibility for funding and operating public hospitals, it is no more clear that the Commonwealth would actually *want* this responsibility in practice than the States *want* the responsibility for collecting their own income tax. Historically public hospitals have rarely provided sources of 'good news' for governments and it is difficult to see why that would change under Commonwealth management. It is thus hard to see why a Commonwealth Health Minister would be anxious to assume responsibility for increasing waiting lists at public hospitals, allegations of medical malpractice, and other problems which are the daily diet of a State Health Minister.

Hence, although I would personally be delighted to see any or all of the above options – or others of similar breadth – 'on the table', I suspect that vertical fiscal imbalance is more than a bit like housing affordability. That is, everyone is aware of it, and everyone acknowledges that it would be a 'Good Thing' if something were done about it: but too many people have too big a stake in maintaining the status quo, and the options for doing something substantial about it are too 'politically difficult', so that in the end any change will only ever be at the margin.

In saying that, it's not my intention to belittle the changes envisaged under COAG's new framework for federal financial relations which commences from 1 January next year. The proposed rationalization of more than 90 different specific purpose payments (SPPs) into five or six national SPPs with States having the flexibility to allocate funds within these categories and without matching requirements should enhance accountability for spending decisions, allow for some reduction in bureaucracy and reduce the need and scope for cost- and blame-shifting (albeit without eliminating either entirely). Of course the extent to which this actually occurs in practice will depend in part on the extent to which the Commonwealth does genuinely relax its detailed prescription of how funds are spent by States and Territories.

Similarly, the proposed structure of National Partnership payments, as outlined in the most recent Commonwealth Budget Papers (2008: 30-31), does have the potential to re-invigorate the process of micro-economic reform which has been stalled for much of the current decade – provided that the Commonwealth is willing to withhold payments if and when individual jurisdictions fail to meet agreed reform targets (which was not always the case with the National Competition payments).

The other distinctive feature of Australian fiscal federalism is the effort which we put into 'horizontal fiscal equalization'. The distribution of GST revenues among the States and Territories takes account of differences in the relative demand for and cost of providing services as well as revenue-raising capacity. By contrast, most other federations which make some attempt at horizontal fiscal equalization do so only in respect of revenue 'disabilities'. Australia's horizontal fiscal equalization is both comprehensive (being based on an examination of 37 different taxes and 359 categories of expenditure) and ambitious (seeking to equalize the capacity of States and Territories to provide public services, rather than merely bringing the weaker States and Territories up to some minimum standard). As an aside, the extent of vertical fiscal imbalance in the Australian system enables a greater degree of horizontal fiscal equalization than would be possible if the degree of VFI were much smaller.

Both Warren (2006) and, prior to him, Garnaut and FitzGerald (2002) were highly critical of the extent of horizontal fiscal equalization in the Australian federal system and the methods by which it is achieved. Their reports argued that the Commonwealth Grants Commission's methodology is unnecessarily costly, complex and opaque, that the process discourages States from pursuing reforms designed to enhance efficiency.

With no disrespect intended to any of these distinguished economists, such views were perhaps to be expected given that their reports were commissioned by governments which like to style themselves, in this context, as 'donor States', and which every year in their Budget Papers include an estimate of the extent to which they are 'cross-subsidizing' other States (see for example New South Wales (2008: 8-16-19), and Western Australia (2008: 82-83)).

As a Tasmanian I'd be expected to view these arguments with some scepticism, and I do. Interestingly, the Commonwealth Treasury also regards as 'questionable' how relevant Warren's and Garnaut and FitzGerald's argument that horizontal fiscal equalization provides a disincentive for States to undertake reforms 'is in practice' (2008: 303). And according to the OECD (2006: 91), 'empirical evidence suggests that the impact on efficiency [of Australia's horizontal fiscal equalization arrangements] is not large'.

