

Reshaping the Federation for Stronger Accountability and Responsibility

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The title of tonight's forum refers to Tony Abbott's new federalism, but Abbott is by no means the first prime minister to call for a 'new federalism.' Just about every prime minister going back to Gough Whitlam has aimed to fix what they perceived to be wrong with the Federation.

Whether because of such initiatives or in spite of them, the system has continued to evolve largely unchecked on a path towards a stronger role for the central government and a diminished one for the states. Whitlam was the prime minister who got most of what he wanted in the way of a new federalism, and that was a vast expansion of Commonwealth influence on states' constitutional responsibilities through a huge increase in conditional grants. This process was really started by the Menzies government, but Whitlam took it to a new level and it has continued ever since with few interruptions.

The current prime minister appears minded to steer the federal system onto a different path. Abbott speaks of making the states sovereign in their own sphere. However, he has also stated a very centralist position in his 2009 book, *Battlelines*. Either he has had a major conversion since then, or we are misinterpreting what he is saying now. We shall see.

So it remains to be seen whether this review is any more likely than other initiatives in the past to bring about a fundamental change of direction. The forces arrayed against such a change are formidable, but the white paper project and its stated objectives deserve to be taken seriously. This is the first time there has been a white paper process devoted to the topic in its own right.

Where the federation has gone off the rails

The CIS has long been an advocate of federalism, but it is one thing to champion federalism as an ideal and another for federalism in practice to live up to that ideal. For that to happen, the structure and incentives of the system have to be right. Australia's federal system falls short of its potential because its structure has drifted away from the principles of federalism.

The drift has occurred in a number of ways. One is Commonwealth regulatory adventurism under various constitutional heads of power such as the corporations power. Another is Commonwealth expenditure directly into functions outside its section 51 constitutional powers—something that has been highlighted recently by the High Court's decision in the *Williams* case concerning the schools chaplaincy program. These are important matters deserving attention in a complete review of federalism, but the subject of focus for me is the breakdown of the link between spending and revenue responsibilities at each level of government.

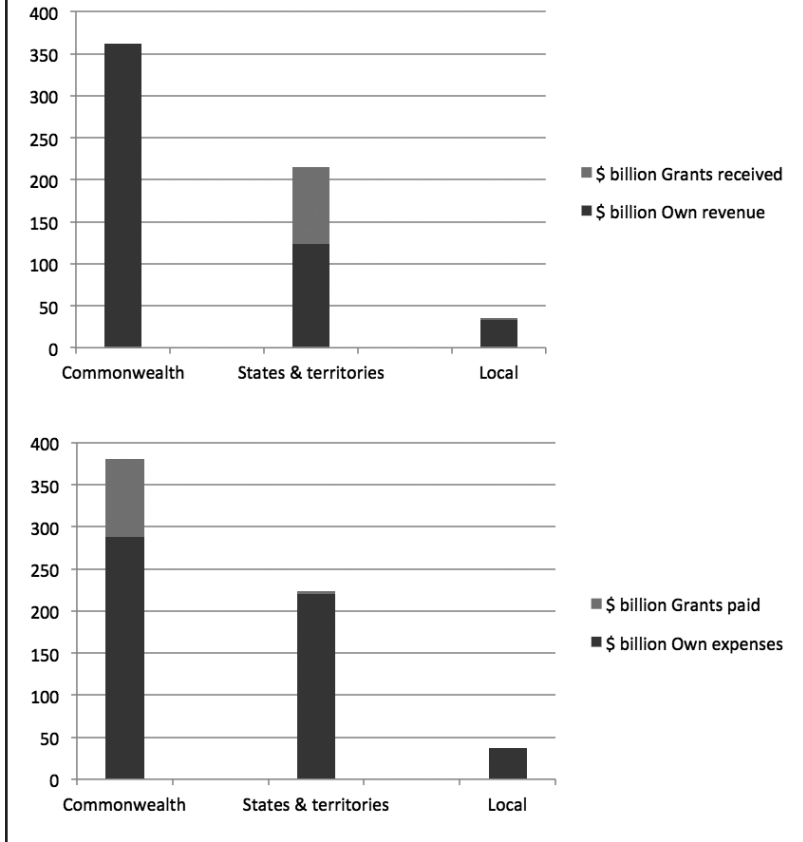
My premise is that the system cannot function as it should if accountability of the various tiers of government is lacking and functional responsibilities are not aligned with the power and capacity to raise the requisite revenue.