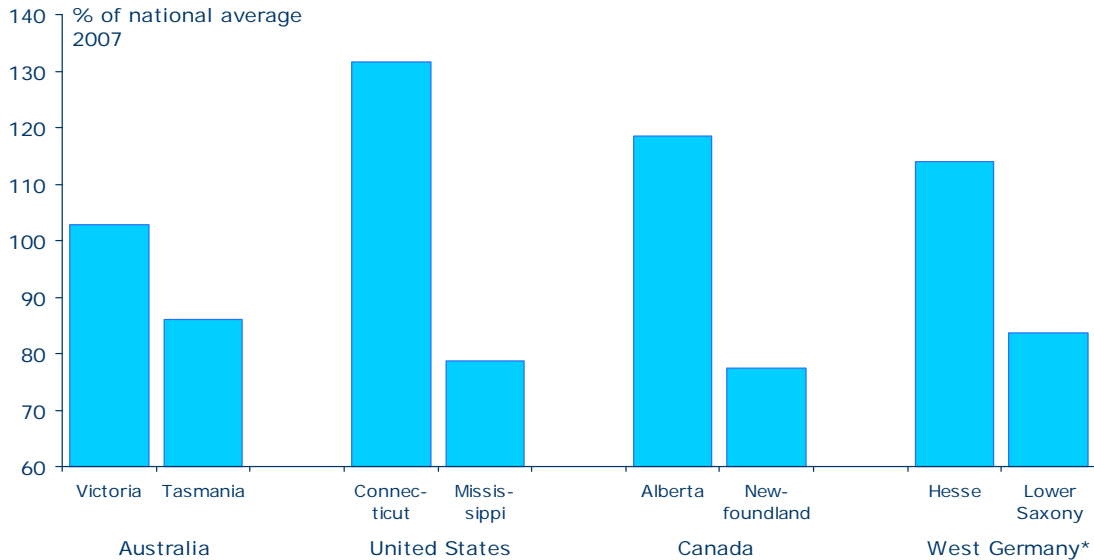
It's always struck me as especially odd to hear Labor politicians (in particular) complaining about the redistribution of income from the rich to the poor (see Eslake 2006), which is what horizontal fiscal equalization is (in principle) intended to facilitate.

Nobody, least of all Labor State Treasurers, seriously suggests that people paying the top marginal income tax rate are entitled to have their tax payments returned to them in the form of an equal amount of Commonwealth Government spending on them or their families. Very few people – and certainly no-one in government today or credibly aspiring to be in government - seriously suggests that the adverse consequences of a progressive marginal rate scale for the simplicity of the income tax system, or its effects on incentives to work and save, are such that it should be abandoned in favour of a flat-rate system.

And the Treasurers of New South Wales and Victoria do not themselves believe that the full amount of the land tax and stamp duties which they collect from the well-heeled citizens of Pymble, Killara and Double Bay or from Toorak, Brighton and Camberwell should be spent in those suburbs rather than in, say, Mount Druitt or Broadmeadows, or in the Hunter and Latrobe Valleys. So why do they continue to assert that the GST paid by the relatively affluent citizens of NSW and Victoria should be entirely spent on them?

I would have rather thought that Labor Treasurers, in particular, would regard as an achievement to be celebrated the fact that per capita household disposable income in Australia's poorest State is only 15% lower than in its richest, compared with a gap of 40% in the United States (between Mississippi and Connecticut) or 35% in Canada (between Newfoundland and Alberta).

Chart 4: Per capita household disposable income in the richest and poorest States of selected federal systems



Note: West German comparison is of per capita gross product.

Sources: ABS; US Bureau of Economic Analysis; Statistics Canada; Statistisches Bundesamt; ANZ.

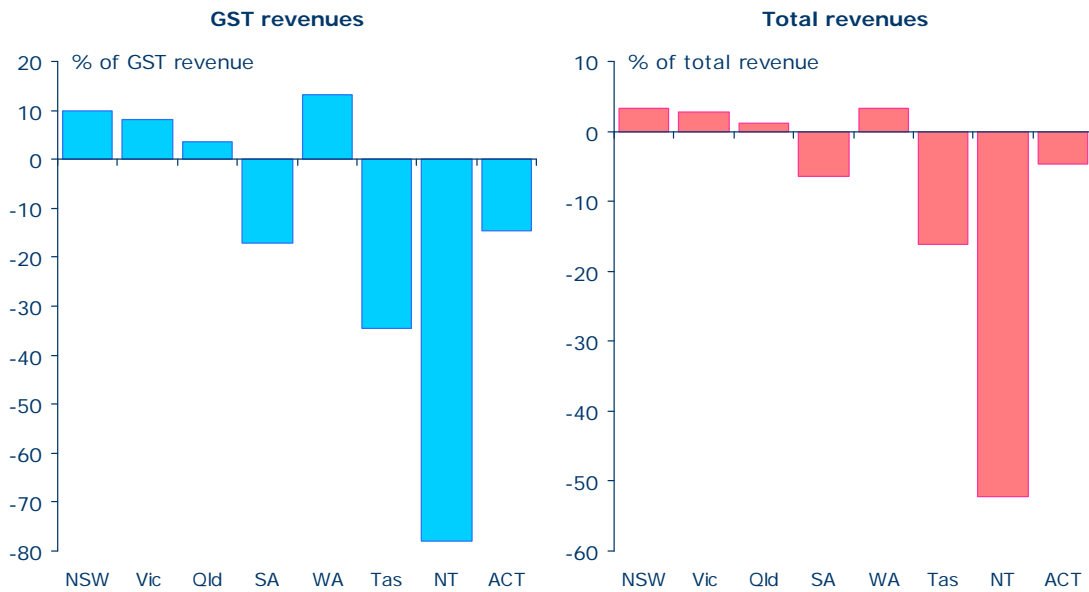
I'm not suggesting for a moment that the smaller degree of spatial inequality among Australia's States is wholly, or even largely, the result of our system of horizontal fiscal equalization.

But it's difficult to see how a move towards equal per capita distribution of the GST revenue, which NSW in particular advocates, would not have a disproportionately large impact on the smaller States, and thereby contribute to a widening in inequalities, including in access to public services, among different parts of Australia.

By comparison with the proposed distribution of GST revenues in 2008-09 in accordance with the Grants Commission's recommendations, an equal per capita distribution would see NSW's and WA's shares of the GST pool rise by 9.9% and 13.3%, respectively, while those two States' total revenues would rise by about 3.3%. These are relatively small changes – less for total revenues than the increase they would expect in a single year. But the same change would result in Tasmania's share of the GST pool falling by 35%, and its total receipts by 16%; while the Northern Territory's share of the GST pool would fall by 78%, and its total receipts by 52% (see Chart 5 on page 9).

None of which is to say that there isn't scope for simplifying the whole process of horizontal fiscal equalization, as indeed is envisaged by the terms of reference for the 2010 Grants Commission Review. But I for one am not an advocate of substantial change to the aspirations which Australia's system of horizontal fiscal equalization has long sought to achieve.

Chart 5: implications of distributing 2008-09 GST revenues on a per capita basis rather than in line with CGC recommendations



Note: Charts show the change in GST and total general government revenue which would result from GST revenues being distributed on an equal per capita basis in 2008-09 rather than as recommended by the CGC.

Sources: Australian Government (2008) and ANZ calculations

In summary my sense of the scope for 'new fiscal possibilities' turns out to be a somewhat limited one. I mean that in three distinct senses.

First, while there is enormous scope for reforms designed to achieve goals such as enhanced productivity, improved international competitiveness, better service delivery, reducing Indigenous disadvantage, and confronting a variety of environmental challenges, it is not at all clear (at least not to me) that a major re-organization of the way in which the Australian federal system works is a prerequisite for advancing reforms in these areas. Rather, a major upheaval in the structure of the federal system (as distinct from a renewed and enhanced commitment to co-operation which I understand has been the focus of most of the contributions at this Conference) would seem to be an unnecessary distraction from more important reform tasks.

Second, most of the changes to Commonwealth-State financial relations which could address some of the long-recognized problems with the way the Australian system operates – changes entailing major transfers of expenditure responsibilities or revenue-raising powers from one sphere of government to another – are almost certainly infeasible politically.

And third, some of the proposals which come up time and again in the context of Australian fiscal federalism, in particular for a substantial reduction in the scope of horizontal fiscal equalization, or its abandonment altogether, are ones which I do not support at all.

Often, the federal system and its institutions are used as an excuse or a cover for other failings. It seems to happen rather more often here than in the United States – where State boundaries are drawn across contiguous economic zones far more commonly than is the case in Australia. I'm not sure why that is so. However 'new possibilities' for reform will be more readily realized if we stop using the existence of the federal system as an excuse for failure to get things done or for failure of political will.

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