Vertical fiscal imbalance and accountability

This inevitably leads us to the concept of vertical fiscal imbalance, which is at the heart of the accountability problem. It is best illustrated graphically using the latest available data, for 2012–13 (Figure 1). The Commonwealth takes in much more revenue than it needs for its own purposes, the states spend much more on their own functions than they raise from their own sources, while for local government spending and revenue raising are more balanced.

The imbalance between the Commonwealth and the states is resolved by the Commonwealth making both unconditional and

**Figure 1:
Vertical Fiscal Imbalance, 2012 - 13**

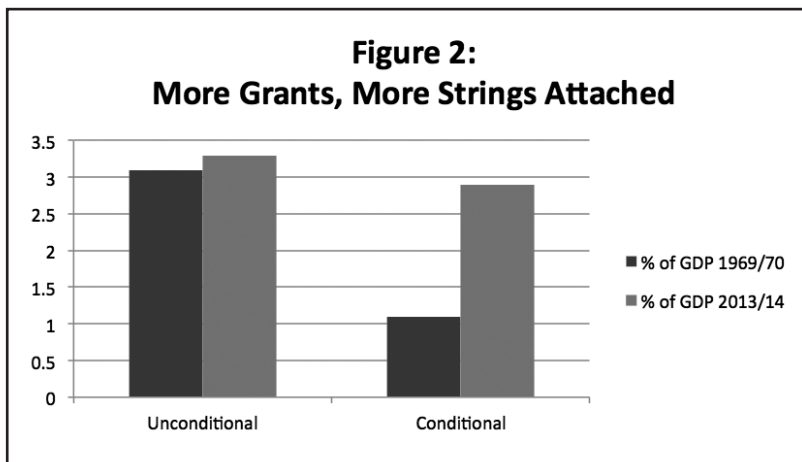


conditional grants to the states.[‡] Conditional grants have to be spent on specific purposes and are subject to all kinds of checking and monitoring by the Commonwealth to make sure the states are complying with the conditions. In the current fiscal year

[‡] Unconditional and conditional grants are also referred to as 'general purpose' and 'specific purpose,' or 'untied' and 'tied,' respectively.

unconditional grants will total \$55 billion, almost all of this being the pass-on of GST revenue to the states, while the conditional grants will total \$46 billion.

A degree of vertical imbalance was built into the Federation from day one, and it exists in all federations, so we should not expect it ever to disappear. But the imbalance has become very pronounced in Australia, and its origins are well enough known: The Commonwealth took over income tax from the states during World War II and never gave it back. This led to the states becoming increasingly dependent on Commonwealth grants. What is not so well recognised is that the growth of grants has occurred much more in the conditional type than in the unconditional or 'general purpose' type (Figure 2).

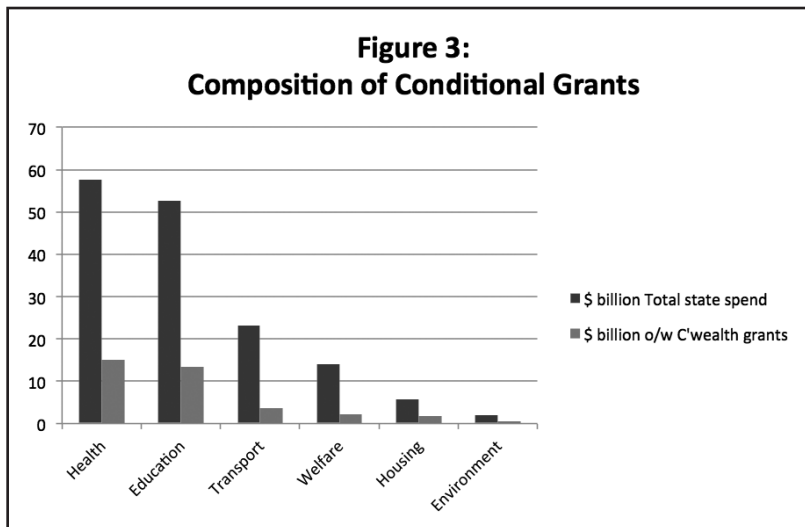


Conditional grants

Before the 1970s conditional grants were a minor feature of the system, but that was before the Commonwealth became heavily involved in funding public hospitals and government schools, among other things. The growth of conditional grants plays a central role in the story of how Australian federalism has evolved. Conditional grants have been the Trojan horse of Commonwealth influence on the provision of public services.

This is not to suggest that conditional grants are the only source of dysfunction in our federal system. States' reliance on unconditional grants also encourages a mendicant culture on the part of state governments and a command culture on the part of the Commonwealth. I believe, however, that conditional grants do the most damage to federalism because of their sheer magnitude and their potential to distort state policies, as well as to create problems of duplication and overlap.

One measure of the Commonwealth's policy influence on state functional responsibilities is the size of conditional grants relative to total state spending in key functional areas. Conditional grants are widely spread, but as Figure 3 illustrates, they are concentrated in six areas: health; education (schools and TAFEs); public housing; transport (mainly roads); welfare services (home and community care, and increasingly in the future National Disability Care Scheme (NDIS)); and environmental protection.



The case against conditional grants is not absolute. In Australia, however, conditional grants have blossomed way beyond any reasonable justification for them.

A reform proposal

The fundamental goal of reform should be to strengthen the link between spending and revenue responsibilities so as to make governments at each tier more accountable and responsive, and remove or at least reduce the scope of duplication and overlap.

To that end, my proposal is to replace most conditional grants with revenue that the states themselves control by shifting tax power down from the Commonwealth to the states. The choice of the words ‘tax *power*,’ rather than ‘tax *revenue*,’ is deliberate. The Howard government assigned all GST revenue to the states, but that shifted revenue downwards, not tax power.

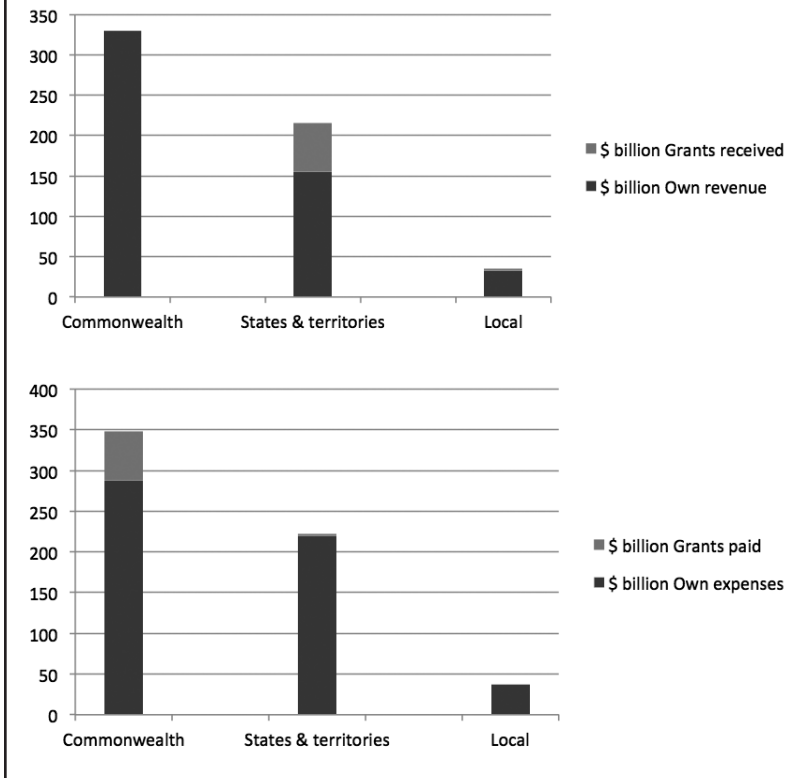
Constitutional experts believe that the states could not exercise legislative power over the GST or any other form of consumption tax. But there is no constitutional bar to the states imposing their own income tax, provided the Commonwealth cooperates. Such sharing of income tax power has been proposed and discussed many times in the past.

In the general community, the very idea of a state income tax is often met with shrieks of disapproval as a knee-jerk reaction, but many of the concerns can be overcome if only we could ever get beyond scare campaigns. The most important point is that any state income tax should be applied to personal, not corporate, income and should begin as a dollar-for-dollar substitute for the existing Commonwealth income tax, not as an additional tax. Then, over time, each state would have the flexibility to vary its personal income tax up or down, subject to the usual political and competitive constraints.

The realignment of expenditure and revenue responsibilities would enable Commonwealth grants to the states to be reduced, and as I have suggested, the first priority should be conditional grants. This could take the form of a reduction in all conditional grants, without abolishing any of them, but it would be more consistent with the aim of reducing duplication and overlap for the Commonwealth to withdraw completely from whole functions.

Public housing would be at the top of my list. Next would come funding of government schools and technical and further education.

**Figure 4:
Vertical Imbalance After Reform**



Health is trickier, because of Medicare, but there are opportunities to at least reduce Commonwealth conditional grants in this area, too. Jeremy Sammut will have more to say about that.

As the withdrawal of Commonwealth conditional grants for particular functions would be matched by increased general funding, the states would be no worse off financially, but they would have more discretion in the allocation of funds. Over time, as masters of their own destinies, the states would shape their budgets more according to their own priorities.

To provide a concrete illustration, if the states were assigned 20% of personal income tax, they would receive \$31 billion (in 2012–13 terms). This would allow almost three-quarters of the value of all conditional grants to be eliminated. Such a reform means, for example, that all the conditional grants excepting those for non-government schools and national roads could be eliminated. Figure 4 portrays the structure of Commonwealth and state finances after this change, as if it had happened in 2012/13. The vertical imbalance remains, but to a lesser degree, and grants to the states are overwhelmingly of the unconditional type.

The Abbott government's recent National Commission of Audit recommended something similar to the reform I have just described, but its version involves income tax revenue sharing rather than devolution of income tax power.

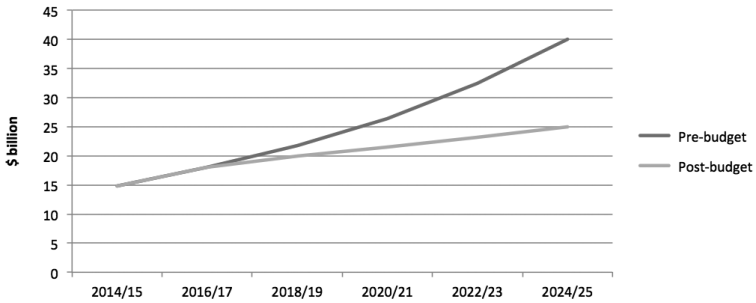
More taxation or a change in the mix?

The proposal I have outlined involves a change in the composition of taxation between the Commonwealth and the states but not in the overall level. However, there are also calls for an increase in the overall level of taxation on the grounds that the public sector needs more tax revenue to meet the rising costs of public services. The one kind of additional tax revenue most frequently nominated is the GST, with the money going to the states.

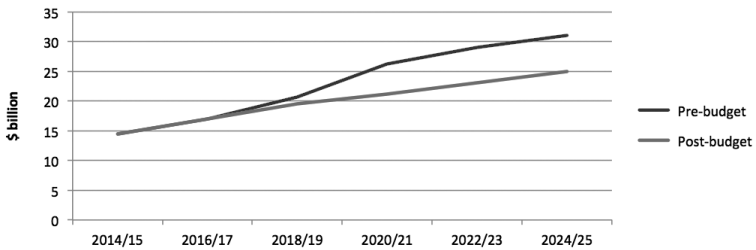
Before governments go off in that direction, however, they need to give a lot of thought to the nature of the problem being addressed: Is it really one of inadequate revenue or is it a case of excessive growth in spending? A strong case can be made that the issue is not one of inadequate revenue growth, but rather the composition of revenue (too much dependence on Commonwealth grants and sub-optimal state taxes) and the very rapid growth of state spending on health, which no 'growth' tax could possibly match.

The Commonwealth budget for 2014–15 sharpened the focus on these issues by lowering the growth path of payments to the states for hospitals and schools from 2017–18 onwards by changing the annual escalation factors. This is the basis for the complaint by state premiers and others that the Commonwealth is taking \$80 billion away from them. Figure 5 illustrates the point.

**Figure 5: The \$80 Billion 'Cut'
Hospitals Share**



Schools Share



One interpretation of this budget announcement is that the Abbott government needed to identify a large saving to meet the goal of a budget surplus of more than 1% of GDP, and the Expenditure Review Committee found it in these large and fast-growing expenditures.

It is not at all unusual in the history of Commonwealth-state financial relations for the Commonwealth, when under fiscal stress, to effectively shift some costs on to the states. But on this occasion the Commonwealth, with an eye to its review of federalism, had the additional objective of opening up in a tangible fashion the whole issue of which tiers of government should bear which costs.

On cue, commentators rushed in with the suggestion that the GST must be expanded or increased. In an arithmetic sense, a GST increase could be designed to fill the state funding gap left by the Commonwealth, at least for a while, but in itself this would do little to reform the federation. It would replace a slab of future conditional grants with unconditional grants, which may be an improvement in a limited way, but it would not remove the Commonwealth from any state function or realign state revenue raising powers with expenditure responsibilities.

I should add that while the GST should not be increased to pay for bigger government, we should be open to the idea of tax reform involving a higher GST to substitute for other taxes, provided such a change is structured sensibly and is not hijacked by populist politics. But I emphasise that this should not be for the purpose of generating additional net revenue to pay for bigger government. The alternative to raising more overall tax revenue is to exercise tighter control over expenses. The Commonwealth budget can be interpreted as saying to the states that they run public hospitals and schools and need to bring their expenses under better control.

Federalism and the long-term fiscal gap

If we join all the dots together, the Commonwealth budget has drawn attention to the long-term budget pressures from galloping health care costs and population ageing. The Productivity Commission projects that after 50 years, this impact will push public sector health, pension and aged care costs up by a staggering 7% of GDP over and above present levels, offset only by about 1% of GDP less in other areas such as education where there will be relatively fewer young people.

The pension and aged care impacts will fall mainly on the Commonwealth, while the health impact will be shared between the Commonwealth and the states. The Commonwealth budget proposal would, if sustained, tilt the balance of the health cost impact towards the states.

Whichever way the impact is distributed, it really points to the need for fundamental changes in the health, age pension, and aged

care systems over the long term, of which the proposal to lift the pension eligibility age to 70 is but one example. Otherwise, there will certainly be pressure on the tax burden to rise at both the Commonwealth and state levels. But the long-term fiscal impact of health spending and ageing is also a key issue for federalism, reform of which would better position the public sector to deal with the problem.

In winding up, I should say while I have focused on the one aspect of federalism that I believe is most in need of reform, the reform process also needs to address other aspects such as the way in which GST revenue is distributed to the states through the Grants Commission process. Indeed, there is no point in giving the states more revenue raising power unless the horizontal equalisation system is changed at the same time.